CPA-Queen’s Centre for Governance

ANNUAL REPORT
STEVEN SALTERIO
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Mission Statement

To be the premier Centre for the thoughtful study of governance in Canada with a special emphasis on the roles of the public accountants and audit committees to whom they report.

Vision and Mandate

CA-Queen’s Centre for Governance (business.queensu.ca/centres/CA-QCG/) vision is to raise the bar on Canadian governance research with respect to transparency and financial accountability and convey that research’s implications to academics, students and the public at large. Situated at Queen's School of Business (business.queensu.ca), one of the world’s premier business schools, the Centre’s mandate includes conducting cutting edge basic and applied research on governance dealing with such issues as fraud prevention and detection and improving the quality of Canadian securities’ regulation. The Centre’s premiere not for profit program mandate is the Voluntary Sector Reporting Awards that rewards voluntary sector organizations for transparent Annual Reports and financial accountability. The Centre is funded, in part, by the Institute of Chartered Accountants of Ontario.

Report on Centre’s Activities and Accomplishments 2009-10

Highlights: 2009-10 marks the year that the basic research program of the Centre came into its own. Basic research is defined as research that seeks to discover new knowledge about the phenomena of interest, in this case, governance broadly conceived. The Centre received five proposals requesting a total of $39,000 and we granted $31,000 in funding. This resulted in a modest reduction in the basic research funding accumulated funds as had been planned in the 2009-10 budget. In addition, a research publication funded by the Centre has been accepted for publication at Contemporary Accounting Research (a Financial Times 45 Journal, a designation that gives broad recognition that CAR is among the elite research journals in business academia). For a research summary see Appendix A. Further, this publication shows that the Centre’s mandate to support basic research is paying off in top tier research publications. The Centre expects more will follow with the increase in research projects being funded.

Another highlight of 2009-10 for the Centre was the 2nd Annual Voluntary Sector Reporting Awards. The awards are designed to reward best practices for accountability reporting in the not-for-profit sector, and are open to registered charities that produce annual reports in Ontario. Organizations compete in four categories:

- International and nationally focused organizations headquartered in Ontario and
- Organizations that only operated in Ontario (or part thereof) that are divided by size into three categories:
  - total revenues over $10 million,
  - total revenues from over $1 million to $10 million and
  - total revenues less than $1 million.

Over 40 organizations were nominated of which 38 met the guidelines for this year’s competition. Over one half of the entrants were new to the competition in 2009. PricewaterhouseCoopers Foundation is the sole sponsor of the Awards. Awards were given to annual reports demonstrating the highest levels of accountability and transparency and
displaying highly-effective communication with beneficiaries, donors and stakeholders. A description of the awards process, the list of finalists and winners, and a list of judges with brief biographies is included as Appendix B to this report.

One issue that has been problematic for the Centre since its inception is administrative support; the need for which is highly seasonal (mainly driven by the VRSA program). With the appointment of the Centre Director as Editor (in-Chief) of Contemporary Accounting Research and the concurrent agreement with the Canadian Academic Accounting Association (CAAA) to provide half-time support for the Editor’s Assistant, it became possible to deal with this challenge. With the consent of the QSB Dean, the Centre hired a full time program assistant who will be funded partially by the CAAA, the Centre, the QSB Dean’s Office and the Director’s Fellowship. Nancy Shield was the successful applicant for the position. Nancy started on March 1 and has had a huge impact on the Centre to date.

**Media Coverage:** The Centre Director was quoted in various print media during the year, the Voluntary Sector Reporting Awards received extensive coverage in local print media in Ontario, and the Centre Director and a doctoral student at QSB had an op-ed about transparency in corporate governance published in the *Bottom Line*, a trade journal for the accounting and finance profession in Canada. In addition, the ICAO members’ magazine, *Checkmark*, featured the Voluntary Sector Reporting Awards twice in its pages with accompanying photos. Further, in the paid media, the Centre advertising program associated with the VSRA lead to a quarter page ad in the Globe & Mail announcing the winners as well as banner advertisements being run on Charity Village, a key not for profit sector website, to encourage applicants.

**Basic Research Grants:**

All research grants are first reviewed by the Director for suitability and he makes a recommendation about their academic merit to the reviewers. The Director selects two members of the Advisory Board to read and comment on the proposal to determine if they agree that funding should proceed and if so, do they agree with the proposed budget. The process is iterated until agreement is reached (or the full Advisory Board would be consulted if agreement could not be reached.)

- Basic research grants were awarded as follows
  - Alex Cram MSc/PhD Student supervised by Professor Kathryn Brohman, $10,200 for project entitled Controlling Systems Development. STATUS: In Progress
  - Professors Clinton Free and Pamela Murphy, $9,850 for a project entitled The Fraud Pyramid STATUS: In Progress
  - Christine Hayne MSc/PhD Student supervised by Professor Clinton Free, $2,500 for a project entitled Business Risk: Are we walking the talk? STATUS: In Progress
  - Professor Wei Wang, $8,200 for a project entitled KERP plans and the Provision of Incentives in Financially Distressed Firms. STATUS: In Progress
- Continuing grant
  - Lu, Richardson and Salterio on Internal Control Reporting in Canada. STATUS: In Progress. First academic publication accepted as noted in highlights above.
- Completed grant
  - Professors Lynnette Purda (Queen’s School of Business) and David Skillicorn
Detecting Deception in Business Documents

Where substantial Centre funds have been expended in this fiscal year, progress reports are attached in Appendix C. As part of the basic research grants program, we also offer infrastructure grants to allow researchers to purchase equipment or access to data bases that will remain the property of the Centre. In 2009-10 we had one such request:

**Infrastructure Grant:** Christine Hayne MSc/PhD Student supervised by Professor Clinton Free, $650 - Acquisition of Professional Recording Equipment for Field Research.

**Not for Profit Initiative:**

The main program, the Voluntary Sector Reporting Awards, is discussed in the Highlights of this report and elaborated on in Appendix B. In addition, the Initiative has a small pool of funds to support case development. All other programs of the Initiative have been cannibalized to provide sufficient financial support for the VSRA. In 2009-10 a grant to support case writing in the not-for-profit sector was made to QSB Assistant Professor David Detomasi in the amount $2,500 for a case entitled *Strategy in Turbulent Times: Export Development Corporation (EDC) and the Global Financial Crises.* Queen’s University and EDC have established links in terms of scholarships, student engagements, and other program initiatives. The case will be used in our Centre’s partner program, *Queen’s Governance Program: For Boards of Municipal, Provincial and Federal Agencies, and Not-For-Profit Organizations* run by the Queen’s Executive Development Centre.

**Advisory Board:**

The Advisory Board members are:

- David Saunders, Dean QSB
- Richard Clark CA, Deloitte, Greater Toronto Area Audit Practice Leader, Queen’s alum with extensive public company client list
- Brian Leader FCA, Vice-President Learning, ICAO
- Tom O’Neill FCA, former CEO of PWC, Queen’s alum who is currently a board member and audit committee member for such Canadian companies as Loblaw and BCE.
- Steve Salterio FCA, Director, *ex officio*
- Teri Shearer CPA, Accounting Faculty Member, QSB (appointed in September 2010) who has been active at the Board and Board Chair level of a number of significant sized not for profits
- Ken Wong, Faculty Member, QSB and active board member of public and private companies. AMA “Marketing Legend” 2006.

The role of the Advisory Board is two-fold. First, to review applications for grant funding by contributing their subject matter expertise to the decision making process. Second, the Board is a source of advice for the Director on matters pertaining to running the Centre and its programs. This is achieved through formal Board meetings (the first held in May 2010) and individual advice to the Director.
Financial Accountability Reports to the Dean and the ICAO:

- Statement of Receipts and Expenditures including accruals for year ended April 30, 2010 (Table 1)
- Balance Sheet as of April 30, 2010 (Table 2)
- Details of accruals regarding research grants and case grants (Table 3)
- Proposed budget for 2010-11 (Table 4) including a schedule with the Voluntary Sector Reporting Awards Proposed Budget
CA-Queen’s Centre for Governance 2009-10

Table 1: Annual Financial Report
CA-Queen’s Centre for Governance
Statement of Receipts and Expenditures
For year ended April 30, 2010

<table>
<thead>
<tr>
<th></th>
<th>Centre 2008-09</th>
<th>Contemporary Accounting Research (CAR) 2009-10</th>
<th>Total 2009-10</th>
<th>Budget Centre and CAR 2010-11</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Donations - ICAO regular</td>
<td>$39,000</td>
<td>$35,000</td>
<td>$35,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Donations – ICAO Not for Profit</td>
<td>23,000</td>
<td>45,000</td>
<td>45,000</td>
<td>45,000</td>
</tr>
<tr>
<td>CAAA re CAR</td>
<td></td>
<td>$2,083</td>
<td>2,083</td>
<td>25,000</td>
</tr>
<tr>
<td>Transfer from within QSB</td>
<td></td>
<td></td>
<td></td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td><strong>$62,000</strong></td>
<td><strong>$80,000</strong></td>
<td><strong>$27,083</strong></td>
<td><strong>$82,083</strong></td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Admin Prof &amp; Tech Salary</td>
<td>$2098</td>
<td>$6,891</td>
<td><strong>$8,974</strong></td>
<td><strong>$50,000</strong></td>
</tr>
<tr>
<td>Research Director, Guest Speakers and RA’s</td>
<td>1,883</td>
<td></td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Website development fee</td>
<td></td>
<td>1,227</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voluntary Sector Reporting Awards: Table 3</td>
<td>24,890</td>
<td>32,636</td>
<td>32,636</td>
<td>39,000</td>
</tr>
<tr>
<td>Research grants paid and accrued: Table 4</td>
<td>16,322</td>
<td>34,832</td>
<td>34,832</td>
<td>40,000</td>
</tr>
<tr>
<td>NPI case grant paid and accrued</td>
<td></td>
<td>2,500</td>
<td>2,500</td>
<td>5,000</td>
</tr>
<tr>
<td>Miscellaneous: postage, office supplies, parking passes for visitors etc.</td>
<td></td>
<td>936</td>
<td>936</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td><strong>$46,420</strong></td>
<td><strong>$77,795</strong></td>
<td><strong>$2,083</strong></td>
<td><strong>$79,878</strong></td>
</tr>
<tr>
<td><strong>Net surplus(deficit)</strong></td>
<td><strong>$15,580</strong></td>
<td><strong>$2,205</strong></td>
<td><strong>0</strong></td>
<td><strong>$2,205</strong></td>
</tr>
<tr>
<td><strong>Opening account balance</strong></td>
<td><strong>$46,188</strong></td>
<td></td>
<td></td>
<td><strong>$61,768</strong></td>
</tr>
<tr>
<td><strong>Closing account balance</strong></td>
<td><strong>$61,768</strong></td>
<td></td>
<td></td>
<td><strong>$63,973</strong></td>
</tr>
</tbody>
</table>

ICAO = Institute of Chartered Accountants of Ontario
CAAA = Canadian Academic Accounting Association
QSB = Queen’s School of Business
Table 2: Annual Financial Report
CA-Queen’s Centre for Governance
Statement of Financial Position
As at April 30, 2010

Assets
Cash $201,934

Accruals
- CAR grant received in advance $25,000
- ICAO grant received in advance 80,000
- Research grants accrued (see Table 3) 31,107
- Case development grant accrued 1,854
  Total $137,961

Surplus $63,973

Total Equities $201,934

Accounting notes:

1. The Centre follows an accrual basis of accounting. See list of accruals in Table 3.

2. Both the ICAO grant and the CAAA grant for the next fiscal year arrive shortly prior to the Centre’s April 30th year end. The revenues received in one year are matched with the expenditures that occur in the following year.

3. The surplus, in part, arises from the initial ICAO funding that allowed the Centre to have working capital in the amount of $35,000, the equivalent of one year’s revenue for the basic research part of the Centre. The remaining surplus has been accumulated mainly due to slower than expected start-up of research grants program. These accumulated amounts will be drawn down in future years given that grant applications now exceed the amount available on an annual funding basis. See proposed Centre Budget in Table 4.

4. Financial statements dated April 30, 2009 have been reformatted to reflect this year’s disclosure and presentation style.

5. The Centre Director receives no stipend for Centre activities; hence all funds granted are used to support Centre programs.
### Table 3: Annual Financial Report
**Accruals for Research Grants and Case Development Grants**
**As at April 30, 2010**

<table>
<thead>
<tr>
<th>Projects in Process</th>
<th>Accrued Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Controlling Systems Development</em>: Alex Cram</td>
<td>$9,990</td>
</tr>
<tr>
<td><em>The Fraud Pyramid</em>: Professors Free and Murphy (see Appendix C for report)</td>
<td>9,850</td>
</tr>
<tr>
<td><em>KERP plans and the Provision of Incentives in Financially Distressed Firms</em>: Professor Wei Wang</td>
<td>6,615</td>
</tr>
<tr>
<td><em>Internal Control Reporting in Canada</em>: Professors Salterio, Lu and Richardson (see Appendix A and Appendix C for report)</td>
<td>1,520</td>
</tr>
<tr>
<td><em>Business Risk: Are we walking the talk?</em> Christine Hayne</td>
<td>2,500</td>
</tr>
<tr>
<td>Infrastructure grant: <em>Professional tape equipment</em> Professor Free and Christine Hayne</td>
<td>632</td>
</tr>
<tr>
<td>Case development grant: <em>Export Development Canada</em> Professor Detomassi</td>
<td>1,854</td>
</tr>
</tbody>
</table>

**Total Accruals:**
research and case ($31,107+$1,854) grants per
Statement of Financial Position

| Total Accruals:                                                                 | $32,961        |

**Contingent liability:** It is possible that payment for the honourable mention award in 2008 VSRA competition may not have been paid to the QEDC for the participation of the North York Harvest Foods representative in the Queen’s Governance Program: For Boards of Municipal, Provincial and Federal Agencies, and Not-For-Profit Organizations in 2009. We are awaiting the results of an inquiry into this matter. If payment is made, it would reduce the Centre’s accumulated surplus by the amount of approximately $4500.
Table 4: Annual Financial Report
CA-Queen's Centre for Governance
Proposed budget for fiscal year 2010-11
(May 1, 2010 to April 30, 2011)

<table>
<thead>
<tr>
<th>Revenue</th>
<th>2010-2011</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICAO research centre</td>
<td>35,000</td>
<td>In accordance with ICAO-QSB agreement</td>
</tr>
<tr>
<td>ICAO Not for Profit Initiative</td>
<td>45,000</td>
<td></td>
</tr>
<tr>
<td>CAAA re CAR</td>
<td>25,000</td>
<td>CAAA grant to support to CAR Editor’s Assistant per CAAA-QSB agreement</td>
</tr>
<tr>
<td>Transfer from within QSB</td>
<td>15,000</td>
<td>QSB support for Centre Program Assistant</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td><strong>$120,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Admin Prof &amp; Tech Salary</td>
<td>$50,000</td>
<td>Centre assistant salary and benefits; CAR Editor’s assistant salary and benefits</td>
</tr>
<tr>
<td>Travel and representational expenses</td>
<td>1,500</td>
<td>Travel regarding Centre</td>
</tr>
<tr>
<td>Voluntary Sector Reporting Awards</td>
<td>39,000</td>
<td>See breakdown in Schedule attached</td>
</tr>
<tr>
<td>Research grants</td>
<td>40,000</td>
<td>To draw down accumulated research funds in surplus</td>
</tr>
<tr>
<td>NPI case grant</td>
<td>5,000</td>
<td>To fund new case development</td>
</tr>
<tr>
<td>Miscellaneous: office supplies, postage, parking passes for visitors etc.</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td><strong>$137,500</strong></td>
<td></td>
</tr>
</tbody>
</table>

Net surplus(deficit)            | (17,500)  |                                                                            |

Opening net surplus             | **$63,973** | Surplus was built up due to slow start on research grants and Centre emphasis on launching VSRA program. |

Closing projected net surplus  | **$46,473** | ICAO allowed for an initial surplus of $35,000 providing Centre working capital. Amounts from that surplus of that can be drawn down as needed for research grants. |
Table 4 Continued: Annual Financial Report  
Schedule to Proposed Budget 2010-2011  
VSRA 2010 Budget

<table>
<thead>
<tr>
<th></th>
<th>2010-11 Proposed</th>
<th>2009-10 Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luncheon</td>
<td>$5,500</td>
<td>$5,018</td>
</tr>
<tr>
<td>Plaques and misc. award expenses</td>
<td>$1,000</td>
<td>$886</td>
</tr>
<tr>
<td>Honourable Mention Award*</td>
<td>$4,000</td>
<td>?</td>
</tr>
<tr>
<td>Publicity</td>
<td>$2,500</td>
<td>$2,321</td>
</tr>
<tr>
<td>Award announcements</td>
<td>$10,000</td>
<td>$6,088</td>
</tr>
</tbody>
</table>

Globe and Mail and National Post ads announcing winners increase to two insertions from one as research shows that single insertions are rarely effective in raising awareness.

<table>
<thead>
<tr>
<th></th>
<th>2010-11 Proposed</th>
<th>2009-10 Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research assistants**</td>
<td>$3,000</td>
<td>$2,842</td>
</tr>
<tr>
<td>Travel of judges</td>
<td>$4,000</td>
<td>$3,805</td>
</tr>
<tr>
<td>CA Technical Director Salary and And related Administration***</td>
<td>$9,000</td>
<td>$11,676</td>
</tr>
</tbody>
</table>

Total Budget                     | **$39,000**      | **$32,636**    |

**NOTE:** The PWC Foundation sponsorship funds are not included in this budget.

**PWC Foundation sponsorship**  | $25,000          | $25,000         |

* Contingent liability in the amount of up to $4500 for 2008 award not billed for by QSB EDC.

** This does not include charges for time of two PhD student Research Assistants who each put in 50 hours in administering the program in 2009-10 and paid for out of Director’s fellowship.

***Other costs not included in the above budget:
- Centre Director’s time to set up, supervise, aid with technical scoring and judging process, aid with press relations, lunch etc.
- ICAO time regarding administrative support, hosting judges’ day (including room breakfast and lunch) and press relations including both external and internal to ICAO publicity.
- PWC time on registering participants for luncheon plus funds expended on internal publicity to raise program awareness among their partners and clients.
Appendix A

Most Canadian Public Companies are Honest: Queen’s Study
Internal Control Design Effectiveness Reporting Found to Promote Accounting Quality

A new study at Queen’s School of Business, recently accepted for publication in Contemporary Accounting Research (one the top five academic journals in the field), reveals that those corporations that have complied with the internal control standard of the Canadian Securities Administrators (MLI 52-109) by disclosing weaknesses in control are making statements that appear to be credible in the eyes of third parties. This is a surprising result given that previous research revealed that many publicly-traded Canadian firms did not disclose their evaluations of the design effectiveness of their own financial safeguards against fraud as they were not required to report anything if they did not have any weaknesses in the design of their controls.

“Silence appears to be golden, at least in Canada” says study co-author Steve Salterio of the CA-Queen’s Centre for Governance referring to the fact that despite the low level of disclosure of complying with the required assessments, it appears that when firms disclosed control weaknesses, these disclosures were clear indications that the firm had lower quality accounting.

The study, co-authored with University of Toronto professors Lu and Richardson, finds that firms that disclosed more internal control design weaknesses had lower levels of accounting quality as measured by the amount of the abnormal accounting accruals booked by the companies in that fiscal year. This strong relationship suggests that companies with weakly designed internal controls have the expected poorer quality accounting that is subject to more “noise” that happens when companies have poorly designed control systems.

The study also provides evidence that the external auditor offsets, to a small extent, these control weaknesses by carrying out additional external audit procedures (as measured by higher audit fees). However, the study found that the substitution of external audit effort for strong internal control strength was small and incomplete, in the vicinity of 5%.

“This lack of substitution between external audit and internal controls supports the CA-Queen’s Centre for Governance long time contention that internal control reporting is necessary in order for investors to understand the quality of accounting information that publicly traded Canadian Companies are providing” stated Salterio.

Sidebar on measuring accounting quality

Measuring accounting quality is a difficult problem but researchers in recent years have come to a consensus that one way of measuring accounting quality is to examine how closely related the accounting numbers are to cash flows after controlling for various characteristics of the company and its industry. Hence, researchers model what non-cash accounting numbers should be based on historical experience and compare them to what the company actually reports in the period under study. The difference between the two numbers is called “Abnormal Accounting Accruals,” the term used in the above release once and thereafter referred to as “accounting quality.” The larger the abnormal accounting accruals, the lower the accounting quality as many studies have shown.
Appendix B

Voluntary Sector Reporting Awards 2009

In the first round of the competition, technical screeners evaluated the annual reports for technical merit (i.e. did they have the minimal elements that made it possible for them to be judged). This involved the development and testing of a scoring instrument. The highest scoring annual reports then advanced to the second stage of the competition, where the reports were scrutinized by a panel of experts nominated by the three founding bodies (see judges listed below). All entrants are provided with a copy of the technical screeners’ completed checklist so they can see where they met expectations or fell short and, hopefully, use that feedback to improve future annual reports. In addition all participants receive an overview of the judges’ general comments on finalists’ annual reports. Each finalist also received a tailored analysis of the judge’s comments about their report in addition to the technical checklist and general report.

Finalists with the **winners (co-winners) in bold text** are:

**Under $1 Million in Revenue**
- Children’s International Learning Centre
- Hospice King-Aurora (Hospice King)
- Sarnia – Lambton Rebound – A Program for Youth

**$1 Million to $10 Million in Revenue**
- Canadian Paraplegic Association of Ontario
- DeafBlind Ontario Services
- The Lifesaving Society Ontario

**Over $10 Million in Revenue**
- Community Living Toronto
- **Covenant House**
- United Way – Centraide Ottawa
- **United Way of Greater Toronto**

**National and International Organizations Headquartered in Ontario**
- Care Canada
- Mennonite Economic Development Associates
- Nature Conservancy of Canada
- **World Vision Canada**
Voluntary Sector Reporting Award Judges Panel 2009

We had one judge rotate off the panel this year, Professor Ken Wong who is a “marketing legend” as well as a Board member of the CA-Queen’s Centre for Governance. Ideally judges will serve two to three years before rotating off the Panel. This year’s judges are a distinguished group, knowledgeable about the voluntary sector from perspectives of accounting and auditing, philanthropy, research and marketing:

• Nancy Cheng FCA, Assistant Auditor General, Office of the Auditor General of Canada who audits making of Canada’s largest crown agencies and corporations;
• Dr. Vaughan Radcliffe, Associate Professor, Richard Ivey School of Business, University of Western Ontario who has research interests in the not for profit sector (unfortunately Professor Radcliffe caught H1N1 and was unable to partake in the judging process);
• Don Bourgeois, has a private legal practice with focus on charitable and not-for-profit law in addition to being the Editor of The Philanthropist, the journal of record in the Canadian philanthropy sector.
• Dr. Cathy Barr, Vice-President, Operations at Imagine Canada who has carried out significant research on the not for profit sector as part of her responsibilities in this advocacy group’s activities.
• Gregory Cochrane, Partner with Graoch Associates Limited Partnership and considered a foremost practitioner in marketing.
• Martin Connell, Toronto based businessman and philanthropist; currently Chair of the Toronto Community Foundation.
• Philip Creighton FCA, Semi-retired auditor, author, and lecturer in auditing with extensive experience in the not for profit sector and in judging annual report competitions.
Appendix C

Research Completed and Update Reports

Detecting Deception in Business Documents – Overview of Preliminary Findings

Lynnette Purda (Queen’s School of Business) and David Skillicorn (Queen’s School of Computing)

Significant room for discretion exists when companies prepare their financial reports. In some cases, this discretion leaves the door open to overly aggressive or blatantly fraudulent financial reports. To date, identifying abuses of this discretion has focused on analyzing the quantitative components of financial reports. Recently, however researchers have begun to turn their attention to the text of these reports and whether language choice holds predictive power for future firm performance and stock returns (Tetlock, Saar-Tsechansky, Macskassy, 2008; Li, 2006a).

We build on this new line of research by asking whether the Management Discussion and Analysis section (MD&A) of a firm’s financial reports displays distinct word-choice and linguistic patterns in reports that are subsequently revealed to be fraudulent. Our approach differs from previous work designed either to capture negative sentiment (Tetlock et al 2008) or uncertainty (Li, 2006b) in that we do not require the ex-ante identification of “clue” words, suspected to be associated with these sentiments. Instead, we allow the data to establish what is and what is not an “interesting” pattern based on the application of a detection algorithm. These algorithms (and similar data-mining techniques) have previously been used in the context of law enforcement and security-related fields but their application to business analysis is in its infancy.

Our results show that the text of the MD&A section of financial reports holds important clues about the integrity of the reported results. Using a sample of fraudulent reports between the years 1991 and 2006 our detection algorithm correctly identifies over 67% of quarterly reports later deemed to be fraudulent. When the model fails to identify a particular report as being fraudulent it is frequently able to identify those around it since fraudulent reporting generally impacts a series of disclosures rather than an isolated incident. In cases where all four quarters within a fiscal year are fraudulent, our method flags at least one of the quarters to be fraudulent in over 95% of cases.

In addition to demonstrating that detection algorithms have the capacity to correctly distinguish between fraudulent and non-fraudulent financial reports, we establish that the word pattern used in reports for quarters 1 through 3 differs significantly from firms’ choice of language in annual reports issued in Q4. Relating these differences to fraud detection, we find that it is significantly harder to identify fraudulent reports occurring in Q4 than at other financial reporting intervals.

EDITOR’S NOTE: Professor Purda presented the results of this research to the Centre Advisory Board meeting held in May 2010. The Board provided Professor Purda with feedback on her project results to date and a very animated discussion ensued. While work is ongoing on the project, the Centre’s funding obligation is concluded under this grant.
Update on Organizational Fraud Triangle Project

Clinton Free and Pam Murphy - Queen’s School of Business

We wanted to update you on the progress of our fraud pyramid research and ask about the possibility for additional funding through the CA - Queen's Centre for Corporate Governance. (EDITOR’S NOTE: The Fraud Triangle Project was rolled into a larger application under the name The Fraud Pyramid after going through the same due diligence process that the large scale research projects are given by the Advisory Board.)

Last week, we visited four prison facilities in the United States: three within the Fort Dix, NJ institution and one in Elkton OH. We administered a total of 50 surveys and conducted about 30 interviews. At least half of the interviews provided valuable insights into the conditions that lead to fraud within organizations, especially with respect to organizational culture. We found this experience incredibly rewarding both personally and academically.

In September, we plan to visit the third and final prison in Allenwood PA. In addition, we will have at least 5 more interviews with fraudsters who have already served their time in prison. We plan to produce at least two top tier academic papers from this work. The first, based on our interviews, will develop theory regarding the types of organizational or sub-organizational cultures that facilitate fraud. The second, based on our surveys, will provide a quantitative analysis of the predictors of fraud.

One aspect of last week's trip surprised us last minute. Less than one week prior to our scheduled meetings at Fort Dix, we were told that we would likely have approximately 30 inmates to survey / interview at each of three locations - a total of 90 inmates. However, they would only provide us with 3 hours of time at one location, and 1 1/2 hours of time at each of the other two locations. Since our plan was that I administer surveys while Clinton conduct interviews, this limited time frame meant we would get at most seven interviews (3 at the first location and perhaps 2 at each of the other two locations). We felt this wouldn't be enough. Two other factors compounded the problem. First, the prisons did not allow the use of recording devices. Second, the prisons weren't able to specifically identify individuals who perpetrated fraud in the course of their employment. We were likely to get inmates who perpetrated fraud both on their own (not employed) or through their employment.

Given this situation, we decided to invite three current PhD/MSc students to join us in Fort Dix to take notes and administer surveys. By doing this, we were each able to conduct interviews (each with a note taker) while the third student administered surveys. We maximized our time which not only leads to more interviews, but also more interviews with our target participants. We also believe this offered a once-in-a-lifetime opportunity for the students. After checking with several PhD and MSc accounting students who had an interest in this research or methodology, we were able to get Carmel Branston, Brent White, and Alec Cram to join us. We told them we would pay their expenses. All three were able to sit in on interviews and take notes.

In retrospect, we actually had 43 participants from Fort Dix rather than the promised 90. However, most of the best participants resided in one of the 1 1/2 hour locations, so we obtained valuable data we likely would have missed otherwise. The students all said they enjoyed the experience.
Update on Determinants of Internal Control Weakness and Financial Reporting Quality for Canadian Firms

Steven Salterio (Professor of Business, PWC/Tom O’Neil Faculty Fellow)  
School of Business Queen’s University  
Gordon Richardson (KPMG Professor of Accounting)  
Hai Lu (Assistant Professor of Accounting)  
Both of Joseph L. Rotman School of Management

Appendix A to this report contains and early draft of a press release about the first paper that resulted from the data collected with the help of the Centre’s grant and will be acknowledged in the published paper. The paper’s title and publication information is:


ABSTRACT: Public disclosure about effectiveness of internal control systems is subject to much controversy in Canada, resulting in Canadian disclosures being made in Management Discussion and Analysis (MD&A). These disclosures are provided to investors without a definition of the weaknesses to be reported, without implementation effectiveness testing, no direct management certification and no external audit of such disclosures. Though the cost of such SOX North disclosures are lower than in the U.S setting, the credibility of these disclosures is far from assured, posing an important empirical issue for regulators interested in the cost versus benefit trade-off of various disclosure regimes. We use OLS regression and path analysis embedded in a structural model to examine the association between the strength of internal control and accrual quality in order to infer whether these disclosures are credible. The OLS regression finding of an overall negative net effect of internal control weaknesses on accrual quality is refined by recursive path analysis which shows that this overall negative effect is composed of a large negative direct effect of weaknesses on accrual quality and a smaller offsetting positive indirect effect of weaknesses on accrual quality via increased audit effort. The modest substitution effect implies that auditors cannot fully compensate for poor internal control by increased substantive work, which is per se evidence justifying some form of internal control disclosures for investors. Overall, our results suggest that lower cost SOX North disclosures are credible. This informs the cost-benefit debate facing regulators around the globe seeking alternatives to the costly U.S. model of internal control reporting.

Currently, we are using the remainder of our funds to bring our internal control report data base up to 2009 which covers the first two years that Canadian listed companies had to report on internal control design and operational effectiveness. We need to collect two years of data due to the Canadian Securities Administrators late implementation guidance in 2008 for the first year of implementation that was to start on December 15, 2008 and the guidance was issued in final form less than one month beforehand. Hence the non-compliance rate was extremely high as the OSC later noted in a staff report. Therefore we had to collect 2008 and 2009 data as some organizations were prepared to report on implementation effectiveness in 2008 whereas others reported for the first time in 2009 (and others still are not in compliance).