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Really Bad Counting: SEC Sanctions Royal Bank of Canada for Accounting Violations

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The etymological origins of “bank” are both interesting and descriptive. “Bank” goes back to the Middle English, which had (after 1066) acquired the term from the Middle French “banque,” itself derived from the Old Italian “banco,” which was adopted from the High German “bank” meaning “bench,” a reference to the benches or exchange counters used by Florentine bankers in the 14th and 15th centuries. Banking existed at least from the days of the Babylonian city states in Assyria including Sumer and Kish (especially as related to providing advances of capital to finance the growing of grain), as discussed by Edward Chancellor in *The Price of Time: The Real Story of Interest (2022)*, but really came into its own in Renaissance Italy.

For various reasons involving the economy, religion (especially prohibitions against usury), geography, and accounting (double-entry bookkeeping, etc.), banking became a necessity, especially in Florence. In 1397 the Medici family founded their own Medici Bank, and in 1472 the oldest surviving bank, the Banca Monte dei Paschi di Sienna was opened in Sienna, a Tuscan neighbor of Florence. In the course of history (long before the existence of anything like a Federal Deposit Insurance Corporation), banks failed – and when that happened (particularly in Germany), the “bench” from which the bank operated would be broken into pieces as a graphic warning of insolvency – hence giving us “bankrupt” (broken bench).

The capacity for accurate arithmetic was and is critical to the efficient operation of a bank, both in counting assets and in evaluating liabilities. Sometimes, though, banking institutions display a peculiar inability to add two plus two and get four as the answer. One example is the Citigroup, Inc., affiliate that for 10 years misallocated underwriting expenses, as laid out in my blog “Mis-Running the Book: SEC Sanctions Citigroup Subsidiary for a Decade of Disarray.” And of course things are a bit more difficult in Canada, with its limitations on the growth of banking institutions north of the border. See my blog “Commerce, Culture, and Compliance,” spelling out those restrictions that led successful Canadian banks to seek growth abroad (to the state of Maine in that case).

Those factors matter, even for financial institutions whose stock in trade is “Loonies” (a reference to Canadian dollar coins bearing an engraving of a loon, and not to the mental well-being of senior bank personnel). On the other hand, the Royal Bank of Canada (one of Canada’s “Big Five”) has had its own difficulties in other areas; see my blog “Maximizing the Fee: Royal Bank of Canada Affiliate Pays $30 Plus Million for Client Abuse.”

And now we have another fascinating example of the arithmetic shortcomings of a major Canadian banking institution, once again the Royal Bank of Canada ("RBC"). RBC has over 94,000 employees operating in 29 countries (especially in Canada and the U.S.). According to its 2023 financial report, RBC is the largest global investment bank in Canada and the 9th largest in the world (and notably, the 6th largest wealth management firm in the U.S.). That financial report also shows 2023 revenue of $56.1 billion Canadian ("CAD") and 2023 profits of $14.9 billion CAD. RBC's corporate headquarters is in Toronto, Ontario, while its head office is in Montreal, Québec. Its common stock is listed and traded on both the Toronto and the New York Stock Exchanges. RBC financial statements are prepared (according to the U.S. Securities and Exchange Commission ["SEC"]) using the International Financial Reporting Standards ("IFRS").

Fortunately for RBC, it came through the Great Recession of 2007-2008 relatively unscathed, but convinced that it needed to improve its capital market information systems to better serve its customers and clients and to protect the safety and soundness of the bank itself. As a result, RBC was determined to make substantial upgrades to its computer systems. From 2008 until 2020, RBC, according to the SEC's Nov. 2, 2023 Order Instituting Cease-And-Desist Proceedings (the "Order"), "experienced a growth in IDS ("internally developed software") spending to support the growth of the organization." As the Order explains at some length, IFRS allows:

> *certain project costs incurred by an entity in creating an IDS application may be capitalized as an intangible asset on the entity's balance sheet. The capitalized costs are then amortized over the course of the estimated useful life of the application. In order to qualify as an internally developed intangible asset, [IFRS] requires, among other things, that the application being worked on provide probable future economic benefit to the firm and that its cost to develop be reliably measured. According to [IFRS], costs outside the development phase, including those associated with maintaining or decommissioning in-use IDS applications,* ***MUST BE EXPENSED*** *(emphasis added).*

As an indication of the extent of growth in the RBC computer systems, the Order notes that RBC capitalized $658 million CAD of IDS assets in 2011, which grew to $1.1 billion CAD by 2021. During the entire period 2008 through 2020, RBC used a capitalization rate of 78 percent. The problem, as the Order asserts, was that this capitalization rate was arbitrarily chosen, and in its divergence from facts, it failed to satisfy the requirements of the applicable IFRS provisions.

> *The calculation did not adequately differentiate between capitalizable and noncapitalizable costs, including by treating some research-phase costs as capitalizable when [IFRS] requires they be expensed.*

The Order notes that in 2017, RBC began to do capitalization rate assessments, but that those rate studies were insufficient due to:

> *Unreliable sampling and response rates to surveys, incomplete information, lack of documentation for certain third-party contracts, and the inclusion in the project pool of projects that were ineligible for capitalization and obsolete projects that should have been impaired and written ofl*.
>
> As a result of these accounting shortcomings, RBC overstated its earnings for 12 years because it capitalized costs that should have been expensed. Thus, the Commission found

> that as RBC's *IDS spending [increased] to support the growth of the organization, development of its control environment did not keep pace and internal accounting control deficiencies affected [RBC's] cost capitalization accounting for IDS projects.*

This result was rather akin in a way to the violations by the Citigroup subsidiary that were the subject of my blog "Mis-Running the Book," where the miscreant subsidiary used a fixed ratio to allocate underwriting expenses as opposed to actually calculating how much should be charged to the offering participants. There is no suggestion that the Citigroup subsidiary was intentionally "improving" its earnings, just as here, the SEC does not assert that RBC was intentionally "window dressing" its results. But in each instance, it was certainly the case that investors were ill-informed due to reliance on a formula, without determining that the formula fit the facts. As quoted by Nicholas P. Grippo, the SEC's Regional Director of the Philadelphia Regional Office in the Commission's Nov.2, 2023 Press Release concerning the RBC case:

> *Royal Bank of Canada had longstanding internal accounting control deficiencies that it failed to adequately address. Properly functioning internal accounting controls are a front-line defense and help ensure accurate financial disclosures- the backbone of our capital markets.*

In any event, the SEC found that RBC violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934("1934 Act"), as amended for:

13(b)(2)A): Failing to

> *make and keep books and records which, in reasonable detail accurately and fairly reflect [the financial results of operations;]* and

13(b)(2)(B): Failing to

> *devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that… transactions are [properly] recorded as necessary to permit preparation of financial statements [consistent with IFRS].*

In determining the sanctions to impose, the Commission cited RBC's "remedial acts undertaken by the [bank]," noting that RBC "institute[ed] additional accounting controls… and alter[ed] its [capitalization] rate study methodology" to include more frequent testing and improved sampling. The Order spells out several steps taken by RBC including:

1. centralizing the IDS capitalization rate assessment process;
2. implementing an automated process to overlay the rate process;
3. improving the inputs into the project management system;
4. conducting enhanced training for project managers on deciding what is development (capitalizable) and what is maintenance (expensed);
5. conducting rate studies quarterly not just annually; and
6. formalizing the impairment (when a capital asset must have its value reduced) review process.

The Commission then with RBC’s consent:

a) ordered that RBC cease-and-desist from further violations of the cited Sections of the 1934 Act; and

b) imposed a civil penalty of $6 million (U.S.), subject to a reduction in the amount of any civil penalty RBC has to pay Canadian regulatory authorities as a result of the same matter.

Interestingly the Order specifies the exchange rate to be used in computing the amount of any offset. If RBC claims an offset, it must provide written evidence of payment to the Canadian authorities.

As asserted in the blog title, RBC “came a-cropper” due to Really Bad Counting, something one would not expect from a banking institution.

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