THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ONTARIO

Founded 1879

PAUL J. HANVEY

APRIL 4 2012

IN THE MATTER OF: **DRAFT ALLEGATIONS AGAINST PAUL J. HANVEY, CA, A MEMBER OF THE INSTITUTE, BEFORE THE DISCIPLINE COMMITTEE**

SETTLEMENT AGREEMENT

made pursuant Section 34 (1)(c) of the Chartered Accountants Act, 2010, and to ICAO Regulation 7-1, s.22.4

Introduction

1. The Professional Conduct Committee ("PCC"), at their meeting of July 19, 2011, approved allegations against Paul J. Hanvey, CA ("Hanvey") **Tab 1**.

2. Hanvey is a partner in the firm Ouseley Hanvey Clipsham Deep LLP ("the firm").

3. Hanvey graduated from the University of Manitoba in Winnipeg where he articled at a local public accounting firm and became a member of the Manitoba Institute in 1976. He joined Revenue Canada in Winnipeg and later transferred to Ottawa in 1979 where he worked with the Transport Commission for five years as a financial analyst.

4. Hanvey left the government and joined McCay Duff, a public accounting firm in Ottawa, in 1983. In 1988 he joined Mr. Ouseley where he has been in practice ever since. The firm has evolved to four partners with staff.

5. Hanvey's practice is 65% to 70% audit of not-for-profit organizations. The balance of his practice is tax consulting services.

Background

6. Hanvey had been the partner in charge of the audit of a not-for-profit charitable organization, Total Communication Environment ("TCE"), for sixteen years since 1994. In particular he was the engagement partner on the audit of the financial statements for the years ended 2008 **Tab 2** and 2009 **Tab 3.**

7. Jose Wilson, C.A. ("Wilson") has been employed by the firm as an auditor for seven years. She works three days per week and 95% of her billable hours are for the audit of not-for-profit clients. She was the sole field auditor of TCE for the last five years.

8. TCE was established in 1979. Its employees provide residential, respite, day services and outreach to long term care homes for adults with multiple disabilities and special communication needs. They provide support to people in many different residential settings including group homes, apartments and townhouses, and outreach at a number of long term care homes in the Ottawa area. Many of the residences are owned by TCE.

9. During the March 31, 2009 year, TCE generated revenues of $9.8 million. In 2008 the revenue was $8.4 million.

10. The Ministry of Community and Social Services for the Province of Ontario ("MCSS") provides TCE with 85% of their revenue with the balance being generated from residence fees, donations and other income. The MCSS requires that TCE provide audited financial statements as a condition of their funding.

11. The Director of Finance of TCE for thirteen years was Yolande Knight ("Knight"). As a result of a misappropriation uncovered at TCE her employment was terminated on October 29, 2009.

12. TCE ended their relationship with the Hanvey firm and are now audited by Christine Prins of Parker, Prins, Lebano Chartered Accountants ("the Prins firm"). The Prins firm was engaged to re-audit the March 31, 2009 financial statement **Tab 4**. It was during this audit that they uncovered the misappropriation.

Allegations of Fraud

13. Knight used her position of authority to misappropriate approximately $1.1 million from TCE over an eight year period starting in 2002. Over this time Knight inappropriately charged personal amounts on her TCE corporate Visa card. In 2010 Knight was charged with fraud in connection with the misappropriation at TCE.

14. In calendar 2002 Knight charged approximately $42,000 **Tab 5** in personal expenses to her corporate Visa card. By calendar 2008 personal expenses charged increased to $207,000 **Tab 6**. Between January 2007 and June 2009 **Tab 6** the monthly personal expense charges ranged from $11,000 to $36,000. These included charges for dry cleaning, hair salons, clothing, travel and dining. An example Visa statement for the period December, 2006 – January, 2007 is attached **Tab 7**.

15. The Visa account had a credit limit of $5,000. As the monthly charges far exceeded the credit limit, Knight made regular telephone banking and electronic funds transfers from TCE's operating account. An example of the electronic transfer payments from TCE to Visa for December 2006 is found at **Tab 8**.

Amount Misappropriated – 2008

16. Once Knight had misappropriated amounts through her corporate Visa and paid for those amounts through the TCE's operating account, she needed to cover-up the payments. In *fiscal* 2008, $256,273 was misappropriated ($251,729 minus Jan & Feb & March 2007 + Jan & February & March 2008) **Tab 6** which Knight charged mainly to payroll and benefits accounts in small odd dollar amounts. TCE has fourteen departments each having their own salary and employee benefits accounts. A portion of the misappropriation was charged to each of these twenty eight accounts.

Amount Misappropriated – 2009

17. In *fiscal* 2009 Knight misappropriated $220,106 ($207,004 minus Jan & Feb & March 2008 + Jan & February & March 2009) **Tab 6** which she charged to many

different expense accounts including payroll and benefits, purchased services, food for the house and salary in very small odd dollar amounts.

The Discovery of the Fraud

18. As TCE was concerned about errors in the previously reported financial results they decided to engage the Prins firm, on a special engagement to review and reconcile only specific areas of concern for 2008 and 2009. These specific areas included unrecorded expenses due to bank reconciliations not being performed and reconciling grant revenue. Many of the procedures performed by the Prins firm during this special engagement would be outside the scope of a normal audit.

19. At the completion of the special engagement in August 2009 the Prins firm concluded there were many problems with the accounting at TCE. Due to batch processing they found it difficult to trace transactions into the general ledger. For each sample month they reviewed they identified differences between the bank and the general ledger. They were unable to satisfactorily reconcile the government grants to the general ledger.

20. In September 2009 the Prins firm returned to TCE for the re-audit of 2008 and 2009. It was during an accounts payable cut-off test that they identified a transfer to TD Visa. As they were unable to locate the relevant Visa statement, they requested Knight to provide it. When she did not provide the Visa statements, they investigated further and found one statement in her name which showed personal charges. The following day Knight was suspended pending further investigation.

21. Subsequent to the discovery of the misappropriation, TCE notified the Ottawa police and, as noted above, Knight was charged with fraud in 2010.

22. As indicated above the Prins firm audited the financial statements of TCE for the year ended March 31, 2009 **Tab 4**. Note **11** describes the theft at TCE.

The Audit in 2008 and 2009

23. The audited financial statements for 2008 **Tab 2** were authorized to be released by Hanvey with an unqualified audit report.

24. The audited financial statements for 2009 **Tab 3** were authorized to be released by Hanvey with an unqualified audit report.

25. Original audit working papers show that similar audit procedures were carried out for each of 2008 and 2009. *Unless stated otherwise the procedures described below were carried out each year.*

26. Field work was completed by Wilson and reviewed by Hanvey. There was no second partner review.

27. TCE's gross revenue grew 44% from $6.8 million in 2006 to $9.8 million in 2009. The number of properties managed increased from 10 to 12. For 2006, 52 hours were charged on the audit and TCE was invoiced $6,500. For 2007, 55 hours were charged and $7,500 invoiced. For 2008, 51 hours were charged and $8,500 invoiced. For 2009, 53 hours were charged and $10,500 invoiced.

Materiality

28. Materiality was set at $35,000 in 2008 **Tab 9** and $50,000 in 2009 **Tab 10**.

Risk Assessment

29. In 2008 **Tab 11** and 2009 **Tab 12** the Risk Assessment procedures worksheets were completed. In both years, on the first page, in answer to the question 'are there any instances of alleged, suspected, or actual fraud?' The answer provided is 'none per Yolanda Knight'.

30. The working paper files for 2008 **Tab 13** and 2009 **Tab 14** also contain "internal control evaluation #552" forms in which the fraud risks were identified as including a lack of segregation of duties and other internal controls and an opportunity for management to override controls.

31. While Hanvey identified factors which would mitigate the risk of financial reporting fraud in 2008 **Tab 13** and 2009 **Tab 14** he did not address the risk of misappropriation of assets. In 2008 and 2009 there was limited oversight of the activities of management personnel such as Knight.

32. *CICA Handbook* section 5135 "Auditor's responsibility to consider fraud" identifies both a lack of segregation of duties and the ability to override existing controls as a cause for increased risk of misappropriation of assets. If there is a higher risk of fraud an auditor is to tailor their audit program with this in mind. The audit program in this case did not adequately address the increased risk of management fraud. ***Authorities*, Tab 1**

33. The audit of TCE for March 31, 2009 was more problematic than in prior years. For example in the general ledger opening net assets did not equal the 2008 closing net assets by $15,009.

34. The 2009 field work was conducted in June of that year by Wilson. During the audit difficulties were experienced with the reconciliation of deferred revenue (g/l a/c #3350), a current liability account, which was in a debit position. **Tab 15, 16**

The Particulars to the Allegations

Allegation 1 (a) - He attached an unqualified opinion to the 2009 financial statements when he believed that revenue was materially misstated

35. At the conclusion of his audit work in 2009 Hanvey believed that revenue was materially misstated in an amount exceeding $350,000 **Tab 15, 16**.

36. Hanvey explained to the Finance Committee on June 26, 2009 that TCE could not have a negative balance in their deferred revenue account (a debit in a liability). The only place an adjustment could be recorded was as a reduction to revenue on the operating statement. On June 29th Hanvey had a telephone discussion with Knight **Tab 15, 16** where she advised that the Finance Committee wanted the statements as drafted to be issued in final.

37. Notwithstanding his belief that revenue was materially misstated Hanvey issued the financial statements with an unqualified opinion dated June 11, 2009 **Tab 3** and they were released on June 29, 2009.

38. Having released the audited financial statements Hanvey issued a management letter dated June 11, 2009 **Tab 16** advising that a discrepancy of $350K had been identified in the recognition of revenue. In that letter he alerted the board to the difficulties experienced in the recognition of the funding revenue from MCSS which was reflected in the deferred funding account. No specific comment is made of weaknesses in internal controls.

39. It is agreed that Hanvey should have identified the significant problems with TCE's ability to properly account for their activities resulting in this material discrepancy.

40. It is agreed that attaching an unqualified opinion to the audited financial statements in these circumstances is a failure to comply with generally accepted standards of practice of the profession contrary to Rule 206.2 of the Rules of Professional Conduct.

Allegation 1 (b) - he failed to obtain sufficient appropriate audit evidence to support expenditures shown on the Statement of Operations for the year ended March 31, 2009;

Allegation 2 (a) - he failed to obtain sufficient appropriate audit evidence to support expenditures shown on the Statement of Operations for the year ended March 31, 2008.

41. Due to the substantive approach taken on the audits for 2008 and 2009, Hanvey audited the total expenses and total project costs rather than how the costs were allocated to these accounts.

42. The audit program in 2008 **Tab 17** and 2009 for cash **Tab 18** is based on the standard Professional Engagement Manual "PEM" form. The bank reconciliation was audited with the last page of the bank statement for the year attached. There is no transfer to Visa on the last page.

43. As one of the disbursement tests performed in 2008 **Tab 19** and 2009 **Tab 20**, Wilson examined all the cheques that cleared the bank in three sample months. She did not trace these cheques into the bank statement in either year. Generally accepted standards of practice required the cheques to be traced from the bank

statement to the cheques and from the cheques to the bank statement. No review of the bank statements was undertaken. Selecting a sample from the bank statement might have brought the excessive number of transfers to Visa to light.

44. An audit procedure which might have identified the numerous transfers to Visa, thereby uncovering the fraud, is identified in the 2009 working paper *"Cash – Audit Procedures"* **Tab 18.** Under Unusual disbursements – fraud risk **Tab 18 p. 3**. The same working paper was prepared for 2008 **Tab 17 p. 3**. While the procedure shown is signed off as performed in each year it was not done.

45. In order to reconcile the year end statement between the bank and the general ledger, each year Knight recorded numerous journal entries to force it to balance. The auditor failed to review bank reconciliations except at year end and made no enquiries as to whether monthly reconciliations were being done. It is agreed that a review of a sample of monthly bank reconciliations should have been carried out by the auditor to comply with generally accepted standards of practice of the profession.

46. In 2008 payroll increased 16% over 2007 **Tab 21**. Little audit work was done with respect to payroll and what was done concluded with a $190,000 unsubstantiated payroll expense which is over materiality of $35,000.

47. In 2009 salaries increased 15% over 2008. Again minimal work was done to reconcile the year over year salary variance and the auditor obtained explanations for $832 of the $1,006K difference only **Tab 22**. The unsubstantiated difference of $174K in 2009 is over materiality of $50,000.

48. When performing variance analysis as a form of substantive procedure, differences should be resolved or the test is of no value as audit evidence (*CICA Handbook* section 5301). ***Authorities*, Tab 2**

49. A more effective audit procedure for payroll would have been to compare the actual payroll disbursements through the bank to the general ledger. Not only would this have been a far more effective procedure (as disbursements through the bank are third party evidence) but it would have brought to light a significant variance that, if investigated, might have led to the discovery of the fraud.

50. To substantively test other disbursements in 2008 **Tab 19** and 2009 **Tab 20** the auditors chose a sample of significant cheques recorded in the cheque register. They traced the items that appeared in the register to the invoice and the general ledger to look for authorization, support, and coding. This test would not have found Knight's improper charges as they were not processed through the cheque register.

51. The auditors should have traced the disbursements through to the bank statements. Had they done so they might have identified the unusually large number of round dollar transfers to the Visa.

52. Tracing and vouching should have been performed in both directions from the bank to the cheque register and from the cheque register to the bank. This was a significant and necessary audit test in the circumstances as little other audit evidence was gathered with respect to expenses. Such a test should have been performed each year to provide evidence over both completeness and occurrence. Transactions selected from the bank statement would have included the population of Visa payments which were not recorded in the cheque register.

53. During the 2008 audit, difficulties were also experienced with the revenue from MCSS and deferred revenue. The confirmation from MCSS was not returned until after the field work was complete but before the financial statements were issued in October 2008. It was discovered that there were some discrepancies between the financial statements and the confirmation related to 2007. All items were cleared in the end to Hanvey's satisfaction **Tab 21**.

Allegation 1 (c) - he failed to conduct sufficient and appropriate audit procedures, including a review of internal controls, to properly assess the risk of material misstatement of the financial statements;

Allegation 2 (b) - he failed to conduct sufficient and appropriate audit procedures, including a review of internal controls, to assess the risk of material misstatement of the financial statements.

54. This was a mainly substantive audit. A walkthrough of the internal control systems was not performed and was identified in the working papers as NCN (not considered necessary) (DOCs 74, 70 **Tab 11 p. 3, Tab 12 p. 3**).

55. Wilson said that OHCD generally did not perform a system walkthrough if they were not planning on relying on the internal controls.

56. GAAS recommends a walkthrough of internal controls regardless of whether controls are being relied upon in order to gain an understanding of the system. *CICA Handbook* section 5141.02 "Understanding the entity and its environment and assessing the risk of material misstatement" provides:

> *The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.* ***Authorities,*** **Tab 3**

57. *CICA Handbook* section 5141.11 outlines how the auditor gains the understanding of the entity required by the Handbook:

> *Observation and inspection may support enquiries of management and others, and also provide information about the entity and its environment. Such audit procedures ordinarily include:*
>
> *(a) observation of entity activities and operations;*
>
> *(b) inspection of documents (such as business plans and strategies), records, and internal control manuals;*
>
> *(c) reading reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings);*
>
> *(d) visits to the entity's premises and plant facilities; and*
>
> *(e) tracing transactions through the information system relevant to financial reporting (walk-throughs).* ***Authorities,*** **Tab 3**

58. In working paper 560 titled "Audit Approach" prepared during the planning stage of the audit in each of 2008 **Tab 23** and 2009 **Tab 24**, there is a note that the inherent, control, detection and overall risks are moderate. The amount of substantive work required is shown as high for the balance sheet but only moderate for revenue and payroll and low for disbursements. The misappropriations in TCE were hidden in the payroll accounts and were perpetrated through the disbursements.

59. Under "audit approach" the working papers **Tabs 23, 24** state that:

> *There are insufficient controls to enable a compliance audit to be performed especially since the organization is small and there cannot be an adequate level of division of duties. Therefore the most appropriate audit approach is to rely on substantive audit procedures.*

60. After the audit work was performed the overall risk of material misstatement was identified to be low for both 2008 and 2009 **Tabs 23, 24.** It is agreed that the assessment was incorrect for both years and the actual risk was moderate or high.

61. It is agreed that Hanvey failed to conduct sufficient and appropriate audit procedures to properly assess the risk of material misstatement of the financial statements for 2008 and 2009.

Allegation 1(d) - he failed to clear outstanding items after the audit work was complete prior to releasing the financial statements;

62. At the end of the field work for 2009 a list of outstanding items was prepared. Included on this list were items such as missing support, outstanding confirmations and questions from Mr. Hanvey **Tab 15**. These were usually cleared by Hanvey if Wilson was not available. In 2009 this list was more extensive than in prior years and some of the outstanding items were never cleared.

63. Among the uncleared significant items for 2009 noted under the heading "OS June 15, 2009" were:

    - "*def quin $520 and Riverbend $198K – also in AR – how to treat*" (**Tab 15** – heading *OS June 15, 2009*)

    This item was never cleared and a balance of $350K remained unreconciled when the statements were issued.

64. Other significant items noted under the heading "OS June 15, 2009" were:

    - "*MCSS confirmation of Quinn capital funding - $520,943 – 705-3 and C6*" **Tab 15**

    Confirmation is missing.

- "*fix def rev – mcss – amount in dr 198078 should be $0*" **Tab 15**.
- "*bank confirm*"

In 2009 the bank confirmed the 2008 balance and not the 2009 balance. The 2009 balance was never confirmed.

65. It is agreed that Hanvey failed to perform his professional services in accordance with generally accepted standards of practice of the profession since he failed to clear outstanding items after the audit work was complete and prior to releasing the financial statements.

Allegation 1 (e) - he failed to exercise professional scepticism appropriate to the engagement.
Allegation 2 (c) - he failed to exercise professional scepticism appropriate to the engagement.

66. The *CICA Handbook* section 5090.05 "audit of financial statement – an introduction" provides:

   The auditor should plan and perform an audit with an attitude of professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. **Authorities, Tab 4**

67. The *CICA Handbook* section 5090.06 also provides:

   An attitude of professional scepticism recognizes that circumstances may exist that cause the financial statements to be materially misstated. It means the auditor makes a critical assessment, with a questioning mind, of the sufficiency and appropriateness of audit evidence obtained, and is alert for evidence that contradicts or brings into question the reliability of documents or representations of management or those charged with governance.... The attitude of professional scepticism is necessary throughout the audit process to reduce the risks of overlooking suspicious circumstances, of over-generalizing when drawing conclusions from audit observations, and of using faulty assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. Representations from management or those charged with *governance generally, in and of themselves, do not represent sufficient audit evidence.* ***Authorities,*** **Tab 4**

68. The *CICA Handbook* section 5090.07 provides:

Honesty and integrity on the part of management and of those charged with governance are critical for the effective operation of the financial reporting process. In planning and performing an audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. This means that it is not the auditor's objective to prove management's honesty and integrity, but to approach the audit with an attitude of professional scepticism that includes being alert for indications of dishonesty. It also means that, notwithstanding prior experience indicating that management is honest, the auditor nevertheless generally obtains corroborating evidence for management representations, including responses to enquiries resulting from the performance of analytical procedures. … ***Authorities,*** **Tab 4**

69. In this case, when testing salaries, little work was done to reconcile the year over year increase of $919K in 2008 **Tab 21** and $1,006K in 2009 **Tab 22**. Management representation (referred to in Note (1) on each of the working papers) was received to explain part of the variance but it is agreed that management representation is not sufficient audit evidence in the circumstances. In addition Note (1) in the working papers refers to an unsubstantiated difference of $190K in 2008 and $174K in 2009 for which no representation was received. Both amounts were material.

70. Mr. Hanvey advised the Finance Committee on June 26, 2009 that TCE could not have a negative balance in their deferred revenue account (a debit in a liability), the only place an adjustment could be recorded was as a reduction to revenue on the operating statement. Mr. Hanvey was not sufficiently sceptical to consider the possibility that the difference may relate to fraud and not simply an accounting misallocation.

71. Mr. Hanvey relied on the representations of management when considering the risk of fraud by an employee. In 2008 **Tab 11, p. 1** and 2009 **Tab 12, p. 1** the Risk Assessment procedures worksheets were completed. In both years in answer to the question 'are there any instances of alleged, suspected, or actual fraud?' The

answer provided is 'none per Yolanda Knight'. This is insufficient audit evidence and reflects a failure to exercise professional scepticism.

72. In the internal control evaluation working papers the fraud risks were identified as a lack of segregation of duties and other internal controls and an opportunity for management to override controls (**Tab 13, p. 2** for 2008) (**Tab 14, p. 2** for 2009). Mr. Hanvey failed to comply with the standards of the profession when he did not change the audit program in light of these fraud risks.

73. Mitigating factors were identified (**Tab 13, p. 2** for 2008 & **Tab 14, p. 2** for 2009) including *"Non-complex structure and operations"* and "*no performance based compensation*" and "*lack of third party pressures*". These would mitigate the risk of financial reporting fraud but do not address misappropriation of assets. As well, *CICA Handbook* section 5090.07 states:

    '*...notwithstanding prior experience indicating that management is honest, the auditor nevertheless generally obtains corroborating evidence for management representations, including responses to enquiries resulting from the performance of analytical procedures.*' ***Authorities,* Tab 4**

74. It is agreed that Hanvey's failure to obtain corroborating evidence for management representations is a failure to exercise professional scepticism appropriate to the engagement in both 2008 and 2009 and consequently a failure to comply with the standards of practice of the profession.

Terms of Settlement

75. Hanvey and the Professional Conduct Committee agree to the following Terms of Settlement:

    a) Hanvey will pay a fine in the amount of $5,000 within three months of this agreement receiving approval of the Discipline Committee;

    b) Hanvey will take the following professional development courses when they are next offered. If any course is discontinued then he shall immediately notify the Director of Standards Enforcement and take another course that he and the Director agree most closely resembles the course cancelled. If agreement cannot be reached the issue may be determined by a Chair of the Discipline Committee sitting alone.

- *Not-for-Profit Organizations and Registered Charities – Accounting Auditing and Taxation Issues*
- *Fraud Happens! What to do When you Suspect Fraud*
- *Auditing in the New CAS Environment*

c) Hanvey will pay costs in the amount of $20,000 within three months of this agreement receiving approval of the Discipline Committee;

d) Notice of the terms of this Settlement will be given to the Public Accountants' Council and to the CICA;

e) There will be full publicity in *CheckMark* Magazine of the terms of this Settlement;

76. Should the Discipline Committee accept this Settlement Agreement, Hanvey agrees to waive his right to a full hearing, judicial review or appeal of the matter subject to the settlement agreement. The allegations approved by the Professional Conduct Committee attached to this agreement shall be stayed.

<u>If Settlement Agreement Not Approved</u>

77. If, for any reason, this Settlement Agreement is not approved by the Discipline Committee, then;

a) This Settlement Agreement and its terms, including all Settlement Negotiations between the Professional Conduct Committee and Hanvey leading up to its presentation to the Discipline Committee, shall be without prejudice to the Professional Conduct Committee and Hanvey;

b) The Professional Conduct Committee and Hanvey shall be entitled to all available proceedings, remedies and challenges, including proceeding to a hearing on the merits of the allegations, or negotiating a new Settlement Agreement, unaffected by this Settlement Agreement or the Settlement Negotiations;

c) The terms of this Settlement Agreement will not be referred to in any subsequent proceeding, or disclosed to any person, except with the written consent of the Professional Conduct Committee and Hanvey or as may be required by law.

78. Any obligations of confidentiality shall terminate upon approval of the Settlement Agreement by the Discipline Committee.

All of which is agreed to for the purpose of this proceeding alone this 9th day of ~~November~~ January ~~2011.~~ 2012

PAUL F. FARLEY
SENIOR COUNSEL,
PROFESSIONAL CONDUCT COMMITTEE
On behalf of the committee

PAUL J. HANVEY, CA
on his own behalf