



Ontario
Securities
Commission

Commission des
valeurs mobilières
de l'Ontario

22nd Floor
20 Queen Street West
Toronto ON M5H 3S8

22e étage
20, rue queen ouest
Toronto ON M5H 3S8

IN THE MATTER OF ROYAL BANK OF CANADA

STATEMENT OF ALLEGATIONS

(Subsections 127(1) and 127.1 of the *Securities Act*, RSO 1990 c S.5)

A. OVERVIEW

1. Accurate financial disclosure is a cornerstone principle of Ontario securities law identified in the *Securities Act* and is fundamental to achieving the purposes of the *Act*. The proper recording of business transactions and financial affairs is an important obligation of reporting issuers. The maintenance of appropriate books and records requires that reporting issuers prepare and maintain those books and records in compliance with applicable accounting standards and their related internal accounting policies. It is essential that reporting issuers remediate identified non-compliance with their internal accounting policies to ensure compliance with Ontario securities law.

2. This matter concerns the books and records of Royal Bank of Canada (**RBC**) as they relate to costs incurred by RBC to develop software applications internally as opposed to purchasing software from third-party vendors. Under accounting rules, certain costs associated with creating such internally developed software (**IDS**) may be eligible for capitalization and recorded as intangible assets on RBC's balance sheet rather than being recorded as expenses. However, such costs must meet certain criteria including that they relate to the development of assets which, among other things, are expected to generate future economic benefits.

3. IDS includes all software applications developed using RBC staff and other internal resources as opposed to the purchase of an “off the shelf” application from a third-party vendor.

4. Although there was no material impact on RBC's financial statements, RBC's books and records and internal accounting controls and processes relating to the capitalization of IDS were deficient because they failed to provide support for RBC's capitalized IDS costs.

5. For many years, RBC applied a practical expedient whereby it aggregated the costs of its smaller IDS projects into a single pool and capitalized a percentage of those costs by applying a single capitalization rate to all projects in the pool (the **Pool Method**). The Pool Method had a number of control and process deficiencies. From 2008 through 2020, RBC included projects in the pool that were ineligible for capitalization. Also, during this period, the Pool Method suffered from additional shortcomings:

- (a) From 2008 to 2016, RBC estimated the capitalization rate to be 78% with limited supporting analysis; and
- (b) Starting in 2017, RBC instituted a "rate study" to determine whether its continued use of the 78% capitalization rate remained appropriate. The rate studies were intended to be a key control in support of RBC's IDS cost capitalization estimation process, but the studies were unreliable and did not provide sufficient support for the 78% capitalization rate due to a number of deficiencies with respect to key inputs into the study and the lack of documentation to support project costs.

6. Finally, RBC also lacked effective impairment assessment and amortization controls and procedures, which resulted in RBC carrying capitalized IDS assets in the large programs (defined below) on its balance sheet at full book value when those assets should have been amortized over time commencing when they became available for use or written off, if they were impaired.

B. FACTS

Staff of the Enforcement Branch of the Ontario Securities Commission (**Enforcement Staff**) makes the following allegations of fact:

Background

7. RBC is a Schedule 1 Bank under the *Bank Act* (Canada) incorporated and domiciled in Canada. Its corporate headquarters are located in Toronto, Ontario and its head office is located in Montreal, Quebec. RBC is a reporting issuer in all provinces and territories of Canada, and its principal regulator is the Autorité des Marchés Financiers. RBC's common shares are listed on the Toronto Stock Exchange and New York Stock Exchange with the ticker symbol RY.

8. RBC is Canada's largest bank whether on the basis of assets, revenue, net income or market capitalization. At October 31, 2022, RBC reported total assets of \$1.9 trillion. RBC's total revenue

in fiscal 2022 was \$49.0 billion, with \$15.8 billion of net income. Its market capitalization at the end of fiscal 2022 was approximately \$174.3 billion.

9. RBC's consolidated financial statements filed with the Ontario Securities Commission are prepared in accordance with International Financial Reporting Standards (**IFRS**).

Applicable Accounting Standards

10. Under applicable accounting standards, in order to qualify as an intangible asset, the expenditure must, among other things, provide future economic benefits and its cost must be subject to reliable measurement. Costs incurred during the development phase of an IDS project are eligible for capitalization provided other applicable criteria are met. Costs incurred for the investigation and planning for potential new IDS projects during the initial research phase and costs associated with maintaining or decommissioning existing IDS must be expensed.

11. Applicable accounting standards also require an entity to assess, at the end of each reporting period, whether there is any indication that an asset, including internally developed intangible assets, may be impaired. Any indicator of impairment requires the entity to then consider whether the carrying amount of the asset exceeds its recoverable amount and, if yes, to reduce the carrying amount to its recoverable amount. For instance, if an entity no longer uses an IDS application, the asset is likely impaired and its carrying amount should be written down to the amount to be recovered through its use, which is typically zero. The applicable accounting standards also require an annual assessment of impairment of intangible assets not yet available for use.

RBC's Internally Developed Software Accounting

Growth in IDS at RBC

12. RBC's spending on IDS, and capitalization of associated costs, has grown over the years. RBC capitalized approximately \$658 million of IDS assets in 2011.¹ That amount grew to \$1.3

billion by 2022. Likewise, the amount spent on pooled projects has grown from approximately \$100 million at the inception of the pool to approximately \$600-700 million.

Accounting for IDS at RBC

13. Generally, RBC's process for capitalizing IDS project costs has depended on the dollar-value of the project. Projects estimated to cost more than \$5 million (increased to more than \$10 million in 2020) are designated as "large program" projects and individually reviewed to determine the amount of costs eligible for capitalization. Projects that have an expected cost of \$5 million or less (later increased to \$10 million or less) are subjected to the Pool Method developed by RBC.

14. The Pool Method, a component of RBC's internal accounting policy, aggregates the costs of RBC's smaller IDS projects into a single pool and capitalizes a percentage of those costs by applying a single capitalization rate. RBC implemented the Pool Method for administrative ease due to the time and expense it would take to assess each small project for capitalization. In later years, the IDS pool has included in excess of 1,200 projects.

15. In theory, the capitalization rate represents the estimated amount of development work eligible for capitalization relative to the total amount of work completed on each IDS project in the pool. The capitalized costs under the Pool Method are then amortized over three years starting one year from the date the costs were incurred.

16. RBC's internal accounting policy required that the capitalization rate be assessed on an annual basis and adjusted if necessary to reflect the nature of the actual expenditures.

Control Deficiencies in RBC's Pool Method

i. RBC Used the Same Unsupported Capitalization Rate

17. From 2008 through 2020, RBC used a capitalization rate of 78%, meaning 78% of its IDS pool costs were recorded as intangible assets on its balance sheet.

18. From 2008 to 2016, RBC's purported process for calculating this capitalization rate was to:

- (a) add up salary, benefits, and professional fees for its IDS pool projects; and
- (b) divide that number by the total costs incurred (salary, benefits, and professional fees plus rent, utilities, training, and management salaries).

19. Consequently, and as an expedient, RBC treated staffing costs and professional fees on IDS pool projects as capitalizable even when certain of these tasks were not truly capitalizable under applicable accounting standards (such as planning and maintenance expenses). This resulted in RBC overcapitalizing costs associated with its IDS pool projects and understating period expenses.

ii. RBC Instituted Rate Studies That Were Unreliable

20. In 2017, RBC began conducting studies as a key internal control to validate its estimated capitalization rate of 78%. RBC conducted additional studies in 2019, 2020, and 2021, but did not conduct a study in 2018.

21. The basic methodology used for the studies involved surveying employees working on IDS as to their activities to determine how much time, on average, various roles spent on capitalizable activities (**Role Rate**). RBC also sampled IDS pool projects to determine how much time was spent in the research and development stages of projects and reviewed project documentation relating to third-party contracts (**Phase Rate**). The resulting Role Rate and Phase Rate were then averaged, providing RBC with two points on a range.

22. The rate studies completed prior to 2021 were unreliable and failed as an internal control and did not support the capitalization rate for the following reasons:

- (a) Starting in 2017, RBC received approximately 150 survey responses from employees. RBC did not in all cases accept the survey results. Instead, if the results of the survey did not match internal notions of a particular role's contributions to IDS project work (and thus what the capitalization rate should be) RBC disregarded the survey result and substituted a different value that more closely aligned with those internal notions;
- (b) For the Phase Rate portion of the studies, RBC sampled 27 to 45 projects in any given year. RBC eventually determined that the relatively small sample sizes resulted in unreliable survey results;
- (c) The sampled projects sometimes included projects that were ineligible for capitalization and should not have been in the IDS pool, such as maintenance and decommissioning projects, and canceled projects that should have been written off. These projects were in the IDS pool because RBC lacked an effective controls

process to identify and exclude them. Maintenance and decommissioning projects were incorrectly coded as "development" and accounted for using the Pool Method, resulting in a percentage of associated costs being improperly capitalized as assets;

- (d) Upon identifying ineligible projects during the study processes, RBC removed the projects from the sample as "outliers" but did not review the pool to ensure that it did not include other projects that were similarly ineligible for capitalization. The removal of "outliers" effectively undermined the representativeness of the project sample and further added to the unreliable nature of the studies;
- (e) Once a project made it into the pool, RBC also lacked an effective process for determining whether it should remain in the pool. This included projects that were started but then canceled (and thus impaired) and should have been written off.

Lack of Documentation for Professional Fees

23. From at least 2017 through 2020, RBC did not have an effective system in place to track and document contracts or the associated statements of work for professional fees paid to third-party contractors in respect of IDS pool projects and large programs. The lack of documentation meant that RBC often had to rely on unverifiable information from project managers as to the content of a contract, the type of work being undertaken, and whether any or all of the activities performed by contractors on a project were capitalizable.

Control Deficiencies in RBC's Large Programs

- i. Lack of Impairment Analysis

24. From at least 2017 through 2020, RBC did not have an effective process to identify and report impaired IDS assets, resulting in impaired assets that should have been written off remaining on RBC's balance sheet.

- ii. Lack of Effective Amortization Start Date

25. From at least 2017 through 2020, RBC did not have an effective process for determining and recording the start date for amortizing capitalized costs arising out of large programs because it did not have an effective method to determine when an IDS application was available for use.

C. BREACHES AND/OR CONDUCT CONTRARY TO THE PUBLIC INTEREST

Enforcement Staff alleges the following breach of Ontario securities law and/or conduct alleged to be contrary to the public interest:

- (a) RBC failed to keep such books and records as are necessary to properly record the business transactions and financial affairs of RBC as they relate to IDS contrary to section 19(1) of the Act.

D. ORDER SOUGHT

Enforcement Staff requests that the Tribunal make the following order:

- 26. It is requested that the Tribunal make an order pursuant to subsection 127(1) to approve the settlement agreement entered into by RBC, on a no-contest basis, with respect to the matters set out herein.

DATED this 1st day of November, 2023.

ONTARIO SECURITIES COMMISSION

20 Queen Street West, 22nd Floor
Toronto, ON M5H 3S8

Mark Bailey

Senior Litigation Counsel
Enforcement Branch

Tel: 416-592-8254

[mbailey@osc.gov.on.ca](mailto:m Bailey@osc.gov.on.ca)

Sakina Babwani

Litigation Counsel
Enforcement Branch

Tel: 416-263-3763

sbabwani@osc.gov.on.ca