



Like Moths Attracted to Flames: Executives and Financial Reporting Frauds

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Abstract

In this paper, we analyze the governance, control and media patterns underlying corporate fraud cases that occurred in Canada over the past decade. From that basis, we develop a framework that synthesizes the drivers underlying the appearance, evolution and ultimate discovery of fraud within corporations. Our analysis suggests that prior work in the area, as well as professional guidance, provides a partial picture of the fraud landscape that does not pay enough attention to the dynamic nature of fraud. More specifically, executive hubris, fed by fawning media and analysts, appears to contribute to corporate fraud. Finally, fraud patterns seem to differ significantly between Canada and the United States.

Key words: financial reporting fraud, fraud triangle, governance, media, hubris, asset misappropriation

Résumé

Cette étude porte sur les aspects sous-jacents aux cas de fraude commis au Canada durant la dernière décennie. Ces aspects incluent, entre autres, la gouvernance, l'actionnariat de contrôle et la visibilité médiatique des dirigeants et entreprises impliquées. Notre analyse nous permet de revisiter le triangle de la fraude et d'y intégrer de nouvelles dimensions. Plus particulièrement, nous observons que la fraude est un phénomène dynamique, fortement influencé par les personnalités des principaux acteurs impliqués, notamment les dirigeants. Or, la couverture médiatique d'une entreprise ou de ses dirigeants, ainsi que l'aveuglement de la communauté des analystes financiers contribuent probablement à renforcer l'orgueil ou le narcissisme des dirigeants (ou «hubris»), ce qui contribue à la fraude. Nos résultats montrent également qu'il existe des différences dans les profils de fraudes entre le Canada et les États-Unis.

Mots clés : fraude dans les états financiers, triangle de la fraude, gouvernance, media, hubris, détournement

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Introduction

1993: Canadian Entrepreneur of the year

1994: Outstanding Achievement Award winner for Women in Television and Film

1997: Honorary Doctorate, Wilfrid Laurier University

1997: 19th among the 50 most powerful women in the world's entertainment industry

1999: Appointed director of BCE Inc., one of Canada's largest and most widely-owned company

The above mentions refer to critical steps in the meteoric rise of Micheline Charest, former co-CEO of CINAR Corporation (CINAR). CINAR, a media and entertainment company co-founded by Ms. Charest and her husband and co-CEO, Ron Weinberg, was once the darling of the investment community, reaching a stock market capitalization of \$1.5 billion. However, at the peak of Ms. Charest's fame and power, the company started to unravel, getting embroiled in copyright, tax, financial reporting and cash management cover-ups and scandals in the tens if not hundreds of millions of dollars.¹ The events at CINAR led to a legal and regulatory saga that, eight years later, is still going on. Through that process, the Charest-Weinberg couple lost their positions, the control of their company, their reputation and, most likely, a significant portion of their fortune.²

¹ On March 15, 2002, without admitting any guilt, Ms. Charest and Mr. Weinberg each agreed to pay an unprecedented \$1,000,000 fine to the Quebec Securities Commission and to abstain from exercising the voting rights related to the shares they owned in CINAR for five years. Other litigations with taxation authorities and their former firm were settled out of court.

² Ms. Charest died on April 14, 2004.

The CINAR story, as well as many other similar cases of corporate fraud, raises many questions. On the one hand, how can such a celebrated business figure as Micheline Charest become, a few years later, a pariah within her community and the target of numerous lawsuits? On the other hand, how can we expect auditors and regulators to prevent and/or detect financial reporting fraud when they are dealing with successful and highly reputable individuals such as Micheline Charest at the peak of her power?

Ms. Charest's story illustrates the current debate regarding auditors' and regulators' responsibilities in the prevention and detection of corporate fraud. Corporate financial reporting scandals such as CINAR in Canada and, on a much larger scale, Enron or Worldcom in the United States, have undermined the public's perception that fraud can be controlled by government-driven governance mechanisms such as mandatory or internal control audits. By putting much emphasis on the role of external auditors in the prevention and detection of management fraud, regulatory interventions have inadvertently exposed what is probably the audit profession "Achilles heel" (Jamal, 2008). Salterio (2008) argues that auditors can face the challenges presented to them by regulators by adopting a more dynamic audit strategy with respect to management fraud prevention and detection. Such an approach is consistent with evidence collected many years ago (e.g., Fellingham and Newman, 1985). However, one stumbling block in the development of innovative fraud detection strategies is auditors' and regulators' heavy reliance on red flags derived from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework, or fraud triangle. In a strange paradox, while COSO's research and analyses have raised the profile of fraud detection, its prescriptions

have led audit standard-setters and auditors to view fraud detection as a more or less mechanical exercise of verifying the presence or not of fraud factors, which are typically presented in a grocery list format.

The purpose of this paper is to revisit the dynamic process that underlies the commitment of financial reporting fraud by top management. More specifically, we 1) investigate how and why individual managers conduce and/or deepen their involvement in fraudulent or improper financial reporting; and 2) discuss how auditors and regulators need to review their analytical approaches with respect to fraud detection. We focus on the population of financial reporting frauds or improprieties committed in Canadian publicly-traded firms during the 1995-2005 period and which led to the imposition of penalties or fines by the securities regulators. While there may be more cases of alleged fraud or impropriety, we only analyze the cases where fines or penalties were ultimately imposed by securities regulators. Consistent with clinical studies that focus on particular events or transactions (e.g., Fogarty et al., 2008), our methodological approach relies on the exhaustive analysis of media coverage surrounding the firms, regulators' reports and corporate documents (e.g., proxy statements, annual reports).

Our findings suggest that existing descriptions of the process underlying management fraud are missing a key ingredient, managerial hubris. Hubris provides managers with the self-assurance to extend and magnify the scope of their fraud. In our view, media or analyst attention raises or even accelerates managerial hubris, thus launching executives toward their downfall. Like moths attracted to the flames that ultimately kill them,

managers under the spotlight will gain in self-assurance and a feeling of invincibility, thus leading them to take more risks in their fraudulent activities. We also find that a firm's ownership structure affects a CEO's ability to engage in fraudulent financial reporting.

Our research contributes to the academic and professional debate surrounding fraud detection in the following ways. First, most prior research adopts a linear approach in which relevant attributes, otherwise labeled as red flags, are identified as potential determinants of financial reporting fraud. However, in practice, decisions, actions or events take place in a sequential fashion. Our reliance on a qualitative methodology allows us to integrate a timing dimension into our analysis. Second, we extend the COSO framework by giving it an additional dimension, managerial hubris driven by public attention, which sheds light on how frauds get ultimately discovered or detected. From this finding, we put forward specific recommendations for auditing standard changes. Third, most prior studies on financial reporting fraud focus on U.S. based evidence. However, institutional arrangements, ownership structures and legal frameworks significantly differ around the world and determinants of financial reporting fraud identified for a U.S. context may or may not be applicable in another context, even a close one like Canada. The fact that potential determinants of fraud may vary across countries raises some questions as to the reliability of universal auditing standards.

Our paper closely relates to another concurrent paper by Cohen, Ding, Lesage and Stolowy (2008) who analyze the media aftermath of U.S. fraud cases to infer the role of

managers' behavior in the commitment of fraud. Their findings suggest that the fraud triangle can be enriched by integrating the theory of planned behavior, which provides insights into the importance of managers' personality traits as fraud risk factors. Our findings also suggest that managers' personalities are an important factor to consider when assessing the potential for a fraud to be committed. However, our paper differs in the following ways. First, Cohen et al. (2008) consider U.S. fraud cases while we consider Canadian cases. Securities legislations, enforcement by securities regulators and litigation environments differ extensively between both countries. Second, while Cohen et al. (2008) look at media coverage after the announcement that a fraud has been committed, we focus on visibility and media coverage before such announcement to assess the informational context and frame of reference faced by fraud perpetrators. Third, while they consider that the theory of planned action maps reasonably well into the fraud triangle model, our analysis suggests that the model needs to be expanded.

The rest of the paper proceeds as follows. The next section provides a brief overview of the appropriate institutional environment underlying fraud detection as well as prior research on the determinants of financial reporting fraud. Section 3 describes our sample and the methodology used in the paper. Our analysis and findings are discussed in Section 4. In Section 5, building upon the evidence that we have gathered, we revisit the COSO framework and propose an alternative. Section 6 concludes the paper.

2. Fraudulent Financial Reporting

Top Management and Financial Reporting Fraud

The issue of top management fraud encompasses a vast literature covering many years. The scope of prior research reflects the diversity of what constitutes top management fraud, i.e. willfully undertaking actions to mislead others: embezzlement, insider trading, self-dealings, lying about facts, failing to disclose significant events, corruption, cover-ups, etc. Zahra, Priem and Rasheed (2005) provide an exhaustive overview of prior research on the antecedents and consequences of top management fraud. They argue that three levels of antecedents drive managerial fraud: societal, industry-specific and organizational. Societal antecedents include differential associations (associating with those who define criminal behavior favorably) and aspirations. Industry-specific antecedents include culture and norms, investment horizons, concentration levels, inter-competitor hostility, dynamism or market heterogeneity. Organizational antecedents essentially encompass a firm's governance (board), its leadership (tone at the top) and its culture. In the authors' view, individual level attributes moderate the influence of such antecedents on a manager's decision to commit fraud. Individual level moderators include age, experience, education, gender and self-control. However, evidence with respect to the importance of these moderators is mixed and seems to be highly contextual.

According to Zahra, Priem and Rasheed (2005), most studies on financial reporting adopt a governance perspective, with findings generally supporting the view that fraud is committed to enrich managers. However, studies on financial reporting frauds typically

focus on potential indicators, or red flags, rather than attempting to establish direct causes or antecedents. Why a firm's top management decides to engage into unethical or fraudulent financial reporting remains, to a large extent, a puzzle. On the one hand, while it is relatively easy to identify environmental, organizational or individual attributes that seem to be associated with the incidence of financial reporting that violates generally accepted accounting principles (GAAP), one can also find such attributes in many other organizational contexts that do not exhibit GAAP violations. On the other hand, beyond external or objective characteristics, it is difficult to infer the interior motives, personalities or combinations of organizational context and personal weakness that drive successful individuals to engage into the slippery slope of unethical behavior. An additional puzzle is why, once they have engaged into unethical activities, top managers will often willingly expand the scope and the scale of their financial reporting manipulations. Several models have been put forward to provide a structured understanding of these questions. We now review and discuss some of these explanatory models.

Jensen (2005) argues that top managers of firms whose shares are overvalued have an incentive to engage into aggressive financial reporting. In his view, a firm's stock market overvaluation, i.e., the difference between a firm's stock market value and its underlying intrinsic value, essentially reflects inflated investors' expectations with respect to its future earnings. Because these expectations are unlikely to be achieved, management may be tempted to engage into accounting manipulations to raise the level of reported earnings so that it matches investors' implied target. While some initial manipulations may be

within GAAP, declines in the underlying business or the continuation of a stock market bubble may bring managers to violate GAAP to stay afloat. Since they have more to lose if the firm share price deflates, managers with extensive stock or option holdings are more likely to feel a pressure to manipulate earnings. Efendi et al. (2007) corroborate Jensen's intuition by finding that managers with extensive in-the-money stock option holdings are more likely to restate financial statements in a stock market bubble context. They observe that managers with powerful bonus incentives and tight financial situations are more likely to restate financial statements. Fogarty et al. (2008) also observe that the forces driving top management to engage into value destroying behavior, as described by Jensen (2005), were also at play in the accelerated rise and fall of Nortel Networks. Finally, Povel, Singh and Winton (2007) provide some analytical evidence that is consistent with Jensen's argument. They show that financial reporting frauds peak toward the end of a boom, and get revealed in the ensuing bust. They also find that the incidence of fraud can increase if firms make more information available to the public.

Jensen's model has the appeal of putting financial reporting fraud into a broader stock market context in which there is a dynamic interplay between managers and investors. However, Jensen's perspective on the drivers behind financial reporting fraud does not integrate many individual, intra-organizational or social factors that relate to fraudulent behavior. As such, the fraud pattern that emerges from Jensen's argument is consistent with an agency theory view that managers are solely driven by financial incentives, even in terms of their ethics. In other words, at any point in time, many firms may be in a situation where their shares are overvalued, thus potentially inducing management to

engage into financial misreporting. But not all managers fall into that trap, only a minority. Why? To answer this question, it is necessary to use slightly different lenses.

Three recent studies, Gillett and Uddin (2005), Carpenter and Reimers (2005) and Cohen et al. (2008), attempt to explain the dynamics of unethical and fraudulent financial reporting using the lens provided by the reasoned action model, which is derived from social psychology and predicts behavioral intentions and corresponding behaviors.

Through a survey of current Chief Financial Officers (CFOs), Gillett and Uddin (2005) investigate the factors linked with CFO intentions to engage in fraudulent financial reporting. The theory of reasoned action assumes that humans are rational and use the information at their disposal in a systematic way, considering all the implications of their actions before deciding to behave in a given way (Ajzen and Fishbein, 1980). Thus, Gillett and Uddin (2005) posit that individual attitudes (beliefs and need for achievement), compensation structure, firm size and the subjective norms derived from referent groups underlie a CFO's intentions to engage in fraudulent financial reporting. The final model that emerges from their structural equation analyses reveals that negative belief evaluations (managers' awareness of the magnitude of outcomes that can be injurious to them) may contribute to a reduction in the occurrence of fraudulent financial reporting. A manager's referent groups (co-workers or others) strongly influence his/her subjective norms and can also attenuate intentions to engage in fraudulent financial reporting. Nevertheless, CFOs in large firms exhibit greater intentions to engage in fraudulent financial reporting. The need for achievement and positive belief evaluations (i.e., a positive view of fraudulent actions) do not seem to influence CFO attitudes. In

contrast to expectations and to most audit standard pronouncements, managers' compensation structure does not seem to affect their intentions either.

In a parallel study, Carpenter and Reimers (2005) use an extension of the reasoned action model, the theory of planned behavior, to examine managers' decision to engage or not into fraudulent financial reporting. In contrast to the theory of reasoned action, the planned behavior theory assumes control over behavior. Hence, the key to explain an individual's behavior is intentions, which are driven by attitudes toward the behavior, subjective norms and perceived control over the behavior. Results from a survey and from an experiment (both with MBA students) provide strong support for the theory, with attitude having the most influence in predicting behavioral intent. More specifically, Carpenter and Reimers (2005) conclude that "Our results show that managers' attitudes, shaped by the tone set by top executives, significantly influence managers' decisions to behave unethically or not" (p. 125). Subjective norms (i.e., influence of family, friends, or other close individuals) do affect behavioral intent, suggesting that further education on ethics would be beneficial. However, the control that participants perceive to have over a decision seems to have little influence on their intention to engage or not in fraudulent financial reporting behavior.

In contrast to the focus on incentives that characterizes Jensen's argument, these two studies actually show that incentives are not necessarily a key driver of financial reporting fraud. Rather, an individual's attitudes, social referents and firm size emerge as key drivers of the intention to engage in fraudulent or unethical financial reporting.

The Institutional Context

Corporate frauds, and their nefarious consequences for directors, investors, and even employees, constitute a major concern to both regulators and auditors. On the one hand, regulators are keen to maintain their reputation as effective guardians of market place integrity and want to ensure a level playing field for investors. The advent of a corporate fraud is often viewed as a regulatory failure, with regulators being fingered as having been ineffective in preventing it. Hence, large corporate frauds are often followed by calls for tighter regulations, greater regulatory oversight, or political intervention to overcome perceived regulatory sclerosis (Jamal, 2008a). On the other hand, the auditor is often the last person left standing following a fraud and, thus, an easy target for disgruntled investors who perceive that he or she should have detected or prevented it. Frauds can actually be very costly for auditors as the demise of Arthur Andersen following the collapse of Enron and Worldcom show.

These threats have provided an impetus for initiatives by both regulators and auditors with respect to the detection of fraud. Professional accounting associations have set up the COSO in 1985 to both investigate the causal factors that can lead to fraudulent financial reporting and develop public policy recommendations.³ The COSO has developed a template of financial reporting fraud determinants, otherwise called the fraud triangle, which has emerged as a benchmark framework for regulators and auditors to understand financial reporting fraud and to guide their efforts in its detection. According

³ COSO is sponsored by the American Institute of Certified Public Accountants, the American Accounting Association, the Institute of Internal Auditors, the Institute of Management Accountants and Financial Executives International.

to that framework, three major drivers underlie most corporate frauds: opportunity, motivation and rationalization. Opportunity implies a control environment with weak internal controls that can easily be overridden by top management. Motivation relates to individual incentives that put too much emphasis on performance or external pressures to meet earnings or budget expectations. Finally, rationalization reflects the ability of individuals who are involved in frauds to adopt an attitude that deflects blame or responsibility (e.g., it will not hurt anyone, we are so close to making our numbers, I am entitled to it because of my hard work). The risk factors comprising each facet of the triangle arise from prior research conducted by COSO in the eighties and nineties, that concluded that fraudulent financial reporting in the United States involved 1) small firms with marginal profitability or even losses, 2) unethical top management, 3) weak board and audit committee governance, 4) inside directors with extensive ownership and 5) significant family cross-relations.

Auditing standards and audit practices now reflect the COSO framework, most notably by suggesting a focused risk-based strategy to detect fraud through the analysis of a list of red flags that have been associated with previous fraud cases, some of which are documented by COSO (COSO 1997). For instance, Appendix 1 of International Audit Standard 240 - Standard on The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements classifies risk factors relating to misstatements arising from fraudulent financial reporting or misappropriation of assets into three categories: incentives/pressures, opportunities and attitudes/rationalizations.

However, there is mixed evidence regarding the effectiveness of a red flag-based approach in detecting fraud. Pincus (1989), Jamal (2008a) and Salterio (2008a) argue that it is not effective as it does not adhere to the contextuality of financial reporting fraud. In contrast, Bell et al. (1991), Hansen et al. (1996) and Boatsman et al. (1997) find that mechanical decisions aids tend to be more effective than unaided fraud risk assessments. One major problem is the lack of weighting of the red flags, which are typically presented within a grocery list while fraud is a strategic activity (Pincus, 1989). Another problem is the static perspective that red flags provide while fraud is a dynamic and contextual phenomenon, which often grows over time (Salterio, 2008a,b; Zahra, Priem and Rasheed, (2005).

Other auditors and regulators' responses take many forms, such as the adoption of various measures to further delineate their responsibilities with respect to the discovery of frauds, redefine public expectations regarding the discovery of fraud, facilitate the indictment and conviction of fraud initiators and perpetrators and better document and systemize the process leading management to commit fraud. It is interesting to note that many aspects of these new laws and standards have also been inspired by COSO findings and reports. First, laws such as Sarbanes-Oxley in the United States put a greater onus on management to report truthfully and provide for a stronger regulatory oversight of corporate financial reporting. Rockness and Rockness (2005) provide an interesting historical retrospective on such efforts, which they label "legislated ethics". Second, the revision of Statement of Auditing Standard 99 (SAS 99) and International Auditing Standard 240 have increased auditors' responsibilities with respect to the discovery of

fraud in financial statements. Third, professional accounting associations have engaged into various public relations, educational or self-regulatory initiatives to buff up their tarnished image. Finally, some jurisdictions have revised their laws, monetary penalties and evidence requirements regarding white collar crime such as financial reporting fraud. In Canada, through an amendment to its securities laws, the government of Ontario has significantly increased the maximum penalties for securities law offences. Moreover, measures were adopted to recognize new statutory offences such as fraud and market manipulation, to impose tougher penalties for violations of the *Ontario Securities Act*, to grant greater rule-making authority to the Ontario Securities Commission and to allow for civil liability regarding continuous disclosure (Gray, 2005; *Keeping the Promise for a Strong Economy Act (Budget Measures)*, 2002).⁴

Reconciling Research and Institutions

The COSO framework, as well as audit standards that are derived from it, maps fraudulent financial reporting in a way that is broadly consistent with Jensen's (2005) argument. For instance, fraudulent financial reporting is perceived to be more likely when top management has incentives (bonuses, stock options, share ownership) and/or feels pressures by analysts and market participants to engage into fraudulent financial reporting. Such financial incentives underlie Jensen's perspective. Moreover, the opportunity for top management to commit fraud is increased if there is weak governance or internal controls, a view that has empirical support. Finally, the rationalization, which

⁴ In Canada, securities violations are a provincial jurisdiction. Hence, enactment and enforcement of securities laws is performed by provincial securities commissions, such as the Ontario Securities Commission or Québec's Autorité des marchés financiers. The Commissions have a similar role than the Securities and Exchange Commission in the United States.

may appear to be a behavioral antecedent, is actually ex-post and unlikely to provide the upfront impetus to commit fraud.

In contrast, behavioral models such as Carpenter and Reimers (2005) or Gillett and Uddin (2005), which picture fraud in a more intricate way, do not seem to have made much of an impact on institutions. A potential reason for their limited practical impact is the difficulty, in the context of an audit or through regulatory interventions, to measure employees' and managers' attitudes as well as their intentions. Moreover, the intent to engage in fraudulent financial reporting does not necessarily imply the commitment of such fraud: there seems to be a missing element, or step, between intent and actual action in the behavioral models.

By looking at a limited sample of actual cases of fraudulent financial reporting, we intend to bridge the gaps between the red flag approach that characterizes our institutions, the narrow financial incentives focus that permeates most prior research on fraudulent financial reporting and our lack of knowledge about antecedents of financial reporting fraud that are actually directly observable.

Field Setting and Methodology

The sample comprises fifteen (15) cases of fraudulent financial misreporting that occurred between 1995 and 2005 in Canada. The selection criterion was for a firm to have been pursued and/or sanctioned by securities authorities during that period for

GAAP violations or asset misappropriation which were not properly disclosed. Hence, other cases of securities fraud such as insider trading or embezzlement are not covered. Firms were identified from the web site of the Ontario Securities Commission as having had cease-trading orders accompanied by financial statement refilings or errors. Since the population of fraudulent financial reporting cases is only 15, we adopt a clinical study approach which allows us to delve into the rich stories underlying each instance of misreporting.

The information used for the analysis is obtained solely from public sources: proxy statements, audited financial statements, annual reports, management discussion and analysis, Ontario Securities Commission briefs or reports, press releases and media articles, and briefs for court proceedings.

Findings and Analysis

Overview

Table 1a provides an overview of the study's cases as well as some summary information regarding the legal and economic outcomes from the fraud or impropriety. The improprieties fall into three broad categories: 1) GAAP violations (accounting), 2) asset misappropriations (assets), and 3) incomplete or fraudulent disclosure (disclosure).

However, the specifics of each case are quite varied. In the case of Atlas Cold Storage, 2002 net earnings were ultimately found to be overstated by \$37.4 million due to overstatements of accounts receivable, prepaid expenses, capital assets and goodwill; and

understatements of accounts payable and accruals. Since asset misappropriation often implies that financial statements were misleading, it is difficult to disentangle the two. More than \$100 million of assets evaporated at Philip Services in its metals recycling business due to improper trading. Its 1996 earnings were restated from net income of \$40 million to a loss of \$20 million as a result. In the case of Bre-X, the discovery of a major gold deposit was eventually exposed as a hoax. Finally, the CINAR case is probably one of the most complexes as it encompasses tax evasion, disclosure and asset misappropriation. CINAR was accused to have falsely represented the citizenship of its artistic creators to obtain special tax credits given by the Canadian government. Afterward, over \$120 million of the firm's liquid assets were found to have been transferred to the Caribbean without the board's approval, with more than \$40 million still missing to this day.

Very few cases were settled in court. One particularity of the Canadian legal regime concerning white collar crime is the slowness of the procedures. While the Conrad Black-Hollinger case was tried in the United States because it relates to a U.S.-based subsidiary of Hollinger, the Ontario Securities Commission civil proceedings against Conrad Black and other senior executives of Hollinger are still pending and were recently postponed (they were started more than four years ago). Similarly, in the Livent case, while the frauds allegedly took place between 1993 and 1998, criminal court proceedings only started in the summer of 2008. The monetary fines or penalties that were eventually imposed on parties involved in fraudulent reporting are also relatively minor compared with the magnitudes of the amounts involved. Only the initiation of civil class action suits

really allows investors to be partially compensated for their losses (although the perpetrators of the frauds themselves are rarely affected). For instance, in the YBM Magnex case, the \$120 million settlement was paid from the firm's assets (\$35 million) and by a group of former auditors, directors, investment bankers and attorneys (\$85 million).

The economic sanctions are of greater consequence. In almost all cases, when comparing the firm's share price peak prior to the announcement of the fraudulent incident to the value as of July 2008, it appears that investors lost almost everything. Eleven out of fifteen firms ultimately went bankrupt and were either liquidated or restructured, with pre-fraud investors' ownership being extensively diluted if not eliminated altogether. In the two takeover cases, Atlas and CINAR, Atlas shareholders were able to recoup about 50% but CINAR investors received less than 5% of the firm's former peak value. In almost all cases, i.e. in all firms except Laidlaw and Mount Real, the principals involved in the fraudulent activities lost significant amounts of money, if not all their firm-specific wealth as they were significant shareholders. Table 1b allows for a comparative analysis of the sample firms' peak stock market valuation, and sales and earnings, as initially reported, in the period preceding or concurrent to the fraudulent activities.

[Insert Tables 1a and 1b]

Red Flags as Red Herrings?

Table 2 provides an analysis of the cases through the lens of the « red flag » template which is often used in auditing and internal control procedures. Since the analysis relies

on public documents, many red flags cannot be identified. Nevertheless, we can observe that the red flag template does seem to capture antecedents of Canadian cases of fraudulent reporting reasonably well. In that sense, a priori, the relationship between red flags and fraudulent reporting does appear to be consistent with prior evidence.

[Insert Table 2]

Opportunities for Fraudulent Financial Reporting

In terms of opportunities for fraudulent financial reporting, in 12 out of 15 cases, the firm's CEO was an important shareholder, if not the controlling shareholder. Hence, he had ample opportunity to override internal controls and governance processes.

Many firms also had complex corporate structures. Atlas Cold Storage was an income trust, a Canadian legal structure that is unincorporated and which allows cash flows from the underlying operating assets to flow through shareholders without being subject to corporate income taxes. Hollinger was controlled by a pyramid of holding companies that were ultimately controlled by Conrad Black while its operating assets were held in a U.S.-based firm (Hollinger International) that had a dual-class share structure. Despite its relatively small size (disclosed assets of less than \$100 million), Mount Real was part of a corporate structure that included hundreds of affiliated and subsidiary companies. Semi-Tech had publicly-traded affiliates in both America and Asia. YBM Magnex had numerous subsidiaries in Eastern Europe and in the Caribbean, in addition to operations in the United States. St. Genevieve was also part of a group of publicly-traded junior mining companies with exploration activities around the world that were ultimately

controlled by the same shareholder, who also happened to be CEO of St. Genevieve.

All case firms had extremely active merger, acquisition and divestiture activities prior or during the time the fraudulent behaviour took place. For instance, within the span of three years (1998-2001), Hollinger purchased and then sold most of its Canadian newspaper properties (the buyer, CanWest Global, paid \$3 billion for these assets). However, these properties were first shuffled into a new corporate entity, Hollinger International, which then promptly issued stock to the public. Between 2002 and 2005, Mount Real engaged in numerous transactions in which it sold some of its underlying operations to other entities to acquire controlling or influential interests in these firms, booking sizable dilution gains in the process. It transferred some of its assets into a new income trust through an initial public offering. It also sold its acceptance business to an overseas finance firm for a nominal amount while retaining much of the credit risk. Similarly, over the span of a few years, Semi-Tech acquired the Singer and Pfaff brands and operating assets (sewing machines) as well as the Akai and Sansui electronics businesses, acquisitions which significantly multiplied its size. Laidlaw engaged in a complete overhaul of its operations, selling its waste disposal business to acquire a controlling interest in a larger U.S.-based entity (Safety-Kleen), acquiring numerous emergency transportation services in the United States (ambulatory services) as well as ground transportation (Greyhound buses) in addition to its core business of schoolchildren transportation. In its 1998 annual report, CINAR reported that more than 50% of its growth in 1997 and 1998 was a result of acquisitions and, in early 1999 it acquired another production firm, EduSoft, for \$40 million.

Finally, a particular feature of many firms involved in fraudulent reporting is the

fuzziness of their business. The best example emanates from Mount Real's 2003 MD&A:

Mount Real's business is management accounting, information management and media services. Mount Real uses "TMI" TacticsMarketing Intelligence, a business intelligence system, for the management of proprietary and non-proprietary consumer databases.

Through our management accounting services, we assist clients by reporting and interpreting relevant data required by our clients to make logical decisions which are consistent with their growth objectives. Our information management services play an even greater role in assisting clients to grow their business by outsourcing the management of their consumer databases for both prospecting and fulfillment purposes. TMI involves the management of consumer databases for direct marketing purposes. The better we manage information the better our clients are served. Mount Real's media services, including Publisher Services, Magazine Subscriptions and Publish-IT, have allowed the company to further the client relationship and assist the clients we work with to be more profitable. These relationships are developed through traditional media services, such as magazine bundling, and through the growing online media sector allowing Mount Real and our clients to cross-promote other products and services. Leveraging the internet by providing more online products and services also helps accelerate growth and reduce unit costs.

What exactly is Mount Real's business? One would be hard-pressed to answer. YBM

Magnex provides another illustration of fuzzy business terminology in its 1996 annual report:

YBM Magnex International, Inc. and subsidiaries (the "Company"), is a manufacturer and distributor of high energy neodymium-iron-hydrogen-boron permanent magnets produced in a wide range of sizes, configurations and magnetic properties. The magnet product line also includes rare earth cobalt, ferrite and aluminum-nickel magnets. In addition, the Company salvages materials as part of magnet production and generates additional revenue by buying crude oil, adding neodymium powder to absorb sulphur content which reduces costs to refiners, and selling the oil

Perhaps not surprisingly, in both Mount Real and YBM Magnex cases, the receivers appointed to manage and liquidate the firms eventually stated that they could not find any trace of operations actually taking place in these firms prior to their failure, despite income statements reporting millions of dollars in sales. For instance, in the case of

Mount Real, the receiver appointed by the securities regulator found out that while the firm reported revenues of \$46 million in 2004, and of \$19 million in the first nine months of 2005, its internal budgets showed revenues that barely exceeded \$7,000 a week, i.e., less than \$400,000 for a year (Robillard, 2005).

Bre-X, Getty Copper and St. Genevieve are also interesting cases as they were junior mining exploration firms with “prospects” around the world, their valuation being based upon investors’ assessment of their likelihood of discovering promising sites or reserves.

Motivations for Fraudulent Financial Reporting

From a motivation perspective, consistent with Jensen (2005), all firms were essentially valued on the basis of unrealistic earnings expectations, their shares selling at very high multiples of their sales and/or earnings. The Bre-X example is an extreme illustration as its value was based solely on the potential cash flows to be derived from its alleged Busang gold deposit: the firm had no assets to speak of and no revenues. Moreover, the development of the deposit would have required large sums of money as well as considerable time and efforts. Getty Copper and St. Genevieve have similar profiles, with little revenue to speak of and a stock market value based upon extremely optimistic assessments of their future prospects. Another high-flying firm was CINAR. At its peak in 1999, the firm’s stock market value was about 90 times its reported earnings for 1998. In all cases, the share prices implied unprecedented earnings growth for years to come. In its last profitable year (1996 pre-restatement), Livent earned \$11 million and reported a cash flow from operations of \$34 million, both supporting a stock market capitalization

that reached \$300 million. The actual cash flow shrank to \$9 million once restated. Philip Services reached a stock market capitalization of more than \$3 billion on the basis of 1996 (pre-restatement) earnings of \$39 million, with cash flow from operations being negative to the tune of \$60 million. In its last filed audited financial statements (1996), YBM Magnex reported sales of \$90 million, earnings of \$17 million and cash flow from operations of \$7.6 million. The firm reached a stock market capitalization of close to \$1 billion in early 1997 after substantial equity issues to investors, i.e., eleven times its 1996 sales, close to 60 times its 1996 earnings and more than a 100 times its 1996 cash flow.

In all cases, beyond the gains to be derived from any asset misappropriation, there were clear monetary incentives for perpetrators of fraudulent activities. For example, 9 out of 15 firms engaged in primary share issues in the period immediately preceding or concurrently to the fraudulent activities. In two other cases, insiders were clearly identified as large net sellers of the firm's shares before the discovery of fraudulent activities. In eight cases, executives involved in fraudulent activities had incentive plans that were clearly linked to the firm's financial performance.

Excessive lifestyles are more difficult to assess. In four cases (Bre-X, CINAR, Hollinger, Livent), there was evidence that top executives, in all four cases also controlling or important shareholders, had expensive and possibly extravagant lifestyles. At CINAR, the Weinberg-Charest couple were acquiring extensive real estate holdings (primary residence and secondary residences). At Hollinger, it is well-known that Mr. Black had

high-end residences in Toronto, London, New York and Florida. At Livent, MM.

Drabinsky and Gottlieb were well-known fixtures of Toronto's society pages.

Rationalization

Ex-post rationalizations are more difficult to infer as they often relate to private conversations. However, it can be inferred that in a few cases, culprits fell above the law. For instance, following Micheline Charest's death in 2004, an ex-CINAR employee said that "...even if everything was illegal at CINAR, in her mind, she was right". Well-known business consultant Marcel Cote, who has advised many of Canada's leading entrepreneurs, adds that "...for this type of businessperson, rules are for ordinary people, they do not apply to them...". At Hollinger, Conrad Black expressed no remorse at his trial and defended his position up to the last minute. Moreover, disclosed emails show a complete disrespect for minority shareholders' interests and rights. At St. Genevieve, commenting upon the improper transfer of \$20 million from two related entities to prop up a third one, former CEO Pierre Gauthier said that it was done in the interest of the company at the time.

Overall, the red flag template does seem powerful in explaining the study's, and Canada's, fraudulent reporting cases. But the red flags can also be perceived to be red herrings and, as such, not very useful for auditors and regulators. First, red flags considered to represent opportunities for fraudulent financial reporting can be observed in large swaths of Canada's business landscape even though most of the firms do not seem to exhibit any fraudulent activities. Therefore, relying on these red flags can translate into

an inefficient use of audit and regulatory resources as there are so many firms that can potentially be chased on that basis. For example, more than 50% of publicly-traded firms have a significant blockholder in Canada, often a family or an individual who also occupies senior executive position(s) (Craighead, Magnan and Thorne, 2004). Complex corporate structures also are a staple of Canadian business. More than 20% of firms on the Toronto Stock Exchange Index have a dual class share structure (Khalil, Magnan and Cohen, 2008). During the 2000-2008 period, income trusts or limited partnerships represented up to 15% of Canada's total stock market capitalization (Cormier, Lapointe-Antunes and Magnan, 2008).⁵ Pyramidal arrangements are quite common, encompassing many of Canada's leading corporate empires such as Weston-Loblaw, Power Corporation, Quebecor or Sobeys. The past decade witnessed a surge in M&A activity in all industrial sectors (Andre, Khalil and Magnan, 2007). Finally, Canada is home to the world's largest junior mining exchange alongside London (U.K.), and has a significant high-tech sector.

A similar observation can be made regarding red flags considered to represent motivations for fraudulent financial reporting. Unrealistic earnings expectations are rampant in bull markets such as the ones experienced between 1995 and 2000, and 2002 and 2005. Similarly, personal incentives in terms of bonuses, share issues or share sales are prevalent in most firms. In retrospect, the red flag template works but, in the broader context in which auditors and regulators want to prevent or detect fraudulent financial reporting, red flags essentially morph into red herrings that may lead to numerous and

⁵ These corporate structures often involve a dual governance oversight system (a board of trustees plus a board of directors), have intricate legal arrangements (trust deeds) instead of corporate charters and often mix unincorporated entities with corporations (Cormier, Lapointe-Antunes and Magnan, 2008).

unfruitful wild investigation chases. While red flags can be deemed to be proximate causes of fraudulent activities, the causality relationship is actually more complex than what the template may suggest.

Counter-Intuitive Red Flags: Providing Cover for Fraud and Impropriety

Further analysis of the sample firms' governance does reveal some troubling facts that further undermine the red flags template. First, 12 out of 15 firms had a majority of independent directors on their board in the period immediately preceding the discovery of the fraudulent activities. In only three cases (Bre-X, Hollinger and Semi-Tech) were the boards clearly dominated by insiders. All boards also had an audit committee comprising independent directors (as required by the Toronto Stock Exchange). Second, 7 out of 15 firms had "star" directors who brought considerable credibility or clout to the board. CINAR's board included one of Canada's leading retail executives, Pierre Lessard, an accountant by trade. It also included an experienced merchant banker who eventually became CEO of Laurentian Bank. A former Canadian ambassador to the United States was on Hollinger's board. Knowledge House had one of the region's leading attorneys on its board as well as a former aide to the country's prime minister. YBM Magnex had a former premier of the Province of Ontario on its board. But Livent's board was perhaps the most star-studded with four of North America's most experienced and well-connected private equity investors and merchant bankers sitting on it: the chairman of Rotschild Canada, the CEO-owner of T.H. Lee (a private equity firm), Joseph L. Rotman (chief benefactor of the eponymous business school) and A. Alfred Taubman. Finally, still from a governance perspective, 12 out of 15 firms also had Big 4 auditors, the only exceptions

being Fareport, Getty Copper and YBM Magnex, which were audited by small to mid-tier auditors.

From a market monitoring perspective, most of the sample firms were supposedly screened or watched by some of Canada's leading financial intermediaries (see Table 3). For example, it appears that 9 out of the 15 firms retained prestige investment bankers during the period immediately preceding or coinciding with the discovery of fraudulent activities. Atlas retained TD Capital for a share issue, an affiliate of one of Canada's largest commercial banks. Bre-X and its affiliates Bresea issued shares through TD Securities, Scotia McLeod (owned by another of Canada's largest banks) and Midland Walwyn Capital. CINAR issued shares through CIBC Wood Gundy (owned by another of Canada's largest banks) and Salomon Canada, a subsidiary of New York-based Salomon Brothers. Hollinger issued notes through all of Canada's largest banks investment banking subsidiaries. Livent issued shares through CIBC Wood Gundy and First Marathon. Philip Services' last share issue is especially noteworthy as it was subscribed by a who's who of Canada investment banking community: Salomon, Merrill Lynch, CIBC Wood Gundy, TD, RBC Dominion, First Marathon, Midland Walwyn.

At least six of the sample firms were also at some point a component of the Toronto Stock Exchange Index, a status that is typically preceded by an investigation by the Exchange authorities and which is accompanied by increased scrutiny by market participants. Finally, while the data is sketchier in that regard, it does appear that 12 out

of 15 firms were subjected to analyst coverage during the period, albeit not always positive.

[Insert Table 3]

Hence, from both governance and market monitoring perspectives, sample firms were subjected to what would appear appropriate oversight and scrutiny by well-informed and independent agents such as directors, auditors, investment bankers, analysts, and stock market authorities, with the above mentioned red flags being visible to all these agents at most times. That governance and market monitoring failed so dramatically in these instances raises two questions. First, with some players probably being co-opted for financial incentives, i.e., additional fees, which interests were these independent agents in fact protecting. Second, adopting a counter-intuitive approach, was the appearance of good governance and active market monitoring used by fraud perpetrators as a cover for their fraudulent activities, creating an aura around their management and actions that prevented further enquiry. In some sense, visible governance and market monitoring mechanisms may have facilitated fraudulent activities, not hindered them.

Managerial Hubris

From the above analysis, it does appear that the presence of red flags constitutes a necessary condition for the enactment of fraudulent financial reporting but that it is certainly not sufficient as many other firms, exhibiting no evidence of impropriety or fraudulent financial disclosure or reporting, share the same attributes. In addition, fraudulent disclosure or reporting seems to be associated as well, if not accelerated, with appearances of good governance and market monitoring. On one hand, under conditions

in which almost all red flags are at mast and directors, auditors, analysts and/or investment bankers have reputations at stake, it takes very smart, cocky or master of deceit executives to have engaged and even plunged even deeper into fraudulent activities. On the other hand, CEOs may have become oblivious to unethical behaviour within the executive ranks as they were blinded by their or their firm's success, building up their feeling of invulnerability. Such a frame of mind and attitude can be driven by managerial hubris, i.e., exaggerated pride or self-confidence (Merriam-Webster Online Dictionary). A more elaborate definition is “... *overweening pride, self-confidence, superciliousness, or arrogance, often resulting in fatal retribution. In ancient Greece, hubris referred to actions which, intentionally or not, shamed and humiliated the victim, and frequently the perpetrator as well. It was most evident in the public and private actions of the powerful and rich*” (Wikipedia). Managerial hubris can emerge and grow in a context where it is nourished by a fawning audience. The media and analyst communities provide such an audience.

Hayward and Hambrick (1997) examine CEO hubris in the context of acquisitions. One of their measures of hubris was recent media praise, a situational condition that was perceived to generate hubris. Their findings suggest that CEOs thought to exhibit hubris engaged in takeovers in a way that was more costly to their shareholders: the extent of the takeover premium was higher for firms with a CEO with visible signs of hubris than for other firms. Their findings are consistent with Ford (2006) who asserts that hubris is one of the key reasons why organizational personnel are prone to fail. Hiller and Hambrick (2005) pursue the analysis further. They note that hubris contributes to enhance an

executive`s core self-evaluation, i.e., how they evaluate themselves and their relationship with the environment. In their view, executives with very high or hyper core self-evaluation are free of anxiety, have little concern about negative outcomes because they feel that they will ultimately prevail. In other words, `”...the upper reaches of core self-evaluation may be thought of as a scientifically validated hubris factor” (Hiller and Hambrick, p. 306.). More importantly, they derive some conceptual predictions about hubris` impact of strategic processes and choices. They predict that CEO hubris, or hyper core self-evaluation, will translate into (among other predictions) 1) less comprehensive strategic decision processes, 2) centralized strategic decision-making, 3), greater deviations from industry trends, 4) greater persistence in pursuing CEO-launched strategies, 5) more extreme performance.

Table 4 provides a summary of how the case firms were assessed by the media and analyst communities before their downfall. It is striking that all sample firms received coverage which can have enhanced executives` self-confidence or arrogance and comforted them in their ability to engage in fraudulent activities without being caught, i.e., fed their hubris. We now briefly review some of the most noteworthy quotes or mentions that illustrate the table.

[Insert Table 4]

Bre-X

- 1997: David Walsh, CEO, is named Developer of the Year and John Felderhof, Chief Geologist, Prospector of the Year by the Prospectors and Developers Association of Canada

CINAR

- 1998: Micheline Charest is named Canadian Woman in Communications of the Year
- 1998: Cinar is recognized by an analyst as “extremely well-managed” and “second to none in terms of delivering shareholder value” (Analyst’s report)
- 1999: Micheline Charest ranks as the 19th most influential woman in the entertainment world by The Hollywood Reporter
- 1999: Micheline Charest is in the top 3 of the 100 most successful women-owned businesses according to Canadian Business (largest Canadian independent business magazine)

Fareport Capital

- 1998: The company is pointed out as an example of successful taxi strategy in the Report to Review the Toronto Taxi Industry by the Toronto Task Force to Review the Taxi Industry: “*The principles in the Fareport strategy are all supported in the proposed recommendations*”

Hollinger

- CEO-owner Conrad M. Black is reviewed in two-well known biographies
 - Newman, P.C. *The Establishment Man: A Portrait of Power*. Toronto: McClelland and Stewart, 1982;
 - Siklos, Richard. *Shades of Black*. Toronto: McClelland & Stewart, 1995.
- 1990: CEO-owner Conrad M. Black made an officer of the Order of Canada
- 1992: CEO-owner Conrad M. Black appointed to the Queen’s Privy Council in Canada
- 1993: CEO-owner Conrad M. Black writes his own biography (*Conrad Black: A Life in Progress*, 1993)
- 1998: Largest newspaper group in Canada and third largest in the world
- 2001: CEO-owner Conrad M. Black takes seat as Peer of the United Kingdom, Lord Black of Crossharbour

Knowledge House

- 2000: Named New Business of the Year at the Metro Halifax Business Awards
- 2000: Ranks first in year-over-year sales and employee growth among Top 101 companies in Atlantic Canada
- 2000: Chosen as the Canadian training agency for Intel of Canada’s Teach to the Future program
- 2001: Dan Potter, CEO, is appointed as chairman of Nova Scotia Business, a government agency set up to finance Nova Scotia businesses, attract investment to the province and develop trade

Laidlaw

- 1998: The Alumni Achievement Award (Ryerson University) is awarded to James Bullock, CEO.

- James Bullock serves as Governor and Chair of the Board of Governors of Ryerson University for six years

Livent

- 1994-1995: "Show Boat" is the highest grossing production on Broadway, setting the all-time record for the largest box office advance for a revival/re-creation, and repeatedly breaking the record for the highest weekly Broadway box office gross in history
- 1994-1995: "Show Boat" is most honored show on Broadway, winning five Tony Awards
- 1994-1995: "Show Boat" is the winner of five New York Drama Desk Awards
- Other awards and acclaims for Phantom of the Opera, Kiss of the Spiderwoman, etc.

Mount Real

- 2003: Honeybee Technology, an affiliate, places 12th on Deloitte & Touche Canadian Technology Fast 50 Winners according to Canadian Corporate News
- 2002-2003: Lino Matteo, CEO, and Joseph Petticchino, COO, are highlighted in the advertising campaign of a major Canadian university after Mount Real agrees to finance a scholarship

Philip Services

- 1994: Is named Canada's fastest growing company by
- 1994: Is named Entrepreneurial firm of the Year by
- 1995 and 1996: Places top 10 on Profit Magazine's Top 100 most profitable companies list

Semi-Tech

- June 1997: Fourth on the list of the world's 200 fastest growing companies compiled by Deloitte & Touche Consulting Group
- Fall 1997: Is named Canada's 10th largest employer
- Fall 1997: Is a member of Team Canada delegation to China, headed by country's prime minister

St. Genevieve

- "I could have predicted this would happen because {Gauthier} is the best promoter of this generation," said MacDonald Mines president Frank Smeenk regarding a major discovery in Cuba and the announcement of a major international financing (as reported by Peter Kennedy, Financial Post, February 1, 1996, p. 25).

Tee-Comm

- 1995-1996: Popular stock for investor wanting to get on the satellite TV trend according to Silicon Investor web site

YBM

- March 1996: Listed on the TSX and in the TSE 300 index. Receives glowing buy recommendations from Nesbitt Burns and First Marathon.

These quotes and citations show that at some point prior to the discovery of fraudulent activities, almost all sample firms or their top executives were the objects of glowing media, society or stock markets' reports. In our view, the prevalence of such favourable coverage may have either enhanced the willingness of perpetrators of fraudulent activities to pursue their actions or removed successful CEOs from carefully monitoring their executive team. A comment by one of Canada's richest investor, Hal Jackman, further illustrates the potential removal from business reality that hubris can create. Talking about Conrad Black, a former friend, who was moving up on the British social circuit, he labeled him "*a parvenu drifting away from reality. I can't understand his priorities. He does too much entertaining and not enough business*" (Tom Bower, 2006, Conrad the Barbarian, Sunday Times, October 22)

Managerial hubris may be also built up over time as individuals pursue unethical or fraudulent activities without being caught, raising the stakes at each new round. From an initial intent to deceive, perpetrators of fraudulent activities raise their goals, their aspirations and, not being caught, gain even more confidence that their actions can continue uninhibited. While such initial intent is more difficult to see through, two signals can be inferred from the sample firms.

First, from publicly released documents, it appears that at least three firms were front operations for criminal elements or groups. For instance, as early as 1995, there were

British court proceedings against a predecessor firm to YBM Magnex alleging large scale extortion, prostitution, arms dealing and drug trafficking by Russian crime gangs and use of Canadian companies to launder money. The firm was supposedly used as a front for a Russian mob boss. In June 1997, a report was issued by the Royal Canadian Mounted Police (equivalent to the United States FBI) and the Canadian Security Intelligence Services identifying Semi-Tech Corporation as one of the companies owned by Chinese Triads. Finally, Mount Real was effectively a “sham” (Quebec Superior Court Justice Jean-Yves Lalonde, February 8, 2007) and part of a vast conspiracy involving a failed hedge holding company (Norshield) and a myriad of affiliates or subsidiaries, some publicly-traded as well.

In addition to official or police investigation reports, other sources can provide insight into the initial intent to deceive. For instance, David Walsh, CEO of Bre-X went bankrupt a few years before and was able to reemerge because of his wife’s personal fortune. Prior to the disclosure and illegal fund transfer scandals, CINAR has allegedly been involved for many years in tax fraud, the case being settled out-of-court. In 1978, Conrad Black seized control of a predecessor firm to Hollinger from the widows of the founding-controlling shareholders in a quick transaction that was always perceived to be a major, if not ruthless, coup. That transaction, which earned him the nickname of “Conrad the Barbarian”, was quickly forgotten when the Globe and Mail, Canada’s leading newspaper, anointed him Businessman of the Year for 1978 (Bower, 2006). Principals at Mount Real, Semi-Tech and YBM Magnex were also involved in other doubtful transactions.

Overall, using the conceptual framework developed by Hiller and Hambrick (2005), it does appear that senior executives or CEOs involved in the fraud cases reported in this study may have build up hubris, as reflected in a fawning press or analyst coverage. Moreover, such hubris may help us understand how frauds were committed and grew as strategic decision making appeared more intuitive and centralized than formalized and decentralized. Moreover, since almost all firms went bankrupt, we can certainly infer that their performance was extreme.

Toward a New Fraud Framework

Our analysis suggests that prior models of fraud involvement such as the red flag approach or the reasoned action model are incomplete as they do not capture the rich institutional, governance and mental backgrounds that facilitate, if not accelerate, the perpetration of financial reporting fraud and impropriety. Figure 1 summarizes the emergent model of fraud involvement that we propose as a result of our analysis of the above case firms.

[Insert Figure 1]

Red flags can at best be described as proximate sources that create a context that is auspicious for fraud or impropriety but are not sufficient to actually translate automatically into fraud. In our view, for fraud or impropriety to be actually committed, governance and markets monitoring conditions need to be present as they provide additional cover that may retard discovery. Moreover, as executives engage into the slippery slope of deception that accompanies fraud, impropriety or deception, their hubris

can be fed or enhanced by positive or fawning external exposure as well as by precedent obscure or forgotten events that comfort them into their likelihood of success in avoiding detection. Our observation is consistent with Schrand and Zechman (2007) who note that executive overconfidence can often be seen as a prelude to fraud.

Conclusion

The purpose of the paper was to analyze cases of fraudulent financial reporting or disclosure that took place between 1996 and 2005 in Canada. A few key findings emerge. First, similar to prior evidence, many red flags can be identified for all cases. However, in the context of Canada's corporate landscape, such red flags may be identified in scores of other firms that are without any hint of impropriety. Second, to develop a powerful template of factors related with fraudulent activities, we assess case firms' governance quality as well as the extent of market monitoring to which they are subjected. In both instances, we conclude that in almost all cases sample firms had adequate cover for fraud or impropriety as a result of good governance in appearance and extensive stock market scrutiny through the use of prestige investment bankers or analyst coverage. Third, we discover that almost all sample firms and/or their CEO were the objects of positive media or analyst coverage in the period preceding or concurrent to the fraudulent activities. In our view, such coverage translated into a higher sense of self-confidence or invulnerability among the executives, i.e., managerial hubris. Managerial hubris either led guilty executives further down the path of deception and fraud or, alternatively, pulled their supervising executives away from efficient and effective monitoring.

The study provides auditors and regulators with a rich template to identify or analyze cases of financial reporting fraud and severely undermines the view being put forward by many institutional investors that “check-list” governance is an effective monitoring tool. Moreover, while the red flag template does include attitude and rationalization as psychological factors underlying fraud, both are very specific and linked to definite actions. As such, they are more after-the-fact themes and are not terribly useful as leading identifiers. In contrast, managerial hubris, while captured in this paper by media quotes or mentions, is more likely to be transparent when asking executives about their plans, realizations, future strategies, coups, etc. Inconsistencies between executives’ statements and observable facts or realities, outlandish claims, and a lack of concern for operational details, can be signals that managerial hubris has set in, creating further risk for auditors and regulators.

The study provides an extension as well as a powerful contrast to prior U.S.-based evidence. The picture of fraudulent financial reporting and disclosure that emerges is not linear, and is unlikely to be solely driven by red flags which, in any case, would describe a large fraction of Corporate Canada. More attention needs to be given to signals and indications that create an appearance of good governance but are in reality deception once looked through the prism of senior management’s hubris. Indeed, it is highly likely that managerial hubris is present in U.S. cases of fraudulent financial reporting as well:

The MCI deal...has become the stuff of legend. (Joseph McCafferty, CFO Magazine)

Scott is being celebrated as one of the country’s outstanding CFOs (Cynthia Cooper, 2007, Extraordinary Circumstances, p. 158)

The above quotes refer to Scott Sullivan, former Chief Financial Officer of Worldcom, who is now serving a five-year prison term for his involvement in the massive financial reporting fraud that led to Worldcom's ultimate collapse.

The study's key limitation is the small sample size (15 firms), which does not represent the population of firms sanctioned by the Ontario Securities Commission with a cease-trade order for improper or fraudulent financial reporting or disclosure. However, the small sample does allow for a deeper investigation of the context surrounding each fraud case.

Future research may attempt to provide further validation to the emergent model through interviews with concerned individuals as well as with formal quantitative studies through experiments or actual data (expanding from actual fraud to lesser offences).

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Table 1a
Overview of Cases and Outcomes

Case	Nature of Business	Type Of Impropriety Sanctioned by Securities Regulators*	Ultimate Regulatory Sanctions (as of June 30, 2008)	Economic Sanction (Stock Market Value Decline from Peak Until 31/07/2008)	Ultimate Outcome
Atlas Cold Storage	Freezer operations	Accounting	CFO and controller fined and barred. Charges against CEO dropped for lack of evidence. \$40 million settlement of class action suit approved by Ontario Superior Court of Justice in June 2008.	\$300,000,000	Takeover
Bre-X	Mining exploration	Disclosure Assets	CEO died during proceedings. \$10,000,000 settlement. Chief geologist cleared from all charges.	\$6,000,000,000	Bankruptcy and liquidation
CINAR	Film and TV producer	Tax evasion Disclosure Assets	Co-CEOs fined and barred. Out-of-court settlements for tax and misappropriation cases.	\$1,900,000,000	Takeover
Fareport	Taxi and ground transportation	Accounting Assets	Both president and COO resigned. Insider cease trading order.	\$150,000,000	Restructuring and change of control
Getty Copper	Mining exploration	Assets	Chair and CEO resigned. Royal Canadian Mounted Police investigation. Lawsuits still pending.	\$400,000,000	
Hollinger	Newspapers	Disclosure Assets	Owner-CEO and executives convicted in criminal U.S. proceedings. OSC proceedings still pending.	\$1,000,000,000	Bankruptcy
Knowledge House	Internet-based learning and education	Insider stock trading and stock price manipulation	Chair of audit committee fined \$50,000 for lack of monitoring.	\$93,000,000	Bankruptcy
Laidlaw	Ground transportation and waste management	Accounting	Out-of-court settlement with claimants.	\$7,000,000,000	Bankruptcy and restructuring

Case	Nature of Business	Type Of Impropriety Sanctioned by Securities Regulators*	Ultimate Regulatory Sanctions (as of June 30, 2008)	Economic Sanction (Stock Market Value Decline from Peak Until 31/07/2008)	Ultimate Outcome
Livent	Live theater production	Accounting Assets	Ongoing criminal trial against controlling shareholders.	\$300,000,000	Bankruptcy and liquidation
Mount Real	Accounting services and magazine subscription management	Accounting Assets Illegal sale of securities	Criminal and civil lawsuits still pending.	\$150,000,000	Bankruptcy and liquidation
Philip Services	Waste management and recycling	Accounting Assets	Senior management fined \$500,000 and barred. Criminal proceedings against another executive still pending.	\$3,700,000,000	Bankruptcy and restructuring
Semi-Tech	Sewing machines and electronics	Accounting Assets	Former CEO sentenced to 6 years in prison by Hong Kong court on one count of false accounting, other charges dropped. Guilty verdict overturned on appeal.	\$1,300,000,000	Bankruptcy and liquidation
Ste-Genevieve	Mining exploration	Assets	Admission of guilt. Owner-CEO removed.	\$120,000,000	Bankruptcy and restructuring
Tee-Comm Electronics	Direct-to-home entertainment products and services	Disclosure	Class action lawsuits still outstanding.	\$500,000,000	Bankruptcy and liquidation
YBM Magnex	Industrial magnets	Accounting Assets	\$120 million settlement. Five former directors, brokerage firms for IPO are sanctioned and fined \$1.2 million. 5-year ban for directors.	\$1,000,000,000	Bankruptcy and liquidation

* Legend – Type of Impropriety Sanctioned by Regulators
Accounting: GAAP violations
Assets: Improper use of assets and asset misappropriation
Disclosure: Non-disclosure of material facts

**Table 1b
Overvaluation**

Case	Date	Approximate Stock Market Capitalization at Peak	Reported GAAP Sales Immediately Before Fraud Discovery or Concurrent to It	Reported GAAP Earnings (Loss) Immediately Before Fraud Discovery or Concurrent to It
Atlas Cold Storage	2002	\$600,000,000	\$295,733,000	\$19,045,000
Bre-X	1996	\$6,000,000,000	Negligible	Negligible
CINAR	1998	\$1,900,000,000	\$150,978,000	\$21,832,000
Fareport	2004	\$150,000,000	Not available	(\$1,656,000)
Getty Copper	2002	\$400,000,000	Negligible	(\$251,000)
Hollinger	1999	\$1,000,000,000	\$3,860,000,000	*(\$259,000,000)
Knowledge House	2000	\$93,000,000	\$39,182,000	(\$6,911,000)
Laidlaw	1998	\$7,000,000,000	\$2,056,000,000	*\$245,000,000
Livent	1997	\$300,000,000	\$331,732,000	\$11,053,000
Mount Real	2002	\$100,000,000	\$38,257,000	\$9,722,000
Philips Services	1997	\$3,700,000,000	\$1,125,510,000	\$52,742,000
Semi-Tech	1997	\$1,300,000,000	\$1,799,400,000	(\$110,100,000)
Ste-Genevieve	1997	\$120,000,000	Negligible	Loss
TeeCom	1996	\$500,000,000	Not available	Not available
YBM Magnex	1997	\$1,000,000,000	\$90,326,000	\$17,072,000

*Excluding certain dilution gains and gains on disposal of long term assets

Table 2
“Red Flags” Summary Analysis

Case	Opportunity				Motivation			Rationalization
	Owner-CEO Control ¹	Complex Corporate Structure ²	Active M&A Strategy ³	Fuzzy Business ⁴	Unrealistic Earnings Expectations ⁵	Incentives	Lifestyle ⁶	
Atlas Cold Storage	X	X	X		X	Bonuses Share issue		
Bre-X	X		X	X	X	Bonuses Share issues and sales	X	
CINAR	X		X	X	X	Bonuses Share issue	X	X
Fareport	X		X	X	X	Personal gains		
Getty Copper	X			X	X	Personal gain to CEO		X
Hollinger	X	X	X		X	Bonuses Special fees	X	X
Knowledge House	X		X	X	X	Bonuses Share sales		
Laidlaw		X	X		X	Bonuses		
Livent	X		X	X	X	Bonuses Share issue	X	X
Mount Real	X	X	X	X	X	Share and debt issues		X
Philips Services		X	X	X	X	Share issue		
Semi-Tech	X	X	X	X	X			X
Ste-Genevieve	X	X	X	X	X	Propping up of related party firm Share Issue		X
TeeCom	X		X	X	X	Bonuses Share issue		
YBM Magnex	X	X	X	X	X	Share issue		

¹ CEO owns at least 5% of shares. ² Numerous subsidiaries, affiliates ³ Recent acquisitions ⁴ Complex or unclear business model ⁵ Stock market price unjustified by earnings ⁶ Media mention

Table 3
Counter-Intuitive “Red Flags”:
Providing Cover for Fraud and Impropriety

Case	Governance				Market Monitoring		
	Majority of Independent Directors	Audit Committee	Presence of Star Directors	Prestige Auditor	Prestige Investment Banker	TSX Index	Analyst Coverage
Atlas Cold Storage	X	X		X	X		X
Bre-X		X		X	X	X	X
CINAR	X	X	X	X	X	X	X
Fareport	X	X					
Getty Copper	X	X					
Hollinger		X	X	X	X		
Knowledge House	X	X	X	X			
Laidlaw	X	X	X	X	X	X	
Livent	X	X	X	X	X		
Mount Real	X	X		X			
Philips Services	X	X		X	X	X	
Semi-Tech		X		X		X	
Ste-Genevieve	X	X	X	X	X		X
TeeCom		X		X		X	
YBM Magnex	X	X	X		X	X	

**Table 4
Managerial Hubris**

Case	External Exposure			Initial Intent to Deceive	
	Top Rated CEO or Senior Executive	Stock Market Darling	Media Coverage Corporate Success	Underground Connection	Other Substantive Improprieties Beyond Financial Reporting and Asset Misappropriations
Atlas Cold Storage			X		
Bre-X	X	X	X		X
CINAR	X	X	X		X
Fareport			X		
Getty Copper					
Hollinger	X		X		X
Knowledge House	X	X	X		
Laidlaw	X		X		
Livent	X		X		
Mount Real			X	X	X
Philips Services	X	X	X		
Semi-Tech			X	X	X
Ste-Genevieve		X			
TeeCom		X	X		
YBM Magnex		X	X	X	X

Figure 1
Emergent Model of Fraud Involvement

