



AUDIT COMMITTEE INSTITUTE

Canadian Audit Committee Update

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Preface



We are pleased to provide you with the 2007-02 issue of KPMG's *Canadian Audit Committee Update*.

From 2011, Canadian publicly accountable entities will cease to report under Canadian GAAP and instead use International Financial Reporting Standards. While 2011 seems far in the future, Canadian publicly accountable entities should begin formulating their implementation plans now. The transition to IFRS is not merely an accounting exercise—it will affect a company's business systems, processes, and people. It may also impact the company's key performance indicators and performance-related compensation.

IFRS provides the opportunity to rethink past accounting choices.

The changeover provides a one-time opportunity for management to rethink its past accounting policies and approaches. This is a unique chance for management, with the audit committee's oversight, to select accounting policies that could potentially recast the look of the company's balance sheet. Significant change can be risky and maintaining accounting policies might be considered a safe choice. The audit committee should ensure that a long-range and strategic view is taken with respect to the changeover, and that all options are considered by management.

In *Current Issues Dominating the Audit Committee Agenda*, we describe how audit committee members can begin to discern the potential impact that the changeover to IFRS will have on current financial reporting. This article discusses the opportunity to re-evaluate accounting policy choices and includes some of the general similarities and differences between Canadian GAAP and IFRS.

In *Financial Reporting Updates* we outline significant regulatory, accounting, and auditing rules, standards, and projects issued since our 2007-01 edition of *Canadian Audit Committee Update*.

*Confusion surrounds
the audit committee's
responsibility for
oversight of IT.*

In Audit Committee Evolving Issues we investigate the audit committee's role in information technology governance. IT governance can be thought of as how a company achieves its business objectives through the use of technology. In another way, this can be expressed as "How can we ensure we get the right information to be used in the right way, at the right time?"

The audit committee should have a keen interest in IT governance since it oversees many areas that are often highly dependent on the quality of information processed by computer systems, such as financial reporting and compliance with legal and regulatory requirements. The pervasiveness of IT can leave audit committee members struggling to determine their role and how they manage their responsibility for oversight of IT. This article provides guidance as to how the audit committee can address these issues.

In Audit Committee Resources, we identify additional resources to help audit committee members meet today's challenges.

KPMG is committed to helping audit committee members fulfill their responsibilities by:

- communicating regulatory, accounting, and auditing changes
- addressing current and emerging issues
- sharing audit committee leading practices.

We hope this publication provides you with relevant, timely information that supports your decision making.

We encourage those in the financial reporting process—management, internal auditors, external auditors and audit committee members—to discuss the financial reporting and other matters included in this issue of *Canadian Audit Committee Update*. While the ultimate impact of certain recommendations may depend upon decisions yet to be made at various regulatory and standard-setting bodies, other elements can be evaluated and implemented, as appropriate, by those involved in the financial reporting process.

Current Issues Dominating the Audit Committee Agenda



The Transition to IFRS: The Past Need Not Be the Future

This section explores current events and issues and their implications for audit committees. In this edition, we discuss how audit committee members should begin to discern the potential impact that the changeover to IFRS will have on current financial reporting. Audit committee members will want to understand some of the general similarities and differences between Canadian GAAP and IFRS and the accounting policy choices available on changeover, including the elective exemptions on first-time adoption of IFRS. Readers are encouraged to consult the rules and their advisors for further guidance.

From 2011, Canadian publicly accountable entities will cease to report under Canadian GAAP and instead use IFRS. While 2011 seems far in the future, Canadian publicly accountable entities should begin formulating their implementation plans now. The transition to IFRS is not merely an accounting exercise—it will affect a company's business systems, processes, and people. It may also impact the company's key performance indicators and performance-related compensation.

Even though the first IFRS financial statements need not be prepared for some time, companies will experience the phased transition to IFRS beginning in 2008. From now until 2011, certain Canadian accounting standards will be converged with IFRS prior to the actual changeover date—all the more reason to get started now!

Why should the audit committee begin considering the adoption of IFRS now?

One of the audit committee's principal responsibilities is to oversee the financial reporting process. Executing this responsibility under a new accounting framework will require obtaining an increased fluency in IFRS, something that will not be achieved overnight. Being aware of the accounting policy choices available under IFRS and the elective exemptions available to the company on changeover will assist audit committee members to oversee more effectively the convergence and overall transition to IFRS.

The changeover provides a one-time opportunity for management to rethink its past accounting policies and approaches and, where choices are available, make changes that are favourable for the company. Significant

Certain new accounting policy choices can be made on initial adoption of IFRS.

change can be risky, and management may be tempted to stay with the familiar and defer to past policies where still appropriate. The audit committee should ensure that management takes a long-range view with respect to the changeover, and considers all options.

Overseeing the company's change to IFRS will involve ascertaining whether management has identified all of the relevant impact areas and considered their effect on the company's financial reporting process. Audit committee members should question the accounting policy choices made and elective exemptions taken by management on initial adoption. They should understand the trade-off between the impact on the company's conversion efforts and the effect of these decisions on post-changeover reported earnings and equity. These choices and elections should be made strategically so that the financial reporting impact on the company is acceptable to all.

General similarities and differences between Canadian GAAP and IFRS

Similar ...

Both IFRS and Canadian GAAP are based on similar conceptual frameworks. Many of the basic concepts in IFRS (e.g., the going concern assumption, accrual accounting) are similar to Canadian GAAP. Many recognition and measurement principles are similar, as is the general structure and content of the financial statements.

"Similar" does not mean "the same."

... yet different

Certain IFRS have fundamentally different recognition and measurement principles than Canadian GAAP. Other IFRS are similar, but "similar" does not mean "the same." The devil is in the details and differences still exist in the standards, their application, and their interpretation. How significant they will be for the company will depend on the specific facts and circumstances.

Some key differences include:

- Impairment of long lived assets—IFRS require a fundamentally different approach to impairment testing. It could result in more impairment charges because the assessment of impairment is based on discounted cash flows, and IFRS require the reversal of impairment charges when circumstances change.
- Provisions—the recognition and measurement of certain provisions, including asset retirement obligations, is different under IFRS. IFRS also require provisions for onerous executory contracts (which are not generally required under Canadian GAAP), and the discounting of provisions is far more common.

The initial accounting for property, plant and equipment may be onerous if component accounting had not been applied in the past.

- Defined benefit pension plans—under IFRS, past-service costs must be recognized over the vesting period, resulting in their faster recognition. For those past-service benefits that are fully vested, the entire cost is expensed immediately.
- Securitizations—sale treatment is very difficult to achieve under IFRS, and most Canadian revolving securitization structures will not likely achieve off-balance sheet treatment.

The accounting for property, plant and equipment may appear similar to Canadian GAAP, but some differences exist that may require considerable effort to apply on conversion. For example, IFRS requires companies to apply component accounting to all separate physical and non-physical components of PP&E. The concept of component accounting exists in Canadian GAAP but generally is not as rigidly applied in practice.

While IFRS revenue recognition principles are similar to Canadian GAAP, the lack of prescribed rules and “bright lines” in IFRS could result in revenue being recognized later, or even earlier, than under Canadian GAAP. IFRS prohibits the use of the completed contract method to recognize revenue. In addition, there are a number of industry-specific differences affecting insurance, extractive, and rate-regulated entities.

More accounting policy choices to consider

In some cases, IFRS explicitly provide for more accounting policy choices than Canadian GAAP. Canadian companies can therefore depart from their past accounting policies and start anew, even if their current Canadian accounting policies are appropriate under IFRS.

New accounting policies might recast the look of the company's balance sheet.

These choices create a unique occasion enabling management, with the audit committee’s oversight, to select accounting policies that could potentially recast the look of the company’s balance sheet. Management should identify the available choices and provide to the audit committee an analysis of the potential impact of the various choices on the company’s financial statements. This analysis will help the audit committee to understand the impact of the choices both on transition and in the future. For example, a move to fair value revaluation for some balance sheet elements may seem more relevant, but it may entail trade-offs such as increased earnings volatility, higher amortization charges, and an increased need for internal or external resources to periodically establish those fair values.

*IFRS has fewer
“bright line” rules.*

... and even more judgment

A consequence of principles-based standards is the absence of detailed guidance for many specific accounting situations. The IASB’s Interpretations Committee issues fewer interpretations than its Canadian or US counterparts.

In some areas of IFRS, practice has evolved to allow for various accounting approaches—more choices that will require consideration. Ultimately, more choices coupled with relatively less interpretive guidance and fewer “bright lines” will require more professional judgment, especially when no specific guidance exists. For those accustomed to a rules-based accounting environment, this may seem daunting, particularly for unique and complex transactions. Others may welcome a break from the rules and the move to greater flexibility.

Management will need to identify the significant judgment areas affecting the preparation of the company’s IFRS financial statements and communicate these to the audit committee. Management should explain its rationale in selecting specific accounting policies and the judgment applied so that the audit committee can consider whether the choices make sense for the company.

Understanding management’s judgment process will be important. Overseeing this process will be key to evaluating that the company has not been too aggressive in selecting its accounting policies.

Adoption of IFRS

*Generally the financial
statements will be
prepared as though the
company always had
reported under IFRS.*

Once management has chosen the company’s IFRS accounting policies, it will apply IFRS 1, *First Time Adoption of International Financial Reporting Standards* to transition to IFRS. Generally IFRS must be adopted retrospectively, as though the company always reported under IFRS. In preparing an opening balance sheet (e.g., January 1, 2010, assuming a calendar year-end with one year of comparative information) companies will generally need to derecognize from the balance sheet all assets and liabilities not satisfying IFRS recognition criteria and recognize those that do. For example, companies may need to derecognize items such as start-up costs and vested past-service costs in preparing the IFRS financial statements if they were previously recorded under Canadian GAAP.

Companies will also remeasure all recognized items according to IFRS. This process may include remeasuring certain liabilities on a discounted basis. It could also include recording impairment charges on the opening balance sheet date—an impairment test is mandatory for any existing goodwill and indefinite life intangible assets on transition to IFRS. Preparing an opening balance sheet may also require certain reclassification adjustments. The net impact of these adjustments will usually be recorded in opening retained earnings (or other equity accounts or goodwill if applicable).

Elective exemptions

IFRS 1 provides certain accommodations and elective exemptions to first-time adopters as “relief” from full retrospective application—companies can pick and choose from the available options. As one-off choices, they need not have any bearing on the accounting policies that the company will choose to apply in the preparation of its IFRS financial statements after the changeover. The audit committee will need to understand which exemptions are available and which exemptions management is considering electing.

The elections should be approached tactically—some may affect the company’s financial results post-conversion, and “relief” on transition needs to be weighed against any post-conversion effects on earnings. The elections may bear little resemblance to how a company has accounted for certain transactions in the past under Canadian GAAP. Depending on the elections taken, the company may be able to manage how or when certain balances are recognized in income.

For example, a first-time adopter may elect to measure individual items of PP&E at fair value on transition date only. This election is separate from the accounting policy choice to measure PP&E using the revaluation model. Subsequent depreciation will be based on the higher fair value (i.e., deemed cost) post-conversion. This election may be attractive for companies that face the potentially onerous task of reconstructing an asset’s cost base under IFRS (e.g., applying component accounting and recalculating capitalized interest). Before deemed cost is elected, a company will need to trade off the benefit of saved effort on transition against the impact of higher depreciation (and lower gains on disposal in the future) on reported earnings.

Elective exemptions in IFRS 1 may bear little resemblance to past accounting practices.

Consider all the options

The transition to IFRS presents a company with a one-time opportunity to evaluate its current financial reporting and make accounting policy decisions that could significantly affect its financial reporting. Do not underestimate the significance of these decisions because they will be made only once. A company should consider all available options under IFRS. Management should start early in the transition process and take a strategic approach to assess all policy choices, followed by the specific elective exemptions. Certain decisions may give the company an opportunity to change past practices under Canadian GAAP. A company may be able to change the timing of income or expense recognition in future periods. It may also be able to change the amount of reported earnings as some policies will result in gains or losses being expressly included in income or in equity.

These decisions are very important. The audit committee should be asking management to start looking at these matters now. In this way, management can begin to provide the audit committee with an understanding of the company's changeover to IFRS. This knowledge will allow the audit committee to provide effective oversight during this important financial reporting transition.

Financial Reporting Updates



In this section, we identify recent significant regulatory, accounting and auditing rules, standards and projects issued since our 2007-01 edition of *Canadian Audit Committee Update*, as well as future projects of broad interest to audit committees. The following discussion is a general summary intended only to increase awareness of financial reporting developments. Readers should consult their financial advisers and the original pronouncements for detailed guidance on the application of these standards.

Regulatory and Other Developments

We highlight here recent significant regulatory and other developments in Canada and the US.

Canadian Developments

Proposed Changes to NI 51-102, *Continuous Disclosure Obligations*

This proposal is intended to improve the quality and transparency of executive compensation disclosure and to provide insight into a key aspect of a company's overall stewardship and governance.

Executive compensation disclosure to be expanded.

The proposed executive compensation form will expand current disclosure of executive compensation. Significant changes include:

- A new column in the summary compensation table showing the total compensation provided to each named executive officer. The definition of an NEO has been amended to include the CEO, CFO, and up to three other executive officers if their total compensation is greater than \$150,000.
- A new compensation discussion and analysis section explaining the rationale for specific compensation programs for executives. For example, the objectives of the compensation program, each element of the compensation program, and how the company determines the amount for each element would be disclosed.
- New disclosures regarding equity awards based on the compensation costs as reflected in a company's financial statements. Equity compensation will be presented in two tables; one showing information on equity awards granted during the year, and the other showing the amounts an NEO realized during the year from exercising options or the vesting of stock or similar awards.
- More specific disclosure of potential payments to NEOs upon termination of their position at the company, including more detail on retirement benefits.

Implementation of new executive compensation disclosure requirements delayed.

- Expanded disclosure of director compensation, including a summary table and equity disclosure similar to that required for NEOs.

In addition, a new table of director compensation has been introduced. This table is similar to the summary compensation table for executives.

After review and consideration of the comments received, the CSA decided to revise the proposal and delay implementation. An amended version of the proposals will be published in the fourth quarter of 2007. The effective date of the final disclosures will be no earlier than for fiscal years ending June 30, 2008.

Revised CSA Staff Notice 51-311, *Frequently Asked Questions Regarding NI 51-102*

The CSA has issued a revised list of FAQs to assist reporting issuers in the adoption of NI 51-102 and its recent amendments. The FAQs are divided into nine categories; definitions, financial statements, MD&A, annual information forms, business acquisition reports, information circulars and proxy solicitations, filing material documents, transition, and other. Issuers following NI 51-102 should refer to this staff notice when preparing their reporting documents.

CSA Staff Notice 52-318, *Audit Committee Follow-Up Compliance Review*

As a result of the inadequate level of compliance with MI 52-110, *Audit Committees*, a follow-up review of 25 issuers (including 10 venture issuers) was performed. This review focused on:

Follow-up review by CSA identifies additional instances of non-compliance.

- the responsibilities of the audit committee
- all direct or indirect relationships that each audit committee member had with the issuer
- the basis upon which each audit committee member was determined to be independent or non-independent
- the relevant education and experience of each audit committee member
- the basis upon which each audit committee member was determined to be financially literate
- any exemptions that the issuer relied on in connection with the independence or financial literacy of an audit committee member.

In seven instances, the issuer's audit committee was not assigned one or more of the responsibilities prescribed by the audit committee rule. As a result of the number of instances identified in the review, the CSA intends to conduct further reviews of issuers' non-compliance as part of the ongoing continuous disclosure review program.

CSA Staff Notice 58-303, *Corporate Governance Disclosure Compliance Review*

CSA staff conducted a review of 100 reporting issuers (65 TSX issuers and 35 venture issuers) to assess their compliance with the requirements of NI 58-101, *Disclosure of Corporate Governance Practices*. Each issuer's corporate governance disclosure was reviewed to determine whether it had complied with the rules' requirements. In addition, the substance of the disclosure was reviewed to assess whether the quality was sufficient to provide a clear and complete account of its governance practices.

Some of the areas of deficient disclosure for TSX issuers included:

- board independence—unclear disclosure regarding what the board does to provide leadership for its independent directors if its chair or lead director are not independent
- board mandate—insufficient disclosure to provide readers with an understanding of the board's responsibilities and only cross-referencing to the issuer's Web site for the text of the mandate (the text must be filed on SEDAR)
- position descriptions—where there was not a written position description for the chairs of various board committees, the disclosure as to how the board delineates the chairs' roles and responsibilities was vague and uninformative
- orientation and education of directors—simply noting that a package of materials addressing these responsibilities had been provided to board members was inadequate since a reader was unable to discern the matters addressed or assess their adequacy
- ethical business conduct—unclear disclosure as to how the board monitors compliance with its code
- nomination of directors—vague and uninformative disclosure of how the board fills vacancies with the required skill sets and not identifying the process by which the board identifies new candidates
- compensation—lack of disclosure regarding the process by which compensation was determined
- assessments—unclear discussion as to how the board determines that it, and its committees and directors, are performing effectively.

CSA review highlights deficient disclosure of corporate governance practices.

Some of the areas of deficient disclosure for TSX venture issuers included:

- board supervision over management—unclear disclosure for a reader to understand how the board facilitates its exercise of independent supervision over management
- nomination of directors—vague and uninformative disclosure of how the board fills vacancies with the required skill sets and not identifying the process by which the board identifies new candidates
- assessments—unclear discussion as to how the board determines that it, and its committees and directors, are performing effectively.

On an ongoing basis, the CSA intends to review an issuer’s corporate governance disclosures as part of the ongoing continuous disclosure review program.

US Developments

SEC Proposed Rule — *Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP*

SEC proposes eliminating IFRS to US GAAP reconciliation.

The SEC issued a proposed rule that would give foreign private issuers a choice between using IFRS or US GAAP in their filings and a concept release to obtain comments on whether the same choice should be made available to US issuers. The potential rule changes could eliminate the requirement for foreign private issuers to reconcile their IFRS financial statements to US GAAP beginning with 2008 calendar-year financial statements.

In addition, the SEC issued a concept release on whether US companies should be permitted to elect to use either IFRS or US GAAP when preparing their financial statements.

SEC Proposed Rule — *Smaller Reporting Company Regulatory Relief and Simplification*

SEC proposes easier filing requirements for smaller companies.

The SEC issued proposals that would make it easier for smaller companies to meet the SEC’s filing and capital-raising requirements. Most companies with a public float below \$75 million would qualify for the scaled reporting requirements, now reserved for companies with a public float below \$25 million. Public float would be calculated on the last business day of a company’s second fiscal quarter. However, a company registering common equity securities for an initial public offering would calculate its public float as of a date within 30 days of the date it files the initial registration statement, and would include shares to be sold in the offering at their estimated offering price.

Evaluation of internal control guidance provided to management.

The proposals also allow companies with a public float of below \$75 million that meet other eligibility criteria to use Forms S-3 and F-3 to register primary offerings of their securities. This enables a company to conduct primary offerings 'off the shelf'.

Other proposals would shorten the holding period for restricted securities of entities subject to the Exchange Act to six months and would create exemptions from the Exchange Act's registration requirements for compensatory employee stock options if certain conditions were met.

SEC Release — *Interpretive Guidance for Management on Evaluating Internal Control over Financial Reporting*

The SEC issued this release to provide guidance to management in its evaluation of ICFR. Highlights of the guidance are as follows:

- introduces a new safe-harbour rule that indicates that an evaluation conducted in accordance with the guidance will satisfy the SEC's management evaluation requirements
- takes a top-down approach that begins with an assessment of areas which pose the greatest risk to reliable financial reporting
- encourages a risk-based approach—the higher the assessed ICFR risk, the more evidence management should obtain to support its assertion that the control is effective
- provides factors that management should consider in assessing the magnitude of an identified control deficiency and lists indicators of material weakness
- addresses the disclosure of material weaknesses
- provides management with flexibility in determining the level and detail of documentation.

This interpretive guidance took effect on June 27, 2007.

Accounting Developments

We highlight here certain significant new accounting standards issued in Canada and in the US since the 2007-01 issue of *Canadian Audit Committee Update*. We also describe current and future projects underway regarding new accounting standards in Canada that indicate the direction of future standards.

Recently Issued Guidance – Canada

HB 1400, *General Standards of Financial Statement Presentation*

The standard was amended to add the IFRS going concern standards to it.

The main features of the changes are as follows:

- Management is required to make an assessment of an entity's ability to continue as a going concern.
- In making its assessment, management takes into account all available information about the future, which is at least, but is not limited to, 12 months from the balance sheet date.
- Financial statements must be prepared on a going concern basis unless management either intends to liquidate the entity, to cease trading or cease operations, or has no realistic alternative but to do so.
- Disclosure is required of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern.
- When financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reason the entity is not regarded as a going concern.

The effective date of these amendments is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2008.

Abstracts from the Emerging Issues Committee – Canada

We highlight here certain abstracts from the Emerging Issues Committee. This is not a comprehensive listing of all recently issued abstracts.

EIC-166, *Accounting Policy Choice for Transaction Costs*

This abstract addresses the accounting policy choice for transaction costs permitted by paragraph 57 of HB 3855, *Financial Instruments – Recognition and Measurement*. The abstract requires that the same accounting policy choice be made for all similar financial instruments classified as other than held for trading and provides guidance for determining whether financial instruments are similar for the purpose of this decision. Disclosure should be made of the accounting policy choice for transaction costs.

Management is required to explicitly assess if an entity is a going concern.

Guidance on how to account for transaction costs for financial instruments.

Guidance provided on the date of acquisition when a purchase is subject to regulatory approval.

The guidance in this abstract is effective retrospectively to transaction costs accounted for in accordance with HB 3855 in financial statements issued for interim and annual periods ending on or after September 30, 2007. Early adoption is permitted.

Revised EIC-119, *The Date of Acquisition in a Business Combination*

This abstract was amended to provide guidance where a company has purchased another company or business but still requires regulatory approval. The abstract concludes that during the period before regulatory approval is received, if the acquiree was not a variable interest entity prior to being acquired, it would not become a variable interest entity solely because of the restrictions imposed by the regulatory authority. As a result, the acquirer is not required to consolidate the acquiree as a variable interest entity during this period.

Projects to Develop Future Guidance – Canada

ED Discontinued – *Employee Future Benefits*

Employee future benefits project discontinued.

After consideration of the comments received on the exposure draft, the AcSB decided not to proceed with the proposed amendments. Although the AcSB believes that the proposed amendments would have enhanced Canadian financial reporting, the AcSB felt that the focus should be on the implications of adopting international standards, on the date of transition to IFRS, as well as the IASB's current project to amend that standard.

Revised ED – *Intangible Assets*

Intangible assets standards to align with IFRS.

A revised exposure draft was issued to modify the original scope of this project to achieve a closer alignment with international standards. The objectives of these proposals are to:

- reinforce the principle-based approach to the recognition of costs as an asset under the current definition of assets and the recognition principles in the conceptual framework
- clarify the application of the concept of matching of revenues and expenses.

The main features of the re-exposure draft include:

- removing material that was interpreted as permitting the recognition of assets which would not otherwise meet the definition of an asset or the recognition criteria
- adding guidance to clarify the distinction between assets and expenses

- including additional guidance concerning the definition of an intangible asset and the recognition of internally generated intangible assets
- withdrawing existing guidance concerning research and development costs since assets developed through research and development activities would be included within the scope of this standard.

ED – Not-for-Profit Organizations

Recently, an exposure draft was issued to update the not-for-profit standards to improve financial reporting by not-for-profit organizations.

The most significant proposals are:

- no longer requiring net assets invested in capital assets to be a separate component of net assets
- requiring the consolidation of controlled entities
- requiring the disclosure of allocations of fundraising and general support expenses.

A final standard is expected to be issued in 2008, effective for interim and annual periods beginning on or after January 1, 2009, except as follows. The exposure draft proposes an extension to the transitional period for certain not-for-profit organizations that control a number of individually immaterial organizations to permit those not-for-profit organizations to make changes to their accounting systems in order to consolidate their controlled organizations. Those not-for-profit organizations can apply the proposed amendments for interim and annual periods relating to fiscal years beginning on or after January 1, 2012.

ED – Rate-Regulated Operations – Recognition and Measurement

The AcSB decided to remove the temporary exemption from applying GAAP standards to the recognition and measurement of assets and liabilities arising from rate regulation. In addition, standards were amended to require the recognition of future income tax liabilities and assets as a separate regulatory asset or liability for the amount of future income taxes expected to be included in future rates and recovered from or paid to future customers.

These changes will apply prospectively to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009.

Recently Issued Guidance – United States

No new US accounting standards have been issued since the 2007-01 edition of *Canadian Audit Committee Update*.

Significant changes proposed to the not-for-profit standards.

Rate regulated operations to follow GAAP beginning in 2009.

Auditing Developments

Wording of compilation report will change.

Canadian and International auditing standards begin to converge.

We highlight here recent significant CICA Auditing and Assurance Standards issued since our 2007-01 edition of *Canadian Audit Committee Update*, as well as significant projects to develop future guidance.

Recently Issued Guidance

HB 9200 – *Compilation Engagements*

The AASB released revised standards that will apply to compilation engagement communications issued on or after July 1, 2007, with early adoption permitted.

The main features of the revisions are as follows:

- Removal of the phrase "... not otherwise attempted to verify the accuracy or completeness" from the suggested wording of the Notice to Reader communication. Public accountants feel this wording does not reflect the amount of work that must be undertaken by the practitioner to ensure that he or she is not associated with false or misleading information.
- Clarifying situations when it is appropriate to issue a Notice to Reader communication.

The AASB does not believe that the changes will result in a change in work effort by practitioners.

Projects to Develop Future Guidance

EDs of Canadian Auditing Standards – Convergence with International Standards

In early 2006, the AASB obtained significant support from stakeholders for adopting International Standards on Auditing. ISA are developed and issued by the International Auditing and Assurance Standards Board. The IAASB is currently undertaking its clarity initiative to amend the ISA to make them even more understandable and help improve their implementation. This process is targeted to be completed by the middle of 2008.

The AASB has issued a number of exposure drafts based on international standards. Simultaneous with the issue of an exposure draft of an ISA, the AASB issues an equivalent exposure draft of a Canadian Auditing Standard. The CAS is based on the ISA and follows the equivalent numbering pattern.

The earliest effective date for the new CASs will be no earlier than for periods beginning on or after December 15, 2008.

ED – *Reporting on Internal Control over Financial Reporting*

The AASB released an exposure draft on the auditor's responsibilities when issuing a report on the effectiveness of an entity's internal control over financial reporting. The ED is based on PCAOB standards on this topic. One differentiating factor of the proposed Canadian standard is that it is quite

Proposed standards outline the auditor's responsibilities when conducting an audit of internal control in Canada.

generic and will be used when entities are required to or choose to have an audit of internal control. In the US, the SEC mandates these audits.

The exposure draft defines two levels of internal control deficiency that might come to the attention of the auditor. A significant deficiency is defined as a deficiency, or a combination of deficiencies in internal control, that are less severe than a material weakness, yet important enough to merit the attention of those charged with oversight. A material weakness differs in that the deficiency, or combination of deficiencies, creates a reasonable possibility that a material misstatement of the entity's annual or interim financial statements may not be presented or detected on a timely basis.

The exposure draft sets forth the Canadian Criteria of Control Framework as the criteria with which to evaluate the effectiveness of internal control. It also details the extent of documentation management requires in order to support its assertion of effectiveness of internal controls. Finally, it addresses to what extent the auditor may use the work of others in this engagement, by providing guidance to assist the auditor in determining the nature and extent of independent testing the auditor needs to perform.

The descriptive and summary statements included in the Financial Reporting Updates section are not intended to substitute for the original rules, standards and pronouncements. All relevant facts and circumstances should be evaluated to arrive at situation-specific conclusions. Persons who apply these rules, standards and pronouncements may want to consult their advisers.

Audit Committee Evolving Issues



IT Governance – Where Does the Audit Committee Fit?

*Some audit committees
are focusing on information
being managed and not on
the managing technology.*

The way a company leverages its information technology is an important factor in meeting its business objectives. However, there is debate as to what IT governance is and how it is achieved. The audit committee has a keen interest in IT governance since it oversees many areas that are often highly dependent on the quality of information processed by computer systems, such as financial reporting and compliance with legal and regulatory requirements.

What exactly is the audit committee's role in overseeing the company's information technology? This can be a difficult question to answer. Any IT discussion can quickly get bogged down in technical jargon, with the result that it can become unclear who is responsible for oversight of technology-related risks. It should be no surprise then, that in many organizations, audit committees are questioning how well IT is governed, and, indeed, who should have responsibility for its oversight. To clarify and manage their responsibility for oversight of IT, some audit committees focus on the information being managed, not the technology being used to manage it.

Many items on the audit committee agenda involve technology. The impact of IT is pervasive, from financial and regulatory reporting, internal control certification, business continuity, and IFRS conversion, to the myriad of laws governing the protection of personal data. Although these are critical business issues, the information needs of a company extend much further than the ambit of the audit committee. For example, the same customer transaction information feeding financial reporting may be critical to the company's sales and marketing activities. How an organization manages its information, not to mention how it manages the often substantial costs of its IT investment, is often pivotal to its competitiveness and ultimate success.

IT governance – a shared concern

IT governance can be thought of as how a company achieves its business objectives through the use of technology. How narrow or how wide IT governance is defined varies from company to company. The common theme is "How can we ensure we get the right information to be used in the right way, at the right time?"

A number of governance frameworks point to a holistic definition, whereby the value of IT to a company can be measured and monitored in several different areas simultaneously, such as:

- compliance with applicable laws, including financial reporting
- control of IT costs
- project delivery timeliness
- risk management
- alignment of IT with operational objectives.

Oversight of IT rests with more than one group.

In practice, these IT areas affect different parts of an organization and frequently the responsibility for their oversight does not rest with only one group. There is often a dual ownership of the systems by users and IT. The IT department “manages the machines” (i.e., purchases, implements, and maintains the tools used that contain, process, protect, and report the information). After all, if a computer crashes—it’s the IT department that fixes it. However, many chief information officers are quick to point out that too often the assumption is made that control of the technology is control of the information. The ownership for the information being entered into the systems, the controls applied around the systems, and the use of the information rests with users such as finance, sales, and others who play a critical supporting role.

If the basis of good governance is accountability and responsibility, then who is in the best position to provide overall oversight of an area that spans such different areas of the organization? Ultimate oversight responsibility should lie with the board of directors. In some organizations, this may be further assigned to the audit committee since a substantial part of IT is often devoted to managing the processes and risks that affect financial reporting.

But is it possible to be responsible for only a part of the oversight of IT governance? What about all the other impacts of IT on an organization, such as cost control, legal compliance, and customer satisfaction? They may not directly impact financial reporting or regulatory matters, but can be affected by the overall quality of how IT is governed. Who oversees that part of IT governance impacting these other areas? Is the audit committee left with responsibility by default? Do audit committee members have the time and the expertise?

Audit committee member survey sheds light on audit committee oversight of IT.

According to the 2007 survey of audit committee members by KPMG’s Audit Committee Institute and the Institute of Corporate Directors, there is variation in practice. When asked about the specific areas of IT for which their audit committee holds primary responsibility for oversight, almost 60 percent of respondents indicated IT compliance and controls, and slightly less than half identified business continuity and information security/privacy. One in five indicated none of these areas. Of course, an audit committee’s role can depend on the size and complexity of the organization. There can also be dissatisfaction with the oversight of IT. Almost one-third of survey

respondents indicated that the board’s oversight of IT risks “needs improvement” with over half indicating they are only “somewhat satisfied.” Audit committees may be ill at ease with their role in an area that has such far-reaching implications for the success of the organization. How does the audit committee achieve its mandate without overstepping their bounds? Some practices are providing useful insights.

Clarify responsibilities at the board level

The board should ensure that IT oversight is appropriately allocated—it is usually not appropriate to mandate oversight of all aspects of IT governance to the audit committee. For example, when a major systems event occurs, such as the development and implementation of a new computer system, oversight that focuses on only financial reporting and regulatory compliance may meet the audit committee mandate, but will not provide sufficient focus on the mission-critical objectives of other large parts of the organization affected by the system changes.

Clarifying the audit committee’s role should be a priority. Some companies create a technology subcommittee of the board to oversee the management of the broader IT components in conjunction with the audit committee. Other companies use internal auditors or external consultants to provide specialized oversight. The key is to make sure someone has an oversight role for all major IT components.

Bridge the communication gap

Clear communication of IT issues can be essential to good governance. It is often seen as a challenge for the technically savvy IT department to clearly communicate to the operational and financial reporting groups. As more complex technologies become commonplace, understanding the rationale for major IT-related capital expenditures has become more difficult for the non-specialist.

If a technology issue cannot be expressed in simple terms, this may be a red flag. Perhaps an IT decision may not be clearly aligned with overall strategic business objectives. Management should be challenged to focus on the implications of changes in how information is managed by the organization, and not on the tools and technology underlying it. It is important to ensure someone has a sufficient knowledge of the technology issues and the business issues to clearly describe each to the audit committee. In some companies, this might be the CFO, the CIO, a special technology committee, or sometimes a third-party consultant.

IT oversight is often a shared responsibility.

Clear communication is essential to good governance.

Focus on strategic IT matters.

Focus on important matters

It is important to focus on specific IT items affecting the audit committee agenda, although it may be difficult to put boundaries on the depth of any technology-related discussion. For example, some companies recently toiled laboriously to demonstrate the effectiveness of the systems supporting financial reporting as part of their internal control certification projects. These projects tended to be so widely scoped that it was difficult to see the real impact on financial reporting of much of the effort. When it becomes obvious that not every aspect of IT needs to be included to support internal control certifications, it is possible to simplify the process.

In its oversight role, the audit committee should focus its attention on strategic IT matters. This can be done by asking:

- What are the key IT-related issues affecting financial reporting, regulatory compliance, and risk management processes, and are they receiving enough attention?
- What are the organization's specific strategies to manage these issues?
- Is success in managing these issues clearly measured and monitored?

Do not be afraid to ask questions.

If the audit committee should be educated about a particular aspect of IT in order to be able to ask the right question, then take the time to do this—but do not let the technology take centre stage. Most importantly, do not accept vague or unclear answers—experience shows that, with some perseverance, most IT issues can be expressed in relatively simple terms.

The risks involved in managing IT can extend throughout the company, beyond just financial and regulatory reporting. Audit committees are becoming more and more involved in overseeing IT governance—but sometimes by default. This is challenging their abilities to keep up with the ever-expanding complexity and the increasingly pervasive impact of IT on the organization. With increased focus on this important area, the audit committee can help ensure it assumes the right oversight role for IT governance.

Audit Committee Resources



KPMG is committed to helping audit committee members fulfill their responsibilities by communicating accounting, auditing, and regulatory changes, and by sharing audit committee leading practices. In each issue of *Canadian Audit Committee Update*, we feature recent publications and other valuable resources pertaining to audit committees. The following resources may be of particular interest.

Shaping the Canadian Audit Committee Agenda

A new and significantly revised edition of KPMG's *Shaping the Canadian Audit Committee Agenda* has recently been published. This publication is designed to assist audit committees in examining what they are doing and how they are doing it. In it, we discuss leading audit committee practices to help audit committees identify and react to current and future economic events, as well as address accounting, auditing, and regulatory changes.

Shaping the Canadian Audit Committee Agenda covers the full range of audit committee activities involved in creating, sustaining, and running an effective audit committee. The publication identifies and describes the audit committee's responsibilities for oversight of financial reporting and disclosures, financial risks and internal control process, and the external and internal audit processes.

The publication has relevant audit committee toolkit items, including an example audit committee charter, potential audit committee topics, a planning framework for audit committee meeting agendas, evaluations of the audit committee and the external auditor, and recommendations for conducting a private session with the auditor.

For a copy of *Shaping the Canadian Audit Committee Agenda*, visit www.kpmg.ca, or contact a KPMG office near you.

Accountability e-Lert

Audit committee members, directors, officers, and others with an interest in corporate reporting are invited to subscribe to KPMG in Canada's e-mail-based information service, *Accountability e-Lert*. This free service provides readers with useful information on some of the most important breaking developments in North American corporate reporting and sends a concise analysis to your personal e-mail address. We also add our own insights based on our knowledge and experience. Previous issues are available on KPMG's Web site. Subscribe to *Accountability e-Lert* on-line at www.kpmg.ca/accountability.

Focus on Financial Reporting

Focus on Financial Reporting is published annually by KPMG and provides an overview of recent financial reporting developments in Canada and the US. Our most recent edition (December 2006) reflects accounting pronouncements released prior to that date. For a copy of *Focus on Financial Reporting*, visit www.kpmg.ca.

Audit Committee Institute – A Resource for Audit Committee Members

Developed by KPMG, the Audit Committee Institute was created to help serve and educate audit committee members. Wholly sponsored by KPMG, the Audit Committee Institute provides complimentary guidance and helps increase awareness for corporate audit committee members who need to keep up with their evolving responsibilities. The Audit Committee Institute's Web site at www.kpmg.ca/auditcommittee provides access to Canadian content of interest to audit committees, including archived issues of *Canadian Audit Committee Update*, the Audit Committee Institute and Institute of Corporate Directors' Canadian survey of audit committee members – 2007, and provides access to the Audit Committee Institute's Web sites in other countries around the world. Audit committees with a particular interest in US developments should visit www.kpmg.com/aci.

Audit Committee Roundtables

The Audit Committee Institute facilitates roundtable sessions designed to provide a forum for the exchange of views and insights on topics of interest to members of audit committees. Feedback from audit committee members attending these roundtables has been consistently positive and enthusiastic.

In fall 2007, roundtable sessions will be held in Calgary, Montreal, Toronto, and Vancouver. These roundtables explore the issues and challenges currently facing audit committee members. For more information on these roundtable sessions, please contact your local KPMG office, or register on-line at www.kpmg.ca/aciroundtable.

Audit Committee Insights – International Edition

The International Edition of the Audit Committee Institute's *Audit Committee Insights* is a complimentary biweekly e-mail alert covering issues and topics of interest to audit committee members, corporate officers, or anyone concerned with financial reporting oversight in a global context. This electronic publication incorporates relevant articles from hundreds of respected business journals, industry publications, and association Web sites. Subjects include financial reporting, surveys and trends, shareholder issues and news, commentary and perspectives, and more.

Subscribe to *Audit Committee Insights* – International Edition on-line at www.kpmginsights.com.

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Many of KPMG's publications are available in electronic and hard copy. If you, a colleague, or associate would be interested in obtaining copies, please contact a KPMG office near you.

Acronyms Defined



AASB — Auditing and Assurance Standards Board (CICA)	IASB — International Accounting Standards Board
AcSB — Accounting Standards Board (CICA)	ICFR — Internal Control over Financial Reporting
CAS — Canadian Auditing Standard	IFRS — International Financial Reporting Standards
CEO — Chief Executive Officer	ISA — International Standards on Auditing
CFO — Chief Financial Officer	IT — Information Technology
CICA — Canadian Institute of Chartered Accountants	MD&A — Management’s Discussion and Analysis
CIO — Chief Information Officer	MI — Multilateral Instrument
CSA — Canadian Securities Administrators	NEO — Named Executive Officer
ED — Exposure Draft	NI — National Instrument
EIC — Emerging Issues Committee (CICA)	PCAOB — Public Company Accountability Oversight Board
FAQ — Frequently Asked Questions	PP&E — Property, Plant and Equipment
GAAP — Generally Accepted Accounting Principles	SEC — Securities and Exchange Commission (US)
GAAS — Generally Accepted Auditing Standards	TSX — Toronto Stock Exchange
HB — Handbook (CICA)	SEDAR — System for Electronic Document Analysis and Retrieval
IAASB — International Auditing and Assurance Standards Board	US — United States

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KPMG LLP, a Canadian limited liability partnership established under the laws of Ontario, is the Canadian member firm affiliated with KPMG International, a global network of professional firms providing Audit, Tax, and Advisory services. Member firms operate in 148 countries and have more than 113,000 professionals working around the world.

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KPMG’s experience in working with audit committees has taught us that those who serve on these committees continually seek to enhance the effectiveness of their oversight role. With that in mind, we strive to make this publication user-friendly for audit committee members. We hope you find it helpful.

Recognizing the importance of audit committees, KPMG has created the Audit Committee Institute to help serve and educate committee members. Historically, audit committees have been largely on their own to keep pace with rapidly changing information related to governance, audit issues, accounting, financial reporting, and even legal issues. Wholly sponsored by KPMG, the Audit Committee Institute provides complimentary guidance and helps increase awareness for corporate audit committee members who need to keep up with their evolving responsibilities. Board members can turn to the Audit Committee Institute at any time for help and advice, or to share knowledge. The Audit Committee Institute’s Web site at www.kpmg.ca/auditcommittee provides access to Canadian content of interest to audit committees. For audit committees with a particular interest in US developments, visit www.kpmg.com/aci.

If you want to learn more, need assistance or have any questions, please contact the managing partner at a KPMG office near you.

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