The Role of Investigative and Forensic Accountants and Their Importance in Maintaining and Enforcing the Integrity of Canada's Capital Markets

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1. Introduction

Over the past few years, several prominent Canadian companies have suffered significant accounting and integrity issues. Some of the recent companies that have been publicly identified as having had these types of issues are Bre-X Minerals Ltd., Livent Inc., and Nortel Networks Ltd. As well, in the United States, a number of large companies that have been caught in accounting scandals and inappropriate behavior on behalf of their officers and directors. Enron was the first large US company to fall, but was joined by Worldcom, Tyco, Adelphia, and others. As the US and Canadian economies and capital markets are so tightly linked, the failure of these large US companies has had ramifications in Canada.

The end result of these accounting frauds and scandals is that the integrity of the capital markets has been called into question. Investor confidence has been visibly shaken through these corporate scandals and something must be done in order to return investors' trust to our capital markets. After years of increased investment in the capital markets, Canadians began to take money out of the markets, due to poor performance and lack of faith in the companies. This should cause all Canadians some concern, as our capital markets are fundamental to the continued growth of the economy, jobs and investment in our nation. To ensure that our economy continues growing and is not impeded by the recent negative impact that accounting scandals have caused, all accounting professionals, especially IFAs, will need to take an active role in ensuring the integrity of these markets. If this is not done, there may be significant consequences to not just some of the players in the capital markets, but all Canadians. As the strength of

our capital markets is directly related to Canada's economy, maintaining and enforcing the integrity of the capital markets should be of concern to us all.

The discovery of these accounting issues has had the effect of undermining investor confidence, reducing investment levels and raising questions about the effectiveness of audits. It has raised questions about the effectiveness of the officers and directors of these publicly traded companies, as well as raising concerns about their compensation and motivation.

These scandals may have been prevented if the officers and directors in charge of these companies followed the spirit of the accounting rules, which would have provided a truer and more accurate financial position than what was disclosed. Instead it appears that some officers and directors either intentionally attempted to overstate their results or did not implement sufficient internal controls to ensure that material misstatements did not occur.

The cost of capital may be affected, as investors who are losing confidence in the markets demand a higher risk premium on their investments. Without strong and reliable capital markets and access to reasonably priced capital, Canada's economy will definitely be negatively impacted through reduced investment and lower returns.

In order to restore and preserve the integrity of the capital markets, IFAs must work together with other professionals to prevent instances of impropriety and enforce the rules

that have been set out to protect them. All accountants, but particularly IFAs, will have many opportunities to work towards maintaining and enforcing the integrity that the investment public requires. Hopefully, with the recent exposure of these problems, they will not occur again.

In the future, IFAs will play very vital roles in maintaining and enforcing the integrity of Canada's capital markets. IFAs will be needed in various roles including regulatory roles, auditing of public companies, and working with law enforcement.

2. Overview of the Canada's Capital Markets

Canada's capital markets are quite diverse, with over 4,000 publicly traded companies, and a total market capitalization of over $1.06 trillion at December 31, 2002. Canada also has a growing and robust debt market, as well as an over the counter ("OTC") market for derivatives. The capital markets are extremely important to business in Canada as they provide up to 30% of the short-term financing and 80% of the long-term financing required by Canadian companies to operate.[1]

The primary purpose of Canada's capital markets is to allow companies and governments to efficiently and effectively raise capital from a variety of investors at as low a cost as is economically feasible. Through investment, Canadian companies and individuals invest in the innovation of Canadians, create new jobs, allow companies to purchase new assets, and ensure the continued growth of the economy. The capital markets are, therefore, extremely important to all Canadians and the integrity of the capital markets must be protected in order to ensure the continuing growth of our economy.

Without an effective, liquid and stable capital markets, Canadian companies would not be able to access capital as easily or efficiently. If the markets are not as liquid, it is more difficult to raise money and the costs associated with this are also increased. An increased cost of capital makes it more expensive for companies to expand and also reduces investors' returns, as the company must use up more of its profits to pay for the more expensive capital.

[1] WPC Committee to review the structure of securities regulation in Canada, "Consultations". Retrieved May 3, 2005 from http://www.wise-averties.ca/consultations_en.html

Since the "bust" that followed the high-tech boom in the late 1990s, Canada's capital markets are still recovering from issues that arose as to the integrity and reliability of the information that has been provided by publicly traded companies. During the peak of the rapidly expanding capital markets, some publicly traded companies felt enormous pressure to meet analysts' expectations as well as the publics. There were also tremendous pressures from shareholders to maintain the high level that the stocks had been trading at. The executives of many of these public companies also had a vested interest in maintaining a high stock price, as most of them had significant holdings in the company through stock options. This led some companies to adopt more aggressive and perhaps even inappropriate accounting practices that were not sustainable in the long run.

Eventually most of these companies had to reverse many accounting entries and restate their overly optimistic financial records to reflect the actual performance at the time. Some of the officers and directors of these publicly traded companies have also been accused of abusing the assets of the companies, which belong to the shareholders and not those of management. All of this had the cumulative effect of causing some serious concerns with the integrity not only of the financial statements, but also the officers and directors running these companies.

The participants who are invested in the capital markets vary widely and are not just the wealthy or large companies. A variety of entities invest in Canada's capital markets such as mutual funds, pension administrators, individuals saving for retirement or other goals,

and reporting issuers (the companies that issue equities and debt securities). All of these participants have been negatively affected by the inappropriate accounting practices that have recently come to light.

Our capital markets, while considered very large in Canada, make up less than 2% [2] of the market capitalization of the world. In order to compete with the global market, Canada needs to ensure that we maintain the access to capital that our companies and government need, in order to prosper in the future. If we hope to capture a larger percentage of global investment, our capital markets will need to be viewed as being secure and reliable.

Another potential issue that may come into play in the future is the recently introduced proposal in the 2005 budget that removes the foreign content limit within personal RRSP's. Up until recently the maximum amount of your RRSP that could be foreign content was 30%[3], which in effect, ensured that Canadians would invest in Canadian companies. Once the new budget is made law, this limit will be removed and Canadian investors will be able to invest their retirement funds anywhere they wish. This may be a big concern, as if Canadian companies are seen as weaker than and not as efficient as other countries companies, investing dollars could be transferred to those countries About which investors feel more secure. Maintaining investors' confidence in the capital

[2] *Ibid*
[3] Canada Revenue Agency, "Registered Retirement Savings Plans and Registered Retirement Income Funds (RRSPs/RRIFs)". Retrieved May 3, 2005, from http://www.cra-arc.gc.ca/tax/registered/rrsp-rrif/tax_tip-e.html

markets would not only prevent money from being taken out of Canada, it may also help to attract foreign investment.

Canada's capital market lets investors of all sizes participate in the growth of the economy, by investing in stocks, bonds and other securities. The capital markets have investments that are suitable for all investors, from low risk to highly speculative securities. If the integrity of the markets is not maintained, they may become suitable for only higher risk individuals and this may cause some investors to leave the markets. If this occurs, there could be a higher burden on social programs like the Canadian Pension Plan ("CPP"), Old Age Security ("OAS") and welfare. One of the benefits of a strong capital market is that most investors would benefit from investing. This would allow our citizens to prosper, save for retirement while reducing their reliance on public assistance, especially among our senior citizens.

The government also wants to ensure a strong and prosperous capital market for their investments. The Canadian government currently invests heavily in Canadian companies to ensure that we have sufficient returns for programs like CPP and OAS. If the risk of return increases on these investments, the government will have to look for either safer investments or if markets do not provide adequate returns on their investments to cover their programs, they may have to take money from other places, reduce payments to programs, or increase taxes on those still working.

The capital markets are the backbone of Canada's economy. Without an efficient capital market, it would be very difficult for Canada to grow, prosper and be innovative. While the integrity of the capital markets is always being threatened, a current epidemic has recently been identified. This is, of course, the financial problems that have befallen some of our most prestigious companies and has caused great concern for not only those companies, but for all Canadians.

Throughout the last several years, more Canadians have been investing in the securities of Canada. In 1989, only 23% of Canadian adults were shareholders in Canadian companies. In 2002, this was up to 46%.[4] As a result, any impact on the integrity of Canada will have far reaching effects on all Canadians. While this is beneficial to the economy and investors, any potential negative perceptions, through failed companies or the media surrounding it, may have a larger effect on the stock markets and investors than ever before.

[4] Statistics Canada, "Stock markets and investment dealers". Retrieved May 15, 2005, from http://142.206.72.67/03/03e/03e_001e_e.htm

3. Securities Industry

Securities, by their definition, are, amongst other things, any document, instrument or writing commonly known as a security. This can include any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company, any bond, debenture, note or other evidence of indebtedness, share, stock, unit, etc. [5]

The securities industry assists companies, governments, and individuals in raising capital for their needs through the capital markets. This can be for the expansion of an existing company through an equity issue, a new company financing through an initial public offering, or the government raising funds for operations through the issuance of debt. Without the ability to raise capital quickly and efficiently, the cost of capital will increase and it will cost companies more to expand their business. Having high costs of capital is of no benefit to investors, companies or Canadians, as investment declines, returns decrease to pay for the cost of capital, and companies fail due to expensive capital.

Secondary markets exist on which equities and debt instruments can be traded. For example, stock markets allow buyers and sellers of securities to easily trade their securities, provided that they are publicly traded securities. Investors, who purchase securities in companies that issue securities pursuant to an exemption, will not have access to the public markets and may have more difficulty in selling their securities.

[5] Alberta Securities Act Per S. 1(ggg) of the Alberta Securities Act

Canada's capital markets include various markets: stock markets, derivative markets, debt markets and exempt markets. Stock markets are the most commonly used capital market, as just about any investor can trade in securities through them. Derivative markets deal in derivatives such as warrants, rights and options. The debt market deals in bonds and other debentures. The exempt market is not a recognized market per se, but describes when certain companies rely on exemptions to raise capital.

To raise capital in a Canadian jurisdiction, under securities legislation, a company must have a valid prospectus in that jurisdiction or they must rely on an exemption from the prospectus requirement. There are a number of exemptions that are used. The common are the private company exemption, (whereby up to 50 individuals can participate in a company), close friends and business associates, and the accredited investor exemptions. Buying a security through an exemption is much more risky than buying a security through a prospectus, in part because there is no vetting by the Commissions of the exempt market issuance as there is in a prospectus issuance. Investors also do not have a ready market to re-sell their shares bought through an exemption, as there are usually restrictions such as hold periods.

Canada's stock markets are comprised of the Toronto Stock Exchange ("TSX") and the Toronto Stock Exchange – Venture ("TSX-V"). The TSX is Canada's primary stock exchange, with the largest Canadian companies listed here. The TSX is the world's seventh largest equity exchange, in terms of market capitalization.[6] The TSX-V is a

[6] Statistics Canada http://142.206.72.67/03/03e/03e_001e_e.htm

smaller exchange made up of many junior resource companies as well as capital pool companies. As a junior market, listed companies enjoy easier access to the equity markets than they would experience on the TSX.

The Canadian Trading and Quotation System ("CNQ"), the Winnipeg Commodity Exchange ("WCE"), and the Bourse de Montreal are all recognized as exchanges by provincial regulators. However, for the purpose of this paper, we will be discussing the stock market, as it is the most commonly understood by Canadians and most impacted by the recent changes to legislation.

4. Players in the Capital Markets

In Canada there are a number of different participants in the capital markets. All of them have a vested interest in maintaining and enforcing the integrity of these markets, as doing so not only ensures individuals continue to invest, it also helps ensure that the Canadian economy continues to grow. We will look at the different participants and their roles.

4.1. Provincial Securities Commissions

Currently, the capital markets are regulated by two separate groups, the provincial and territorial securities commissions and the self-regulatory organizations. The Canadian Securities Administrators ("CSA") is an umbrella organization that was set up by the various commissions to attempt to coordinate and harmonize the legislation and regulation of Canada's capital markets. The CSA has three primary objectives, the protection of investors, fair, efficient and transparent markets, and the reduction of systemic risk. [7]

Although the CSA addresses itself to the issues in the Canadian capital markets, it is not an official regulatory body. In Canada, there is no single entity that is responsible for maintaining the integrity of the capital markets. Instead, the various provincial securities commissions and the self-regulated organizations regulate the capital markets. Currently, the capital markets are considered to be a provincial matter and are therefore governed by provincial legislation. Each province and territory has their own securities commission that is responsible for overseeing the capital markets in their jurisdiction.

As each province is responsible for creating and maintaining their legislation, each province's legislation has developed on their own. The legislation is different for each province. This causes additional delays and cost for those parties dealing with more than one province. The CSA has attempted to harmonize legislation by drafting common

[7] Canadian Securities Administrators, "About the CSA". Retrieved May 2, 2005, from http://www.csa-acvm.ca/html_CSA/about.html

policies and instruments, however it is up to the individual province to decide if they will participate in any proposed instruments.

Efforts have been made to unify the legislation, with the introduction of the Uniform Securities Legislation project that is being headed up by the Alberta Securities Commission.[8] Until the legislation is made uniform, capital market participants are confronted with regulations that vary from province to province.

Some progress has been made in terms of multi-lateral instruments and national instruments, which have brought some consistency to some jurisdictions. These have assisted the parties involved in the securities markets. Provinces are not, however, required to participate in these initiatives.

In 2003, the Minister of Finance appointed the Wise Person's Committee ("WPC") to identify possible opportunities for improving securities regulation in Canada. This committee was asked to identify opportunities while maintaining the investor protection, efficient capital markets, the innovation of capital markets, and to ensure that foreign investors trust and invest in Canada's capital markets.

On December 17, 2003, the WPC released their report. This report stressed the need for one national regulator in Canada, if we wish to remain competitive and continue our economic growth. The current fragmented provincial system has been criticized by some

[8] Alberta Securities Commission, "Uniform Securities Legislation". Retrieved on April 28, 2005, from http://www.albertasecurities.com/index.php?currentPage=3867

as being inefficient and more costly than it needs to be. Currently, Canada is the only "developed" country that continues without a national regulator overseeing the capital markets.[9] While there have been steps taken to bring the rules closer together, it will most likely take the federal government to decide that one national regulator is what Canadians need. Until that time, securities regulation will remain a provincial matter.

4.1.1. Increased Penalties

If Canada is going to seriously reduce the number of offences that occur in our capital markets, regulators will need to make the penalty for breaking securities legislation much more significant, and not just a cost of doing business. If we compare the Canadian landscape to the United States, we see that the punishments south of the border are much more severe than in Canada. There have been calls from investors and members of government to increase our penalties to make them true deterrents to potential offenders.

In an attempt to deter individuals form committing capital market offences and to punish those that have committed them, the various securities commissions have sought increased penalties under their legislation. Securities commissions' matters are "quasi-criminal", and there have been steps taken to increase the penalties associated with breaking securities legislation.

In Ontario, the maximum sentence for a securities legislation offence is a fine of not more than $5 million and/or imprisonment of up to 5 years, less a day.[10] In Alberta, the

[9] WPC http://www.wise-averties.ca/consultations_en.html
[10] Ontario Securities Commission, "Ontario Securities Act", S. 122(1). Retrieved on May 12, 2005, from http://www.e-laws.gov.on.ca/DBLaws/Statutes/English/90s05_e.htm#BK162

maximum sentence for a securities legislation offence is a fine of $1 million and/or imprisonment up to 5 years, less a day.[11] In the United States, under their new securities legislation, a guilty party can be put in jail for up to 20 years for a variety of offences.

4.1.2. Role of the IFA

The securities commissions are responsible for investigating securities legislation violations. Due to the complexity of files that the various securities commissions face, they will need accountants with investigative and forensic training in order to properly investigate the various types of files that they will be facing. The files they investigate include:

- Illegal insider trading on information that had not been disclosed to the public.
- Market manipulation and the creation of false markets
- Filing false or misleading financial statements
- Illegal distributions of securities
- Registrant misconduct
- Other securities law offences

All of these files have financial components, and IFAs would be ideally suited to investigating these sorts of offences. The IFA could use their knowledge of the markets, financial statements, and investigative skills to conduct thorough investigations of allegations.

[11] Alberta Securities Commission, "Alberta Securities Act", S. 194. Retrieved on May 12, 2005, from http://www.e-laws.gov.on.ca/DBLaws/Statutes/English/90s05_e.htm#BK162

IFAs employed at the securities commissions will need to ensure that they are familiar with all of the relevant securities legislation that is in effect in their jurisdiction. IFAs will also need to ensure that they keep up to date with all the changes to GAAP and financial accounting so that they will be able to identify issues from financial statements.

Currently, several of the large provincial securities commissions have Investigative Accountants on staff. These individuals are typically IFAs or accountants who are in the process of obtaining their IFA designations. The various securities commissions will likely need additional IFAs to keep up with calls for increased enforcement of securities legislation, especially with the introduction of the new securities legislation aimed at restoring investor confidence. As these proposed instruments are technical in nature, an IFA will be able to provide their unique skill set to the securities commissions, to assist in the investigation of violations.

IFAs will also be employed in the defense of individuals who are brought before a securities commission for their offences. IFAs working for the defense will focus on reviewing the accounting matters in the securities commission's case to ensure that the defendant is getting the best possible defense.

For a list of files that have used IFAs, please refer to Appendix 1. Due to confidentiality concerns, provincial securities commissions usually only confirm that an investigation is underway when it is deemed to be in the public interest or when a notice of hearing or settlement agreement has been issued.

4.2. Self-Regulated Organizations

Certain aspects of the regulation of Canada's capital markets have been delegated to various self-regulated organizations ("SRO"). SROs are entities that represent registrants and are organized for the purpose of regulating the operations and the standards of practice and business conduct of their members and their representatives.[12] The SROs oversee particular segments of the capital markets and the registrants in these markets must be a member of the relevant SRO. SROs are then required to administer not only certain aspects of provincial securities legislation, but also their own rules and bylaws. In most instances, the SROs impose more onerous requirements on their members than are imposed by the provincial legislation.

There are several SROs in Canada. Of these, three are relevant to this discussion. They are the Investment Dealers Association ("IDA"), the Mutual Fund Dealers Association ("MFDA") and Market Regulation Services Inc. ("RS Inc."). Each of these SROs have been delegated the regulation of a particular segment in the capital market. In this capacity they have the power to make a wide range of decisions that affect their members.

Parties that take an issue with an SRO's decision may be able to appeal it to the appropriate provincial securities commission.

[12] Per S. 1 (hhh) of the Alberta Securities Act.

4.2.1. Role of the IFA

As is the case with the provincial securities commissions, the SROs could use the skills of IFAs to assist them in their investigation of offences under their rules and bylaws.

4.2.2. Investment Dealers Association

The IDA was first formed in 1916 by a group of bond traders who believed they could not only protect and educate the investor but they could improve the savings and investment process. The IDA oversees the operation of over 190 investment dealers throughout Canada.[13] Investment dealers are typically known as stockbrokers and they are involved in the raising of capital companies and government and facilitating trades for investors. The IDA regulates the activities of their members and ensures that they maintain an adequate level of capital and conduct their business affairs in an appropriate manner. The IDA strives to protect investors and through the implementation of rules and policies, to enhance the efficiency of our capital markets. The IDA oversees over 97% of the industry's revenue and capital.[14]

In several provinces, the IDA has also been delegated the responsibility for registering its member firms and individuals.

The IDA also has the goal of enhancing the efficiency of the capital markets. In pursuit of this goal, the IDA has three primary roles, market regulator, public advocate, and international representative. The IDA also takes an active role in the education of

[13] Investment Dealers Association of Canada, "About the IDA". Retrieved on April 20, 2005 from www.ida.ca/about/roles_en.asp
[14] I*bid*

participants in the industry and the general public. In 1970, the IDA assisted in the creation of the Canadian Securities Institute, which provides a variety of courses dealing with the securities market. These courses range from basic to advanced, and some courses are required to become registered. For example, to become registered as a sales representative with the IDA, an individual must pass two exams, one on rules and regulation (Canadian Securities Course), one on ethics and conduct (Conduct Practices Handbook), and take a 90 day training course with their firm. If registrants are providing different types of service, such as options trading, they must have additional courses.

4.2.3. Mutual Fund Dealers Association

The MFDA oversees approximately 190 mutual fund dealers and their 70,000 salespeople.[15] Mutual fund dealers and their salespeople are only permitted to sell shares or units of mutual funds. Mutual funds are usually managed investments, which take bundles of securities and manage them for the investor. There are many different types of mutual funds, which vary from sector and style of management. The MFDA sets capital requirements for all dealers and ensures that they are in compliance with all rules, by-laws, and policies of the MFDA. All members of the MFDA must also comply with any applicable securities legislation, as set out by the provincial securities commission in which the dealer operates.

4.2.4. Market Regulation Services Inc.

Market Regulation Services Inc. ("RS Inc.") is an independent market regulator that is responsible for reviewing and monitoring all trading activity on Canadian equity markets.

[15] Mutual Fund Dealers Association of Canada, "MFDA Update", November 2004. Retrieved on April 22, 2005 from http://www.mfda.ca/updates/Update-11-04.pdf

RS Inc. oversees TSX, TSX-V, CNQ[16], Bloomberg[17] and Liquidnet[18]. RS Inc. strives to protect investors and market integrity by regulating trading on these markets in accordance with trading rules.

RS Inc. monitors all trades in real time, which allows them to react quickly to changes in the marketplace. RS Inc. will then investigate any suspicious trades or breach of a trading rule. If RS identifies a problem, they have the authority to reverse trades and take action against the parties involved.

RS Inc. has an integral role in enforcing the integrity of our capital markets, as they are constantly looking for possible illegal insider trading and market manipulation that would have a negative effect on our markets. If RS Inc. finds instances of inappropriate trading behavior, they will conduct investigations and prosecutions of breaches of the trading rules. RS Inc. also refers possible cases of insider trading to the appropriate securities commission for investigation and prosecution.

[16] CNQ is a new Canadian stock exchange that allows investors to trade in equity securities of emerging companies. From CNQ – Canadian Trading & Quotation System Inc., "About CNQ". Retrieved on May 22, 2005, from http://www.cnq.ca/Page.asp?PageID=907&SiteNodeID=162&BL_ExpandID=29
[17] Bloomberg Tradebook is a global electronic agency brokerage serving institutional investors, brokers and dealers. From Bloomberg Tradebook. Retrieved on May 22, 2005, from http://www.bloombergtradebook.com/index_fl.htm
[18] Liquidnet is an US based electronic marketplace for trading large blocks of shares for institutional investors. Liquidnet Canada Inc. is a member of the IDA and regulated by the OSC and RS Inc. Liquidnet, "About Liquidnet". Retreived on May 22, 2005, from http://www.liquidnet.com/company/about.jsp

4.3. Law Enforcement

Historically, the Commercial Crime sections of the RCMP have investigated criminal market manipulation, criminal code offences, and criminal offences related to registrants. As a result of the recent corporate scandals that have shaken the world's capital markets, the Canadian government decided that something must be done to ensure that investor confidence was restored and that criminal acts would be appropriately punished.

4.3.1. Integrated Market Enforcement Teams

On June 12, 2003, the government of Canada announced new legislation that would increase enforcement against serious capital market fraud. As a result, the government has budgeted $30 million per year for five years to create up to nine Integrated Market Enforcement Teams ("IMETs") within the RCMP. [19] There are currently IMETs teams operating in Canada's financial centers in Toronto, Montreal, Vancouver and Calgary.

These IMETs are comprised of RCMP, lawyers and other investigative experts, who specifically target capital markets fraud cases. IFAs will most likely be an integral part of the IMETs teams, as the teams are going to include forensic accountants. IFAs will be working with the other experts to decipher complex accounting issues that are quite often involved in capital market fraud.

[19] RCMP, "Government of Canada Announces New Measures to Deter Capital Markets Fraud", June 12, 2003. Retrieved on April 12, 2005, from http://www.rcmp-grc.gc.ca/news/2003/n_0329_e.htm

4.3.2. Bill C-13: Capital Markets Fraud and Evidence Gathering

In addition to establishing the IMETs teams, the government has also introduced new amendments to the *Criminal Code of Canada*, which were passed into law on February 12, 2004. These changes have created a new *Criminal Code* offence of improper insider trading, for employees of corporations that use material information that is not available to the public to trade to benefit themselves. This is commonly called "illegal insider trading". Under the new provision there is a maximum penalty of 10 years in jail for persons found guilty of this offence.

A whistle-blower provision has been implemented that protects employees who come forward when they identify inappropriate conduct. Under section 425.1 of the *Criminal Code,* it is now a criminal offence to take or threat to take action against an employee in order to prevent the employee from reporting an illegal act. If an individual is convicted under this section, they can face a maximum of 5 years in prison.

The new legislation allows federal prosecution when the offense is so heinous that it could threaten the integrity of capital markets on a national level. This leaves offences that do not affect the national capital markets in the hands of the appropriate securities commission.

Fraud sentencing guidelines have also been increased to reflect the seriousness of the offence, with maximum sentences raised from 10 to 14 years for fraud and fraud affecting the public markets. Persons who file fraudulent financial statements are

covered by this provision. If individuals are found to have fraudulently manipulated stock exchange transactions, they would now face a maximum of 10 years in jail, up from 5. This is commonly known as market manipulation and occurs when individuals attempt to create a false price or evidence of activity on a security. These measures are aimed at increasing the integrity of the capital markets, through increased deterrence.[20]

The provisions stipulate aggravating circumstances to fraud that the courts should consider when determining sentences for market fraud offences. These four circumstances are:

- The fraud is over $1 million
- The stability of the Canadian markets or financial systems were adversely affected or had the opportunity to affect it
- The offence impacted large number of victims
- The individual involved used their position in the community or their reputation in committing the offense.

If any of these factors are present, then the court will be able to impose harsher penalties on the perpetrator. For example, this will allow the courts to impose harsher sentences on individuals who behavior has a larger impact on the integrity of the capital markets.

The IMETs will now be able to use production orders instead of search warrants to obtain some documents from third parties not under investigation. The use of production orders will allow the teams to get the required documents on a timelier basis, as they would be

[20] Department of Justice Canada, "Government of Canada Announces New Measures to Deter Capital Market Fraud", June 12, 2003. Retrieved on April 12, 2005, from http://canada.justice.gc.ca/en/news/nr/2003/doc_30926.html

more efficient and less disruptive to the holder of the evidence. These production orders would still have Charter safeguards in place to ensure that they do not violate the *Canadian Charter of Rights and Freedoms.* Anyone receiving a production order could apply to the court to object, if they feel the information is privileged or protected.

4.3.3. Role of the IFA

Law enforcement agencies have used IFAs to assist them in investigating files that have financial components, such as stock market manipulation, insider trading, and fraudulent financial statements. Given the increasing complexity of the financial frauds and scandals that law enforcement will be facing in the future, it will be imperative to enlist the services of individuals who have the training, knowledge and experience to successfully unravel these files. The IFA has these skills and will, therefore, be very useful in assisting the RCMP in their investigations.

With the increased publicity surrounding accounting related capital market offences, the RCMP will need to retain experts in accounting, such as IFAs, to assist them in their review of financial matters if they want to retain the confidence in the markets. IFAs possess a very useful skill set in assisting the RCMP in their investigations.

Given the increased criminal penalties associated with the Bill C-13, the individuals who are accused of these crimes will also be looking to IFAs to assist in the preparation of their defense. With the requirement of law enforcement to fully disclose their

investigation[21], the defendants will require IFAs to assist in an analysis of the case against them.

IFAs may be asked to respond to or assist in the preparation of production orders, under the new legislation. IFAs working for the RCMP will be able to identify what specific financial information would be required. IFAs that have performed investigations into a company's affairs may find that the RCMP issues a production order for their investigation files. IFAs should therefore become familiar with the requirements under the production orders and get a legal opinion when required.

[21] R. v. Stinchcombe, (1991), 3 S.C.R. Retrieved on June 2, 2005, from http://www.lexum.umontreal.ca/csc-scc/en/pub/1991/vol3/html/1991scr3_0326.html

4.4. Registrants

To trade in securities with or on behalf of the general population, unless you are trading pursuant to an exemption, you must be registered with the appropriate provincial securities commission or SRO. Registrants are restricted in products they can sell. The restrictions are based on the education and experience requirements for trading in the various products. Common types of registrants are mutual fund salesperson, registered representative, portfolio manager and investment counsel. Each of these classes of registration has their own requirements that must be met before the individual will be registered.

The company that a registered individual works through must also be registered with the appropriate entity. Registration usually involves ensuring that the company has the appropriate level of capital, adequate bonding or insurance, and has a sufficient compliance structure in place to ensure that the various rules are being complied with.

Investment dealers are registered through the IDA. In Ontario only the firm registers with the IDA and the individuals register through the OSC. One of the requirements of registration with the IDA is that the dealers that employ these brokers must report, on a monthly basis, their risk adjusted capital, calculated in accordance with the Joint Regulatory and Financial Questionnaire. This document contains a complicated calculation that determines how much capital is available in the company. Investment dealers must maintain an adequate level of regulatory capital to maintain their

registration. Accountants generally prepare these documents, as they are quite technical in nature.

4.4.1. Role of the IFA

Registrants may have occasion to employ the services of IFAs if they suspect that they have been involved in a fraudulent activity. For example, if they suspect that one of their employees has been stealing money from their clients, they may wish to have an IFA review the transactions to ensure that they are maintaining adequate controls over their clients' accounts.

IFAs may also be brought in to review the registrant's internal controls to ensure that they are no significant vulnerabilities in their policies and procedures. IFAs may also be useful when reviewing client complaints and determining losses of clients.

4.5. Auditors

Public accounting firms are charged with a very important role in maintaining the integrity of capital markets, i.e., ensuring that the audited financial statements filed by public companies, are free of material misstatement. In Canada, all reporting issuers must file their audited financial statements with the jurisdictions in which they report. This is usually done electronically, through the System for Electronic Document Analysis and Retrieval ("SEDAR").

As this financial information is readily available for all investors to review, it must be assumed that it will be reviewed by a large audience. However, the existing case law does not hold auditors liable to shareholders.[22] The courts were concerned that if auditors were held liable to shareholders, they would not issue audited financial statements, as they would be exposed to such large liability. After the accounting scandals, new legislation, discussed below, has been implemented to maintain auditor independence, which will hopefully prevent auditor negligence.

All public accounting firms must ensure that they are following the appropriate standards that have been set out in generally accepted audit standards ("GAAS") and generally accepted accounting principles ("GAAP").

[22] See Hercules Management Ltd. vs. Ernst & Young (1997), 146 D.L.R. (4th) 577 (S.C.C.). Retrieved on May 1, 2005, from http://www.lexum.umontreal.ca/csc-scc/en/pub/1997/vol2/html/1997scr2_0165.html

The failure of auditors to detect and report financial statement fraud or misstatement has been heavily reported in the last few years. There have been allegations of collusion between auditors and the reporting issuers as well as suggestions of lack of independence.

Under section 5135 of the CICA Handbook, auditors are not required to detect fraud. However, auditors are required to consider the risk of material misstatement that could result in the financial statements from fraud or error. Auditors must consider fraud in planning their audit and should talk with the audit team to see if there is any suggestion of fraud or material misstatement. The auditors must also discuss with management about their assessment of whether a fraud or material misstatement has occurred and if so, what steps they have taken to minimize this risk.

If fraud or a material misstatement is detected, the auditors must communicate their findings to the audit committee and management.

4.5.1. Arthur Andersen Fiasco

One of the biggest examples of fraud and material misstatement is the collapse of Enron and Arthur Andersen ("Andersen") in the United States. Andersen was one of the "Big Five" accounting firms and was the auditor of Enron. As a result of an alleged negligent audit and missing or ignoring red flags, Andersen provided a clean audit opinion on Enron's financial statements. It was later determined that Andersen had knowledge about the issues facing Enron and that they shredded alleged incriminating documents.

Andersen was fined $500,000 USD and given 5 years of probation.[23] Andersen lost its registration to audit public companies and sold its assets to the remaining "Big Four" accounting firms.

The loss of one of the biggest accounting firms also creates problems for auditors and the investing public. Now that there are only four large firms left, the requirements of the new legislation regarding auditor independence may be more difficult to maintain.

On May 31, 2005, the Supreme Court overturned Andersen's conviction for destroying documents relating to Enron. The Supreme Court, in a unanimous opinion said the obstruction decision was improper[24]. It is too early to determine if there will be an appeal or new charges.

Under the new SOX legislation, audit working papers and other related information supporting the audit opinion must be retained by the audit firm for five years.[25] Destroying these documents is a punishable offence that can result in significant fines and up to 20 years imprisonment.[26]

4.5.2. Role of the IFA

Auditors have been placed in a very precarious situation as a result of the public's increased awareness of the failure of some audits to identify fraud and inappropriate

[23] CBC News, "Arthur Andersen fined, given probation over Enron Scandal", October 16, 2002. Retrieved on May 14, 2005, from http://www.cbc.ca/stories/2002/10/16/business/arthurandersen_021016
[24] Associated Press, "Enron auditor's verdict reversed", May 31, 2005. Retrieved on May 31, 2005, from www.msnbc.msn.com/id/8046535
[25] S. 802, Sarbanes-Oxley Act of 2002.
[26] *Ibid*

behavior or management, such as in the cases of Enron, Livent, etc. As a result, auditors must be more selective when taking on new clients to ensure that they fully understand the risks facing a new client. Auditors will most likely be able to use the skills of IFAs to assist them with the risk identification in the internal control work that will be required under SOX and the proposed Canadian legislation. See Appendix 2 for a listing of skills that IFAs should possess.

Auditors must ensure they are not in violation of independence requirements. This is discussed later in the report. IFAs will most likely be brought in to identify riskier areas that should be reviewed more closely. IFAs will be able to do so by using their skills in risk assessment and fraud detection. IFAs can also review the internal control framework and identify weaknesses and possible areas of concern.

If during the course of an audit, the auditors find evidence of fraud or material misstatement, they are required by section 5135 of the CICA handbook to confirm or dispel the suspicion of fraud or material misstatement. Therefore, the auditors may call on their associated IFAs to assist them in confirming whether or not a fraud or material misstatement occurred. The IFA may be able to provide advice on a no-name basis to the auditor to assist them in the identification of fraud. If the auditor has evidence that a fraud has occurred, the IFA would determine whether there were any conflicts involved in continuing to investigate the matter.

To properly prepare the audit team to identify fraud or material errors, many accounting firms have been using IFAs to train auditors for red flags and warning signs. By doing this, the IFAs are able to pass on some of their knowledge to the auditors so that they will know what to look for when they are completing their audits.

4.6. Reporting Issuers

A reporting issuer is a company that has filed a prospectus with a securities commission and received a receipt. Although not all reporting issuers are listed on a stock exchange, all companies that are listed on the stock exchanges are reporting issuers. The reporting issuer is the most important part of the capital market, as they are the companies in which investors invest. To provide investors with sufficient information on which to base their investment decisions, reporting issuers are responsible for filing financial statements with the various provincial regulators in the jurisdictions in which they are active. These filings must be made on a timely basis, as set out in the legislation.

As a result of the fraud and accounting scandals that have been uncovered over the past few years, new legislation has been drafted which will require significantly improved disclosure regarding the financial information provided to investors. Hopefully, this will allow investors to make appropriate investing decisions.

Reporting issuers must now concentrate on increased corporate governance and internal controls, in order to comply with the proposed and new legislation aimed at increasing investor confidence.

4.6.1. Role of the IFA

Reporting issuers will require the use of IFAs to assist them in compliance with some of the proposed legislation that has been drafted by the CSA. These new pieces of legislation are outlined later in this paper.

Reporting issuers should also be enlisting the services of IFAs when they have reason to suspect that there is a potential fraud or theft from the issuer. Bringing in independent IFAs may be beneficial to the reporting issuer in identifying the existence of a fraud or embezzlement, as well as quantifying the damages suffered.

IFAs would also be useful to reporting issuers in developing appropriate internal controls to minimize the risk of fraud or theft from the organization. The IFA will be able to use their skill and knowledge of internal control weaknesses to identify areas that should be addressed in new policies and procedures.

IFAs can provide assistance in setting up appropriate corporate governance procedures for reporting issuers. The IFA will be able to assist reporting issuers in determining the appropriate method of ensuring that corporate governance appropriately considers all risks facing the organization.

In order to adequately serve all of the various players in the capital markets, IFAs must keep abreast of all of the relevant securities legislation, accounting standards, and appropriate laws that come into play, based on the jurisdictions that the company operates in.

Reporting issuers who have internal auditors may begin to look at hiring IFAs for these positions to ensure that they can complement the skills that the internal auditors already

possess. The internal auditors could benefit from the skill and expertise that an IFA could bring to this role and would be helpful in ensuring that the internal controls are as complete as possible and that any potential investigations are handled in an appropriate manner. For those organizations that do not wish to hire additional staff, their existing staff could seek IFA certification, or they could look to firms to provide expertise when required.

The new legislation, which includes the review and documentation of reporting issuer's internal control framework, will require the internal audit departments of companies to do more work to comply with the legislation. As a result, more testing of these internal controls will be done and presumably this will result in a more complete internal control system. IFAs will be able to provide their skill set in the identification or risks and control weaknesses to assist the internal control department.

4.7. Investors

Investors lost the most in the recent accounting scandals and frauds that have been widely reported in the media. Due to the huge amount of publicity that some of the failed companies have received, investor confidence has been significantly and negatively impacted. Over the past few years, individual investors have been taking their money out of the markets and trying to find other more safe places for their investments.

This has resulted in more people investing in other types of investments such as real estate, GIC's and others. Unfortunately, with the interest rates being quite low, investors who were used to getting double-digit returns on their investments are finding it difficult to accept a 4-5% interest payment from a GIC. This has opened the door for a number of unscrupulous individuals who have been preying on these investors through other investments, which "guarantee" high rates of return. Many of these investments are later found out to be Ponzi schemes or outright frauds.

If the integrity of the capital markets is restored, through increased corporate governance, disclosure and a reduction in the number of frauds being perpetrated, investor confidence should be restored. Investors will then realize that many of those alternative investments are not appropriate and return their capital to the equity markets.

4.7.1. Role of the IFA

While most individual investors will not be able to utilize the services of IFAs, they may be able to benefit from the utilization of IFAs by investment managers and reporting

issuers. IFAs may be called in to assist investment managers in assessing the financial statements of companies that the investment managers are including in their portfolios or suggesting to their clients.

5. Canadian Accounting Scandals

The two cases that will be looked at in this report are Nortel Networks and Livent Inc.

5.1. Nortel Networks Corporation

Nortel Networks Corporation ("Nortel") is one of Canada's largest companies. Nortel has been one of Canada's largest success stories as well as one of its biggest disappointments. Nortel is currently listed on the NYSE and TSX and had 2003 revenues of $9.81 billion USD[27]. Nortel was initially formed in 1895 and started off life as a telephone manufacturing company. Nortel has grown into one of the world's largest companies specializing in global communications and internet connectivity and has customers in over 150 countries.

Nortel was one of the biggest success stories of the technology boom, but also suffered greatly when the bubble burst. After reaching an all time high of approximately $120 per share in late 2000, the company has been plagued by poor financial results requiring significant write-downs and restatements. As a result, the stock price plunged to as low as less than $1. The stock is currently trading at around the $3-4.00 per share range on the TSX.

Nortel began its accelerated growth when John Roth took over in 1997 as president and CEO. Mr. Roth recognized the value of the internet and the possible opportunities it could provide. As a result, Mr. Roth restructured Nortel so that it could respond more

[27] Nortel, "About Nortel". Retrieved on May 1, 2005, from http://www.nortel.com/corporate/cm/index.html

quickly to the changing internet and wireless world. Mr. Roth also began an aggressive manufacturing restructuring in which he decided to outsource much more of their production than had previously been contemplated. This allowed Mr. Roth to pick those suppliers that could react quickly to Nortel's changing demands.

Mr. Roth's restructuring efforts had a dramatic effect on Nortel. In the late 1990's, it was estimated that up to 75 percent of North American internet traffic was going through Nortel equipment.[28]

Mr. Roth's aggressive strategies were not only limited to restructuring. Nortel began actively acquiring other IT related companies, especially in the internet connectivity market, and in 2000 they acquired 11 companies for $19.7 billion USD[29].

5.1.1. Nortel's Issues

In late 2000, when the technology bubble burst, many technology companies ran into financial difficulties and either went bankrupt or had their shares drop significantly in value. There were several reasons for the "bubble bursting". Many technology companies were overvalued – they had never turned a profit and did not have a viable product. Companies' shares had been bid up by investors "hopping on the bandwagon", hoping to cash in on the phenomenal returns that internet stocks had produced. These overly optimistic expectations of internet and other technology companies of the "new economy" were not sustainable, and unfortunately, most of the companies were

[28] CBC News, "Nortel: Canada's Tech Giant", May 2, 2005. Retrieved on May 5, 2005, from www.cbc.ca/news/background/nortel/
[29] *Ibid*

completely overvalued and their performance could not support their inflated stock prices. Without a sound business model and positive financial results, many companies were forced to close their doors.

Even though Nortel had a viable business, many of their customers went bankrupt or had to scale back their purchases significantly. As a result, Nortel's revenues dropped 62%, from $27.9 billion USD in 2000 to $17.5 billion USD in 2001.[30] This resulted in an operating loss for 2001 of $26.8 billion, compared to an operating loss of $2.4 billion in 2000[31]. The value of many of the companies that Nortel had recently acquired also dropped significantly.

Due to Nortel's poor financial performance, Mr. Roth stepped down in 2001. The company then began to try to recover. This involved laying off thousands of staff and attempting to rebuild their sales base.

In February 2002, Terry Hungle, Nortel's CFO, resigned amid allegations that he broke Nortel's trading rules regarding some personal transactions.[32] Nortel's bond status was also downgraded to "junk" by S&P and Moody's.[33]

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[30] Nortel, "Annual Audited Financial Statements", March 11, 2002. Retrieved on April 29, 2005, from http://www.sedar.com/csfsprod/data29/filings/00427713/00000001/w%3A%5C3w_out%5C21387%5Ce_finst.pdf
[31] *Ibid*
[32] CBC News, "Nortel: Canada's Tech Giant", May 2, 2005. Retrieved on May 5, 2005, from www.cbc.ca/news/background/nortel/
[33] *Ibid*

Nortel did recover slightly in 2003, when they began posting positive results for the first time in several years. The share price of Nortel began to rebound as well, nudging the $6 level, up significantly from the $0.69 it closed at in October 2002.[34]

On March 10, 2004, Nortel issued a release stating that it would delay filing its financial statements and would most likely have to make restatements. Nortel identified new concerns with respect to the recognition, timing and support of income as well as accruals and provisions made in prior periods.[35] At this time, both the SEC and the OSC stated that they had begun investigations into Nortel's filed financial statements.

As the share value of Nortel continued to drop, there were continual questions about the performance of the company. Nortel failed to meet analysts' predictions. There would have been incredible pressure for the financial statements to reflect positive results. It appears that some of the individuals involved in the financial reporting may have succumbed to this pressure and issued financial statements that were more generous than they should have been or contained errors that should have been caught.

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[34] Big Charts, "CA:NT", Java Chart. Retrieved on April 20, 2005, from http://bigcharts.marketwatch.com/javachart/javachart.asp?symb=CA:NT&sid=175706&time=

[35] Nortel, Press Release, "Nortel Networks to Delay Filing of 2003 Annual Financial Statements *Additional Review of Previously Issued Financial Results Likely to Result in* Restatements", March 10, 2004. Retrieved on April 29, 2005, from http://www.sedar.com/csfsprod/data43/filings/00620600/00000001/C%3A%5Csedarpdf%5Cnortel0310eng.pdf

On April 28, 2004, Nortel terminated the employment of its CEO, CFO and Controller, and announced that its 2003 results would be even worse than originally expected. They also disclosed that the results of 2004's first quarter would be delayed indefinitely.[36]

On May 14, 2004, Nortel disclosed that it had been served with a Federal Grand Jury Subpoena, requiring the production of documents for January 2000 to date as part of an ongoing criminal investigation. This investigation is being conducted by the US Attorney's Office for the Northern District of Texas. [37]

5.1.2. Regulator Action

On May 17, 2004, the Ontario Securities Commission issued a notice of hearing against Nortel Networks Limited ("NNL") and Nortel, relating to certain directors, officers and insiders of the two companies that were involved with either company on September 30, 2003.[38] The notice of hearing was issued to determine if it would be in the public interest to prevent those individuals listed in the notice of hearing from trading in securities for a period of 15 days. The OSC issued the notice, because on April 28, 2004 Nortel issued a press release that stated that NNL and Nortel would restate their financial statements for each quarter of 2003 and for 2002 and 2001. The filing of its December 31, 2003 annual financial statements would also be delayed. As a result of the failure to file their

[36] Nortel, Press Release, "Nortel Networks Announces William Owens as new President and CEO, President and CEO, as well as former CFO and Controller, Terminated, Update on Audit Committee Independent Review, Planned Restatements and Related Matters", April 28, 2004. Retrieved on April 29, 2005, from http://www.sedar.com/csfsprod/data45/filings/00635732/00000001/C%3A%5Csedarpdf%5Cnt0428e.pdf

[37] Nortel, Press Release, "Nortel Networks Receives Document Subpoena from U.S. Attorney's Office", May 14, 2004. Retrieved on April 29, 2005, from http://www.sedar.com/csfsprod/data46/filings/00643307/00000001/C%3A%5Csedarpdf%5Cnt0514.pdf

[38] OSC, "In the Matter of Certain Directors, Officers and Insiders of Nortel Networks Corporation and Nortel Networks Limited", May 17, 2004. Retrieved on May 5, 2005, from http://www.osc.gov.on.ca/Enforcement/Proceedings/2004/noh_20040517_nortel-networks.jsp

financial statements, the OSC issued a cease trade order against the respondents as they were breaching the financial statement disclosure requirements of Ontario's securities legislation. The OSC decided that they would not cease trade the company, as this would adversely affect the investors more than the respondents. Cease trading a company that has not filed their financial statements is often done by other jurisdictions, but given the size of the market capitalization, it would not be in the public interest to do so. The OSC decided that it would be prejudicial to the public interest to allow these individuals to continue trading in these two companies, until such time as the appropriate financial statements have been filed.

In cease trading only the respondents the OSC sent a message to the markets. The OSC is in effect punishing those individuals who have power to control the release of the financial statements. As these individuals have shares and stock options in the company, it is in their best interests to see that the financial statements are filed and the cease trade is lifted. The OSC may also have been trying to instill some confidence in the market by not punishing the general investing public for Nortel's inability to file their financial results.

5.1.3. Nortel's Consequences

Nortel is also facing a class-action lawsuit by the Ontario Public Service Employees Union Pension Trust, which was heavily invested in Nortel and lost a significant amount of money.

The restated audited financial statements for 2003 show that Nortel overstated revenue by $300 million. Questions were also raised about bonuses paid to executives while the financial scandal was occurring.

The fall of Nortel has had wide reaching effects, with almost all Canadians affected through their RRSPs, pension funds, and mutual funds. This dramatic fall in value has eroded several billion dollars from the capital markets of Canada and as a direct result, from the net worth of Canadians. The issues facing Nortel have also raised concerns surrounding the reliability of the financial reporting in Canada and the integrity of our capital markets. Due to Nortel's size and complexity, they have had significant problems in issuing their restated financial statements.

Nortel's market capitalization has varied considerably over the past few years. It currently has a market capitalization on the TSX of approximately $14 billion. [39] This is down significantly from July 26, 2000, when Nortel closed at its all time high of $123.10[40]. Based on 2,976,620,325[41] issued and outstanding common shares, this would have given Nortel a market capitalization of $366,421,962,007.50. On October 10, 2002, Nortel hit bottom. Nortel's shares closed at $0.69[42] and with 3,849,891[43] shares issued and outstanding, Nortel had a market capitalization of $2,656,424.79, or less than 1% of its previous value.

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[39] Per www.tsx.com at May 9, 2005
[40] Big Charts, "CA:NT", Java Chart. Retrieved on April 20, 2005, from http://bigcharts.marketwatch.com/javachart/javachart.asp?symb=CA:NT&sid=175706&time=
[41] Per Nortel's June 30, 2000 Interim Financial Statements, obtained from www.sedar.com
[42] Big Charts, "CA:NT", Java Chart. Retrieved on April 20, 2005, from http://bigcharts.marketwatch.com/javachart/javachart.asp?symb=CA:NT&sid=175706&time=
[43] Per Nortel's September 30, 2002 Interim Financial Statements, obtained from www.sedar.com

Nortel is continuing to work to regain the investor confidence that has been lost as a result of the problems that they have encountered over the past few years. This has involved engaging many accountants and most likely IFAs to determine the errors that had been made.

The seriousness of Nortel's financial disclosure problems are highlighted by the fact that the NYSE and the TSX threatened to de-list their shares off of their respective exchanges if Nortel did not provide restated financial statements within an appropriate time frame. Nortel has been working with the regulators to keep them up to date on their progress in the restatement of the financial statements.

Once suspicions were raised, IFAs should have been brought in to perform an audit review, risk assessment and fraud detection on the revenue and expense recognition portions of the audit. The IFAs would most likely have been able to find the inappropriate gains. Of course, if management had falsified documents to cover their wrongdoing, it would be less likely that the full extent of the misstatement would be determined without a detailed investigation. The fall of Nortel has also been one of driving forces behind the CSA's recent initiatives into new securities legislation that requires additional disclosure and assurance regarding the financial performance and internal controls of reporting issuers.

5.1.4. Criminal Case

In August 2004, the RCMP IMETs team began a criminal investigation into Nortel's accounting practices.[44] No charges have been filed yet.

5.1.5. Summary

The fall of Nortel from its former glory to its current battered state highlights the need for more proactive action by issuers and regulators to ensure the integrity of Canada's capital markets. If the issues facing Nortel had been identified sooner, the impact may not have been as devastating for investors. The auditor's may also have to bear some of the responsibility in issuing the financial statements that now appear to have been materially misstated.

Hopefully, the new securities legislation that addresses the responsibilities of auditors, audit committees, officers and directors will be enough to prevent this from happening again. Also, the drastic change in financial reporting and the impact of these changes on a company and its investors highlights the need for professional skepticism and the use of specialists, such as IFAs when accounting issues arise.

5.2. Livent Inc.

Livent Inc. ("Livent") was an Ontario production company that produced live theatre presentations at their own theatres. They also had traveling productions that would visit other locations. Livent had theatres operating in Toronto, Vancouver, Chicago and New

[44] Nortel, "Nortel Networks Updates Status of RCMP Review", August 16, 2004. Retrieved on June 8, 2005, from http://www.nortelnetworks.com/corporate/news/newsreleases/2004c/08_16_04_rcmp_investigation.html

York, and did reproductions of some of the more recent popular musicals. Some of the shows that Livent produced were "Show Boat", "Kiss of the Spider Woman" and "Phantom of the Opera".

Livent's former chairman Garth Drabinsky was originally credited with making Livent a success story, as historically live theatre production companies are considered very risky. As a theatre company can be destroyed based on one bad review or a poor turnout, the fact that Livent appeared to be doing well originally spoke well about Mr. Drabinsky's methods. However, upon further review, there were some serious issues with the accounting at Livent.

Livent had its initial public offering on the Toronto Stock Exchange on May 10, 1993, at which point it became a reporting issuer. Livent later obtained a listing on NASDAQ as well as on CDN-OTC.[45] The Ontario Securities Commission ("OSC") issued a cease trade order against Livent on February 6, 2001 for failing to file their financial statements.

Livent made national headlines when it declared bankruptcy in November 1998. It was later determined that Livent was involved in questionable accounting practices which resulted in misstated financial statements being filed with the regulators and investors.

[45] SEDAR, "Company Profile, Livent Inc.". Retrieved on April 29, 2005, from http://www.sedar.com/DisplayProfile.do?lang=EN&issuerType=03&issuerNo=00003144

Although Livent was not a huge company, with $386 million CAD in assets at December 31, 1997, it was a very public company in Canada. Being in the entertainment industry, Livent attracted a lot of attention. The resulting accounting scandal was one of the first to hit a public company and began to chip away at the investor confidence in Canada.

5.2.1. Livent's Issues

Livent first disclosed their accounting issues in its 1997 financial statements. At this time, a new management team performed some due diligence and found that there were improper revenue recognition practices and expenses were not recorded as they were incurred. As a result of the issues identified, the new management hired KPMG LLP to review the finances of Livent. Up until this time, Deloitte & Touche LLP had been Livent's auditors.

On August 10, 1998, the new management of Livent suspended Mr. Drabinsky and Myron Gottlieb, after they had found many accounting issues in the financial records.

This was followed by a lawsuit, filed in November 1998, seeking $225 million for breach of fiduciary duty, breach of contract, fraudulent misrepresentation, conversion, and conspiracy to defraud Livent. In the lawsuit, the new management claimed that Messrs. Drabinsky and Gottlieb attempted to hide losses of $100 million by fraudulently manipulating financial statements. Messrs. Drabinsky and Gottlieb were terminated on November 19, 1998.

On November 18, 1998, Livent issued a material change report that contained the restated financial statements for 1996, 1997 and the first quarter of 1998. This caused a reduction in net income for the periods of $85 million. The new management of Livent stated in the material change report that they uncovered "pervasive and systemic accounting irregularities".

In the first quarter 1998 financial statements, filed November 19, 1998, new management restated the 1997 results to reflect a loss of approximately $15 million, on revenues of $84 million. The original financials showed a profit of $1 million. The loss relates to the increased operating costs and the amortization of production costs. The results for 1998 showed a loss of $45.8 million on revenues of $89 million. This was largely due to increased operating costs and a write-down of assets of $26 million.

Livent filed for protection under the Company's Creditors Arrangement Act as well as Chapter 11 of the U.S. Bankruptcy Code on November 19 and 18, 1998, respectively, as a result of the "… massive scale of the accounting irregularities and inappropriate business practices uncovered at Livent …".[46]

Livent's auditor's, Deloitte & Touche, withdrew their audit report on the 1995 financial statements, as they have not been restated. Also, the quarterly results for 1996 were not restated. The new management of Livent felt that the restated financial statements for

[46] Livent Inc., "Material Change Report", November 19, 1998. Retrieved on April 29, 2005, from http://www.sedar.com/csfsprod/data12/filings/00135182/00000001/a%3A%5Cmatchg.pdf

1996, 1997 and 1998 reflect a fair and accurate representation of Livent's financial position for those periods.

5.2.2. Accounting Irregularities

Livent's new management identified transactions that were being improperly recorded as revenue. Before the new management had taken over, Livent had entered into side deals with third parties, which were never disclosed to the board of directors or the audit committee. As a result of these side deals, the nature of the transactions changed so that the revenue that had been recognized with third parties should have been classified as loans. As a result, 1996 net income was reduced by $19.4 million. In 1997, the reduction was $23.3 million.[47]

Livent's operating costs were being improperly capitalized to fixed assets. The previous management had capitalized production expenses instead of expensing them as they were incurred. The charge against net income was $3.1 million in 1996 and $10.7 in 1997.[48]

Expenses were improperly carried forward to future periods. The expenses were then incurred in a later period, resulting in misstated net income. Restating the expenses caused a reduction in net income of $3.9 million in 1996 and $0.5 million in 1997.

Preproduction expenses were capitalized instead of being expensed in the appropriate period. Some of the preproduction costs for current shows were capitalized to the

[47] *Ibid*
[48] *Ibid*

accounts of shows that had not yet opened. Restating these expenses reduced net income by $11.1 million in 1996 and $1.6 million in 1997.

Some revenues that should have been recognized over a period of time were recognized all at once.

All of these adjustments reduced Livent's net income from $11.1 million to a net loss of $18 million in 1996. In 1997, Livent's restated net loss was $98.7 million down from an unadjusted net loss of $44.1 million. The first quarter of 1998 also had a restated loss of $31.3 million, down from an unadjusted net loss of $29.9 million.

These restatements caused the auditors to issue a going concern note in the 1996 and 1997 restated financial statements. There was at this point significant concern regarding Livent's ability to continue operating. In fact, Livent ceased operations shortly thereafter.

There were allegations that Messrs. Drabinsky and Gottlieb issued false filings with the Securities Exchange Commission ("SEC") and orchestrated a scenario where non-related individuals purchased tickets to keep poorly performing shows running. Messrs. Drabinsky and Gottlieb are also alleged to have set up an elaborate scheme in which they inflated invoices for production of sets and then write-off the amounts as expenses. As a result, they are alleged to have received $4.6 million[49]. The SEC claims that these

[49] CBC News, "Former Livent execs face indictments", January 13, 1999. Retrieved on April 21, 2005, from www.cbc.ca/cgi-bin/templates/view/cgi?/news/1999/01/13/livent990113

actions resulted in the overstatement of profits in the 1991 financial statements and the understatement of losses in the 1992 financial statements.

Two former officers Maria Messina, CFO, and Gordon Eckstein, senior VP of finance and administration, pled guilty in the case.[50]

On January 13, 1999, Mr. Drabisnky and Myron Gottlieb, the former president of Livent, were indicted on 16 felony counts of securities law violations. The SEC also filed a civil suit against 9 former officers for their role in alleged accounting fraud that occurred from 1990 to 1998.[51]

Livent was investigated by the U.S. Attorney's office for the Southern District of New York, the SEC, and the Federal Bureau of Investigation ("FBI").[52] Five of Livent's employees were alleged to have participated in illegal insider trading by the SEC.[53] Livent also agreed to a cease and desist order.[54] These investigations are still ongoing.

Livent is estimated to have raised over $500 million from private and public investors from 1989 to 1998.[55] Livent sold off most of their assets in 1999 to a US entertainment company, SFX Entertainment Inc., for $96 million USD.[56]

[50] *Ibid*
[51] CNN Money, "Ex Livent execs indicted", January 13, 1999. Retrieved on May 14, 2005, from http://money.cnn.com/1999/01/13/companies/livent/
[52] *Ibid*
[53] SEC, "1999 Annual Report, Enforcement" page 5. Retrieved on May 21, 2005 from http://www.sec.gov/pdf/annrep99/enforce.pdf
[54] *Ibid*
[55] Norris, Gary, "Curtain rises, silence descends on Livent fraud trial", *Vancouver Sun*, January 11, 2005, Page D5.

5.2.3. Causes

This is one of the largest Canadian accounting scandals in recent memory. It is important for reporting issuers to learn from the breaches of Livent to ensure that such issues do not arise again. The eventual bankruptcy of Livent cost the Canadian economy millions of dollars not just from what the investors lost but also from lost tourism dollars Toronto and Vancouver, where Livent had theatres.

Lack of independent directors on the Livent board is a reason why this situation was allowed to continue undetected. Further, Livent executives were on the audit committee. That is not appropriate as they are not independent and have a conflict of interest in overseeing the audit of their work. By having executives on the audit committee, they may have been able to deflect the investigation away from issues that independent parties would have examined further. Independent directors should be placed on the audit committee to ensure that there are appropriate financial controls in place.

Clearly, the fact that officers and directors can operate a public company with obvious conflicts is unacceptable. Left unchecked, officers and directors can do incredible damage not just to their own company, but also to the capital markets.

5.2.4. Regulator's Response

The OSC, as the principal regulator over Livent, first became aware of the issues surrounding Livent when Livent issued its press release on August 10, 1998, disclosing

[56] *Ibid*

that they had found serious irregularities in the financial records. After the release of the press release, trading in shares of Livent was halted on the TSE and Nasdaq.

On August 13, 1998, Livent applied to the OSC for an extension for the filing of its June 30, 1998 financial statements. On August 28, 1998, the OSC denied Livent's application and immediately ordered a cease trade in Livent securities. The OSC argued that investors did not have enough information to make informed decisions as to trades in the shares of Livent. This cease trade order was extended on September 11, 1998 until Livent filed appropriate information with the OSC. As Livent issued their press release on November 18, 1998, disclosing the results of their findings, the OSC determined that investors would have all the information required to make informed decisions. The OSC then revoked the cease trade order effective noon EST, November 20, 1998.

The OSC then began enforcement action against those individuals that were involved in the Livent problems. On July 3, 2001, a notice of hearing was issued, naming Livent Inc., Garth Drabinsky, Myron Gottlieb, Gordon Eckstein, and Robert Topol as respondents. Mr. Eckstein was the VP, Finance and Administration. Mr. Topol was a director and chief operating officer.

In the statement of allegations, the OSC alleged that the respondents filed misleading or untrue financial statements. They alleged that the respondents acted inappropriately and caused improper recording of financial information, improper revenue recognition, and the payment of false invoices, which resulted in the overstatement of net income, retained

earnings and earnings per share for the periods fiscal 1996 and 1997 and the first quarter of 1998.[57]

With respect to the inappropriate recording of financial information, the OSC alleged that Livent performed the following:[58]

- Modified the accounting system to remove the audit trail of entries to the general ledger
- Did not record or deleted certain expenses from the general ledger
- Deferred the amortization of costs into other accounting periods
- Removed expenses and certain costs from the general ledger and then entered them in later periods
- Removed expenses and re-entered them as fixed assets
- Prepared a separate set of books and records that enabled the respondents to track the actual performance of the company

Livent was alleged to have recognized revenue improperly. The OSC alleged that the respondents entered into side deals, which changed the structure of the transactions from revenue to lending arrangements and therefore resulted in recognizing revenue that was not earned.

[57] OSC, "Statement of Allegations of Staff of the Ontario Securities Commission". Retrieved on May 10, 2005, from http://www.osc.gov.on.ca/Enforcement/Proceedings/2001/soa_20010703_livent.jsp
[58] *Ibid*

The OSC also alleged that the respondents concealed inappropriate payments involving false invoices. Apparently, before Livent was listed, Messrs. Drabinksy, Gottlieb and Eckstein made payments to third parties on the basis of false invoices submitted to the company. These payments were then made back to the respondents.

The OSC alleged that the respondents acted in a manner that was contrary to the public interest and were going to conduct an enforcement hearing. However, as a result of the criminal charges placed against the respondents, the OSC ordered that the hearing is adjourned *sine die,* pending the conclusion of the criminal matter.[59] Once the criminal prosecution is complete, the OSC will revisit the file to see if further action is warranted.

5.2.5. Criminal Case

The RCMP have investigated the actions surrounding Livent and on October 22, 2002, charged four of the former executives with fraud affecting the public market. Pursuant to Section 380(1)(a) of the Criminal Code of Canada, the following individuals were charged with fraud over $5,000:[60]

Name	# of Counts of Fraud over $5,000
Garth Drabinsky	19
Myron Gottlieb	19
Gordon Eckstein	18

[59] OSC, "Order", November 15, 2002. Retrieved on May 10, 2005, from http://www.osc.gov.on.ca/Enforcement/Proceedings/2002/rad_20021115_livent-adj.pdf
[60] RCMP News Release, "RCMP charge former Livent execs with fraud", RCMP, October 22, 2002. Retrieved on April 30, 2005, from http://www.rcmp-grc.gc.ca/on/press/2002/2002_oct_22_e.htm

Robert Topol	13

According to the RCMP, these individuals defrauded investors and creditors of approximately $500 million dollars between 1989 and 1998. If convicted, they could face sentences of up to 10 years and serious fines. The trial is expected to start sometime in 2005. [61]

[61] CBC News, "Fraud inquiry begins for Livent's Drabinsky", January 10, 2005. Retrieved on May 12, 2005, from http://www.cbc.ca/story/canada/national/2005/01/10/drabinsky-preliminary050110.html

6. U.S. Initiatives

On July 30, 2002, the U.S. implemented the Sarbanes-Oxley Act of 2002 ("SOX") as a result of the number of frauds and corporate failures. This comprehensive piece of legislation set out much more stringent requirements for auditors providing an audit opinion. The senior officers of publicly traded companies must now ensure that the financials are not materially misstated and that they have appropriate internal controls to prevent similar scandals from occurring.

There have been several complaints about the SOX legislation. The biggest complaint from reporting issuers is the huge expense that SOX requires companies to incur. Accounting firms and other specialists are required to perform significant testing of the internal controls and these must be reported on quarterly. This has resulted in very large increase to the professional fees that a company incurs in the year, often many times the actual cost of the company's audit fees.

As this is a US Act, all companies listed on US stock exchanges are required to comply with its terms. This has resulted in several large and small Canadian companies having to comply with the requirements to maintain their US listings.

In discussions with some "big four" auditors in Calgary, Alberta, they indicated that some of the work required is so onerous that it does not make sense for a company to maintain their listing in the US. One even told of how a small company, whose audit fee is normally below $100,000, was forced to pay over $1 million in SOX compliance and

attestation work. There have also been questions as to whether this huge expense is really providing the investors with an appropriate level of assurance, given the huge costs associated with it.

Initially, the SEC estimated that the cost of compliance to comply with SOX 404 would be approximately $34,300 USD. However, in a survey by Finance Executives International that was released in February 2005, they revealed that the average cost of compliance with SOX 404 is actually $4.3 million USD. This amount includes 12,000 hours for internal staff and 3,000 hours of external professionals.[62]

The huge cost of SOX and the related requirements has also had another perhaps unexpected affect i.e., there have also been several companies in the US that are considering going private. Companies that are private would not have to comply with this legislation and would not have as much exposure to liability as they do in the public markets. This is likely not in the best interests of the investing public, as private companies, although creating jobs and paying taxes, do not allow the investing public to share in the risks and rewards of the company. When companies go private, the average investor can no longer invest in that company.

The added costs of SOX have also reduced the return on investment on publicly traded companies, due to the much higher accounting and other professional fees which decrease the profit of a company. This increase in cost is hopefully offset by the added

[62] Mavin, Duncan "Slow to speak up on governance", *Financial Post*, May 25, 2005, FP 1 & 3.

investor confidence and increased integrity in the capital markets. Only time will tell whether the requirements of SOX are working or whether they are too onerous to justify given the benefit achieved.

Having a company comply with SOX does not guarantee that a fraud does not exist or could not happen, it just gives investors increased assurance that there are internal controls in place to prevent the kind of scandals that we have seen in the past few years.

Other countries have identified this as a huge opportunity and have been actively soliciting companies to change their listing to European or Canadian stock markets that do not have these onerous requirements.

There have been several papers written on SOX legislation and its impact on IFAs. For further information on SOX, please see "Sarbanes-Oxley Act of 2002 and the Implications for Investigative and Forensic Accountants" by Richard Lederman, June 22, 2003.

For the purpose of this paper, we will be discussing how the Canadian legislation has developed, the requirements, and how IFAs will be affected by it.

7. Canadian Initiatives:

Due to the accounting scandals that had occurred both in the US and in Canada, Canadian market participants identified the need to do something to restore investors' confidence in the market and integrity of our capital markets. To do this, additional legislation needed to be developed.

Although the US and Canada are trading partners, there are fundamental differences that set us apart. Canadian reporting issuers are generally smaller than their US counterparts and cannot afford the large costs associated with complying with SOX's strict requirements. As a result, it would not be appropriate to simply put a Canadian version of SOX into place. The CSA, CICA and others took this into consideration and developed their own version of legislation, covering corporate governance, auditor independence, the independence of boards, and continuous disclosure requirements that should address the investing publics concerns without onerous costs.

Looking to the US as a starting point, they saw that SOX set a very high standard for disclosure and audit requirements for US listed companies.

As a result of some of the issues raised by reporting issuers about the overly taxing requirements of SOX, the CSA has established several pieces of legislation that are intended to restore investor confidence in the Canadian capital markets. This proposed legislation, while quite robust, is not as onerous as SOX. It definitely provides

significantly improved requirements for disclosure, independence and procedures, compared with the previous requirements.

The CSA believes that their version of corporate governance and disclosure legislation will be sufficient to please investors and help restore the lost confidence in the markets. It is also hoped that the new legislation will be manageable by Canada's typically smaller companies. The CSA also hopes that Canada's typically smaller companies can manage the requirements of the new legislation.

There may be another benefit to having a Canadian version of these requirements. Companies that are considering listing for trading on a stock market may look to Canada, with its more reasonable approach to corporate governance and disclosure, rather than the US with its more stringent and costlier SOX requirements. The Canadian legislation will still provide the companies with a higher level of comfort than other countries, but at a lower cost to the organization.

7.1. NI 51-102 *Continuous Disclosure Obligations*

National Instrument 51-102 ("NI 51-102") covers all reporting issuers, except for investment funds, in Canada. NI 51-102 sets out the required disclosure for reporting issuers' financial statements. NI 51-102 states that all reporting issuers must file annual financial statements that include a balance sheet, income statement, statement of retained earnings and a cash flow statement for the most recently completed financial year and the

preceding year, if applicable, for comparison purposes.[63] The annual financial statements must also include notes to the financial statements. Annual financial statements must have an auditor's report filed with them. This requirement ensures that the financial information reported has been audited and therefore the investing public can place more reliance on it than on un-audited financial statements.

NI 51-102 also sets out the timelines that financial statements must be filed. Financial statements must be filed within a reasonable period of time after the period to which they relate so that investors can determine the performance of the company and its management. Timely financial statements provide investors with the information that they require to make investing decisions. Annual financial statements and audit report are due on the 90th day after the end of their fiscal year end.[64] For a venture issuer, they are given 120 days after their fiscal year end. A venture issuer is a reporting issuer that does not have their securities listed or quoted on the TSX or a US or other market. For example, a reporting issuer listed only on the TSX-V is a venture issuer. Venture issuers, due to their smaller size, are allowed a longer time to provide their information, as they have more limited resources and do not typically have as big of a market capitalization. Therefore, a delay in providing the information would not have as large an impact on the integrity of the capital markets as a delay by a large cap company.

[63] CSA, "National Instrument 51-102, *Continuous Disclosure Obligations*", December 19, 2003. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/3146/8521__1389383_v1_-_NI_51-102_-_PUB_DEC_19,_2003.pdf
[64] *Ibid*

NI 51-102 also sets out the requirements for interim financial statements to be filed. Interim financial statements are required so that the investing public can determine how reporting issuers are performing throughout the fiscal year. Interim financial statements require a balance sheet, income statement, statement of retained earnings, and a cash flow statement. These statements must include the appropriate comparative figures to the previous year and year-to-date figures as well as notes to the financial statements. An auditor should review these statements. If an auditor did not review them or the review was not complete, this should be disclosed as well as the reason why the auditor was unable to complete their review. If the auditor has expressed a reservation in the interim review report, a written review report from the auditor must accompany the interim statements. These interim financial statements must be filed 45 days after the interim period for a reporting issuer and 60 days after the interim period for a venture issuer.

An additional measure of reliance is placed on the financial statements, as all members of the board of directors must approve the statements before they are filed with the appropriate regulator. The board of directors may choose to delegate the approval to the audit committee, but they still retain responsibility for the statements.

The purpose of NI 51-102 is to ensure that investors have, on a timely basis, access to relevant financial information regarding the reporting issuer. The board of directors' approval implies that they have read and agree with the disclosed financial position of the company.

NI 51-102 also deals with disclosure requirements of financial statements for issuers becoming a reporting issuer, changes in the financial year end of a company, changes in the corporate structure of a company, reverse takeovers and change of auditors.

A change in the auditor of a company can be a very important event for an investor. If the reporting issuer is changing their auditor due to a disagreement over an accounting treatment or a possible reservation of opinion, the investing public should have the right to know this, as it could affect their investing decisions. Due to the importance that a resignation of an auditor can play in the perceived value of a reporting issuer, NI 51-102 sets out requirements for disclosing this fact. Upon the termination or resignation of an auditor, the reporting issuer must prepare a change of auditor notice to the former auditor and request the former auditor to review the notice and prepare a notice to the appropriate regulator whether it agrees, has no reason to agree or disagree, or disagrees with reasons, as to each item in the change of auditor notice. The former auditor is required to return this letter to the reporting issuer with 20 days after the date of termination.

Within 30 days of the termination or resignation date, the audit committee should review the former auditor's letter and then approve the change of auditor notice. The appropriate documents would then be sent to the appropriate regulators and a copy to the former auditor. This process allows the former auditor to review and confirm or deny any potential issues as to why they are no longer acting for the reporting issuer.

The new auditor must then review and approve the reporting issuer's change of auditor notice and the letter reviewing each of the statements in the change of auditor notice. Within 30 days, the audit committee must review the new auditor's response and submit the reporting package to the appropriate regulators as well as the current and former auditors. This allows the new auditor as well as the former auditor to ensure that all of the reasons for the change in auditor are accurately reflected and disclosed.

The change of auditor notice must contain the date of the termination or resignation, as well as whether the former auditor resigned, was terminated, was removed, or was not reappointed. This notice must also contain whether the termination or resignation of the former auditor and the appointment of the new auditor was approved by the audit committee or by the board of directors. If the former auditor's report contained any reservations, these should be described in detail so that the investing public can ascertain why the termination or resignation occurred. If there were any reportable events, such as a disagreement, a matter was sent to the new auditor for consultation, or an unresolved issue, the details of these matters should be described along with whether the matter was brought up to the audit committee and whether the former auditor can respond to the new auditor's inquiries.

One of the areas of disclosure that has consistently come under criticism for inconsistencies between reporting issuers is the Management Discussion and Analysis (MD&A). All reporting issuers must file MD&A with their annual and interim financial

statements. NI 51-102 attempts to resolve the lack of consistent disclosure by mandating what sort of information must be disclosed in the MD&A.

Among the things that must be disclosed in the MD&A is the outstanding share data, including each class and series of outstanding securities and the impact of convertible securities must be outlined. The board of directors must approve the annual and interim MD&A.

NI 51-102 also deals with material changes to a reporting issuer. If the reporting issuer identifies a material change, they must file a news release immediately, outlining the nature of the material change. The reporting issuer must also follow this up, within at the most 10 days, with a Material Change Report. If the matter is confidential, the reporting issuer can ask the regulator to not release the report to the public. The regulator will only agree if the company is of the opinion that the disclosure of the material change would have an unduly negative impact on the reporting issuer. The reporting issuer will still be required to file the report with the appropriate regulator. The report should be marked confidential and be accompanied by a letter outlining why the information should be disclosed.

Once a confidential material change report has been filed, the reporting issuer must update the regulator in writing every 10 days as to whether the report should still be confidential. If the reporting issuer becomes aware that individuals with access to the material change are actively trading in the securities of the reporting issuer, the material

change must be immediately disclosed to the public. This ensures that the investing public is not at a disadvantage to insiders of the company.

If the reporting issuer is making significant acquisitions, the audited financial statements of the acquired business must be included in the financial statements of the reporting issuer. NI 51-102 also requires the preparation of pro forma financial statements and earnings per share information. This allows the investing public to determine what impact the significant acquisition will have on the reporting issuer.

All information regarding the reporting issuer must be filed via SEDAR. NI 51-102 came into affect on March 30, 2004 and all reporting issuers that have their fiscal years beginning on or after January 1, 2004 must comply with the legislation.

As NI 51-102 is a very comprehensive and important piece of legislation, the CSA has issued a National Policy to accompany the instrument. NP 51-102 ensures that there is guidance available to reporting issuers. The CSA was concerned about the level of disclosure that reporting issuers were making of material non-public information to entities that exclude the investing public. This puts the investing public at a disadvantage, as those entities that have the non-public information could use it for their benefit, and to the detriment of the investing public. If this disclosure is allowed to occur, insider trading may also occur.

For example, the OSC entered into a settlement agreement with Air Canada on July 27, 2001, for selective disclosure. According to the settlement agreement, Air Canada employees provided a revised forecast and earning per share results to 13 analysts who covered the company. This disclosure was not made to the marketplace generally, even though material information could affect the price of the securities.[65] In this case, Air Canada agreed to pay the OSC $500,000, have their auditors ensure compliance with securities laws regarding public disclosure, and pay the OSC's investigation costs of $80,000.[66]

The CSA's NP 51-102 provides guidance on best disclosure practices that issuers can use in complying with the regulations.[67] The CSA acknowledges that some judgment will be needed to determine when a material change has occurred. Material change announcements need to be factual and accurate, regardless of whether they are positive or negative events. The press release that accompanies a material change report should be detailed enough so that the investing public will understand the essence and the importance of the change.

Reporting issuers who believe that their material change is confidential may apply to have it kept confidential. It is up to the reporting issuer to control the confidentiality of the information regarding the change. The company should monitor the trading of its

[65] OSC, "In the Matter of Air Canada, Settlement Agreement", July 27, 2001. Retrieved on June 11, 2005, from http://www.osc.gov.on.ca/Enforcement/Proceedings/2001/set_20010727_aircanada.jsp
[66] *Ibid*
[67] CSA, "National Policy 51-201 *Disclosure Standards*", July 12, 2002. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/1420/1421_1022158_v2_NATIONALPOLICYNP51201JULY12_02.pdf

securities, and if it appears that the confidential information is either being abused by people trying to make a quick profit, or that the information is no longer confidential, they should immediately release a public announcement clarifying the matter.

Securities regulators are trying to maintain a fair and efficient capital market system, whereby information is available to all investors at the same time. People who are insiders of a company obviously need to make sure that they are not trading on material information that is not publicly disclosed, or they will be in violation of securities law. In the past, there have been a number of high profile individuals who have been accused of insider trading e.g. Michael Cowpland, Martha Stewart, etc.

Individuals who are deemed to be in a "special relationship" must also ensure that they are not trading when they are in possession of a material fact that has not been disclosed. Special relationships is actually a defined term in securities legislation and generally means a person who is an insider, affiliate or associate of the reporting issuer, is proposing to make a take-over bid, is proposing to become a party to a reorganization or merger, is proposing to acquire a substantial portion of a company, or the person is engaged in any business or professional activity on behalf of the reporting issuer.[68] This means that any individual who has become aware of a material change or event through their role or relation to an insider or reporting issuer should not trade on the information. There have been several cases in Canada, whereby engineers, geologists, accountants and other professionals who were hired to perform some sort of due diligence or related work,

[68] Per S. 9 of the Alberta Securities Act

were found guilty of insider trading because they traded on material information that had not been generally disclosed.

All investors should therefore be very careful when they are investing in companies with which they have any sort of relationship. They must ensure that if they are investing in a company in which they are possibly in a "special relationship", they must not have access to information that has not been publicly disclosed, or they may be prosecuted under securities legislation.

Due to the increased scrutiny surrounding insider trading and material changes and events, reporting issuers should strongly consider implementing trading policies and procedures to try and minimize the potential for regulator investigations. These policies and procedures should outline items like blackout periods, trading bans, and a general code of conduct that employees, officers and directors are expected to follow. Reporting issuers may also want to include confidentiality agreements in their contracts to ensure that professionals or other individuals do not act on confidential information.

Tipping is a very serious offence and should not be taken lightly by either the reporting issuer, or the insiders of the company. Generally individuals outside of the company should only be tipped of the information when it is required for them to do their jobs. For example, if an engineer is retained to provide some due diligence work on another company that is a potential acquisition, the engineer could be informed about the potential acquisition but should be reminded it is confidential.

Most professional bodies have a code of conduct that strictly states that they cannot use confidential information gained in their duties to personally benefit themselves.[69] As adherence to the code of conduct is usually a requirement to be a member of professional bodies, the failure to comply with it may not only result in action being taken against an individual by the appropriate securities regulator, but also by their professional association. There have been instances in Canada, where professionals have had action taken against them for securities law violations.

Material information must be generally disclosed to the public before individuals who are insiders or in special relationships can actively trade in the securities of the reporting issuers. Information is considered generally disclosed if the matter has been disclosed in a manner that effectively reaches the marketplace and public investors have been given a reasonable period of time to absorb the information. To satisfy the requirement of disclosure, material information can be disclosed through news releases through a major news service, press conferences or conference calls. To be considered generally disclosed, the average investor must be able to access this information.

If a reporting issuer does not make the appropriate disclosure with respect to material events or changes, enforcement proceedings may be initiated. In determining whether there would be any sanctions against the reporting issuer, the regulator would look at

- Why the disclosure was inadequate

[69] For example, S. 4.3.3. of APEGGA's "Guideline for Ethical Practice" per http://www.apegga.org/pdf/Guidelines/02.pdf and S. 208 of the "Rules of Professional Conduct" of the ICAA, per http://www.icaa.ab.ca/pdf/RulesProfessionalConduct.pdf

- Whether the company has established policies and procedures to prevent inappropriate disclosure
- Whether the disclosure was intentional
- If any steps were taken to properly disclose the information once it was discovered that there was selective disclosure.

Reporting issuers must disclose all material facts or changes pursuant to the guidelines in NI 51-102. A fact or change is considered material when it is expected to or actually does significantly affect the market price of the reporting issuer's securities.

The following items would potentially be considered as being material information[70]:

- Changes in corporate structure
    - Changes in ownership
    - Major reorganizations
    - Take-over bids, insider bids, or issuer bids
- Changes in capital structure
    - Sale of additional securities
    - Repurchase of securities
    - Dividend information
- Changes in financial results
    - Significant changes in financial performance or results of the issuer

[70] CSA, "National Policy 51-201, *Disclosure Standards*", July 12, 2002, pages 14-16. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/1420/1421_1022158_v2_NATIONALPOLICYNP51201JULY12_02.pdf

  - Changes in cash-flows or large asset write-downs
- Changes in business and operations
  - Significant changes to the industry in which the issuer operates
  - Labor disruptions
  - Significant changes to the customers or suppliers of the issuer
  - Changes to the officers or directors of the issuer
  - Commencement of material legal action
- Acquisitions and Dispositions
  - Significant changes in assets, property, or companies
- Changes in Credit Arrangements
  - New credit facilities
  - Default of loan covenants

7.1.1. Implications for IFAs

There are a number of implications for IFAs with this legislation, depending on where the IFA is employed. All IFAs that deal with reporting issuers should become familiar with the legislation to ensure that any work that they are doing complies with the legislation.

IFAs could be used by reporting issuers to ensure that all material disclosure is completed in accordance with the legislation. When a material event has occurred, IFAs may be called upon to review the actions of individuals who had access to this information before it went public, in order to ensure that they were not trading on this information. If it is found that individuals did trade on material information that had not been disclosed to the public, the IFA would report this to the audit committee.

IFAs will be able to assist with the review of codes of conduct, ethics policies and internal policies and procedures to ensure that there are no conflicts of interest and no significant areas that are not addressed by the code of conduct. IFAs will therefore be able to assist the reporting issuers in creating an ethical environment in which employees, directors and officers know what appropriate behavior is and what will not be tolerated. Individuals will also know what the potential ramifications of breaking the code of conduct would be. IFAs can also assist reporting issuers in ensuring that these code of conduct are followed, by reviewing suspicious activities and ensuring that these activities do not violate the code.

Regulators will have IFAs on staff, who will be looking at illegal insider trading, tipping, special relationships and market manipulation. The IFAs will be determining whether there was selective disclosure that allowed individuals access to information that had not been publicly disclosed. If there is substance to the allegations, enforcement action may be taken against the offending party.

7.2. NI 52-108 *Auditor Oversight*

The CSA created National Instrument 52-108 ("NI 52-108") to restore the public confidence in the reliability and integrity of the financial statements provided by reporting issuers. This instrument is designed to achieve this objective by promoting the use of independent auditors who can provide high quality audited financial statements without being tied to the reporting issuer.[71]

NI 52-108 requires that all auditors who file audit reports on financial statements for reporting issuers be participants in the Canadian Public Accountability Board ("CPAB"). Auditors must be a part of the CPAB oversight program and be in compliance with the requirements of CPAB. [72]

NI 52-108 requires that all public accounting firms be registered and inspected by CPAB. There are approximately 240 participating firms in Canada. This instrument was implemented in all jurisdictions on March 30, 2004.

7.2.1. CPAB

As a result of the accounting scandals that clearly had a negative impact on the reputation of the accounting profession, in July 2002, securities regulators and Canada's chartered accountants created CPAB, whose main function is to oversee auditors of public

[71] CSA, "Notice of National Instrument 52-108, *Auditor Oversight*", January 16, 2004. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/3131/9196__1406877v1_-_CSA_NOTICE_52-108_-_PUB_JAN_16,_2004.pdf
[72] CSA, "National Instrument 52-108, *Auditor Oversight*", January 16, 2004. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/3131/9197__1407202v1_-_NI_52-108_-_PUB_JAN_16,_2004.pdf

companies and other reporting issuers in Canada. The purpose of this board is to restore the confidence of the investing public in the audited financial statements of reporting issuers in Canada. All auditors of public companies in Canada must be members of CPAB as set out in CSA NI 52-108, which was issued on June 27, 2003.[73]

CPAB or the provincial accounting organizations will conduct inspections of all audit firms that prepare financial statements for reporting issuers to ensure that the audits are of a sufficient standard. CPAB will work in conjunction with the provincial accounting organizations to ensure that their recommendations are being implemented and that if there is a need for disciplinary action, the provincial organization can take the appropriate steps. CPAB will also notify the appropriate securities regulators if they find issues with an audit firm's work.

[73] CPAB, "Background". Retrieved on May 1, 2005, from http://www.cpab-ccrc.ca/dynamic.php?first=412a3e3729b6c&second=412b4cbdad8cc&language=English

7.3. MI 52-109 *Certification of Disclosure in Companies' Annual and Interim Filings*

As a result of the issues facing the integrity of Canada's capital markets, the CSA began working on legislation that would improve the quality of the disclosure provided by reporting issuers, both annually and on an interim basis. This undertaking is intended to provide investors with increased confidence in the integrity of the capital markets. All securities commissions across Canada, with the exception of British Columbia, are introducing this measure.

Under the proposed Multilateral Instrument 52-109 ("MI 52-109") every issuer must file a separate annual certificate stating the following that:[74]

- They have reviewed the annual filings and that based on their knowledge the filings do not contain any untrue statements of material facts.
- The individual signing the document believes that based on their knowledge, the filings present in all material respects the financial condition, results of operations and cash flows of the issuer for the period covered by the financial statements.
- The individual signing the form is responsible for establishing and maintaining disclosure controls and procedures in addition to the internal controls of the issuer.
- These controls were designed and implemented in order to provide reasonable assurances that material information relating to the issuer is disclosed.

[74] CSA, "Multilateral Instrument 52-109, *Certification of Disclosure in Issuer's Annual and Interim* Filings", February 4, 2005. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/3134/12030__1730484_v1_-_PROPOSED_REPEAL_AND_REPLACEMENT_MI_52-109.pdf

- The internal controls were designed to provide reasonable assurances that the financial statements are fairly presented in accordance with GAAP.
- The effectiveness of the company's disclosure controls and procedures and internal controls have also been evaluated.
- The MD&A contains their conclusions on the effectiveness of the controls and procedures.
- The individual has also disclosed if there are any significant deficiencies or material weaknesses in the internal controls of the organization or if any internal fraud has been discovered, regardless of whether or not it is material.
- The individual has also disclosed in the annual MD&A if there were any significant changes in the issuer's internal controls or other factors that could significantly affect the internal controls for the period under review. This would include any actions taken to correct significant deficiencies or material weaknesses in the issuer's internal controls.

These statements must then be signed by each CEO, CFO, or if there is no such person, the person who acts as the CEO and CFO if the issuer does not have one.

An issuer is exempt from complying with this legislation if they are in compliance with section 302(a) of the Sarbanes-Oxley Act and they have filed the appropriate documents on SEDAR.

One of the biggest differences between the Canadian legislation and Sarbanes Oxley is that SOX requires the attestation of internal controls. This is not required in Canada. Venture issuers, which are considered those issuers not listed on TSX, NYSE, American Stock Exchange, NASDAQ, or the Pacific Exchange must comply with MI 52-109 but investment funds are exempt.

The required form for the annual certificates will depend on the market capitalization of the issuer. Larger issuers, with market capitalizations of $250-500 million will need to file their annual certificates for year-ends after June 30, 2007. Issuers with market capitalizations of $75-250 million will need to file for year-ends after June 30, 2008. If the market capitalization is less than $75 million then the implementation is June 30, 2009. Issuers can choose to begin filing their certificates early, if they so desire.

Annual certificates must be filed by the issuer in accordance with the appropriate securities legislation. The annual certificate is due the later of the AIF due date, if it is required to file an AIF pursuant to NI 51-102 or the filing date of its annual financial statements and MD&A letter.

Unlike SOX, under MI 52-109, interim certificates will not require the certification of the CEO and CFO. The CSA has decided that the cost of providing this interim certification outweighs the incremental benefit of an interim certificate. The CEO and CFO must certify the annual certificates and the controls will need to be maintained throughout the year. The CSA has determined that having the CEO and CFO perform an informal

evaluation of the internal controls on an interim basis can still protect investors. These informal filings are due with the regular interim filings.

7.3.1. Implications for IFAs:

IFAs will be able to assist the reporting issuers in compiling their reports on the internal controls, reviewing and evaluating existing internal controls and procedures and providing suggestions as to new more effective internal controls that would reduce any significant or material weaknesses in the organizations internal control framework. IFAs can use their risk assessment and fraud detection skills to identify any potential weaknesses in the internal control structure that the reporting issuer has developed.

IFAs will be able to perform a detailed review of any internal controls that the CEO and CFO must certify. By using the IFAs skills and knowledge, the CEO and CFO will be able to gain additional assurance that the internal controls are free from material misstatement. If the IFAs find any areas that can be improved, the CEO and CFO can then document this in their MD&A that needs to accompany the reporting issuer's filings. IFAs will be able to review the internal control framework to determine if the controls were designed and implemented so that the disclosure standards of MI 52-109 are met.

IFA's can use their skills in auditing, risk assessment and fraud detection in evaluating the effectiveness of the internal controls. If an internal fraud is found, the IFA can investigate the extent of the fraud and whether sufficient controls have been put in place to ensure that the fraud does not continue.

7.4. MI 52-110 *Audit Committees*

The CSA created Multilateral Instrument 52-110 ("MI 52-110") as a result of SOX. The CSA felt that as the US and Canadian markets are so closely tied together, that Canadian markets are not immune to the perceived decrease in investor confidence in the US. This instrument is therefore based on the SOX, SEC, NYSE and NASDAQ requirements for audit committees.[75]

As a result of the US and Canadian accounting scandals, it became clear that there could be a potential conflict when management is overseeing the audit of their company. While the US requirement under SOX is very strict in terms of the audit committee requirements, 52-110 had to be drafted to take into account Canada's corporate law and the fact that there are many more junior issuers. As SOX requirements are very stringent, US listed companies who comply with SOX, are exempted from MI 52-110.[76]

MI 52-110's goal is to make audit committees more effective in their role of providing oversight of the company's external auditor. A strong and independent audit committee should remove any potential conflicts of interest and restore investor confidence in the financial statements of Canadian reporting issuers. To that end, MI 52-110 requires all reporting issuers to establish an audit committee to whom the external auditor must report. The audit committee will also be responsible for overseeing the work of the

[75] CSA, "Notice of Multilateral Instrument 52-110, *Audit Committees*", January 16, 2004. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/3140/9205__1405914v2_-_CSA_NOTICE_52-110_-_PUB_JAN_16,_2004.pdf

[76] CSA, "Multilateral Instrument 52-110, *Audit Committees*", January 16, 2004. Retrieved on May 5, 2005, from http://www.albertasecurities.com/dms/1144/3140/9206__1400058_v1_-_MI_52-110_-_PUB_JAN_16,_2004.pdf

external auditor, pre-approving non-audit services that the audit firm may provide to the reporting issuer, and reviewing all financial disclosure of the reporting issuer before it is disclosed to the public.

The audit committees will be responsible for recommending the external auditor to the board of directors as well as obtaining approval for the audit fees.

MI 52-110 sets out the basic requirements for the formation of an audit committee. Audit committees must be comprised of at least three financially literate and independent members. The perception of independence is a key factor in maintaining the integrity of the capital markets, and in this case, a member is considered independent if they have no direct or indirect relationship with the issuer.

MI 52-110 ensures that the audit committee is independent by requiring that members must be able to retain and pay independent counsel or other advisers to assist them in carrying out their. The instrument also requires that both the external and internal auditors are allowed to discuss issues with the audit committee.[77]

Venture issuers are exempt from certain aspects of the instrument, in that their members of the audit committee do not have to be independent or financially literate. In order to compensate for a potential lack of independence or financial knowledge, venture issuers

[77] *Ibid*

must disclose this fact through Form 52-110F2 with its management information circular, AIF, or annual MD&A.[78]

MI 52-110 came into force for all jurisdictions except for British Columbia and Quebec on March 30, 2004. Quebec will soon be adopting the legislation. All reporting issuers in the remaining jurisdictions must comply with the instrument beginning at either the issuer's first annual meeting after July 1, 2004 or July 1, 2005, whichever comes first. The participating issuers will be conducting compliance reviews to ensure compliance with the instrument.

7.4.1. Implications for IFAs:

Pursuant to MI 52-110, the audit committee must pre-approve all non-audit services to be provided to the issuer by the external auditor.[79] Therefore, in order for IFAs to provide services to companies that are audited by the same firm, the audit committee must pre-approve the non-audit work.

As the audit committee must be comprised of financially literate individuals, IFAs may be sought out to be members, due to their unique skill set. IFAs who are asked to sit on the audit committee would obviously not be allowed to perform any services for the reporting issuer due to conflict of interest concerns, but they would bring unique perspectives to reviewing and questioning the financial statements.

[78] *Ibid*
[79] CSA, "MI 52-110 *Audit Committee*" Section 2.3(4). Retrieved on May 12, 2005, from http://www.albertasecurities.com/dms/1144/3140/9206__1400058_v1_-_MI_52-110_-_PUB_JAN_16,_2004.pdf

7.5. MI 52-111 *Reporting on Internals Control Over Financial Reporting*

The CSA has also proposed Multilateral Instrument 52-111, *Reporting on Internal Controls Over Financial Reporting* ("MI 52-111"). The purpose of this instrument is to improve the quality of the continuous disclosure reporting ("CDR") that issuers currently provide. The CSA believes that increasing the quality of the disclosure in the CDR process will increase investor confidence in the integrity of the capital markets. [80]

The purpose of the CDR process is to ensure that investors have access to financial and other information that is current, reliable and not materially misstated. The CSA has also proposed other instruments to increase the quality of the information being provided to investors. These proposed documents include CDR rules that ensure that MD&A is sufficient and covers minimum areas (NI 51-102), audit committees are independent and financially literate (MI 52-110) and that issuers disclose their corporate governance practices (NI 58-101 and 58-201). Investment funds and venture issuers are exempt from MI 52-111.

The proposed instrument deals with requirements that are similar to those under SOX 404 Rules. The proposed instrument will require issuers to evaluate the effectiveness of existing internal controls over financial reporting against a suitable control framework, maintain reasonable support for the evaluation of the effectiveness of internal controls,

[80] CSA, "Notice and request for comment of proposed MI 52-111 Reporting on Internal Control over Financial Reporting", February 24, 2005. Retrieved on May 12, 2005, from http://www.albertasecurities.com/dms/1144/12032/12033__1730458_v1_-_CSA_NOTICE_-_PROPOSED_MI_52-111_&_PROPOSED_REPEAL_AND_REPLACEMENT_OF_MI_52-109.pdf

reporting of all material weaknesses regarding the internal controls that oversee financial reporting, and the auditing of the internal controls that oversee financial reporting.[81]

The proposed internal control instrument requires the management of issuers to evaluate the effectiveness of their financial reporting internal controls. This will be required for the annual financial statement filings. This evaluation by management must be specific enough that it deals with the internal controls surrounding the financial reporting of any subsidiaries, variable interest entities, joint ventures, equity investments, portfolio investment, or an interest in a business that was recently acquired.

The proposed instrument states that the internal control evaluation must be done by comparison to a suitable control framework. It will be up to management to determine what the appropriate control framework for the company is. The proposed instrument also requires issuers to maintain sufficient evidence supporting management's assertions that the internal control framework overseeing the financial reporting is effective.

Each issuer is required to determine the type and amount of evidence to be maintained as it may vary depending on the complexity of the organization, the nature of the business and the company's size. The information must be accessible, so some thought must be given to the method in which the evidence will be stored, so that it can be retrieved in a timely fashion. This information must be maintained for the same period that the

[81] CSA, "Proposed MI 52-111 Reporting on Internal Control over Financial Reporting", February 4, 2005. Retrieved on May 12, 2005, from http://www.albertasecurities.com/dms/1144/12032/12034__1730475_v1_-_PROPOSED_MI_52-111_-_Reporting_on_Internal_C..pdf

financial records must be maintained as per the *Income Tax Act (Canada)* (for 7 years) so a document storage and retention system will be required.

The proposed legislation has provided a sample internal control report that includes such things as[82]:

- Management of the reporting issuer stating their responsibility for establishing and maintaining adequate internal controls over the financial reporting
- Identification of the internal control framework that management has implemented to evaluate the effectiveness of the internal controls over the financial reporting
- Management assessing the effectiveness of the internal controls over the annual financial statements, including whether the internal controls were effective
- Management would disclose any material weaknesses identified in the internal controls over financial reporting
- The auditors that audited the financial statements have also issue an internal control audit report
- The identification of any limitations in determining the effectiveness of internal controls that deal with the financial reporting in which the issuer has a material interest in a joint venture or a variable interest entity

[82] CSA, "Proposed MI 52-111 Reporting on Internal Control over Financial Reporting", February 4, 2005. Retrieved on May 12, 2005, from http://www.albertasecurities.com/dms/1144/12032/12034__1730475_v1_-_PROPOSED_MI_52-111_-_Reporting_on_Internal_C..pdf

- The identification of any limitations in determining the effectiveness of internal controls that deal with the financial reporting relating to a recently acquired business.

The board of directors must then approve this information before it is filed by the company.

The proposed legislation also requires an auditor's opinion as to management's assessment of the effectiveness of the issuer's internal control framework.

This internal control audit report would be prepared in accordance with the CICA standards, be dated the same date as the auditor's report that accompanied the financial statements, be signed by the auditor and identify the internal control report that the audit report relates to.

There has been considerable debate recently regarding the cost of implementing SOX 404 in the United States. Canadian corporations have been watching the developments in the U.S. with interest, as MI 52-111 closely resembles SOX 404. Although Canadian companies have indicated that they are willing to comply with better regulations, there is a concern that the costs of the current legislation will be too high. On May 12, 2005, the ICAO and Ontario Chamber of Commerce met with accounting firms and reporting issuers to discuss the proposed CSA legislation.[83]

[83] Mavin, Duncan. "Companies assail CSA proposal on governance: Akin to Sarbanes Oxley", *Financial Post*, page FP4, June 3, 2005.

As a result of this meeting, a letter was sent to the OSC saying, "… participants were virtually unanimous that the costs of implementing the new rules and auditing standards would outweigh the benefits."[84]

As a result, the CSA has extended the comment period on this new instrument from June 6, 2005 to June 30, 2005 to allow individuals time to consider new guidance from the SEC and Public Company Accounting Oversight Board, released on May 16, 2005.[85]

7.5.1. Implications for IFAs:

An IFA would be able to assist management in the creation and evaluation of an effective internal control framework, as they would be able to identify potential strengths and weaknesses from a fraud perspective. IFAs may be needed to assist the auditors in reviewing the internal controls systems, as they could assist in identifying control weaknesses, red flags and other areas that would need attention. IFAs would also be able to assist the reporting issuer in documenting the internal control framework that exists currently, as well as suggesting improvements. In order to test the efficiency of the internal controls, the IFA could assist either the auditors or the internal auditors in testing the effectiveness of the controls. The IFA should be able to provide enough support so that the executives feel comfortable on signing off on the internal controls or designing new ones to address any inadequacies.

[84] *Ibid*
[85] Langton, James, "CSA extends comment period for internal control and certification rule." *Investment Executive*, June 3, 2005.

The proposed instrument stipulates that the documents must be retained and accessible. As IFAs have considerable experience and training in dealing with the storage and retention of evidence, they will be able to assist issuers in developing their retention system. An IFA will be able to assist the issuer in identifying what documents should be maintained and what would be the best way of storing them. An IFA would be able to assist the companies in the retrieval and maintenance of evidence, using their expertise in the data management. This would ensure that the issuer would be able to retrieve any required documents in a timely fashion.

7.6. NI 58-201 *Disclosure of Corporate Governance Practices* & NP 58-201 *Corporate Governance Guidelines*

The CSA has also proposed National Instrument 58-201 ("NI 58-201") and its associated policy, National Policy 58-201 ("NP 58-201") to address the issues surrounding how companies should establish effective corporate governance practices and how this should be disclosed to the investing public. This instrument is in response to the US's implementation of SOX.

NI 58-201 establishes the requirements for reporting issuers to disclose their corporate governance practices that they have implemented. NI 58-201 differs from the SOX legislation in that, as we have smaller venture issuers, they will most likely not have procedures set out in as formal a manner and therefore they will not be required to file the same level of disclosure. The instrument is accompanied by two forms for disclosure, one for venture issuers (Form 58-101F2) and one for regular reporting issuers with their increased requirements (Form 58-101F1).

NI 58-201 requires that all reporting issuers must file any written codes of conduct or ethics via SEDAR so that the investing public can review the corporate governance procedures in place.

The forms for a normal reporting issuer require the disclosure of the identity of the directors, as well as stating whether they are independent. This requirement includes whether the board has a majority of independent directors and whether the directors sit on

any other reporting issuer. The written mandate of the board must be disclosed. If there is no written mandate on how the board separates their duties, this must be disclosed.

NP 58-201 was developed to assist reporting issuers in developing appropriate corporate governance practices. As with the instrument, this policy applies to reporting issuers, except for investment funds. NP 58-201 will allow reporting issuers to develop a full and comprehensive set of practices that will ensure that their corporate governance practices allow investors to rely on their financial statements. This will provide support to the integrity of the capital markets.

NP 58-201 sets out several guidelines for reporting issuers to consider, including the following[86]:

- Maintaining a majority of independent directors on the board of directors. Having mostly independent directors will be perceived as providing fewer opportunities for conflicts of interest to arise.
- Appointing a chair of the board who is an independent director. As the chair of the board is integral to the success of a board, having this person independent will give investors greater confidence in the board's objectivity.
- Holding regularly scheduled meetings of independent directors, without non-independent directors or management in attendance. This will allow the independent directors to discuss potentially sensitive matters that the related parties or management may try to influence.

[86] CSA, "Notice of National Policy 58-201 Corporate Governance Guidelines", April 15, 2005. Retrieved on May 12, 2005, from http://www.albertasecurities.com/dms/1144/9211/12375__1805595_v1_-_CSA_NOTICE_OF_NATIONAL_POLICY_58-201_AND_NI_..pdf

- Adopting a written board mandate. By outlining the guiding principles of the board, shareholders will be able to determine how effectively the board members are doing their jobs.
- Developing position descriptions for the chair of the board, the chair of each board committee, and the chief executive officer. Again, this will allow these individuals to be evaluated by comparison to their position descriptions. This will allow shareholders to determine how effectively their directors and officers are performing.
- Providing each new director with a comprehensive orientation, and providing all directors with continuing education opportunities. For the directors to be effective, they must understand the business that the reporting issuer is in. Further education will also allow the board members to be more effective in their roles.
- Adopting a written code of business conduct and ethics so that directors, officers and employees will know what acceptable behavior is and what is expected of them.
- Appointing a nominating committee composed entirely of independent directors. This will allow independence in the nomination process and remove suggestions of conflicts of interests.
- Identifying the skills and competencies that the board should have so that new directors can be recruited with the appropriate skills. This will ensure that the board has a broad base of knowledge from which to draw expertise.

- Appointing only independent directors to the compensation committee. This will remove any potential conflict of interest and ensure that employees and officers are compensated fairly.
- Conducting regular assessments of the board effectiveness, including the effectiveness and contribution of each board committee and each director. By reviewing the performance of the board members and the committees on which they serve, the board will be able to determine if they have the appropriate individuals in the correct roles. This will allow the board to determine if additional directors are required and whether committees are effective.

NI 58-201 is effective June 30, 2005 and will apply to all information circulars and annual information forms which are required to be filed for financial years ending on or after this date.

7.6.1. Implications for IFAs:

IFAs will be able to assist reporting issuers in the creation of the disclosure documents. The IFAs will be able to review the code of conduct and ensure that it covers off all of the main issues that are facing the company. Using their knowledge of fraud and accounting systems, the IFA will be able to determine if there are any significant issues of concern in the corporate governance practices of the company. The IFA may also review the backgrounds of the directors and officers to determine if there are any conflicts of interest or independence problems that must be disclosed.

An IFA could assist the issuer in discharging its duty to assess the integrity of the CEO and other executive officers. An IFA could assist in the identification of risks to the issuer and ways to minimize the issuer's business risk. An IFA can assist in the analysis and response to any issues encountered during the preparation of the report.

8. CICA Initiatives

The Canadian Institute of Chartered Accountants ("CICA") sets Canadian accounting standards through the Auditing and Assurance Standards Board ("AASB"). As a result of the issues that have faced companies in Canada, the CICA has revised some of its rules to ensure that investors maintain their confidence in audited financial statements and, in effect, the capital markets. The CICA has reviewed the existing legislation and using the knowledge gained from the scandals, they have implemented new provisions to prevent more reliable financial statements.

In October 2002, the CICA created the Auditing and Assurance Standards Oversight Council ("AASOC") as an independent body to oversee the activities of the AASB.[87] The AASOC consists of business leaders and regulators and aims to bring a broad base of knowledge to ensure that complex accounting issues are appropriately recorded and disclosed. The AASOC is comprised of at least nine and no more than twelve members, of which the majority of members are not Chartered Accountants.[88]

The responsibilities of AASOC will include:[89]

- Providing input into the activities of the AASB, primarily in terms of its strategic direction and priorities;

[87] CICA, "Auditing and Assurance – Oversight. About AASOC". Retrieved on May 12, 2005, from http://www.cica.ca/index.cfm/ci_id/205/la_id/1.htm
[88] *Ibid*
[89] *Ibid*

- Informing the AASB of the diversity of views represented on the AASOC as well as the views of other individuals or groups with an interest in audit and assurance standards;
- Being satisfied that the standard setting process is appropriate and responsive to the public interest;
- Overseeing the activities of the AASB, including monitoring and evaluating its performance, the fulfillment of its responsibilities, accomplishment of its work program and the use and adequacy of its resources.

9. Auditor Independence

As a result of the issues surrounding auditor independence, the CICA began drafting a new auditor independence standard in 2001. This standard was sent out for comments and was publicly released on October 8, 2003.[90] This standard was created to provide guidance to all auditors in every assurance engagement. The standard requires auditors to remove or reduce independence threats to a reasonable level. If possible, safeguards should be put in place to reduce the threat of an engagement to an acceptable level. If this cannot be done, the auditor must not accept the engagement.

If a threat has been identified as being significant, it shall be documented along with the decision to continue or reject the engagement. The documentation should contain the nature of the engagement, the nature of the threat, the safeguards identified, and an explanation as to how the safeguards eliminate or reduce the threat to an acceptable level.[91]

This standard applies to all audit and assurance engagements and will be effective on all engagements starting after December 31, 2003.

9.1. Implication for IFAs

[90] CICA, "The New Auditor Independence Standard". Retrieved on May 12, 2005, from http://www.cica.ca/index.cfm?la_id=1&ci_id=7755&highlight_keywords=independence
[91] CICA, "Rules of Professional Conduct". Pages 1, 17, 18, 20-28. Retrieved on May 12, 2005, from http://www.cica.ca/multimedia/Download_Library/Public_Affairs/CICAPublicAffairs/Rules_ProfConduct.pdf

The auditor independence standard will allow an auditing firm, who is engaged by an audit committee, to investigate potential accounting impropriety provided that the matter comes up and the audit committee has pre-approved the engagement.[92] Therefore, audit firms will be able to have their forensic accounting practices assist them in reviewing instances of impropriety.

The standard sets out a series of threats to independence that IFAs would need to be aware of. These threats are self-interest, self-review, advocacy, familiarity and intimidation.[93]

A self-review threat occurs when professionals provide assurance on their own work. Therefore, a self-review threat may occur if an IFA is brought in to perform an investigation into the handling of their audit group's work.

An advocacy threat could exist if the professional firm has provided an expert opinion or other expert service for the entity, for the purpose of advocating the entity's interest in a criminal, civil, regulatory, administrative or legislative proceeding or investigation, during the period covered by the audit or the engagement period.[94]

In both of these instances, the professional must determine whether there are sufficient safeguards in place to ensure that the threats have been reduced to an acceptable level. If

[92] CICA, "Rules of Professional Conduct". Page 20, per S. 204.4 (21)
[93] CICA, "Rules of Professional Conduct". Page 24, per S. 204.4 (39)
[94] CICA, "Rules of Professional Conduct". Page 22, per S. 204.4 (29)

this is the case, this should be documented. If the threat cannot be reduced to an acceptable level, the engagement should be refused.

10. Conclusion

Due to the events of the past few years, investors' confidence has been shaken and needs to be rebuilt if the Canadian capital markets are going to grow and prosper. The various players in the capital markets need to ensure that they are doing everything that they can to restore this lost confidence.

With the recent introduction of new securities legislation, the CSA hopes that investor confidence will be restored and that the capital markets will recover and continue to grow. To do this, reporting issuers must ensure that they have effective corporate governance, appropriate and fair disclosure, and strong systems of internal controls to reduce the likelihood of fraud and accounting problems. The new and proposed legislation will require significantly more work from the reporting issuers and auditors, but will provide the desired result, i.e., the return of integrity and investor confidence to the capital markets.

Throughout this paper, opportunities for IFAs have been identified. With the SOX legislation in the US and the resulting Canadian legislation, demand for IFAs will continue for the foreseeable future. With law enforcement taking a harsher stance on white-collar crime, more IFAs will be needed to investigate increasingly complex financial crimes. In Canada, this will mean that more chartered accountants will need to commit themselves to specializing in this area. Through education, experience and knowledge, IFAs will be able assist the various players in the capital markets in enforcing and maintaining the integrity of the capital markets in Canada.

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Appendix 1: IFAs in Securities Matters

Provincial securities commissions have confidentiality requirements under their respective securities act which restricts them from disclosing the existence of an investigation unless it is deemed to be in the public interest, a notice of hearing has been issued, or a settlement agreement has been reached. They generally do not comment on who is conducting the investigation.

As most hearings by securities commissions are public, the media is allowed to attend. The media often mentions the name of the investigator on the files as well as relevant information regarding their position at the securities commission.

IFAs would most likely be used in cases that require investigation into financial matters, such as insider trading, misstated financial statements and tracking funds from illegal distributions. The following is a list of hearings in which the media has identified IFAs as being involved in the file:

- The ASC used an investigative accountant to investigate the accounting practices of Proprietary Industries Inc., which was found to have materially misstated its financial statements.[95]
- The OSC extended a temporary cease trade order against Andrew Keith Lech, based on evidence provided by one of their forensic accountants.[96] Mr. Lech is alleged to have defrauded Canadian investors of over $25 million.[97]

[95] Lang, Michelle, "'Unusual' gains sparked inquiry: Proprietary reports 'unduly optimistic': ASC", *Calgary Herald*, December 24, 2003, page C11.

- The OSC is using a forensic accountant in the investigation of Andrew Rankin,[98] who is accused of tipping off an acquaintance who then participated in illegal insider trading.
- The OSC is using a forensic accountant in the investigation of K. Y. Ho, chairman of ATI Technologies Inc[99], who is accused of donating securities of ATI before negative financial results were made public and the stock price declined.
- The OSC used a forensic accountant in the case against Saxton Investments Ltd., who sold $37 million of illegal shares.[100]

If a company identifies that there are issues with their company's financial statements, they may engage IFAs to perform an investigation into their affairs[101]. The securities commissions may require that the IFAs' findings be provided to the commission.[102] Whether the forensic work is handed over depends on any privilege that may be attached to the report.

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[96] OSC, "News Release 2003 – OSC Issues Reasons in the Matter of Andrew Keith Lech", June 2, 2003. Retrieved on June 12, 2005, from http://www.osc.gov.on.ca/About/NewsReleases/2003/nr_20030602_osc-lech-reasons.jsp

[97] *Ibid*

[98] Kari, Shannon, "Paper trail enough to convict, says OSC: Rankin charged with tipping, insider trading", *National Post*, May 3, 2005, FP1.

[99] Paddon, David, "E-mail at centre of legal squabble in ATI case: Letters are 'hearsay', lawyers argue", *The Ottawa Citizen*, April 14, 2005, page D3.

[100] Arnold, Steve, "Saxton men suspended for sales scam; Licences revoked for up to 12 years", *The Hamilton Spectator*, October 1, 2002, Page C1.

[101] ASC, "In the Matter of the *Securities Act* and Douglas Brian Wenzel, Wenzel Downhole Tools Ltd., and 376348 Alberta Ltd., Section 33 Interim Cease Trade Order - Extension", April 2, 2004, page 2. Retrieved on June 12, 2005, from http://www.albertasecurities.com/dms/1404/8895/10687_Wenzel,_Douglas_Brian_-_Interim_CTO_Extension_-_2004-04-02_-__1467374v1.pdf

[102] OSC, "OSC Places Terms and Conditions on Phoenix Research Trading Corporation, Press Release", January 11, 2000. Retrieved on June 12, 2005, from http://www.osc.gov.on.ca/About/NewsReleases/2000/nr_20000111_phoenixresearch.jsp

As the securities commissions continue to review the recent accounting and financial issues, IFAs will be involved with more investigations. The IMETs teams may also be providing some publicity for IFAs when they begin laying charges with respect to some of their investigations.

Appendix 2: IFA Skills and Attributes

Investigative and forensic accountants ("IFAs") are accountants who have developed specialized skills in investigation techniques. Typically, IFAs have developed their skills through experience and education in different areas of investigation and may have been qualified as an expert witness in court proceedings.

IFAs typically have strong accounting knowledge and auditing skills, which are complemented by an investigative mindset, which allows the IFA to understand how the criminal mind operates. IFAs are often used to analyze financial information in criminal investigations, fraud, loss quantifications, and litigation support. IFAs have been involved in internal control reviews for SOX reporting and using their knowledge of risk assessment and identifying areas susceptible to fraud, have assisted organizations in creating more efficient internal control frameworks.

Given the nature of the work that IFAs perform, desirable qualities include:

- Strong accounting, auditing and tax knowledge in order to understand the full impact of the event being investigated.
- An investigative mindset to drive the IFA to understand how the event occurred and how evidence supporting the event can be preserved. IFAs should be skeptical of claims and verify crucial items independently if possible.

- Ability to breakdown a complex business transaction to understand the true nature of the transaction and the implications for parties involved.[103]
- Excellent communication skills, both written and verbal. IFAs have to deal with varied levels of staff in their engagements and may have to testify in court.
- Ability to evaluate complex and potentially disorganized financial and accounting information systems. [104]
- Interviewing skills are paramount, as a great deal of information will be gleamed from individuals who are interviewed. IFAs must be able to successfully obtain truthful testimony from suspects or at least be able to identify when it is not truthful.
- Basic legal knowledge as files may be done in contemplation of litigation or result in criminal charges being laid. It is important that the IFA understands the legal framework in which they operate.
- Strong computer skills are required in order to process the vast amount of data collected.
- Document management skills need to be developed to ensure that the continuity of evidence is maintained. This is especially important for investigations that may result in criminal charges.

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[103] RSM, "IFA Body of Knowledge". Retrieved on June 7, 2005, from http://www.rotman.utoronto.ca/difa/DIFA-Specialization.htm#Nature
[104] *Ibid*