Restoring Investor Confidence: Background on Recent Developments in Canada

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Business failures caused by inadequate corporate governance and deficiencies in corporate financial reporting are by no means new. However, recent high-profile cases in the United States such as Enron, Worldcom, and others, as well as many lesser cases worldwide, have focused attention on this area. Particularly troubling are indications that the interests of corporate management were, in a number of cases, profoundly misaligned with those of shareholders. This arguably contributed to sharp losses in equity markets and to a more generalized loss of confidence in capital markets globally.

Financial statements have historically been an essential means of providing information to investors. Doubts about the validity of these statements can undermine investor confidence and lead to a higher cost of capital, which reduces the economy's productivity.

As a recent task force committee sponsored by the International Federation of Accountants (IFAC), and chaired by former Bank of Canada Governor John Crow, reported, “Almost all the high-profile failures are the result of failures in business, failures in governance, and failures in reporting. The business issue that should be communicated to users of the financial statements is not properly disclosed, governance structures fail to prevent or detect this, and a reporting failure results. As an entity moves closer to business failure, the incentive to distort reporting increases and, therefore, the chance of reporting failure increases” (IFAC 2003, 5).

It has been noted that during the period of overheated equity markets in the late 1990s, pressures to push share prices ever higher often took precedence over proper governance and disclosure practices. Executive compensation increasingly based on the granting of stock options added to these pressures. This environment created the conditions for the high-profile corporate frauds.

These extreme cases generated tremendous pressures for reform in the United States, which culminated in the passage of the landmark Sarbanes-Oxley Act (July 2002). Among the most far-reaching legislative reforms to affect the U.S. corporate sector, it sets extensive new standards—from governance and accounting practices to reporting deadlines, ethics codes, and penalties for altering corporate documents.

Given Canada's relatively small markets and high degree of integration with U.S. capital markets, Canadian authorities have endeavoured to react in a way that acknowledges U.S. developments while accommodating the unique features of our corporate sector and financial markets—in essence, arriving at a “made in Canada” solution. Complicating this process has been the fact that U.S. regulation has traditionally emphasized the application of detailed rules, whereas in Canada the emphasis has been on the development of overarching principles to which practices should broadly conform.

Recent reform efforts in Canada have involved the co-operation of the federal and provincial governments, regulators, and the private sector. The Department of Finance (2003) has broadly categorized the Canadian reforms to date as

- strengthening corporate governance and ensuring management accountability,
- improving financial reporting and disclosure,
- enhancing the credibility of the audit process, and
- strengthening enforcement.

The proposed changes are aimed at building confidence while keeping compliance costs manageable. In this article, some issues in each category are highlighted.

Strengthening Corporate Governance and Ensuring Management Accountability

Corporate governance can be broadly thought of as the way in which directors and managers handle their responsibilities towards shareholders.

Concerns about governance come to the fore only when there is a separation of ownership from control, which happens exclusively in the corporate form of business organization.[1] This separation can give rise to what is referred to as the "agency problem," that is, the risk that the managers (the agents) of the firm will make decisions in their own interests rather than in the interests of the shareholders (the principals). In the extreme, such behaviour, if unchecked, can threaten the viability of the firm. To mitigate this problem, shareholders elect directors to the board who, in turn, appoint managers and hold them accountable.

Who sets corporate governance standards in Canada?

In Canada, rules and guidelines related to governance originate from a number of sources. Federally incorporated companies are subject to provisions in the Canada Business Corporations Act (CBCA), and provincial companies are subject to the various provincial business corporation acts. In addition, public corporations are subject to provincial securities laws and stock exchange requirements, if applicable.

Regulated financial institutions may be subject to additional standards. For example, in January 2003, the Office of the Superintendent of Financial Institutions (OSFI) released a new guideline with respect to corporate governance for federal financial institutions. It should also be noted that in 2001, the Canada Deposit Insurance Corporation (CDIC) updated and modernized its *Standards of Sound Business and Financial Practices.*[2]

Over the last decade, there have been several prominent public reviews of the quality of governance in publicly held corporations in Canada. These have generally provided assessments and suggestions for improvement.[3] Most recently, the Senate Standing Committee on Banking, Trade and Commerce released a report (2003) that addresses the various dimensions of the recent crisis of confidence in financial markets (of which corporate governance is one aspect) and makes wide-ranging recommendations. Much useful work was done through this period although, for the most part, proposed reforms have remained voluntary for public corporations.

The thrust of recent board reform

In the aftermath of the recent high-profile corporate scandals, the need for reform in corporate governance has taken on much greater urgency. Not surprisingly, given the number of apparent board failures, considerable focus has been on reforming boards and making them more accountable and more independent.

In the United States, proposed measures introduced by the major stock exchanges (expected to receive final approval from the Securities Exchange Commission for a phased introduction) will lead to a requirement that boards be composed of a majority of independent directors. In addition, board committees that are generally considered to be the most important—audit, compensation, and nominating—are to consist exclusively of independent directors and to be subject to additional rules.[4] Under the proposals, independence is defined strictly and

1. The other major business categories are single proprietorships and partnerships, where there is no distinction between ownership and control.
2. These Standards for CDIC members (which include all federally regulated institutions that take retail deposits) are a codification of practices at the best-run deposit-taking institutions.
3. For example, in 1994, the Toronto Stock Exchange created a committee under Peter Dey (a former head of the Ontario Securities Commission), which made 14 recommendations for best practices, focusing on the board of directors and its relationship with shareholders and management. In 1998, the Senate Standing Committee on Banking, Trade and Commerce produced a report (The Kirby Report) that focused on the governance practices of institutional investors. In 2000, the Joint Committee on Corporate Governance, chaired by Guylaine Saucier, was created. Its final report proposed modifications to the Dey recommendations in light of trends in globalization.
4. For example, for audit committees there would be new rules related to the financial expertise of committee members and how frequently committees must meet.

excludes all those individuals with a material financial relationship to the company, as well as family members and former employees. In terms of prior relationships, an extended "cooling-off period" (likely to be five years) has been established as a condition for achieving independent status.

In Canada, the process of board reform has intensified. Of course, many of Canada's largest corporations are interlisted in the United States and will have to comply with many of the new U.S. standards if they wish to have continued access to U.S. capital markets. Meanwhile, after more than a year of debate and review, many Canadian companies have been carrying out internal reforms in areas such as committee composition, board practices, and compensation policies (McFarland 2003). *The Globe and Mail* recently surveyed 207 of the largest public companies in Canada, assigning scores for a range of factors related to good governance. It found that over the year, scores improved for two-thirds of the companies in the sample (McFarland and Church 2003).

Pressure for governance reform is also coming from other fronts. For example, in June 2002, major Canadian institutional investors established the Canadian Coalition for Corporate Governance, a vehicle for sharing information and working towards better governance practices. In August 2003, the Coalition published guidelines. In September 2002, the Canadian Council of Chief Executives released a statement outlining actions that they felt chief executive officers (CEOs) and boards of directors could take to strengthen corporate governance.

Doubts have been expressed about the appropriateness of the new U.S. standards for all Canadian firms. Canada has a different corporate structure than the United States, with a relatively larger proportion of small public firms and firms controlled more narrowly (by families and others) as opposed to being widely held. It has also been argued that the proposals for independent directors are too onerous for small firms—the argument being that they would not be able to attract enough qualified independent directors—and are not reasonable for narrowly controlled (family) firms. This has led some to advocate the notion of "two tiers" of governance standards in Canada, with less-stringent standards being applied to small firms.

At this point, the reform of governance standards is still a work in progress. One step occurred in June 2003 when 12 of Canada's 13 provincial and territorial securities regulators published new draft rules for public companies that

- prescribed the role and composition of audit committees, and
- required the CEO and chief financial officer (CFO) to certify annual and interim disclosures.

Companies listed on the TSX would be required to have audit committees that are fully independent and financially literate. By contrast, smaller companies listed on the TSX Venture Exchange and unlisted issuers would be required to disclose only those audit committee members who are independent and financially literate.

In addition, a "certification rule," applicable to all public companies, will require CEOs and CFOs to attest to the accuracy of their company's financial statements and to disclose the effectiveness of their internal controls.

The TSX has also promoted the adoption of new corporate-governance standards. In September 2002, the TSX proposed changes to its voluntary guidelines and listing requirements to reflect new views on best practices. As a result of the investor-confidence measures proposed by securities regulators, amended proposals are expected.

Similarly, specific proposals are being prepared that would result in revisions to the governance provisions in the federal CBCA and to statutes governing financial institutions.

Financial Reporting and Accounting Standards

A key dimension of proper corporate governance is adequate and sufficient financial reporting. As noted by the recent Report of the Senate Standing Committee on Banking, Trade and Commerce (2003), "A lack of financial transparency is an important issue for every stakeholder, including shareholders, investors, lenders, and auditors."

The standard-setters

In Canada, supervision of financial reporting involves a number of regulatory, self-regulatory, and oversight bodies. In terms of legislation, the federal CBCA, as well as provincial corporation acts and provincial securities acts, requires that companies prepare financial statements in accordance with Generally Accepted Accounting Principles.

The Accounting Standards Board (AcSB) of the accounting industry association, the Canadian Institute of Chartered Accountants (CICA), sets accounting standards. Public oversight of the AcSB is provided by the Accounting Standards Oversight Council, which consists of a mix of individuals from both within and outside the accounting profession.

Accounting standards

Generally Accepted Accounting Principles—or GAAP—are a set of standards intended to bring clarity and uniformity to the financial reporting of corporations.

Traditionally, Canadian GAAP has been more principles based and judgment driven, and U.S. GAAP has been more rules based, although both systems encompass rules and principles. The International Accounting Standards Board is promoting the development of global uniform accounting standards that tend to rely more on principles. The U.S. Financial Accounting Standards Board is participating in this initiative. Canadian standards, while continuing to be strongly influenced by those in the United States, will likely be affected by international efforts aimed at greater harmonization.[5]

Important changes to Canada's accounting standards, designed to improve disclosure, are coming into effect. These include

- guidance on speculative derivatives that was brought into effect for fiscal years starting in July 2002;
- a new guideline requiring the disclosure of financial guarantees, which came into effect on 1 January 2003;
- a new guideline for variable-interest entities, which will come into effect by January 2004; and
- a draft guideline on the expensing of stock options, which is expected to come into effect by January 2004.

Enhancing the Credibility of the Audit Process

The recent failures in corporate governance were often associated with breakdowns in the integrity of the audit process. This, in turn, has triggered a global re-examination of the external audit function. The growing importance of the consulting services that audit firms provide to their corporate clients has come under particular scrutiny. In certain cases, this may have compromised the objectivity of the audit process.

In Canada, the audit firm is appointed, in principle, by the shareholders—often with the guidance of the board's audit committee. Overall, Canadian audit practices follow a self-regulatory framework. Auditing and assurance standards are set by the Assurance Standards Board under the aegis of the CICA. The Board sets Generally Accepted Assurance Standards. In October 2002, the CICA announced the establishment of the Auditing and Assurance Standards Oversight Council, an independent body to oversee the setting of auditing standards; this body began to operate earlier this year.

Standards relating to public practice, such as auditor-independence rules and professional codes of conduct, have been developed by provincial institutes or associations of professional accountants for application to their members.

One important regulatory development has been the creation of The Canadian Public Accountability Board (CPAB), which is chaired by former Bank of Canada Governor, Gordon Thiessen. The mission of the CPAB, which was announced in 2002, is to contribute to public confidence in the integrity of financial reporting of Canadian public companies by promoting high-quality, independent auditing. The new agency, which aims to ensure both independence and transparency, means that auditors of

5. Harmonization does not necessarily imply adopting U.S. or other rules verbatim but rather capturing the essence of their intent using a Canadian format.

Canada's publicly listed companies will be subject to more frequent and rigorous reviews.[6]

With regard to the important issue of auditor independence, the CICA released a draft independence standard in 2002 to apply to Canadian auditors and other assurance providers. According to the CICA, "the core principle of the new standard is that every effort must be made to eliminate any real or perceived threat to the auditor's independence" (CICA 2002). Among the issues addressed in the independence standard are which categories of non-audit services provided by an auditing firm to a corporate client are acceptable, as well as requirements for auditor rotation.

Strengthening Enforcement

Considerable action has been taken to strengthen Canada's enforcement framework. In the 2003 federal budget, the government announced a coordinated national approach to enforcement aimed at strengthening the investigation and prosecution of serious corporate fraud and illegal market activity. Up to $30 million a year has been provided for this coordinated approach, which includes

- Legislative amendments to the Criminal Code to create new offences (e.g., improper insider trading) and evidence-gathering tools to increase penalties, to provide guidance on sentencing, and to establish concurrent jurisdiction with the provinces in the prosecution of serious cases of capital market fraud
- New resources dedicated to investigating serious cases of capital market fraud—special teams of investigators, forensic accountants, and lawyers will be established in key Canadian financial centres
- New resources to support the prosecution of capital market fraud offences under the Criminal Code (including cases generated by the special investigative teams)

At the provincial level, governments have bolstered the enforcement framework for securities laws. For example, Ontario and Quebec have passed legislation to modernize the definition of securities offences, increase penalties, and broaden the investigative powers of their securities commissions.

On 12 November 2003, the Canadian Securities Administrators (CSA) announced that they had received a report from the Illegal Insider Trading Task Force. The report recommends practices to address illegal insider trading in Canadian capital markets.[7] The recommendations focus on addressing the problem from three directions: prevention, detection, and deterrence. The CSA stated that it will consider the recommendations as it develops an action plan to address the problem of illegal insider trading.

Conclusion

Numerous initiatives have been taken with respect to corporate governance, accounting, and auditing standards in Canada. While more remains to be done, it should be remembered that such regulatory changes are not costless for businesses (which are subject to the increased reporting and governance standards). It is therefore important that the authorities try to achieve the desired goals with minimum effect on efficiency. To ensure that these measures will serve Canada well in the years to come, it will be essential to rigorously assess the reforms implemented.

6. CPAB's five-member Council of Governors is made up of the: Chair of the Canadian Securities Administrators, the Chairs of two provincial securities commissions (the Ontario Securities Commission and the Commission des valeurs mobilières du Québec), the Superintendent of Financial Institutions, and the President and CEO of the Canadian Institute of Chartered Accountants.
   It should be noted that a draft rule by 12 of Canada's 13 provincial and territorial securities regulators, published in June 2003, requires auditors of public firms to be members in good standing of the CPAB.

7. The Illegal Insider Trading Task Force was established in September 2002 and included representatives from the Ontario, Quebec, British Columbia, and Alberta securities commissions, the Investment Dealers Association of Canada, the Bourse de Montréal, and Market Regulation Services Inc.

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