Diogenes and the Quest for an Honest Audit

By Albert S. Frank, LL.B.

There is a legend that the eccentric ancient Greek philosopher Diogenes of Sinope used to wander the street of Athens with a lit lantern in broad daylight, looking for an honest man. If his quest failed – and the legend certainly does not say it succeeded – was this because there were no honest men to be seen or because lantern-light had no magical power to identify them?

In these post-Enron days we face a similar problem with the audited financial statements of publicly traded corporations. Are most of them honest? Some of them? Any of them?

Unfortunately, some CFOs, in the service of dishonest management, place creativity above accuracy. Unfortunately, auditors then sometimes rival the skill of the Three Wise Monkeys in seeing no evil, hearing no evil, and speaking no evil.

Suppose you wanted to buy gold and someone offered to sell you an ounce. You looked up the current market price of gold and found that it was $325 per ounce. What would you pay the seller for that ounce of gold? About $325.

Now suppose that the seller might be a liar, so you cannot be sure that the ounce is exactly an ounce. Maybe the gold is impure. Maybe some gold has been shaved off the bottom. Maybe a hole has been drilled, and some gold extracted and replaced with lead. Moreover, there is no practical way to get a refund once you have paid for the alleged gold.

Now how much would you pay for the alleged ounce of gold? Something significantly less than the market price of $325 per ounce. The greater the perceived chance of fraud, the less you would pay. The greater the perceived possible magnitude of fraud – e.g. a possible 50% adulteration is worse that a possible 5% adulteration – the less you would pay. If you perceived a high chance of a fraud of high magnitude, you might not buy the alleged gold at all.

This is the situation we see in the stock markets today. It is hard enough to make a sensible decision about what stocks to buy and what is a reasonable price, without having to worry that the financial statements could be grossly and fraudulently false. The epic cheating by prominent corporations that has been coming to light recently must tend to reduce stock prices generally, even for good companies with honest financial statements, since investors generally have no way to tell the honest financial statements from the false.

Why pay for gold that could be mostly lead?

For years there has been talk of prohibiting accounting firms from providing consulting services to the corporations they are auditing. This idea faced stiff opposition from various major accounting firms, possibly because the auditing was being used as a loss leader to get the more lucrative consulting work. Post-Enron, such opposition is withering. The emerging consensus among accountants, regulatory bodies, and the market, is that such arrangements shall have to be rigorously regulated, reduced, or eliminated.

The CGA News section of the CGA webpage now has a heading “Post-Enron CGA Positioning.” I am pleased to see that one of the issues addressed under that heading is conflict of interest and the position taken is:

> CGA-Canada supports the view that the practice of auditing and the practice of consulting should be separated for publicly traded companies. This view has emerged in the post-Enron era as a measure to safeguard the objectivity of auditors and the audit process and for the protection of shareholders who are separate from the company's management.

The draft independence standard of the Canadian Institute of Chartered Accountants released September 5, 2002 points in the same general direction.

This is good, but is it enough? Maybe not. Over time even auditors who provide only audit services could be subverted by the management that pays them. I suggest that publicly traded corporations pay their auditing fees directly to the stock exchanges on which they are listed. The stock exchanges, with no input from the corporation into the choice of auditor, would then appoint and pay the auditor. The auditor would provide auditing and only auditing. The appointment would be for a pre-set non-renewable term.

These suggestions are not enough in themselves to restore confidence in audited financial statements, but they would be a reasonable start. Auditors could still be fooled by management, but at least they would no longer be motivated to wink at deceiving the public.

# # #

The above article first appeared in the Mid-October, 2002 issue of ***The Bottom Line.***

# # #

Research has NOT been done to see if this article is still good law. Also, this is general information that might not apply to your particular situation.

# # #

Albert S. Frank is a business and trial lawyer with over 30 years of experience. His offices are in Toronto's financial district:

The Exchange Tower
130 King Street West, Suite 1800
Toronto, Ontario M5X 1E3

Phone: 416 929 7202
Email: afrank@FrankLaw.ca
Web: www.FrankLaw.ca