

# PROTECTING THE PUBLIC INTEREST

## *The Role of the Chartered Accountancy Profession*

Prepared for the  
Canadian Institute of Chartered Accountants  
By Kroll Associates





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## INTRODUCTION

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The Chartered Accountancy profession is entrusted with an important public-interest mandate: to examine objectively and comment on the fairness of financial statements of Canadian companies. Corporate Canada, the investment community, regulators and the public all have a crucial stake in the professional competence, independence and ethics of auditors.

Recently, auditor independence and the CA profession's commitment to the public interest have been questioned by regulators amid media stories of "creative" accounting. There has been growing concern among CAs about how well the role of the auditor is understood and how effectively the profession is perceived to be carrying out its mandate by those it serves.

In response, the Canadian Institute of Chartered Accountants (CICA) invited Kroll Associates to conduct independent research. Reflecting the views of over 2000 key stakeholders, this study is, to our knowledge, the most comprehensive survey of attitudes toward and perceptions of the CA profession across Canada.

The results are both reassuring and challenging. The CA profession is well regarded for ethical practices. The quality of audited financial reporting is also rated highly. Furthermore, investors value audited financial statements as key information sources, second only to brokers' advice in importance.

Despite these clear expressions of confidence, understanding of the auditor’s role (and audit committees) is sketchy among retail investors and the business media. This is worrisome given the unprecedented number of Canadian shareowners who have direct interests in the quality of corporate governance and financial disclosure. The media’s general unfamiliarity with audit-related issues magnifies the need for education.

All participants in the corporate governance system – management, boards of directors, audit committees, auditors and regulators – must work together to protect the public interest. Accordingly, this report is published to advance understanding and support the CA profession’s commitment to “act with integrity, objectivity and a commitment to excellence and the public interest.”

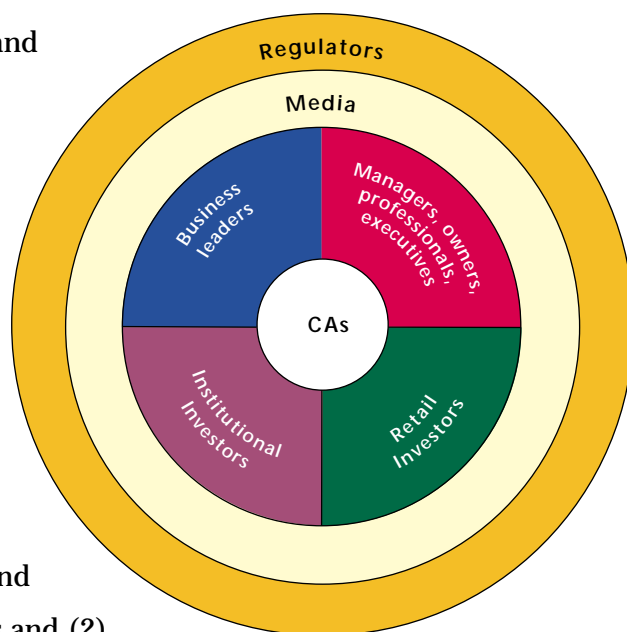


## SCOPE AND METHODOLOGY

In late 2000, the Canadian Institute of Chartered Accountants (CICA) commissioned Kroll Associates to evaluate how well the role of the auditor is understood and how effectively the profession is perceived to be fulfilling its public service mandate by stakeholders and influencers.

As background, Kroll Associates reviewed print media, press releases, speeches, and public pronouncements by Canadian securities regulators in over 100 documents, spanning 15 months from August 1, 1999 to October 31, 2000. More than 2000 business leaders, investors, analysts, and business media, as well as CAs, were surveyed between November 2000 and February 2001.

Methodology and survey instruments were tailored by segment (1) to recognize the different knowledge, experience and sophistication of the various respondent groups and (2) to take advantage of cost-effective omnibus survey vehicles. Questions were designed to ensure comparability of results across segments.



### Retail Investor Survey:

A telephone survey was conducted from November 1 to 5, 2000 to gauge the views of the public and, in particular, retail investors. The nationwide representative sample of 1005 adult Canadians included 584 retail investors who owned mutual fund and/or stock and/or corporate bonds.

### **Business Community Survey:**

Self-administered questionnaires were completed and returned by 364 respondents, including 71 CEOs (or designates) of TSE 300 companies; 232 “MOPEs” (managers, owners, professionals, executives); and 61 Canadian securities analysts and institutional investors during December 2000. For ease of reference, this report refers to these corporate and institutional respondents collectively as the “business community.”

### **CICA National Member Survey:**

Self-completion questionnaires were returned by 1067 CAs in November 2000 through January 2001.

### **Media Survey:**

Seventy-seven journalists were interviewed as part of a telephone omnibus survey conducted between November 2000 and February 2001.

*Note:* Data tables presented in this report may not add to 100% exactly, either because data have been rounded to the nearest decimal point or because of multiple mentions.



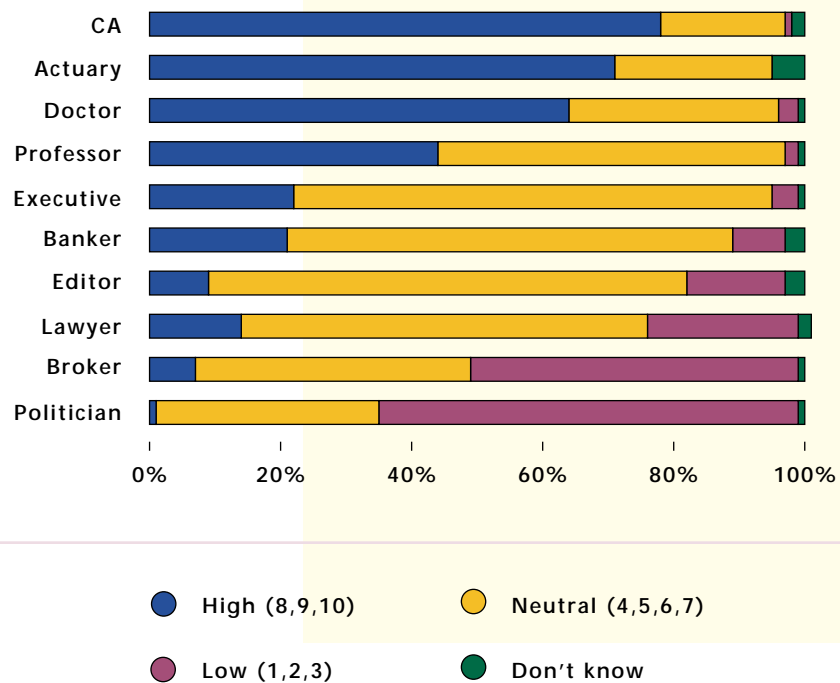
## REPUTATION FOR ETHICAL PRACTICES

### *Chartered Accountants are Esteemed for Their Ethics*

Overall, CAs enjoy a healthy reputation for ethical practices across all stakeholder groups. The business community – executives, professionals, business owners, institutional investors and securities analysts – rated CAs highest among the ten professions evaluated (mean rating of 8.2 on 10-point scale). Seventy-nine percent of this group rated CAs highly.

### Question

On a scale from 1 to 10, where 1 is "poor" and 10 is "excellent," how would you rate the following professions in terms of their reputations for ethical practices?



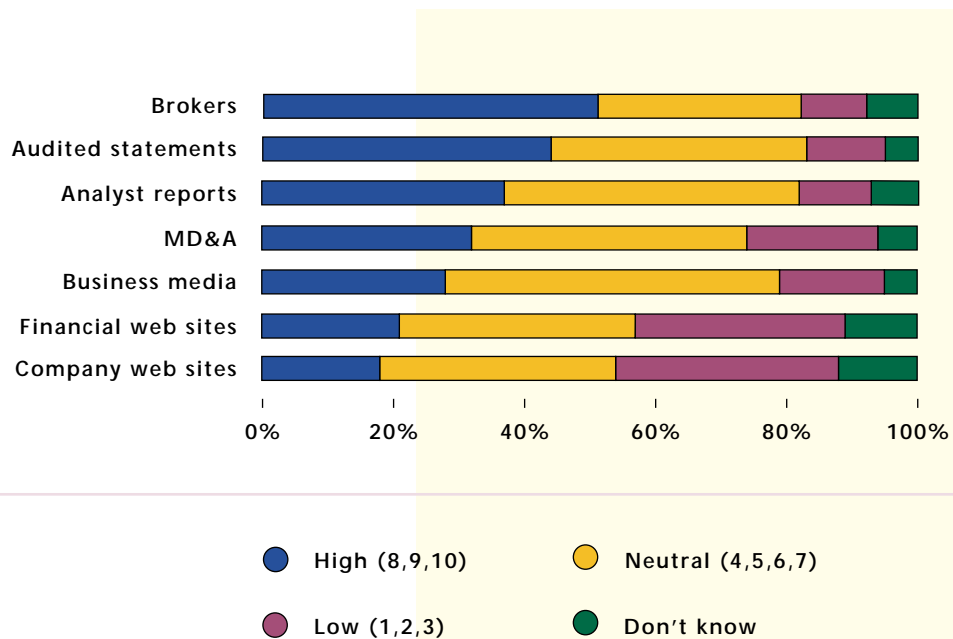
CAs themselves have confidence in their profession's reputation for ethics (mean rating 8.4). Most believe this good name has been maintained (65%) – or even improved (6%) – in the past five years.

*Audited Financial Statements are Key Information Sources for Retail Investors*

Audited financial statements are vital sources of information for investors. Of the seven information sources rated by retail investors, only advice from brokers ranked as more important. Among francophones, audited financial statements were as important as brokers as sources of information for investment decisions.

Question

On a scale from 1 to 10, where 1 is “not at all important” and 10 is “extremely important,” how important are the following sources of information to you when you evaluate a stock or mutual fund as an investment?

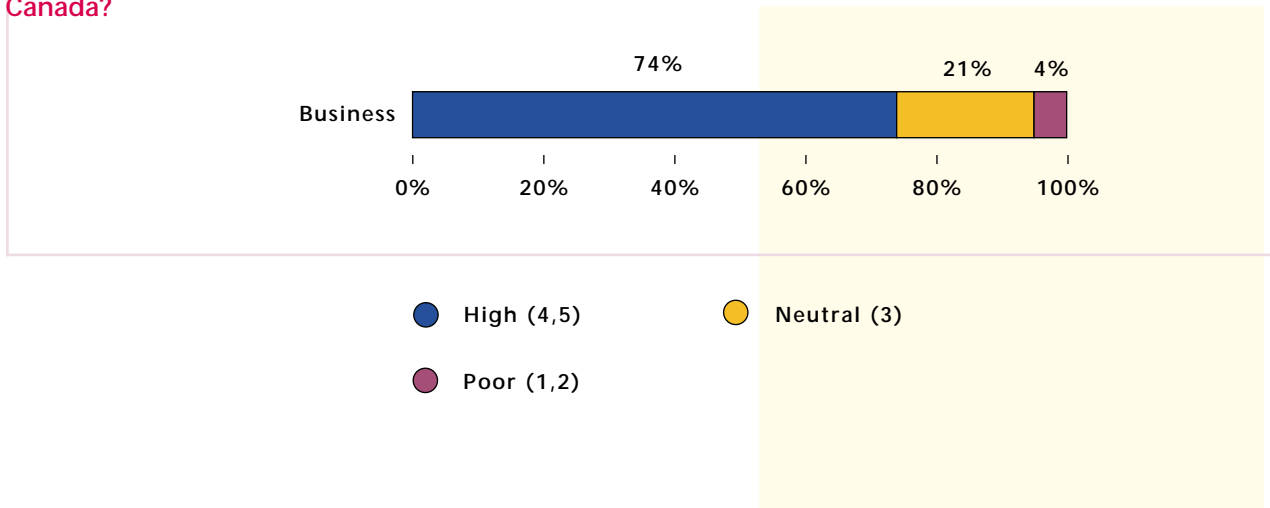


*Audited Statements Are Rated Highly on Quality*

The quality of audited financial reporting was generally rated highly. Broadly speaking, the business community is confident in the quality of Canadian audited financial statements: 74% rate the overall quality as “4” or “5” (on a 5-point scale, where 5 is “excellent” and 1 is “poor”). Virtually no one (4%) rated quality below a neutral “3”. Outright criticism was rare.

Question

How would you rate the quality of audited financial statements in Canada?



*Quality Sustained and Improved*

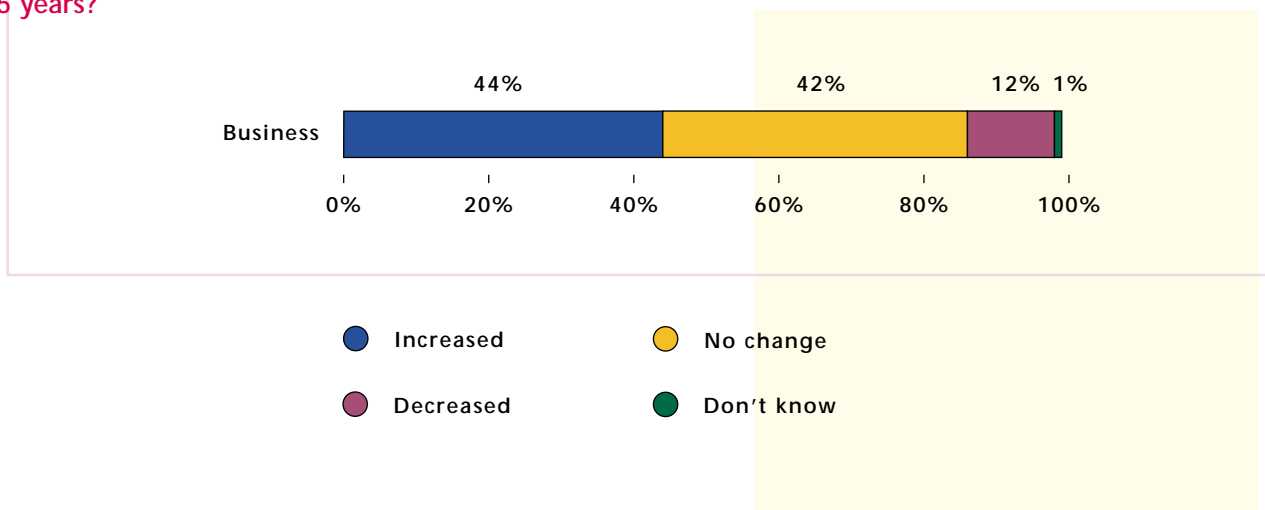
Seventy-seven percent of CAs said the quality of audited financial statements had been preserved (63%) or improved (14%) in the past five years.

Another 16% of CAs thought quality had slipped – interestingly, almost twice as many thought the *public’s perception* of the quality of financial statements had dropped. This group generally blamed media reports of fraud, high profile lawsuits and business failures.

Overall, 86% of the business community thought audited financial statements had improved (44%) in the past five years or that quality had been maintained (42%). Improvements were generally attributed to higher professional standards and more complete guidelines.

Question

Has the overall quality of audited financial statements.... over the past 5 years?



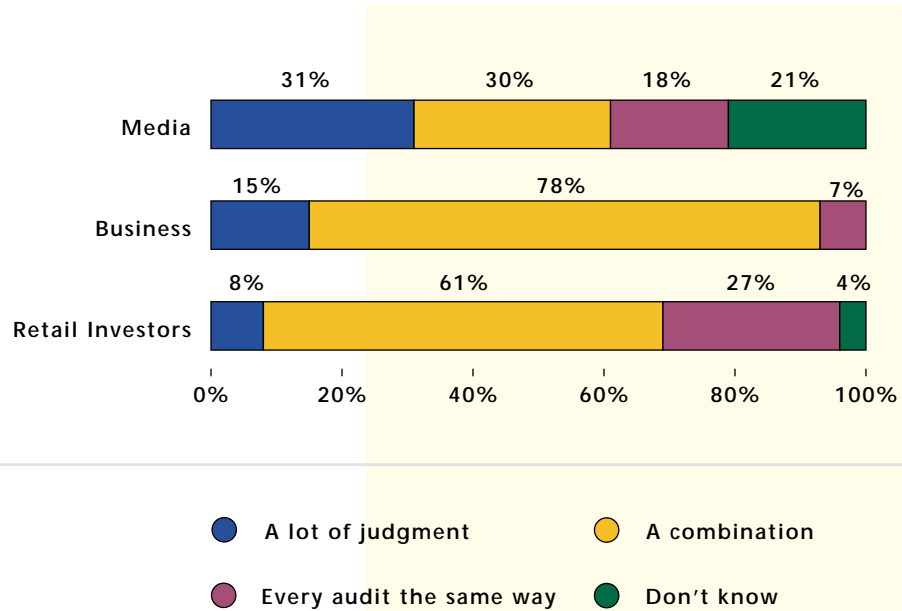
*Latitude for Professional Judgment*

Only a minority of business people and retail investors believe auditors use “a lot of judgment,” suggesting that any concerns about “creative accounting” are not widespread. Most believe auditors use “a combination of set practices and case-by-case procedure.”

There was less consensus among the media, and one-fifth of journalists (21%) were unable or unwilling to offer an opinion on this question.

Question

From what you know, which of the following statements best describes how much judgment auditors typically use when auditing financial statements. Do they... use a lot of judgment?...or use a combination of set practices and case-by-case procedures? .... or alternatively, conduct every audit in the same way?

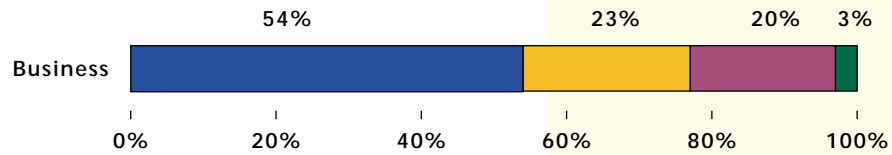


*Some Perceived Need for Guidance in New Economy*

Some respondents believe the latitude for professional judgment varies by sector. Specifically, just over half the business community (54%) believe accounting standards offer greater scope for judgment in knowledge-based industries than traditional manufacturing.

## Statement

Level of agreement/disagreement with statement: **In general, accounting standards offer greater latitude for professional judgment in “new economy” or “knowledge-based” industries than in traditional manufacturing industries.**



- Agree (4,5)
- Neutral (3)
- Disagree (1,2)
- Don't know

Greater flexibility raises questions of consistency. The OSC is examining revenue recognition practices of 75 companies, principally in the technology sector *“to ensure that the standards are being applied appropriately and to identify any areas in which more specific guidance may be required, for example, in the form of new standards, or interpretations issued by the Emerging Issues Committee of The Canadian Institute of Chartered Accountants.”*

### *Need to Educate Retail Investors and Business Media*

Most CAs question how well the audit-related issues are understood by retail investors and the media. Only 9% of CAs think Canadian retail investors “understand the role and accountabilities of the auditor.” Although retail investors are more confident about their own knowledge, just half (49%) rate their personal understanding of the auditor’s role above a neutral “3” (on a 5-point scale, where 5 is “excellent” and 1 is “poor”).

Survey responses by journalists suggest that the media are not well equipped to inform the public on audit-related issues. For example, only 40% of journalists rate the business media’s understanding of the auditor’s role highly (above a neutral “3”).

As shown in later sections of this report, the research highlighted specific misconceptions and knowledge gaps to be addressed by those responsible for investor education and protection.

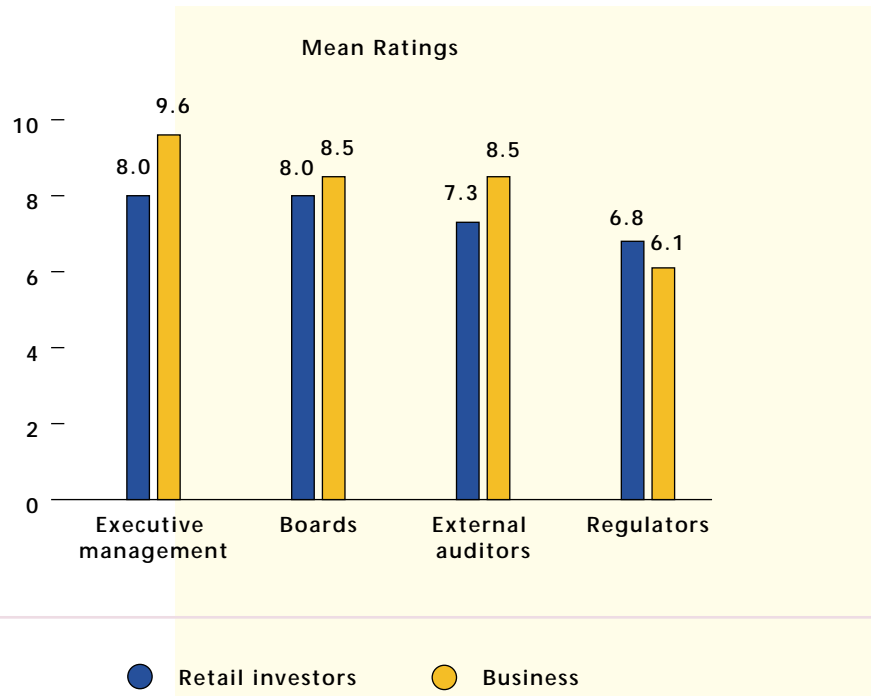
### *Credibility of Financial Reporting a Collective Responsibility*

The credibility of financial statements is generally viewed as a collective responsibility. Most business people and retail investors believe responsibility rests with executive management, boards, external auditors and – to a lesser degree – regulators.

Overall, the business community sees executive management as most responsible (mean score 9.6), followed by boards and external auditors (8.5).

Question

In your view, how much responsibility does each of the following groups have for the credibility of a public company's financial statements? (Using a scale from "1" to "10", where 1 means "no responsibility" and 10 means "full responsibility," indicate how much responsibility each group has.)

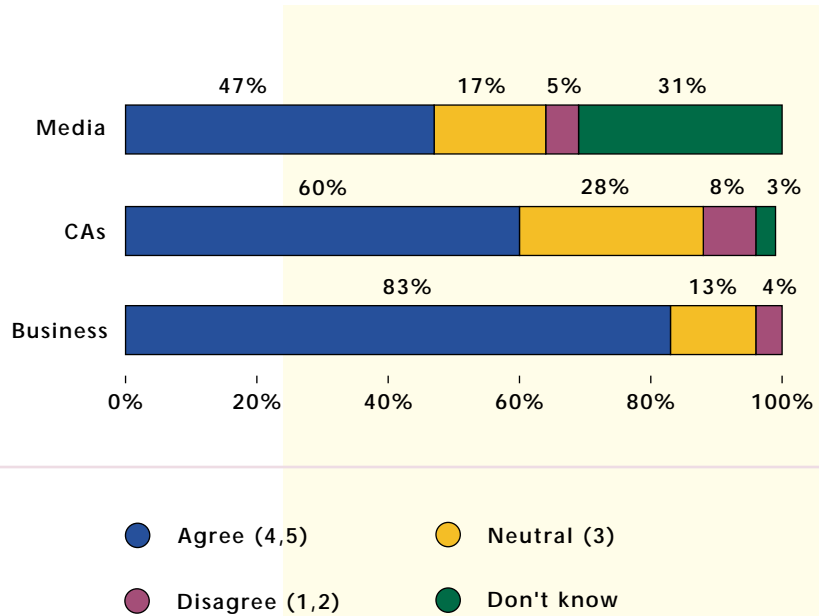


*The Pivotal Role of Audit Committees*

The business community (83%) generally agreed that "audit committees can play a determining role in the quality of audited financial reporting," as did a majority of CAs (60%). Media respondents who voiced an opinion also asserted the importance of audit committees. Significantly, almost one-third of media respondents (31%) were unable or unwilling to offer an opinion.

Statement

Level of agreement/disagreement with statement: **Audit committees can play a determining role in the quality of audited financial reporting**

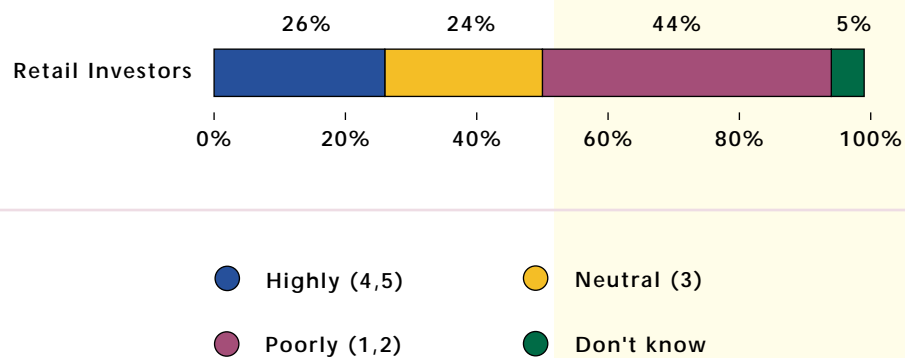


Retail investors are largely unfamiliar with audit committees.

When asked to rate their own understanding, only 26% of retail investors claimed to have a good grasp of the audit committee's role. This suggests an opportunity for education on corporate governance and specifically the role of audit committees.

Question

As you may know, the Toronto Stock Exchange has guidelines for corporate audit committees. Using a scale from 1 to 5, where 1 is “poor” and 5 is “excellent”, how would you rate your own understanding of the responsibilities of audit committees?



*Meaning of “Unqualified” Opinion Not Always Well Understood*

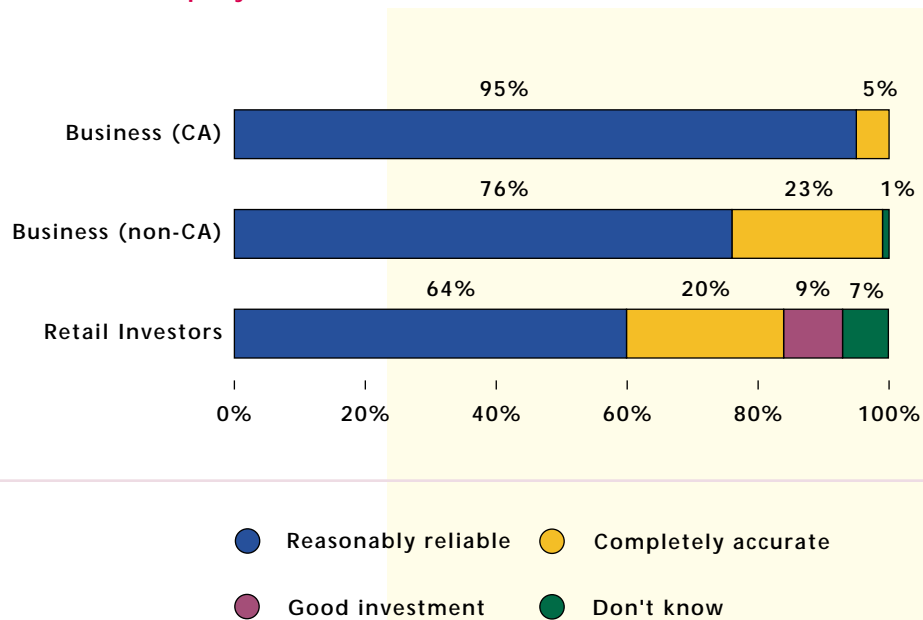
Overall, most business people (84%) understood an “unqualified” audit opinion to mean the audited statements are “reasonably reliable.” Those with CA designations agreed with this definition almost unanimously (95%). Among the non-CAs in the business community, there was less consensus: a significant minority (23%) believed an unqualified audit opinion attested that “all figures in the financial statements were completely accurate.”

Only 14% of retail investors claimed to know the term – and of these, 20% believed an “unqualified” audit opinion meant that “all figures were completely accurate,” while another 9% thought an “unqualified audit” attested to the investment quality of the audited company.

The confusion over the significance of an unqualified opinion may reasonably concern regulators and others charged with investor education. To the extent that “complete accuracy” is an important and unreasonable expectation, misconceptions may also create reputation risk for CAs.

Question

In your view, which of the following descriptions most accurately describes the meaning of “unqualified audit opinion” – does “unqualified audit opinion” suggest that...financial statements are reasonably reliable?...all the figures in the financial statement are completely accurate?...the audited company is a good investment?



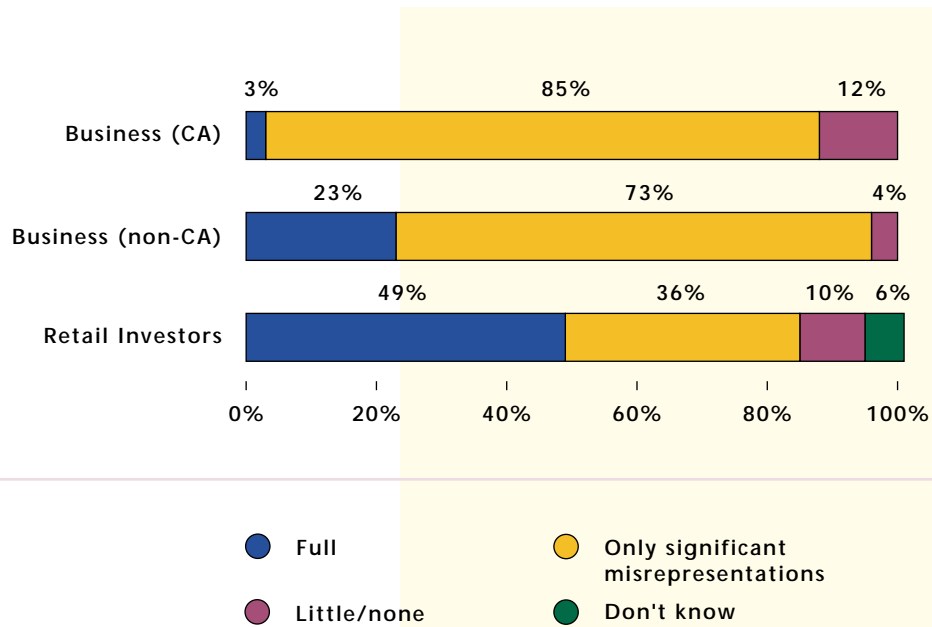
*Limits of Responsibility for Detecting Fraud Not Fully Understood*

Although most business people understand auditor responsibilities for spotting fraud are limited to material misrepresentations in financial statements, a significant minority of non-CAs (23%) believes auditors are “fully responsible for detecting fraud in companies they audit.”

Half (49%) of Canada's retail investors believe auditors' professional obligations extend to full responsibility to detect fraud in audited companies. Investors who believe auditors are responsible for detecting fraud may have a false sense of security and an inappropriately relaxed attitude toward due diligence.

Question

What responsibility, if any, do auditors have to detect fraud in the companies they audit – does auditor have ...full responsibility?... only to detect significant misrepresentations ?..little or no responsibility ?



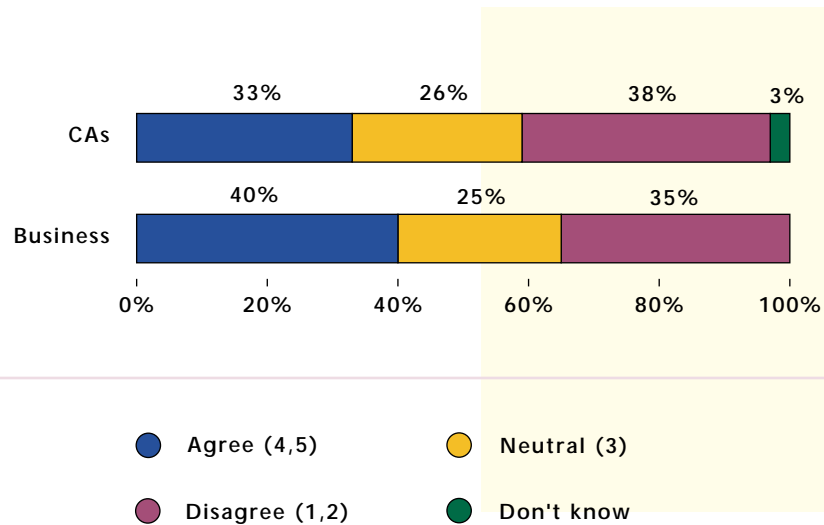
## AUDITOR INDEPENDENCE

The OSC has expressed the view that selling consulting services to audit clients can compromise an auditor's independence and objectivity. Chair David Brown has stated: "As [accounting firms] continue to expand their range of services, and the audit practice contributes a lesser proportion of the profits, [the OSC has] a growing concern about the real and perceived threat to the independence of the auditor where non-audit services are provided to audit clients. We believe the potential for conflict is significant..."<sup>1</sup>

In the business community, opinions varied on the validity of this concern. The CA profession was also divided.

### Statement

Level of agreement/disagreement with statement: **Selling audit services and non-audit services to the same client creates a fundamental conflict of interest.**



<sup>1</sup> David A. Brown, Q.C., *Public Accounting At A Crossroads*, Remarks to the Business Leaders' Luncheon organized by the Institute of Chartered Accountants of Ontario, June 8, 1999.



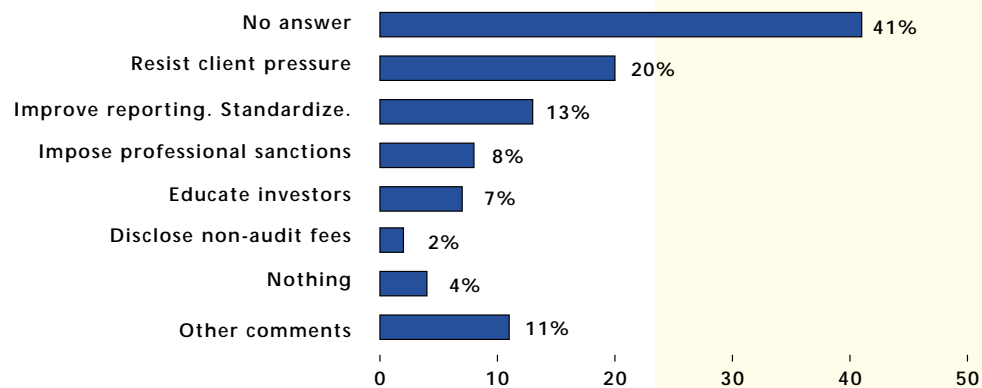
## STAKEHOLDER ADVICE TO THE CA PROFESSION

CAs were asked to rate the effectiveness and practicality of various ways their profession might address auditor independence concerns. There appears to be receptiveness for best practice guidelines – or even hard-and-fast rules – suggesting an opportunity for the profession’s leadership. Specifically, restrictions on loans and investments in audited companies and mandatory disclosure of business relationships between audit firms and clients were favoured as the most effective and practical actions.

The business community was also asked how the CA profession might preserve investor confidence in the objectivity and quality of external audit opinions. Not everyone was able to suggest changes: 41% offered no comments, while another 4% advised “staying the course” and “keeping up the good work.”

### Question

[Business community]: What suggestions can you offer to the accounting profession to preserve investor confidence in the objectivity and quality of opinions that are expressed by external auditors?



The 55% who made recommendations offered widely varied suggestions. One-in-five respondents (20%) simply encouraged auditors to “just say no” and resist any client pressure to bend the rules; for example:

- *Be honest. Do not waiver under pressure from clients to make that audit report say what the company wants. Protect the public's interest, not your contract or your salary. P.S. My accountant is firm and fair. I respect him for it.* MOPE (Public company)
- *Ensure they are not bullied into accepting statements and explanations from management and directors they are not fully convinced of. Complete the audit to the standards set and required.* MOPE (Public company)

A few respondents suggested ways to mitigate risks of pro-management bias; for example, having third parties appoint external auditors, requiring peer reviews, imposing penalties for infractions, mandating rotation of audit assignments, and instituting ethics training.

A small minority of the business community (12%) suggested addressing concerns that selling non-audit services to audit clients can impair – or be seen to impair – objectivity. Suggestions ranged from disclosing all business relationships with audit clients, to building firewalls between auditing and consulting practices or spinning off the consulting business. To illustrate:

- *Perhaps adding a summary section to an annual report that gives the following: 1) duration of term with client; 2) disclosure of non-audit services; 3) any outstanding legal proceedings; and 4) partner with responsibility for audit.* Analyst

- *Create visible firewalls between the audit and non-audit function.* Analyst
- *Segregate non-audit activities from the audit practices – or get out of consulting altogether. Introduce mandatory rotation of audits between firms.* MOPE (Public company)

Roughly the same percentage (11%) suggested that preserving investor confidence requires keeping the expectations of the public in line with the auditor's actual responsibilities: *“There is a need to reduce if not eliminate the gap between the expectation from those [the accounting profession] serves and the duty and legal responsibility of the auditor.”* To this end, some suggested education and PR programs. For example:

- *I believe the accounting profession has to get its message across to the public. Accountants are unfairly looked upon as the “easy defendant” or the “deep pocket” when something goes wrong. Auditing is a very difficult task. An audit opinion is just that, an opinion, and not a verification or guarantee.*  
MOPE (Public company)
- *The public needs to be educated about what an audit opinion means (i.e., fraud detection responsibility, etc...).*  
MOPE (Business leader )

Others felt maintaining public confidence would be best served by reducing competitive fee pressures. Recommendations ranged from mandating audit rates and/or hours to overcoming price-sensitivity by promoting the benefits of in-depth audits. Comments included:

- *[CAs] should encourage governments and regulators to make it clear to companies that they require full audits and that the fees are appropriate to ensure that a full audit is done.* MOPE (Professional)
- *...if possible, standardize fees to help eliminate fee pressures.*  
MOPE (Public company)
- *Increase minimum number of hours corporations are required to give auditors for audit...* MOPE (Owner)
- *Consider 'super audit' requirement every three years where materiality thresholds are lowered and more checking at lower levels of [the] company than normal.* MOPE (Professional)

Thirteen percent of respondents took the opportunity to lobby for various reporting changes they felt would improve financial statements. Only 4% specifically suggested adopting U.S. Generally Accepted Accounting Principles (GAAP) or harmonizing with International Accounting Standards (IAS).



## CONCLUSIONS

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The CA profession enjoys a healthy reputation for ethical practices across all stakeholder groups, from corporate Canada and the investment community to the business media. Audited financial reporting is also rated highly.

Broadly speaking, business is in tune with the responsibilities of the auditor, although there is a pressing need to educate retail investors and journalists on key audit concepts, including the meaning of an “unqualified” opinion and the role of the audit committee. The apparent gap between an auditor’s actual duties and the expectations of unsophisticated investors must be bridged.

The survey also highlights complex questions where consensus is far from complete. For example, opinions are divided on whether selling consulting services to an audit client compromises an auditor’s independence. Views also vary on what – if anything – the CA profession should do to preserve faith in the objectivity of audit opinions. This is a clear opportunity for the CA profession to show leadership in addressing these issues and to sustain investor confidence, while protecting their professional reputation for integrity.



## ABOUT KROLL ASSOCIATES

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Kroll Associates aims to be “Canada’s most trusted provider of precise, reliable information to identify market opportunity, reduce risk and facilitate action.”

Kroll Associates specializes in strategic research for financial services and investment firms. Our clients include leaders in all branches of the sector – portfolio management, insurance, banking, brokerage, asset servicing and securities regulation. Kroll research addresses a broad spectrum of business issues, from evaluating corporate governance and analyzing stakeholder perceptions to measuring brand equity and defining new service strategies.

The market research team imposes scientific standards on all aspects of the survey process, from study design, questionnaire development and interviewer training to coding, tabulation, analysis and interpretation. Attention to detail means valid, reliable results that clients can depend on. Rigorous standards have enabled Kroll to become Canada’s top provider of market research evidence for litigation.

The Toronto-based market research group is part of a worldwide business consultancy and investigations firm. A company of 2500 employees, Kroll has built an international reputation through a network of 59 offices in 20 countries.







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