AUDIT COMMITTEE INSTITUTE

Canadian Audit Committee Update

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KPMG LLP

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Oversight of Risk Management: What is the Audit Committee's Role?

Frequently Asked Questions – Evaluating Design of Internal Control

Regulatory, Accounting and Auditing Developments

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Preface

We are pleased to provide you with the Fall 2006 issue of KPMG's *Canadian Audit Committee Update.*

Leading audit committees are recognizing the critical link between effective oversight of financial reporting risk and effective oversight of risk management. A robust risk management process can help the audit committee more effectively oversee the management and reporting of significant financial reporting risks. However, audit committees are beginning to understand that the oversight of risk management is a difficult task.

Oversight of risk management is a difficult task.

Most audit committees are comfortable in their oversight of traditional financial reporting and related compliance risks. However, the audit committee's oversight of the financial reporting process relies on the company's risk management efforts in several respects, such as determining the financial reporting implications of non-financial risks, reviewing that for each significant risk the company has appropriate internal controls, and monitoring internal and external audit plans to be satisfied they appropriately address risk. As the potential financial reporting implications of non-financial reporting risks become more recognized, audit committees are asking what is their oversight responsibility for these broader risk management areas.

In Current Issues Dominating the Audit Committee Agenda, we look at why the audit committee should be concerned with risk management, as well as review the ownership of risk management oversight and the need to coordinate risk oversight responsibilities. This article also reports the results of polling at the Spring 2006 Roundtables, where oversight of risk management was the focus.

In Financial Reporting Updates we outline significant regulatory, accounting and auditing rules, standards and projects issued since our *Canadian Audit Committee Update* – Spring 2006.

The CSA has established requirements for internal control certification in Multilateral Instrument 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings*. These rules require the CEO and CFO to certify that they have designed internal control over financial reporting to provide reasonable assurance over the reliability of financial reporting and the preparation of external financial statements. This is in addition to the certifications relating to disclosure controls and procedures that commenced for years ending after March 30, 2005.

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The CSA also requires the CEO and CFO to make a certification that they have caused the company to disclose—in the annual or interim MD&A, as appropriate—changes in internal control that have had or may have a material effect on the company's internal control. These certification rules are effective for years ending after June 29, 2006, and apply to most reporting issuers, including venture issuers.

Little guidance is provided as to what is required to support internal control certifications.

Although the internal control certification requirements are established, the CSA provides very little guidance to management or the audit committee as to what is required to support the internal control certifications.

In Audit Committee Evolving Issues, we answer some of the most frequently asked questions from management and the audit committees. Questions such as the following cover a wide range of issues:

- What is meant by the design of internal control?
- What are the minimum procedures that should be carried out to support the certification?
- What impact do weaknesses in the design of controls related to internal control over financial reporting have on the certification related to disclosure controls and procedures?
- What are typical design deficiencies?
- What should the audit committee do to gain comfort over the certification process?

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 process.

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.

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Current Issues Dominating the Audit Committee Agenda

This section explores current events and issues and their implications for audit committees. In this edition, we discuss the audit committee's role in the oversight of risk management. Readers are encouraged to consult the rules and their advisers for further guidance.

Oversight of Risk Management: What is the Audit Committee's Role?

The essential issue

In their efforts to strengthen the integrity of the financial reporting process, leading audit committees today are recognizing the important—if not imperative—link between effective oversight of financial reporting risk and effective oversight of risk management. A robust risk management process—for systematically identifying and analyzing, avoiding, transferring, mitigating or accepting the spectrum of risks facing a company—can help the audit committee more effectively oversee the management and reporting of significant risks. As many audit committees are discovering, however, oversight of risk management is no simple matter.

Most audit committees are comfortable in their oversight of traditional financial reporting and related compliance risks, however, oversight of other risks that could become financial reporting risks is a different challenge. Frequently it is not clear whether the board, the audit committee, or another board committee is responsible for overseeing such risks.

Often it is not clear who is responsible for overseeing non-financial risks.

Inadequate reporting of risk information can hamper oversight efforts, internal and external audit plans that do not clearly focus on key areas of risk can make oversight more difficult, and lack of a common "risk" vocabulary complicates matters.

These challenges notwithstanding, audit committees have a central role to play in the oversight of risk management.

To help audit committee members and directors gain a better understanding of risk and the role of the audit committee in the oversight of the risk management process, KPMG's Audit Committee Institute facilitated interactive roundtable discussions in Montreal, Toronto, Calgary and Vancouver in the Spring of 2006 ("Spring 2006 Roundtables"). These discussions generated insights into key concerns, perspectives, and emerging practices driving the oversight of risk management today. During the roundtables there were questions concerning the oversight of risk management. This article reports some of those results.

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Considering risk

Risk—broadly defined as anything that could preclude a company from achieving its objectives—is inherent in doing business. An organization's critical risks can be wide-ranging including, for example, risks affecting reputation, ethics, technology, health, safety and the environment, not just financial or insurable hazards.

From the audit committee's perspective, risk falls into two general categories: financial reporting risks, such as critical accounting judgments and estimates, and non-financial reporting risks with possible financial reporting implications, such as a supply chain problem, product recall, or a marketing practice affecting revenue recognition.

Risk management involves identifying, analyzing and managing risks.

Risk management involves identifying risks that may prevent an organization from achieving its objectives, analyzing those risks, avoiding certain risks, and transferring, mitigating or accepting the risks that remain.

The role of management is to implement business strategies—and manage their associated risks—based on the amount of risk the company deems acceptable and the return it aims to achieve.

The role of the board, audit committee, and other board committees—as guardians of shareholder interests—is to provide risk oversight: to help ensure the company's process for risk management is effective and in line with the company's strategies and the expectations of shareholders and regulators.

The management and the oversight of risk are made more difficult in the absence of a formal risk management process. Heavily regulated industries, such as financial services, utilities, and health care, tend to have more mature risk management processes in place for certain categories of risk. Generally, however, risk management in most other industries is still an emerging practice, often lacking a common vocabulary, consistent context, and formal framework.

In polling at the Spring 2006 Roundtables, on average only one in four respondents indicated they thought the board, including the audit committee, was very effective in overseeing the potentially significant business risks—both financial and non-financial—facing the company, and another quarter of the respondents felt that there was a need for improvement. The balance were somewhere in between.

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Respondents were slightly more negative about the process that management uses to identify and prioritize the potentially significant business risks.

Unlike the New York Stock Exchange, Canadian regulators do not specifically require audit committees to be responsible for discussing guidelines or policies to govern the process for risk assessment or risk management. Notwithstanding this fact, oversight of risk management is an area of significant concern and is gaining attention.

Risk management: why it matters to the audit committee

In Canada, primary oversight responsibility for the company's financial reporting and disclosure process rests with the audit committee.

A robust risk management process identifies and prioritizes significant non-financial risks that may have financial reporting implications.

A company's risk management efforts are critical to the audit committee's oversight of the financial reporting process in several respects: A robust risk management process can be invaluable to the audit committee by identifying and prioritizing the company's significant financial reporting risks and non-financial risks that may have financial reporting implications. It also can help the audit committee ensure that, for each significant risk:

- the company has appropriate internal controls
- management makes appropriate disclosures, e.g., the presentation of critical accounting judgments and estimates in MD&A
- the financial statement impact of the risk is properly recorded
- CEO and CFO certifications are appropriate, especially with respect to disclosure controls and procedures, and internal control over financial reporting
- internal and external audit plans appropriately address the risk

Given the breadth, complexity, and dynamic nature of risk, the alignment and allocation of oversight responsibilities is vital to ensure that risks and their financial reporting implications are identified, assessed, and managed effectively.

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Ownership of risk oversight

Ultimate responsibility for risk management rests with the board.

The board is ultimately responsible for assessing the principal risks, approving risk tolerance levels and overseeing risk management. The entire board should participate in this process on a company-wide basis. However, because some risks are highly technical or complex, the detailed work of overseeing certain risks is often delegated to specific board committees.

While most audit committees may be comfortable in their oversight of traditional financial reporting and related compliance risks, the oversight of non-traditional risks—such as operational, strategic, regulatory, cultural, and others that could become financial reporting risks—present formidable challenges. Often it is unclear whether the board, audit committee, or another board committee is responsible for overseeing these risks.

Audit Committee versus Board (Committee): Who oversees what risks?

This figure illustrates, from a governance perspective, who is responsible for overseeing which risks. The audit committee's responsibility for overseeing financial reporting risks is represented in the top left triangle. The board must clarify the responsibilities for non-financial risk, represented in the lighter blue, deciding who will oversee these risks. As depicted by the black boxes, boards must have a process by which the audit committee is informed of non-financial reporting risks that may have financial reporting implications. The audit committee requires notice as early as possible, and certainly long before a crisis occurs, when conditions can change quickly.

The audit committee should be informed of non-financial risks that may have financial reporting implications.

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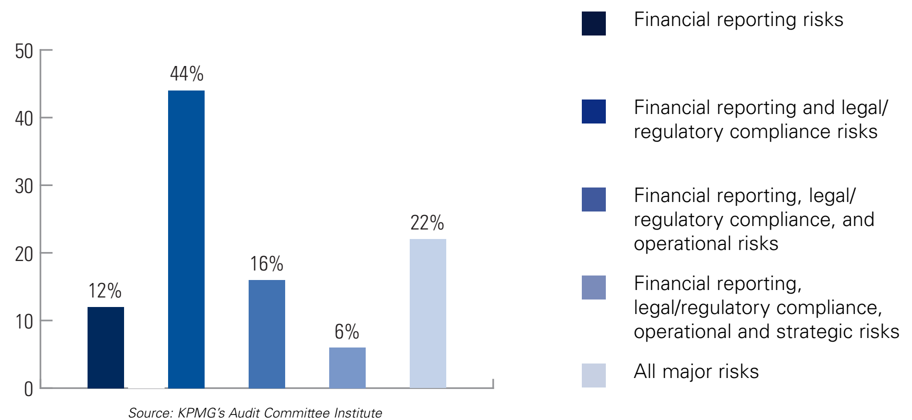
At the Spring 2006 Roundtables, participants were asked for what categories of risk should the audit committee have primary oversight responsibility. There was a diversity of opinions as can be seen in the following chart.

For what categories of risk should your audit committee have primary oversight responsibility?



Source: KPMG's Audit Committee Institute

This broad range of views points to the need for audit committees to review their charters to ensure they understand the scope of their risk oversight responsibilities—and that their oversight activities correspond to those responsibilities.

The charter should clearly define the scope of the audit committee's risk oversight responsibilities.

Over time, the diversity of opinion about the audit committee's role in risk oversight may narrow with the evolution of oversight practices, regulatory guidance, and perhaps court decisions on the matter.

Absent a "bright line" that delineates such responsibilities, leading audit committees are taking a common sense—and prudent—approach to determining which risks are (or should be) within the committee's purview, and for those that are not, where the oversight responsibility lies and the process by which the audit committee stays informed of potential financial reporting risks that are "owned" by other committees.

Coordination of risk oversight

Oversight activities need careful coordination where there are multiple board committees.

Information flow between the audit committee, the full board, and other board committees is increasingly seen as vital to ensuring that risk oversight responsibilities are appropriately assigned and coordinated, and that key risks don't fall through the cracks. While the committee structure can improve efficiency and provide specialized oversight through delegation of responsibilities, it also poses the potential for "balkanization" of risk oversight activities—and possible gaps in oversight. Recent scrutiny of stock option backdating, executive incentive compensation, and pension

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accounting demonstrates the importance of coordinating the oversight activities of multiple board committees—such as the compensation, finance, technology, governance, and risk committees—with the audit committee on issues that have financial reporting implications.

There should be a clear understanding of what information the audit committee needs from other committees as well as what information other committees need from the audit committee to ensure effective coordination and communication regarding significant risks.

Boards approach risk management in a variety of ways. The board may assume that responsibility itself or it may assign selected oversight responsibilities to other board committees. Nonetheless, the board retains overall responsibility for risk management. As such, risk management should always be on the board agenda, demonstrating the board's clear ownership of risk management oversight.

As risk underlies nearly all business activities, the responsibility for managing and reporting on various risks may reside with different members of management, the CEO, the CFO, internal audit, line managers, and others.

Possess a clear understanding of the company's process for identifying, managing, and reporting risk.

In its oversight role, the audit committee should have a good understanding of, and level of comfort with, the company's process for identifying, managing, and reporting risk.

To help the audit committee obtain a clear picture of the company's risks and its risk management approach, the information generated by this process should include:

- identifying and prioritizing significant risks
- quantifying the financial implications of each risk
- determining who has primary responsibility for management of specific risks
- evaluating the status of management's risk mitigation efforts

Certain risks that are more "qualitative" in nature—for example, management inexperience or misalignment of employee incentives and strategy—can be difficult to quantify or translate into financial terms. Nevertheless, management should have a method for reporting these types of risks to the audit committee.

In polling at the Spring 2006 Roundtables, about 58 percent of directors and audit committee members indicated they were either very or somewhat satisfied with the reports that management provides regarding the potentially significant risks facing the company. However, 42 percent felt that such reports needed improvement. This is not surprising due to a lack of a common and consistent understanding of what is risk.

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Periodically assess the adequacy of risk management information, both financial and non-financial.

The board or the audit committee must demand relevant, timely and accurate information from senior management, the internal auditor, and the external auditor, to ensure it is meeting its oversight responsibilities. In addition, the board or the audit committee needs to assess periodically whether they are receiving appropriate risk management information, regularly enough, and in a format that meets their needs. They need to evaluate, at least annually, the adequacy and timeliness of management reporting to the board or the committee on financial, non-financial, current and emerging risk trends. By asking probing questions about risk management, the board and its committees can help bring clarity to the processes for managing risk.

Risk and the audit process

Review internal and external audit plans dealing with significant business risks.

An important role for the audit committee is to help ensure that the internal and external audit plans properly focus on internal controls associated with potentially significant business risks—both financial reporting risks and non-financial reporting risks that may have financial reporting implications—facing the company.

In its review of internal and external audit plans, the audit committee should consider whether the internal and external auditors have:

- communicated their process for identifying and ranking the financial and non-financial reporting risks they believe may have financial reporting implications
- focused their audits on key areas of risk and that audit procedures are appropriate given the potential impact and potential occurrence of significant risks
- identified the same risks that management identified
- explained variations from management's identified risks or risk rankings
- communicated the design and performance of planned audit procedures (including their nature, timing, and extent) and demonstrated that the procedures are responsive to the identified risks
- communicated the potential "consequences" if a control is found to be ineffective, including any additional audit procedures required to be performed

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Putting it all together

In *Risk—From the CEO and Board Perspective*[1], risk management professional James Lam observes that "the only alternative to risk management is crisis management." Similarly, from an audit committee perspective, the likely alternative to oversight of risk management is oversight of financial reporting crisis.

As the potential financial reporting implications of non-financial reporting risks become more widely appreciated and better understood, leading audit committees—working with their boards—are devoting more time and resources to ensuring that:

- management has a process in place to identify, evaluate, and mitigate significant risks that may have financial reporting implications
- management's process for reporting risk information and the status of risk management efforts to the audit committee is robust
- responsibility for oversight of specific risks is clearly allocated among the audit committee, board, and other committees, and that the audit committee understands—and is carrying out—its risk oversight responsibilities as articulated in its charter
- risk oversight activities are coordinated and communicated among the various board committees that have ownership of the oversight of risks
- management and auditors understand the audit committee's expectations of them in conjunction with the audit committee's role of overseeing risk management objectives and processes, including risk reporting and tone from the top
- internal and external audit plans and activities complement and support the audit committee's consideration of the company's risks, including risk prioritization and allocation of audit resources to address those risks
- the audit committee's oversight activities are appropriately documented (in consultation with counsel) in its meeting minutes

Management and the auditors must understand the audit committee's risk expectations.

By focusing on these oversight activities and practices—within the context of the company's own needs and objectives—audit committees should be well positioned to answer the question underlying their role in the oversight of risk management: Are the audit committee's oversight processes, including the risk reports provided by management, sufficient to demonstrate that the committee is fulfilling its fiduciary duties of care and good faith?

[1] *Risk—From the CEO and Board Perspective*, Mary Pat McCarthy and Timothy Flynn, McGraw-Hill, New York, 2004

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Financial Reporting Updates

In this section, we identify recent significant regulatory, accounting and auditing rules, standards and projects issued since our C*anadian Audit Committee Update* – Spring 2006, 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 the original pronouncements and their financial advisers 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

CSA Staff Notice 51-319, *Report on Staff's Second Continuous Disclosure Review of Income Trust Issuers*

This notice publishes the findings and recommendations of the CSA's review of income trust issuers and their compliance with continuous disclosure requirements. Staff concluded that income trust issuers need to significantly improve the nature and extent of their disclosure, particularly with respect to distributable cash.

Income trust issuers need to significantly improve the nature and extent of their disclosures, especially for distributable cash.

Distributable cash disclosures in the MD&A were significantly deficient in their disclosure of the following areas:

- *Liquidity*. In many cases, income trust issuers did not provide sufficient disclosure about their sources of funding relating to current and future cash distributions but rather provided "boilerplate" discussions with minimal or no quantification of the sources of cash flows.
- *Risk and uncertainties*. Some income trust issuers provided only a "boilerplate" discussion of the risks and uncertainties the income trust was subject to that may materially affect the underlying entity's performance and thereby impact current and future distributions of the income trust. These disclosures related to trust structure, taxation, regulation and industry-specific risk factors.
- *Overall performance and results of operations*. Some income trust issuers did not provide an adequate discussion of the events in the year that caused variances in the specific financial statement line items, including the quantification of those factors.

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Staff also concluded that, in many cases, the presentation of non-GAAP financial measures by income trusts did not meet the minimum standards set out in CSA Staff Notice 52-306, *Non-GAAP Financial Measures*, which requires that the non-GAAP measure be reconciled to the most directly comparable GAAP measure.

Thus, when income trust issuers present distributable cash, they should reconcile from the most directly comparable GAAP measure, which would be cash flows from operations from the issuer's financial statements, including changes during the period in non-cash working capital balances. In many instances, income trust issuers began their GAAP reconciliation with earnings or EBITDA. In addition, many income trust issuers did not give equal or greater prominence to the most directly comparable GAAP measure.

Staff also expressed concern that some income trust issuers failed to conduct goodwill impairment testing when triggering events had occurred.

CSA wants full disclosure of compensation paid to certain external management companies.

With respect to the disclosure of compensation paid to the reporting issuer's executive officers, staff found that there was a failure to fully disclose the compensation paid to any external management company where the officers of the external management company perform functions for the trust similar to those normally performed by senior officers of the company.

Staff also identified timely disclosure deficiencies. Some income trust issuers failed to file material change reports in response to events at the operating entity level that appeared to meet the definition of a "material change".

Finally, regarding the filing of material contracts on SEDAR, staff found that several income trust issuers had obtained waivers for financial covenants and made amendments to their credit facilities but failed to file the amended credit agreements on SEDAR. Income trusts should file on SEDAR any changes to these contracts, as well as filing any new contracts.

CSA Staff Notice 51-320, *Options Backdating*

As a result of media attention about the apparent backdating of options in the US, the CSA published this notice to communicate its understanding of the issue in the Canadian market.

Issuers should review their options-granting policies to determine whether backdated options may have been issued.

The notice discusses some of the different regulatory requirements in Canada that may reduce the opportunity for Canadian companies to backdate or time option grants. It also reminds the board of directors that they are responsible for ensuring that the issuer prices options appropriately and discloses them properly.

Staff recommends that all issuers assess their current policies, procedures and controls for option grants and equity-based awards to ensure that they comply with relevant stock exchange rules and securities legislation.

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CSA calls for more balanced disclosure of non-GAAP financial measures.

CSA Staff Notice 52-306, *Non-GAAP Financial Measures (Revised)*

In August 2006, CSA staff published this notice to issuers that publish non-GAAP financial measures in their disclosure documents. Staff commented that some issuers present a more positive picture of financial performance by using non-GAAP financial measures derived from net income that omits selected items. The following problems were encountered:

- the presentation of a non-GAAP financial measure without any explanation of the reasons for presenting that measure or a discussion of how management uses that measure
- the reporting of non-GAAP financial measures that appeared to be defined differently from quarter to quarter or from year to year
- the failure to discuss the nature of "non-recurring" or "one-time" charges and to explain why they are not expected to recur in the future
- the improper classification of items as non-recurring, infrequent, or unusual, even though a similar charge or gain either occurred within the previous two-year period or is reasonably likely to recur within the next two years
- greater prominence being given to non-GAAP financial measures related to earnings than to net income determined in accordance with GAAP

Staff continues to be concerned that investors may be confused or even misled by such non-GAAP financial measures. To minimize the potential for confusion, such measures need to be accompanied by clear disclosure that the measures do not have a standardized meaning, an explanation of their composition and a reconciliation to the most directly comparable measure in the issuer's GAAP financial statements.

Distributable cash disclosures must include a reconciliation to cash flows from operations.

The notice was revised to clarify that distributable cash (a non-GAAP financial measure) is, in all circumstances, a cash flow measure. This is a change in staff position since the original notice was published. Thus, in order for issuers to comply with the obligation to provide a reconciliation from the non-GAAP financial measure to the most directly comparable GAAP measure, distributable cash disclosure must include a reconciliation to the cash flows from operations as presented in the issuer's financial statements including changes in non-cash working capital balances.

In the event that cash distributions paid do not equal distributable cash, the issuer should discuss the reasons for the difference and where distributions paid are materially less than distributable cash, discuss why the distributable cash was not fully distributed.

CSA Staff Notice 52-315, *Certification Compliance Review*

Staff recently conducted a review of issuers' compliance with the annual certification requirements. This review focused on whether the issuer had

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filed the correct form of certificate and whether the issuer's annual MD&A contained disclosures regarding the certifying officers' conclusions about the effectiveness of disclosure controls and procedures.

Conclusions about disclosure controls and procedures must be disclosed in the MD&A.

Staff noted that 28 percent of issuers failed to disclose in their annual MD&A the certifying officers' conclusions about the effectiveness of disclosure controls and procedures as required under MI 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings*, while 4 percent of issuers failed to file the correct certificate.

The CSA was particularly concerned with the failure to include the disclosure regarding the effectiveness of disclosure controls and procedures in the annual MD&A since, in most cases, the certifying officers specifically represented in their certificates that they had caused the issuer to include this disclosure in the annual MD&A.

The CSA also made the following observations:

- certificates should be dated the same date as the financial statements, MD&A, and AIF, as applicable, are filed
- where a continuous disclosure document is re-filed, a new certificate is to be filed and that certificate should be the same as was filed with the original continuous disclosure document
- if a venture issuer voluntarily files an AIF for a financial year after the issuer has filed its financial statements, MD&A and annual certificates, it must file new annual certificates for that financial year

The CSA intends to monitor this area closely and to conduct further reviews as part of its continuous disclosure review program.

CSA Staff Notice 52-316, *Certification of Design of Internal Control over Financial Reporting*

Disclose material weaknesses in the design of internal control in MD&A.

In September 2006, the CSA published this notice to communicate staff's views regarding the ability of certifying officers of a reporting issuer to certify the design of the issuer's internal control over financial reporting if the certifying officers are aware of a weakness in the design of the issuer's ICFR that has not been remediated.

The notice indicated that there are circumstances in which the certifying officers of a reporting issuer can conclude that they are able to certify that they have designed the issuer's ICFR as required by the full annual certificate even though the certifying officers have identified a weakness in the design. In the CSA's view, the certifying officers can certify the design of the issuer's ICFR if the issuer's disclosure about the identified weakness presents an accurate and complete picture of the condition of the design of the issuer's ICFR.

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The certification rule does not explicitly require the certifying officers to disclose a weakness in the design of the issuer's ICFR but it does require the certifying officers to disclose in the annual MD&A their conclusions about the effectiveness of the disclosure controls and procedures. In the CSA's view, the conclusions about the effectiveness of the DC&P should include disclosure of identified weaknesses in the DC&P.

Given the substantial overlap between the definitions of DC&P and ICFR, it is the CSA's view that the certifying officers therefore should disclose in the annual MD&A the nature of any weakness in the design of the issuer's ICFR, the risks associated with the weakness, and the issuer's plan, if any, to remediate the weakness. If no such plan exits, the issuer should consider disclosing its reasons for not planning to remediate the weakness.

NI 81-107, *Independent Review Committee for Investment Funds*

An investment review committee must oversee conflict of interest situations.

In July 2006, the CSA issued this rule in an effort to improve the governance of publicly offered investment funds. The rule requires investment funds that are reporting issuers to have a fully independent body, the Independent Review Committee, to oversee all decisions involving an actual or perceived conflict of interest faced by the fund manager in the operation of the fund.

The rule requires that written policies and procedures be established and followed by the fund manager in situations where a decision involving a conflict of interest matter must be made. Furthermore, the matter must be referred to the IRC for its review. The rule also requires the IRC to approve certain changes to a mutual fund before the fund manager may proceed with the change.

US Developments

SEC Final Rule – *Executive Compensation and Related Person Disclosure*

SEC amends executive and director compensation disclosures.

Recently, the SEC approved rules that amend disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters, and security ownership of officers and directors. The rules affect disclosure in proxy statements, annual reports, registration statements and Form 8-K.

The rule amends executive compensation disclosures as follows:

- redefines the individuals for whom compensation must be disclosed and requires that a total compensation amount and its components be disclosed for each of those individuals
- mandates an explanation of the key determinants of the company's compensation decisions
- requires compensation disclosures for the CEO and CFO and the three other highest-paid executive officers, and the company's directors

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- introduces a new required narrative section, Compensation Discussion and Analysis, that will be used to disclose the most important factors used to determine the company's executive compensation policies and decisions. This new section will be subject to certification by the CEO and CFO
- revises tabular information concerning compensation figures covering three broad categories: total compensation over the last three years, outstanding equity-related interests received as compensation that are the source of future gains, and retirement plans and other post-employment payments and benefits

Related party transactions disclosures are expanded.

There are also additional related-party transactions disclosures. Registrants must disclose information about their policies and procedures for approving related-party transactions; the categories of related parties would be slightly expanded; and the threshold for disclosure would be changed from $60,000 to $120,000.

The rules create new disclosure requirements about director independence including:

- whether each director and director nominee is independent
- a description of any relationships not otherwise disclosed that were considered when determining whether each director and director nominee is independent
- any audit, nominating, and compensation committee members who are not independent

Foreign private issuers are permitted to continue to follow the compensation disclosure requirements contained in Form 20-F. A foreign filer must provide more detailed information if it makes the information publicly available for some other reason (e.g., a home-country reporting requirement).

For issuers subject to Regulation S-B, the rule calls for less extensive disclosures.

The effective dates for compliance with the new rules vary based on the filing form. Companies must comply with these disclosure requirements in Form 8-K for triggering events that occur after 59 days from the date the rules are published in the Federal Register and in Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006.

SEC Final Rule — *Management's Report on Internal Control over Financial Reporting*

Foreign private issuers granted one year extension.

In September 2006, the compliance dates for foreign-private issuers that are accelerated filers was extended again by one year to years ending on or after July 15, 2007.

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Need to quantify uncorrected misstatements using both balance sheet and income statement methods.

SAB 108 – *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*

This bulletin addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements.

It requires registrants to quantify misstatements using both the balance sheet (iron curtain) and income statement (rollover) approaches and to evaluate whether either approach results in an error that is material in light of relevant quantitative and qualitative factors.

The guidance is effective at the beginning of the first fiscal year ending after November 15, 2006.

A material error identified upon application of this guidance for the first fiscal year ending after November 15, 2006, may be corrected through a one-time cumulative-effect adjustment to beginning-of-year retained earnings, provided that the misstatement was determined to be immaterial in the past based on the application of the registrants' previous method for quantifying misstatements.

When a cumulative-effect adjustment is recorded, the following disclosures are required; the nature and amount of each individual error included in the cumulative-effect adjustment, when and how each error arose, and the fact that the errors had previously been considered immaterial.

This bulletin is applicable to all SEC registrants.

Letter provides SEC staff views on stock option granting practices.

SEC Letter – *Staff Views on Accounting Consequences of Prior Stock Option Granting Practices*

The SEC published a letter stating its views on accounting for stock-based awards when entities may have used inappropriate measurement dates, thereby misstating stock-based compensation cost.

When reassessing their previous accounting, some companies may find their accounting to be in error or unsupportable based on evidence currently available. Companies will need to consider the potential materiality of any adjustments, evaluating both quantitative and qualitative factors to determine the appropriate actions to take.

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Accounting Developments

We highlight here certain significant new accounting standards issued since our *Canadian Audit Committee Update* – Spring 2006. We also describe current and future projects underway regarding new accounting standards in Canada and in the US that indicate the direction in which future standards are moving.

Recently Issued Guidance – Canada

HB 1506, *Accounting Changes*

Addresses accounting and enhanced disclosure requirements for changes in accounting policies, estimates and errors.

Recently the standards were revised. The new standards:

- allow for voluntary changes in accounting policy only when they result in the financial statements providing reliable and more relevant information
- require changes in accounting policy to be applied retrospectively unless doing so is impracticable. The threshold for impractical is quite high and requires a careful analysis of the standard
- require prior period errors to be corrected retrospectively
- call for enhanced disclosures about the effects of changes in accounting policies, estimates and errors on the financial statements

The standards are effective for fiscal years beginning on or after January 1, 2007 with earlier adoption encouraged.

HB 3855, *Financial Instruments – Recognition and Measurement*

Standards on accounting for fees and costs incurred upon the modification or extinguishment of debt.

Recently, amended standards were issued to clarify the accounting for fees and costs incurred in connection with a modification or extinguishment of a debt instrument as follows:

- when an exchange of debt instrument or modification of terms is an extinguishment of debt:
  - any fees would be recognized as part of the gain or loss on extinguishment, and
  - the entity could adopt an accounting policy of either recognizing any costs in net income or adding any costs to the carrying amount of the new financial liability and amortizing them over its expected life
- when an exchange or modification is not accounted for as an extinguishment of debt and the liability is classified as held for trading, all fees and costs would be recognized in net income for the period
- when an exchange or modification is not accounted for as an extinguishment of debt and the liability is classified as other than held for trading:
  - any fees would be added to the carrying amount of the modified financial liability and amortized over its remaining expected life, and
  - the entity could adopt an accounting policy of either recognizing any costs in net income or adding any costs to the carrying amount of the modified financial liability and amortizing them over its remaining expected life.

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HB 3865, *Hedges*

Methods for assessing hedge effectiveness and calculating the ineffective portion of a hedge may be different.

Recently, the AcSB revised these standards to allow the use of a different method to assess the effectiveness of the hedge from that used to calculate the ineffective portion of the gain or loss on the hedging item. The AcSB also amended the transition requirements of the standards to clarify the accounting for a cash flow hedging relationship entered into prior to transition.

HB 3862, *Financial Instruments – Disclosures*
HB 3863, *Financial Instruments – Presentation*
HB 1535, *Capital Disclosures*

Recently, the AcSB approved a set of disclosure and presentation requirements for financial instruments that replace the current standards.

The disclosure standards are based on international standards. The standards place an increased emphasis on disclosures about the risks associated with both recognized and unrecognized financial instruments and how these risks are managed.

Standards on presentation and disclosures for financial instruments and capital.

The standards require disclosure, by class of financial instrument that enables users to evaluate the significance of financial instruments for an entity's financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk, and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net income and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable.

The existing requirements on presentation of financial instruments have been carried forward unchanged.

The capital disclosures standards establish required disclosure of information about an entity's capital and how it is managed, including:

- an entity's objectives, policies and processes for managing capital
- quantitative data about what the entity regards as capital
- whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such non-compliance

These standards are effective for interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007.

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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-163, *Determining the Variability to Be Considered in Applying AcG-15*

Guidance on how to distinguish between contracts or arrangements that create variability in an entity and contracts or arrangements that are exposed to or reduce that variability.

This abstract addresses whether certain arrangements, such as a contract to reduce or eliminate the variability created by certain assets or operations of the entity, should be treated as variable interests or considered creators of variability when applying AcG-15.

The variability to be considered by an entity in applying AcG-15 should be based on a two-step analysis of design. The first step is to analyze the nature of the risks in the entity (including credit, interest rate, foreign currency exchange, commodity price, equity price, and operations risks) to which the potential variable interest entity is exposed. The second step is to determine the variability (created by the risks) that the entity was designed to create and pass along to its interest holders based on the purpose for which the entity was created. Examples are provided in the abstract.

This abstract is to be applied prospectively to all entities with which the entity first becomes involved, and to all other entities previously required to be analyzed under AcG-15 when a reconsideration event occurs, beginning on the first day of the first interim or annual reporting period beginning on or after January 1, 2007.

Retrospective application to the date of the initial application of AcG-15 is permitted but not required.

EIC-162, *Stock-Based Compensation for Employees Eligible to Retire Before the Vesting Date*

Guidance on accounting for stock-based awards for employees eligible to retire before the vesting date.

This abstract addresses how to account for compensation costs attributable to a stock-based award for a compensation plan that contains a provision that allows an employee to continue vesting in accordance with the stated vesting terms after the employee has retired.

In the case of an employee who is eligible to retire at the grant date, compensation costs should be recognized on the grant date as the employee could retire at any point in time and retain the award without performing any further services.

For an employee who will become eligible to retire during the vesting period, compensation cost should be recognized over the period from the grant date to the date the employee becomes eligible to retire.

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This abstract is to be applied retroactively, with restatement of prior periods, to all stock-based compensation awards in financial statements issued for interim and annual periods on or after December 31, 2006.

Projects to Develop Future Guidance – Canada

ED – *Earnings per Share*

Project direction revised to converge with international standards.

In July 2006, the AcSB decided to change the direction of the project from harmonizing with US standards to harmonizing with international standards. A new exposure draft based on international standards will be developed. It is expected to be issued in the first quarter of 2007.

ED – *Going Concern*

In August 2006, the AcSB issued an exposure draft that would adopt the international standards on going concern.

The main features of the proposed standards are as follows:

Management must look forward at least twelve months to assess going concern issues.

- 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, twelve months from the balance sheet date
- financial statements must be prepared on a going concern basis unless management 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

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

ED – *Inventories*

In July 2006, the AcSB released an exposure draft that would supersede existing standards and converge with international standards on inventories.

The proposals would apply to inventories of all entities, except work in progress under construction contracts, financial instruments, and contributions not recognized by not-for-profit organizations.

Standards apply to most types of inventory.

Specific guidance is provided for not-for-profit organizations for the contribution of materials and services, and for inventories to be distributed at no charge or for a nominal charge. The proposals also provide specific scope exemptions, from the measurement requirements only, for certain agricultural products, mineral products and commodity broker-traders.

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The exposure draft proposes significant changes to the measurement and disclosure of inventory as follows:

Measurement of inventory to undergo significant changes.

- the elimination of LIFO
- the requirement to measure inventories at the lower of cost and net realizable value
- the allocation of overhead based on normal capacity
- the use of the specific cost method for inventories that are not ordinarily interchangeable, or goods and services produced for specific purposes
- the requirement for an entity to use a consistent cost formula for inventory of a similar nature and use
- the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories

Disclosures of inventory policies, carrying amounts, amounts recognized as an expense, write-downs and the reversals of write-downs will be required.

The proposed standards would be effective for interim and annual periods relating to fiscal years beginning on or after July 1, 2007, with earlier adoption encouraged.

Project – *Accounting Standards in Canada: Future Directions*

Implementation plan for adopting IFRS is published.

In August 2006, the AcSB published its *Implementation Plan for Incorporating IFRSs into Canadian GAAP*. The implementation plan outlines the expected timing of adoption of each IFRS standard as well as a summary of the differences between IFRS and existing Canadian standards.

Project – *Consolidations*

The AcSB has approved a project to harmonize Canadian GAAP for consolidations with new standards under development by the IASB and FASB.

Canadian consolidation standards to harmonize with IASB and FASB joint project.

The key issues to be addressed include the definition of control, the application of the definition to various circumstances, special purpose entities/variable interest entities and disclosures.

The AcSB is monitoring the IASB project. The IASB is expected to issue an exposure draft in early 2008.

Project – *Income Taxes*

US position on uncertain tax positions will not be adopted in Canada.

In January 2006, the AcSB decided not to proceed with a project to adopt the FASB's interpretation on uncertain tax positions. The AcSB currently expects to review the IASB's proposal on uncertain tax positions, which is expected to be released in the fourth quarter of 2006, and make similar proposals.

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Project – *Joint Ventures*

Joint venture standards to align with international standards.

The AcSB has approved a project to converge with proposed international standards on joint ventures. The IASB proposal will require a change from the use of the proportionate consolidation method to the equity method when accounting for interests in jointly controlled entities. The IASB proposal is also expected to clarify the difference between an interest in a jointly controlled entity and a direct interest in the underlying individual assets and liabilities of a joint arrangement (for which the accounting would not change).

An exposure draft is expected to be issued by the AcSB once the IASB has released its exposure draft, which is expected in the second quarter of 2007.

Recently Issued Guidance – United States

SFAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106 and 132(R)*

This statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability on its balance sheet and to recognize changes in the funded status in the year in which they occur. Plan assets and benefit obligations will be measured at the fiscal year-end.

Highlights of the statement include:

Overfunded or underfunded pension plan status to be recognized on the balance sheet.

- recognition of the over-funded or under-funded status of a benefit plan, measured as the difference between the fair value of plan assets and the benefit obligation, on the balance sheet. For a pension plan, the benefit obligation is the projected benefit obligation. For any other postretirement plan, the benefit obligation is the accumulated postretirement benefit obligation
- recognition of gains and losses and the prior service costs and credits that arise during the period but are not components of net periodic benefit cost as a component of other comprehensive income, net of tax. Amounts recognized in accumulated other comprehensive income, including any transition asset or obligation remaining from the initial application of SFAS 87 or 106, would be adjusted as they are subsequently recognized as components of net periodic benefit cost
- measurement of defined benefit plan assets and defined benefit plan obligations as of the balance sheet date
- disclosure of additional information about certain effects on net periodic benefit cost in the upcoming fiscal year that arise from delayed recognition of the gains and losses and prior service costs and credits

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An employer with publicly traded equity securities is required to apply this statement, excluding the requirement for fiscal year-end measurement of plan assets and benefit obligations, for fiscal years ending after December 31, 2006.

The requirement to measure plan assets and benefit obligations as of the balance sheet date is applicable for fiscal years ending after December 15, 2008.

SFAS 157, *Fair Value Measurements*

In September 2006, the FASB issued this statement to define fair value, establish a framework for measuring fair value under GAAP and expand disclosures about fair value measurements. The statement applies only to fair value measurements that are already required or permitted by other current accounting standards.

Consistent framework for measuring fair value is introduced.

This statement replaces the various definitions of fair value in accounting literature with a single definition. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price definition).

For the purposes of fair value, market participants are defined as buyers and sellers in the principal or most advantageous market for the asset or liability meeting four criteria; they are independent of the reporting entity, they have the knowledge needed for a reasonable understanding of the asset or liability and the transaction, they have the financial and legal ability to transact for the entity, and they are willing to transact without compulsion.

The principal market is defined as the market with the greatest volume and level of activity that the reporting entity uses to sell the asset or transfer the liability.

An entity that has no principal market for the asset or liability would determine its most advantageous market. The most advantageous market is the market in which the reporting entity would sell the asset or transfer the liability. Transaction costs are included in determining the net amount to be received or paid when determining the most advantageous market, but excluded from the fair value measurement.

The statement requires reporting entities to establish a valuation premise based on the asset's highest and best use. This premise is often an integral part of valuing non-financial assets and other assets for which there is no observable market price.

Three possible valuation approaches are identified by the statement; the market, income, and cost approaches. The term 'fair value hierarchy' as used in the statement, refers to the relative reliability of inputs to a valuation technique used in arriving at a fair value estimate.

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There is a three-level fair value hierarchy. It is based on inputs ranging from inputs based on quoted market prices in active markets for identical assets and liabilities to unobservable inputs based on the reporting entity's own assumptions about the assumptions that a market participant would use.

A fair value measurement may be based on inputs from more than one level in the hierarchy.

The statement requires additional disclosures in both interim and annual periods by each major category of assets and liabilities.

The statement is effective for fair value measures already required or permitted by other standards for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods in those fiscal years.

SFAS 156, *Accounting for Servicing of Financial Assets – An Amendment of SFAS 140*

Recently, the FASB issued a statement that amends the accounting for separately recognized servicing assets and liabilities.

Accounting for separately recognized servicing assets and liabilities is amended.

This statement:

- requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations
- requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable
- permits an entity to choose, as the subsequent measurement method, to either report servicing assets or liabilities at fair value or to amortize servicing assets or liabilities in proportion to and over the period of estimated net servicing income or net servicing loss
- requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities

At its initial adoption, this statement permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value.

This statement is effective for fiscal years beginning after September 15, 2006.

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Auditing Developments

Revised standards when relying on the work of another auditor.

We highlight here recent significant CICA Auditing and Assurance Standards Board projects.

Projects to Develop Future Guidance

ED – *Audit of Group Financial Statements*

Recently, the AASB issued this ED, which replaces existing standards. The proposed new standards will require a significant increase in work effort when a group auditor is relying on another auditor to obtain sufficient appropriate audit evidence to support the content of his or her report on the financial statements of the group.

This proposed guidance is being developed in parallel with proposals recently issued by the IAASB. It is the intent that the proposed standards would be converged with the international standards.

The main features of the proposed standards are:

- the nature, timing and extent of the group auditor's involvement in the other auditor's work are affected by the significance of the component, identified significant risks, and the group auditor's understanding of the other auditor
- the group auditor's decision to accept or continue an engagement is subject to the group auditor being able to obtain sufficient appropriate audit evidence on which to base the group audit opinion. This is achieved by the group auditor performing the work on the financial information of significant components, or being involved in the work that other auditors perform on the financial information of significant components
- the group auditor cannot accept a group audit engagement if the group auditor's access to component information, those charged with governance of components, component management, or other auditors, including relevant parts of their audit documentation, will be materially restricted

The effective date of the proposed standards will be the same as the effective date of the final international standards.

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Wording of auditor's report will change.

ED – *The Auditor's Standard Report*

Recently, the AASB issued an ED to revise existing standards for the auditor's report to more closely conform to international standards.

The main features of the proposed revisions are:

- an expanded description of management's responsibility to indicate that it includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
- an expanded description of the auditor's responsibility indicating that:
  - an audit includes assessing the risks of material misstatement in the financial statements
  - the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances
  - the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control, and that, accordingly, the auditor expresses no such opinion
- the proposals do not permit the auditor a choice of wording of the opinion, and require the opinion to state that the financial statements present fairly, in all material respects, in accordance with Canadian GAAP

The AASB intends to make its proposals effective in 2007 in order to allow sufficient time to implement the proposals.

Auditor's responsibility when a going concern issue exists is clarified.

ED – *Going Concern*

Recently, the AASB released an ED that would deal with the auditor's responsibility to assess the adequacy of financial statement disclosures when there are material uncertainties about an entity's ability to continue as a going concern.

The ED is largely consistent with the principles and guidance in existing international standards. However, the AASB intends to revise the proposed new standards to converge with international standards when they are next revised.

The proposed standards require that auditors consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In light of such events or conditions, the auditor is required to perform procedures relevant to factors that may mitigate the effect of identified events or conditions on the entity.

The ED also considers the necessary disclosures in such circumstances.

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Auditor's assistance to directors for continuous disclosure documents to be addressed.

Project – *Comfort to Directors*

Recently, the AASB undertook a project to develop guidance for an auditor who is asked by the board of directors to provide comfort on financial information in continuous disclosure documents such as MD&A, AIF, annual reports to shareholders and possibly earnings press releases.

The AASB intends to address the following issues:

- the type of information that can be addressed
- whether comfort can be provided before completing the related audit work
- the nature of the comfort or assurance that can be provided
- whether the comfort must be in writing

The AASB expects to issue an ED in late 2006.

* * * * * *

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.

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Audit Committee Evolving Issues

Frequently Asked Questions – Evaluating Design of Internal Control

The Canadian requirements for internal control certification have pushed many companies into high gear as their year-end approaches. In this article, we answer some of the questions that we are asked most frequently—by management in preparing their certifications and by audit committees in determining their oversight process.

What do regulators require?

Multilateral Instrument 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings* requires the CEO and CFO to certify that they have designed internal control over financial reporting to provide reasonable assurance over the reliability of financial reporting and the preparation of external financial statements. This is in addition to the certifications relating to disclosure controls and procedures that commenced for years ending after March 30, 2005. These internal control certification rules are effective for years ending after June 29, 2006, and apply to most reporting issuers, including venture issuers.

For the same effective date, the CSA requires the CEO and CFO to make a second certification. They must certify that they have caused the company to disclose—in the annual or interim MD&A, as appropriate—changes in internal control that have had or may have a material effect on the company's internal control.

The CSA, however, provides very little guidance to management or the audit committee as to what is required to support the internal control certifications.

What is meant by the design of internal control? How does the certification of design differ from the evaluation of operating effectiveness?

Internal control over financial reporting is properly designed when those controls would be expected to prevent or detect errors or fraud that could result in material misstatements in the financial statements. Information is considered material if its omission or misstatement could influence the economic decisions of users of the financial statements.

Evaluating design involves:

- considering whether those controls, when in operation, would achieve the objective
- determining whether the controls have been implemented (i.e., the control exists and the company is using it) and

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- considering whether appropriately qualified persons are carrying out the control

The process for evaluating the effectiveness of internal control builds on the process for evaluating design. Significant incremental elements include:

- testing if the control, when in operation, functions as designed and
- determining the consistency with which the controls were applied.

Why does management need to do anything regarding ICFR—is not the auditor required to report material weaknesses in internal control?

The auditor is required to report to the audit committee material weaknesses in ICFR found during the audit. If the auditor comes across a potential weakness, such as exceptions while doing control testing or identifies audit adjustments, the auditor should consider the underlying cause to determine if a material weakness exists.

However, the auditor is not obligated to seek out control weaknesses and does not undertake a comprehensive evaluation of internal controls. Thus weaknesses may go undetected by the auditor.

Furthermore, an auditor may have decided not to communicate annually material weaknesses for which there is no reasonable cost-effective solution, such as when there is a lack of segregation of duties in a small company.

Management therefore cannot rely on the auditor's work to uncover material weaknesses in ICFR. Management must carry out its own work.

What are the minimum procedures that should be carried out to support the certification?

The rules do not prescribe what is required and explicitly state it is best left to management's judgment. However, in Staff Notice 52-313, the CSA indicated it will monitor the MD&A disclosures regarding ICFR, together with the related certifications as part of its continuous disclosure reviews. The CSA may enquire into the procedures that support the disclosure and certifications, particularly where the continuous disclosure filings contain material misstatements or apparent errors.

At a minimum, we believe management should consider the risks of a material misstatement in their financial statements, identify controls over those risks and have a basis to assert that the controls have been implemented. Documentation of this process is strongly encouraged.

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How can management establish that the controls have been placed in operation?

The rules do not explicitly require testing to establish that controls have been placed in operation; however, obtaining evidence that the controls have been implemented is sensible. For smaller companies, the CEO and CFO are more likely directly involved in ICFR and have the opportunity to observe the implementation of the controls that they have designed. However, in larger companies where the operation of the controls cannot be directly observed in the normal course of business, it may be prudent to apply some procedures to provide support for the certifications.

Several techniques may enable management to assess whether the internal controls are in fact being used as designed. These include:

- *Inquiry/corroborative inquiry* — obtain information by interviewing appropriate personnel. Corroborative inquiry involves confirmation with other members of the entity regarding inquiries made of personnel. Corroboration helps to confirm the validity and consistency of the application of a control.
- *Observation* — observe the performance of the control.
- *Inspection* — look at records or documents supporting the operation of a control.
- *Walkthrough* — follow the flow of actual transactions, inspecting the same documents and observing information technology used, and questioning those people involved in significant aspects of the activities or controls to validate that the controls are operating as documented.

What type of reporting is required in MD&A?

The rules require the CEO and CFO to certify that they are responsible for establishing and maintaining disclosure controls and procedures and ICFR for the issuer. As part of this process, disclosure is required in the annual MD&A of the conclusions regarding the effectiveness of the issuer's DC&P as of the end of the period covered by the annual filing.

In addition, the rules require for the first annual certification and every annual and interim certification thereafter, disclosure in the MD&A regarding any change in the issuer's ICFR that occurred during the most recent interim period. The changes disclosed are those that have materially affected, or are reasonably likely to materially affect the issuer's ICFR.

Recently, the CSA issued Staff Notice 52-316. It calls for additional disclosures when there are weaknesses in ICFR. This notice says that, when a design weakness exists, the CEO and CFO can sign the certification regarding the design of the issuer's ICFR only if the MD&A disclosure about the identified weakness presents an accurate and complete picture of the condition of the design of ICFR.

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The notice specifically requires the following disclosures:

- the nature of any weakness in the design of the issuer's ICFR
- the risks associated with any weakness in ICFR
- the issuer's plan, if any, to remediate the weakness

The notice also indicates that, if there is no plan to remediate a weakness, the issuer should consider disclosing its reasons for not having a remediation plan.

What impact do weaknesses in the design of controls related to ICFR have on the certification related to DC&P?

The rules indicate that there is substantial overlap between the definition of DC&P and ICFR. As a result, we believe that, similar to the US, it will be rare for an issuer to disclose design weaknesses in ICFR but conclude that its DC&P are effective. However, this type of disclosure may be the case for a small company, where the CFO prepares all journal entries related to complex matters. Here there is a risk of management override due to the lack of segregation of duties and the lack of other individuals with appropriate knowledge of generally accepted accounting principles to appropriately review the entries. In this case, the CFO may be able to conclude that DC&P are effective because of his or her direct knowledge of the transactions and recording, despite ineffective internal controls.

What determines if a deficiency in the design of ICFR is reportable?

Staff Notice 52-316 requires disclosure of the nature of any weakness in the design of ICFR in the MD&A. At first glance this might suggest a very low threshold when determining what to disclose. However, the MD&A rules indicate that only material information needs to be disclosed.

The OSC has indicated that it is appropriate to apply the concept of materiality in determining disclosures. Its intention was to not make the reporting requirements in Canada any more onerous than those in the US. Under the *Sarbanes-Oxley Act*, companies are required to disclose material weaknesses that would not prevent or detect material misstatements in the financial statements.

CICA auditing standards apply a similar concept in that they state that a weakness in internal control is material if the deficiency is such that a material misstatement is not likely to be prevented or detected in the financial statements.

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What are the indicators for what are typically considered to be possible reportable deficiencies?

In the United States, the PCAOB sets out in Audit Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* certain circumstances that were strong indicators of a material weakness. These indicators include:

- restatement of previously issued financial statements to reflect the correction of a misstatement
- identification by the auditor during a quarterly review or annual audit of a material weakness in the financial statements that was not initially identified by the company's ICFR (even if corrected prior to issuance of the financial statements)
- ineffective oversight by the audit committee
- ineffective internal audit or risk assessment function at a company for which such a function needs to be effective, such as at a very large or highly complex company
- an ineffective regulatory compliance function for complex entities in highly regulated industries
- fraud of any magnitude on the part of senior management
- significant deficiencies that have been communicated to management and the audit committee and remain unremediated after some reasonable period of time
- an ineffective control environment

If management has identified any one of these situations but concluded that it was not a reportable deficiency, we believe that a reasonable investigation should be conducted by the audit committee to confirm the decision was appropriate.

What determines if a change in internal control is reportable?

The rule requires disclosure in the interim or annual MD&A of any change in the issuer's ICFR that has occurred during the issuer's most recent interim period and that has materially affected or may materially affect the issuer's ICFR.

We believe that the CSA would expect that a change in internal control to remediate a reportable weakness should be disclosed. This disclosure would be consistent with the practice seen in the US whereby issuers disclose remediation efforts related to previously reported material weaknesses.

However, we believe the requirement to disclose material changes goes beyond only remediation of reported weaknesses. It can include any change in the normal course of operations that may materially affect ICFR. There is

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virtually no guidance in Canada or the US for making this determination, and management should be encouraged to consult with legal counsel when making this judgment.

As a minimum, management should have a process in place to identify changes in ICFR that can be evaluated by the CEO, CFO, and other members of management against materiality.

Considerations in this regard might include:

- Are the changes pervasive and covering multiple accounts? For example, a major conversion involving an ERP system.
- Does the change affect a material risk to the reporting process? For example, anti-fraud controls put in place to enhance the control environment, such as the introduction of code of conduct annual sign offs.
- How extensive are the changes relative to material accounts or risks? Is the change a compete overhaul that includes both information technology changes and process flow, or are the changes more selective "tweaking"?
- Are there changes to the more important key controls, particularly those involving significant judgments? An example might include new or changed personnel who were necessary to handle complex accounting areas such as financial instruments, revenue recognition, or accounting for income tax.
- Are there a number of relatively minor changes that may, in the aggregate, be considered material?

Generally we believe that if a responsible person would determine that the change could affect the reasonable assurance given, regarding the reliability of financial reporting or the preparation of financial statements, then disclosure would be prudent.

What are typical design deficiencies?

The design deficiencies related to ICFR disclosed in Canada may resemble those reported in the US during the first year of implementation of the *Sarbanes-Oxley Act*.

During that first year, only companies with a public float in excess of US$750 million were required to evaluate the effectiveness of internal control.

Areas where material weaknesses were reported in the US include (percentages represent the proportion of companies reporting the weakness)[1]:

- Tax accruals, deferrals 32%
- Revenue recognition 31%
- Inventory/vendor COS 27%
- Fixed/intangible assets 19%
- Leases or contingencies 17%
- Depreciation/amortization 13%
- Consolidation / VIE's 9%

[1] From a study conducted by Audit Analytics of 629 companies that reported material weaknesses in the first year of SOX 404. The study was published in *Section 404 Internal Control Material Weaknesses Dashboard – Results for the first full year of Section 404 Disclosures*, April 2006.

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These material weaknesses related to:

- Material year-end adjustments 53%
- Restatements 49%
- Personnel issues 48%
  (lack of knowledge of complex accounting, lack of tax expertise)
- Segregation of duties 21%
- IT processing, access issues 21%

Because Canadian issuers are generally smaller than issuers in the US, we anticipate that personnel issues and segregation of duties matters may also be prevalent. Disclosures such as these have already been filed in Canada. We also expect that many companies may disclose that they do not intend to remediate these weaknesses.

Can business acquisitions be scoped out of the evaluation of design of internal control in the year of acquisition?

We believe any significant acquisition is within the scope of the rules.

Can the company involve the external auditor or others in the certification process? Is the external auditor restricted in what services can be provided?

The rules do not require involvement of an external auditor in the certification process. If the company does not have sufficient resources, the external auditor and/or other third parties may be able to provide additional resources to complete the project. If special skills are lacking, the project team can be supplemented with people from outside the company (e.g., project management or information technology skills). In addition, the external auditor or other third parties may provide objective observations and recommendations regarding the scoping, documentation or evaluation of any control deficiencies. Such people could also be engaged to perform specified procedures, for example, to determine that the documented controls have been placed in operation.

Independence rules allow the auditor to provide substantial help, but the external auditor must not act in a management capacity and cannot audit his or her own work. Management functions generally include managing the projects, making final decisions and implementing changes. If there are appropriate safeguards that prevent the external auditor from performing these functions, then assistance such as that discussed above is allowed. As long as the auditor is not being asked to provide an opinion on internal control, there should be little risk of the auditor auditing his or her own work while providing these types of services.

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How important is senior management buy-in?

For any project to succeed, it requires appropriate leadership from the top of the organization. The importance of having the right attitude cannot be overestimated. If the message from senior management is that "we are going to do only the bare minimum to comply with regulatory requirements", then the project will likely languish at the bottom of priority lists or be conducted in an incomplete way. If senior management sets the tone that strong ICFR is good business, then the project is more likely to receive adequate attention.

The audit committee is part of that leadership. An active audit committee that proactively communicates to management the importance of managing this project is far superior to a passive audit committee that just waits to see what management delivers. Action by the audit committee is particularly required when senior management is not appropriately prioritizing and resourcing the project.

What should the audit committee do to gain comfort over the certification process?

We believe that merely reading the MD&A disclosures and certifications is not sufficient demonstration of appropriate audit committee oversight. To demonstrate appropriate due diligence, the audit committee should require a reasonable investigation be conducted to support the certifications. The interpretation of what is a reasonable investigation is a question for legal counsel.

We believe the audit committee should at least obtain an understanding from management on matters such as:

- the planning and scoping of the project
- the status of the plan
- the process to evaluate design
- the process to identify and assess the severity of deficiencies

This understanding can be obtained through discussions with senior management, the project leader, internal audit, and any advisors (auditors or third parties), and supplemented with review of assessment plans, status updates, and deficiency findings. Overall,the audit committee should feel comfortable that management had an appropriate plan and that management executed that plan.

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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.

New: 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 Canada's e-mail-based information service, *Accountability e-Lert*. This service is free of charge. It provides readers with useful information on the most important breaking developments in North American corporate reporting and governance. Each issue includes a concise KPMG analysis on current issues, plus links to relevant, current news and features selected by KPMG. Previous issues are available on the KPMG Web site. Subscribe to *Accountability e-Lert* on-line at www.kpmg.ca/accountability.

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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 2005) 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 serve and educate audit committee members. Wholly sponsored by KPMG, the Audit Committee Institute provides complimentary guidance and increases awareness for corporate audit committee members who need to keep up with their evolving responsibilities. The Audit Committee Institute 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*, and provides access to the Audit Committee Institute Web sites in other countries around the world. For audit committees with a particular interest in US developments, 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 the fall of 2006, roundtable sessions were held in Calgary, Halifax, 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.

Audit Committee Insights – International Edition

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 sourced from Audit Committee Institutes from around the world. Subjects include financial reporting, surveys and trends, shareholder issues and news, commentary and perspectives, and more.

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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)

AcG — Accounting Guideline (CICA)

AcSB — Accounting Standards Board (CICA)

AIF — Annual Information Form

CEO — Chief Executive Officer

CFO — Chief Financial Officer

CICA — Canadian Institute of Chartered Accountants

CSA — Canadian Securities Administrators

DC&P — Disclosure Controls and Procedures

ED — Exposure Draft

EIC — Emerging Issues Committee (CICA)

ERP — Enterprise Resource Planning

FASB — Financial Accounting Standards Board (US)

GAAP — Generally Accepted Accounting Principles

GAAS — Generally Accepted Auditing Standards

HB — Handbook (CICA)

IAASB — International Auditing and Assurance Standards Board

IASB — International Accounting Standards Board

ICFR — Internal Control over Financial Reporting

IRC — Independent Review Committee

MD&A — Management's Discussion and Analysis

MI — Multilateral Instrument

NI — National Instrument

NP — National Policy

OSC — Ontario Securities Commission

SAB — Staff Accounting Bulletin

SEC — Securities and Exchange Commission (US)

SFAS — Statement of Financial Accounting Standards (FASB)

US — United States

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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 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, Audit Committee Institute provides complimentary guidance and increases 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 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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