

The background of the entire page is a photograph of a Gothic-style building. A large, dark, ornate doorway with a pointed arch is the central focus. The doorway is decorated with intricate carvings and a shield-shaped crest above it. To the right of the doorway, a smaller shield-shaped crest is mounted on the wall. In the foreground, a blue bicycle with a white basket is parked on a sidewalk. The overall scene is set in a city street with a stone building facade.


SHAPING THE
CANADIAN AUDIT COMMITTEE
AGENDA



Shaping the Canadian Audit Committee Agenda



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The issue of corporate governance has continued to gain widespread prominence in Canadian business. Expectations of stakeholders in the corporate governance process, including financial reporting, have never been higher, and the scrutiny by regulators and investors never more stringent. As a consequence, the role of the audit committee is rapidly increasing in importance and expanding in scope. Today, audit committees are being asked to assume responsibilities well beyond their traditional duties.

Recognizing that effective corporate governance is the cornerstone of shareholder protection, initiatives by regulators and stakeholders to help shape and guide corporate governance practices have confirmed the audit committee's key role in corporate governance and oversight. The U.S. Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees and Canada's Joint Committee on Corporate Governance have issued recommendations for audit committees designed to strengthen the effectiveness of audit committees, clarify and enhance their oversight roles, and enhance their accountability over the financial reporting process. Understanding the purpose and implications of these recommendations is critical in evaluating the challenges facing audit committees and the direction in which corporate governance is heading.

With an increased emphasis on the role of the audit committee in corporate governance, audit committees must assess what they are doing now and how they are doing it to ensure they are ready for the challenges ahead. We believe that the building blocks of an effective audit committee, from an effective agenda and committee structure to a keen awareness of current and emerging issues, are fundamental in fulfilling the audit committee's responsibilities. This publication identifies current and emerging issues that audit committees must be aware of, and react to, and describes audit committee practices that provide the support and structure necessary in fulfilling their mandate. We believe all audit committees can benefit from comparing their practices against the practices described in this publication in their effort to critique, tailor and improve their own practices.

In today's complex and evolving business environment, audit committees can contribute tremendously to a "no surprises" environment. An audit committee that operates effectively is a key feature in a strong corporate governance culture and can bring significant benefits to a company. We hope this publication will help ensure that audit committees achieve their objectives and add value to the board of directors, the organization and its stakeholders.



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Introduction

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The role of those responsible for corporate governance and the financial reporting process continues to face intense scrutiny by regulators, legislators, security analysts, institutional investors and the general public. Attention is being placed not only on the board of directors but also on those committees that have been delegated responsibility and accountability by the board as it fulfills its fiduciary obligations. Audit committees are clearly viewed as a critical component of the overall corporate governance process. Accordingly, many audit committees are examining the nature and extent of their oversight roles, members' qualifications and independence, and their interaction and involvement with the audit process.

Effective audit committees are supported by fundamental “building blocks”—an appropriate structure and foundation, reasonable and well-defined responsibilities, and an understanding of current and emerging issues. Only through carefully designed practices can an audit committee maximize its contribution to an organization. Audit committees need to understand these building blocks and the specific practices that can be used in implementing governance activities. By comparing practices currently being performed to leading practices, audit committees can identify and select a “set” of practices as the most effective and efficient in its particular circumstances. This publication describes such practices.

The mandate to be adopted by an audit committee will vary by company—no one set of practices will fit all entities. Each committee should select a unique set of practices that is considered best in the circumstances. Audit committees should understand the objectives of corporate governance and their responsibilities, and tailor their practices to fit their individual circumstances. Audit committees, however, should not avoid those practices that appear onerous—often those are the practices that may be most effective and should receive additional attention if warranted by the circumstances.

Background

Audit committees have evolved over the past century from unlegislated committees with few defined responsibilities to what they are today: critical committees with growing responsibilities that are accountable to the board of directors, and ultimately to shareholders. One of the first major milestones in Canada was the MacDonald Commission's Report (*Report of the Commission to Study the Public's Expectation of Audits*, CICA, Canada) in 1988. This report recommended that audit committees of public companies be comprised of outside directors only, established guidelines for communications that external auditors must make to audit committees and required audit committees to report annually to shareholders on how their mandate was fulfilled. In 1994, *Where Were the Directors?* (Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, *Guidelines for Improved Corporate Governance in Canada*, Canada) was issued. In 1995 the TSE Corporate Governance Guidelines were effected

from this report, and further advanced governance in Canada. In 1999, the TSE Corporate Governance Guidelines were further revised to require explicit disclosure statements for TSE listed companies regarding how each of the original 14 guidelines was being addressed. These milestones, among many others, have shaped corporate governance practices in Canada. In November 2001, the Joint Committee on Corporate Governance, which focused on reviewing the current state of corporate governance in Canada and comparing Canadian and international leading practices, made a number of recommendations that will likely continue the evolution of Canadian audit committees.

Over the past decade, significant advances in the United Kingdom and in the United States have also influenced corporate governance practices in Canada:

- The U.K. Turnbull Report (*Internal Control: Guidance for Directors on the Combined Code*, The Institute of Chartered Accountants of England and Wales, 1999) requires that boards disclose how they discharge their responsibilities for internal control and that external auditors review the directors' statement of compliance on to this process.
- The report by the U.S. Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee"), released in 1999, resulted in the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASDAQ) and the American Stock Exchange (AMEX) revising their listing requirements and mandating various audit committee practices. The recommendations also resulted in new regulations by the U.S. Securities and Exchange Commission (SEC) regarding audit committee processes and reporting.
- The SEC has also introduced new requirements to prevent selective disclosures and to strengthen the independence of external auditors.

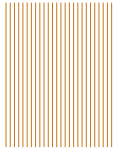
From these developments, practices of audit committees have evolved and improved, and leading practices have emerged. Many audit committees in Canada are currently performing a number of these leading practices; however, others are not. All audit committees can benefit from comparing their practices against the practices described in this publication in an effort to critique, tailor and improve their own practices. We recognize the identified practices may not equally apply to different entities.

Although this publication focuses on practices audit committee members can undertake to improve their effectiveness, audit committees also need the support of the board of directors and management of the company. The board and management must be fully committed to build and maintain effective audit committees and to work with the committee to ensure it meets its objectives in a dynamic environment.






Recommendations of the
Joint Committee on Corporate
Governance



Recommendations of the Joint Committee on Corporate Governance

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The Joint Committee on Corporate Governance (the “Joint Committee”) was established in July 2000 by the Toronto Stock Exchange (TSE), the Canadian Venture Exchange (CDNX) and the Canadian Institute of Chartered Accountants (CICA). The Joint Committee’s mandate was to review the current state of corporate governance in Canada, compare Canadian and international best practices and make recommendations for change that will ensure Canadian corporate governance is amongst the best in the world. The Joint Committee recommendations were necessitated by concern that the commitment to corporate governance may have lost its momentum in recent years in Canada. The theme throughout the Joint Committee report is to address and focus on the behaviours of directors and audit committee members, and less on the structure, such that the Canadian corporate community will fully endorse a “corporate governance culture.”

While the report of the Joint Committee includes numerous recommendations that will affect boards of directors, our analysis discusses those recommendations that have the most significant impact on Canadian audit committees.

A complete text of the Joint Committee recommendations pertaining to audit committees is included in Appendix II.

Four broad recommendations pertain to audit committees. These recommendations are aimed at:

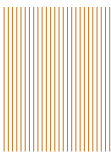
- strengthening audit committee independence;
- making the audit committee more effective; and
- enhancing accountability among the audit committee, external auditors and management.

The Joint Committee’s approach in developing its audit committee recommendations included seeking harmonization, where appropriate, with U.S. practices. The recommendations adopt several, but not all, of the Blue Ribbon Committee proposals.

A comparative summary of the Joint Committee audit committee recommendations and the Blue Ribbon Committee recommendations is included in Appendix III.

The most significant aspects of the Joint Committee recommendations affecting Canadian audit committees include:

- All members of the audit committee should be independent directors.
- All members of the audit committee should be financially literate, the definition of which is determined by each board, and at least one member should have accounting or related financial expertise.



- The audit committee mandate should set out explicitly the audit committee's roles and responsibilities, and should be approved by the full board and disclosed to shareholders.
- The effectiveness of the audit committee against its mandate should be regularly assessed and reported to the full board. The audit committee mandate should explicitly affirm that the external auditor is accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholder representatives have the authority and responsibility to select, evaluate and, where appropriate, recommend replacement of the external auditor.
- The audit committee should periodically request from management a review of the need for an internal audit function and, on the basis of this review, determine whether such a function should be instituted.
- Interim financial statements and related financial documents should be reviewed by either the audit committee or board prior to any public disclosure of the information. As a matter of best practice, external auditors should be asked to review this material before the audit committee considers it.

What are the implications for audit committees as a result of the Joint Committee recommendations?

The Joint Committee recommendations attempt to influence cultural change through disclosure requirements rather than through structural recommendations or recommendations mandating "regulatory" enforcement. The U.S. Blue Ribbon Committee recommendations were "enacted" by appropriate regulatory and professional bodies. U.S. companies therefore had little choice but to make substantive changes in their audit committee practices. While the Canadian regulatory assessment and amendment process, if any, will take time to be determined, certain implications for audit committees are taking shape now:

- *The recommendations establish clarity, and a benchmark for, expected practice.* Audit committees may now be judged in relation to the recommendations put forth by the Joint Committee. Marketplace and public expectations will place pressure on audit committees to adopt and comply with the recommendations, and will scrutinize those that do not. The Joint Committee clearly expects market reaction to encourage, if not effect, adoption of the recommendations. In essence, the Joint Committee endorses the spirit of the TSE listing disclosure requirement as set out in Section 473 of the listing requirements, which requires disclosure against the TSE guidelines, which should be modified to incorporate the Joint Committee recommendations, and where there are differences, an explanation of differences. Companies therefore can make their case for differences from the guidelines and allow their stakeholders to judge the validity and persuasiveness of their arguments.





- *Current practice likely will change.* Audit committees will be scrutinizing their own procedures and practices and comparing them to the Joint Committee recommendations to determine where they conform and where their committee will need to make changes. Progressive audit committees will be adopting the spirit of the recommendations before a mandated change. Companies may encourage audit committees to meet or exceed the recommendations, as a means toward achieving a competitive and financial edge.
- *The expanding roles of audit committees will need to be supported.* There may be implications to the resources, including financial, administrative and time commitments, required by audit committees in order to act in accordance with the recommendations. Audit committees may need to assess whether sufficient attention is being given to attracting and recruiting audit committee members with appropriate skills and experience, periodic training and education, and monitoring of new regulations and emerging issues.

What should audit committee members be doing now?

The Joint Committee recommendations are based on the premise that behaviour is more important than structure, and that an audit committee must have a professional approach to the discharge of its responsibilities. Therefore, we believe that a committee should not wait for potential regulatory change before considering and acting on the recommendations.

Audit committee members should read and understand the recommendations of the Joint Committee in conjunction with this publication, in order to gain an appropriate knowledge of both existing and recommended practice. From there, a plan of action should be put in place. The plan may consist of:

- comparing existing practice against the Joint Committee recommendations and leading practices to identify any actual or potential gaps;
- assessing whether your company operates in a specialized industry or has unique characteristics that may require additional considerations;
- ensuring the audit committee agenda for the upcoming year provides adequate time to discuss these recommendations and their implications;
- establishing meetings with senior management and the board of directors to fully evaluate the recommendations and establish working plans; and
- consulting with your auditors and legal and financial advisors.



Evaluating Your Practices

Audit Committee Responsibilities

No formal Canadian regulatory, stock exchange or professional rules and regulations set out how audit committees must be constituted or conduct their activities. However, audit committees should examine what they are doing and how they are doing it with a view to becoming more effective in discharging their very significant responsibilities. To aid in this examination, we highlight practices that, based on our experience, form the foundation for effective audit committees—from broad oversight responsibilities to committee composition. We emphasize that there are many ways of achieving good governance, and the following practices are some that audit committees may consider.

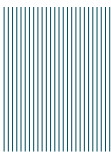


The recommendations of the Joint Committee that parallel these leading practices have been abridged and included in the margins throughout the remaining sections of this publication. They are identified by the above symbol. The full recommendations are contained in Appendix II.

The most effective audit committees not only are critically aware of their responsibilities but also completely understand and embrace them, and recognize what is necessary to effectively fulfill them. The work of audit committees has been evolving in response to changes in the business environment and leading practices.

Every audit committee must assume three fundamental responsibilities:

- overseeing the process related to the company's financial risks and internal control;
- overseeing financial reporting; and
- overseeing internal and external audit processes.



Overseeing the Process Related to the Company's Financial Risks and Internal Control

The audit committee is the overall guardian of financial integrity for the shareholders. Audit committee members must be critically aware of their oversight responsibilities, and must completely understand them. How the responsibilities are carried out may vary, but a failure to address them may have consequences for the audit committee, the board and, most of all, the shareholders.

Overseeing the process related to the company's financial risks

Risk management involves identifying risks that may prevent a company from achieving its objectives, analyzing those risks, avoiding certain risks, and managing the risks that remain. The board of directors oversees management's responsibility to address what risks are acceptable to the company and to ensure that systems to manage these risks are in place. The process related to identifying and managing the company's risks, as a part of the company's overall control environment, influences the identification and management of financial risks that can affect the company's financial reporting—a matter of critical importance to the audit committee.

The audit committee, as a committee appointed by the board of directors, is responsible for assisting the board in fulfilling its oversight responsibilities. In particular, the audit committee's primary duties and responsibilities are to monitor the management of the principal risks that could impact the financial reporting process of the company, monitor the integrity of the system of internal controls regarding financial reporting and accounting compliance, and oversee the internal and external audit process.

In addition to their direct oversight responsibilities for risks affecting financial reporting, audit committees are sometimes asked by the board to objectively examine the degree to which management has assumed "ownership" for overall risk management, the appropriateness of the risk management strategy and process adopted in addressing this responsibility, and the adequacy and effectiveness of systems to support the process. By asking probing questions about risk management, the audit committee can help bring clarity to the process used to manage risk and the assignment of accountabilities to monitor and react to changes in the organization's risk profile.

Overseeing internal control

An effective control environment needs more than good controls; it needs competent oversight. Management, internal auditors, external auditors and the audit committee each have roles in ensuring an effective control environment exists.

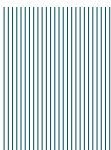


The audit committee is responsible for overseeing the financial reporting process, including the risks and controls in that process. Internal control, however, encompasses not only financial reporting but also compliance with laws and regulations and operational control. The board is responsible for the overall risks and controls of the company and, therefore, has the discretion to give the audit committee responsibility for oversight of compliance with laws and regulations and operational controls. The audit committee should ensure that it clearly understands any responsibilities it has for internal controls beyond those related to financial reporting.

Management is responsible for designing and implementing an effective system of internal control. The audit committee must determine that management has implemented policies that ensure the company's risks around financial reporting are identified and that controls are adequate, in place, and functioning properly. As part of its assessment of the processes relating to a company's risks and control environment, the audit committee should consider requesting from management an overview of the risks, policies, procedures, and controls surrounding the integrity of financial reporting. The audit committee should supplement those representations with information from the internal and external auditors. The audit committee makes inquiries of the internal and external auditors regarding internal controls as part of its responsibilities for overseeing the controls over financial reporting.

The integrity and attitude of senior management and the board of directors, including its committees (referred to as the "tone at the top") is the most important factor contributing to the integrity of internal controls, including those surrounding the financial reporting process. The "tone at the top" becomes the cultural core of the company and a model of appropriate conduct for every level. The committee should annually evaluate whether management is setting, documenting and communicating the appropriate tone. To facilitate the review, the committee should consider requesting updates and briefings from management and others on how compliance with ethical policies and other relevant company procedures is being achieved.





Overseeing Financial Reporting

The audit committee will review the annual financial statements prior to their release. As part of this review, the audit committee should ensure they are made aware of accounting policy or disclosure issues and that this information is communicated to them early enough that adequate actions may be taken as needed. The audit committee should inquire of management and/or the auditors regarding recommended audit adjustments and disclosure changes, those made by management and those not made by management; the accounting principles and critical accounting policies adopted by management; unusual transactions; and accounting provisions and estimates included in the financial statements. A thorough understanding of all of these factors is integral to the committee's ability to meet its oversight responsibilities.

The recent publicity concerning a number of high-profile irregularities has intensified both regulators' and the investing public's interest in the propriety of a company's financial reporting. In an environment where missing Bay Street's expectations by a small amount can lead to significant decreases in share price, market capitalization and overall investor confidence, this focus is hardly surprising. As a result, audit committees would be prudent to sharpen their focus on current and emerging issues and respond accordingly. Understanding the company's financial statements is therefore crucial for audit committee members. In general, audit committees should assume the following responsibilities:

- understand management's responsibilities and representations;
- understand and assess the appropriateness of management's selection of accounting principles and the most critical accounting policies;
- understand management's judgments and accounting estimates applied in financial reporting;
- understand the communications received from the external auditors concerning their responsibilities under generally accepted auditing standards;
- confer with both management and the external auditors about the statements;
- assess whether financial statements are complete and fairly presented and that disclosures are clear and transparent; and
- review earnings releases and financial statements prior to release.



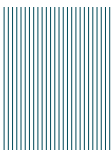
The audit committee should review the quarterly financial reports and related financial documents before any public disclosure of the information.



The audit committee, as a matter of best practice, should ask their external auditors to review the quarterly financial statements and related financial documents.

To assist the audit committee in carrying out its responsibilities, the Joint Committee has commented that "the audit committee needs to assure itself that the external auditors are satisfied that the accounting estimates and judgments made by management, and management's selection of accounting principles, reflect an appropriate application of GAAP." The appropriateness, including the degree to which management bias, if any, is evident, of the company's accounting principles and underlying estimates and the transparency of the financial disclosures in reflecting financial performance would be at the core of these discussions. The committee should be interested in discussing and understanding the auditors' views on accounting issues, and should actively seek to develop a relationship with the external auditors that allows a full, frank and timely discussion of all material issues.

During the year, the external auditor's review of interim financial information can be a valuable resource to the audit committee as the committee fulfills its oversight responsibility for financial reporting.



Overseeing the Internal and External Audit Processes

Internal Auditors' Oversight

Companies often need to weigh the benefits and costs of internal control considerations. One such decision often relates to the need or desirability of having an internal audit function. Internal audit functions, designed and deployed effectively, can have a very positive impact on the control environment of a company and the effective design and operation of internal controls. As an important aspect of its mandate, internal audit can provide the audit committee with a means of monitoring if the controls management has put in place are reliable, functioning properly and sufficient to address the risks in the financial reporting process. Accordingly, the audit committee should review the need for an internal audit function.

If a company has an internal audit function, both the internal audit department and the external audit firm execute a company's audit coverage. While each has its own unique responsibilities, the audit committee should ensure that they complement each other, that their audit effort is coordinated and that there is effective communication between them. The external auditor is responsible for auditing and attesting to the company's financial statements; the internal auditor for monitoring the performance of a company's internal controls. The external auditor should identify the internal audit activities that are relevant to planning the external audit.

Where an internal audit function exists, the audit committee should participate in the appointment, promotion, or dismissal of the internal audit director, and help determine his or her qualifications, reporting hierarchy—to ensure access to all necessary contacts both at the board level and within the organization—and compensation. The audit committee should also be involved in developing and approving the internal audit department's mandate, goals and mission to be certain of its proper role in the oversight function. A collaborative effort with both management and internal audit in the development of the internal audit mandate often helps ensure a proper balance between the assessment of internal controls related to financial reporting and other special projects, operational efficiency and risk management responsibilities. The audit committee should also be satisfied that the internal audit function has adequate resources. The committee should stay up to date on the scope and results of the department's operations and management's responses to the department's recommendations on internal controls and compliance. The department's objectivity and independence of judgment should be periodically evaluated. The committee should ensure that the internal audit department's involvement in the financial reporting process is appropriate.



The audit committee should review the need for an internal audit function.

Recognizing the important role of internal audit and its changing activities in today's business environment, the audit committee should also consider the following as it oversees the internal audit function:

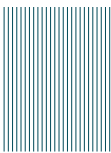
- How does the internal audit department best add value to the business model?
- How effectively does the company use the internal audit department to evaluate management's response to its strategic, financial, technological, security, and operational risks?
- Should the internal audit department be driving process improvements and best practices sharing? Is it?
- Is internal audit a training ground for future leaders?
- Does the internal audit department have the resources and appropriate expertise to satisfy its responsibilities?
- Would the company's objectives for the internal audit function be better served or supplemented through the use of a third-party service provider?

The internal auditor is in the unique position of being employed by management yet expected to review its conduct. The audit committee should have mechanisms in place to facilitate confidential exchanges with the internal auditor, with regular meetings scheduled between the audit committee and the internal auditor.

The internal audit function today should apply a risk-based methodology, and have access to the specialized skills necessary to deal with complex treasury, technology and operational strategies being employed by the company.

External Auditors' Oversight

First and foremost, the external auditor and audit committee should have a strong and candid relationship—anything less may limit the committee's effectiveness in achieving its oversight responsibilities. The audit committee should ensure that the external auditors are directly accountable to the audit committee and to the board of directors. The audit committee should ensure its actions and communications with the external auditor are consistent with this accountability. The audit committee should also ensure that they communicate their expectations to the external auditor, and that both parties understand and have agreed to those expectations.



Selecting and evaluating the external audit firm is an important responsibility the audit committee performs in conjunction with management. As shareholders' representatives, the audit committee has ultimate authority for selecting, evaluating, and, if needed, replacing the auditor. The committee's evaluation should consider the auditor's competence, the quality and efficiency of the audit, and whether the audit fee is appropriate in relation to the size, complexity, risk and control profile of the company to ensure that the company's audit is not compromised.

The audit committee should consider the auditor's independence in its evaluation. For their part, all auditing firms should have internal policies and procedures in place and properly monitored to ensure that the audit firm and its individual members are independent from the company. In considering matters that may bear on the auditor's independence, both the auditor and the audit committee should ensure that no conflicts exist, such as the auditor holding a financial interest, either directly or indirectly, in the company; personal and business relationships of the auditors' immediate family, close relatives, partners or retired partners with the company; economic dependence by the auditor through its the relationship with the company; and the nature and extent of services provided by the auditor in addition to the audit engagement.

Once an external auditor has been appointed, the committee needs to understand the audit engagement's scope and how it is to be approached. An effective way to achieve this is to hold a pre-audit meeting with the external auditors and to review the audit plan. After this, the committee may determine that the external auditors should be performing additional work to satisfy the needs of the company, such as increased internal control testing. This process may also help the audit committee understand and coordinate activities with the internal auditors.

The audit committee should oversee the audit results, including any changes in audit approach or any modification to the standard auditors' report.



The audit committee should have ultimate authority and responsibility to select, evaluate, and, where appropriate, recommend replacement of the external auditors.

Auditors must work constructively and meet regularly with audit committees to build an effective relationship.



Creating an Effective Audit Committee

An audit committee is established by a corporate board of directors to help the board discharge its fiduciary responsibility. How the committee fulfills that mandate varies according to the clarity of the committee's mission, the abilities of the committee's members, and the tone set at the top of the governance structure. An audit committee that operates effectively is a key feature in a strong corporate governance culture and can bring significant benefits to the company. We present some of the characteristics and practices that, based on our experience, mark a strong and effective audit committee, from the mandate through the many facets of the committee's composition, structure and operation. We encourage each audit committee to review these characteristics not as elements carved in stone but as components in a process that can be—and should be—continually improved to enhance the committee's effectiveness.

Audit Committee Mandate

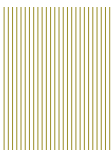
In essence, the focus of the audit committee mandate should define the scope of the committee's oversight responsibilities and how these are to be discharged. The audit committee should tailor its mandate to the company's specific needs and clearly outline the committee's duties and responsibilities, including structure, process and membership requirements. The mandate should ideally describe the background and experience requirements for committee members and set guidelines for the committee's relationship with management, the internal and external auditors, and others.

Audit committee mandates and responsibilities should be coordinated with other committee responsibilities—some companies have a governance committee, others have committees focused on a particular business risk (e.g., investment committee, environmental committee, etc.) Care should be taken to clearly define roles and responsibilities of each. Mandates should be detailed enough to clarify roles and responsibilities, but not so detailed that it include items that cannot be reasonably accomplished. The mandate should serve as a guide in establishing the audit committee work plan and meeting agendas. The work plan would specifically set out how the audit committee intends to fulfill each of its responsibilities as disclosed in the mandate. Both the mandate prepared by the audit committee and the derived work plan should be approved by the board. We have prepared an example audit committee mandate to assist committees in creating or updating their complete mandates consistent with the Joint Committee recommendations and leading practices. This is included in Appendix I—Exhibit 1.

It is very important that the audit committee take into consideration the responsibilities laid out in the mandate and related work plan as each meeting's agenda is set, and that all responsibilities are reviewed on at least an annual basis. This review could be incorporated into any self-evaluation process that the audit committee has undertaken.



Audit committees should adopt a formal written mandate that is approved by the board and that sets out the scope of the committee's responsibilities. This mandate should be disclosed to shareholders, and should set out explicitly the role and responsibilities of the audit committee with respect to its relationship and expectations of internal and external auditors, its oversight of internal control, and disclosure of financial and related information.



Once established, the audit committee mandate should be updated annually. The annual assessment of the committee's mandate should be a robust process reflecting changes to the company's circumstances and any new regulations that may impact the audit committee's responsibilities.

The Joint Committee recommends that the audit committee mandate be disclosed to shareholders. Audit committees should be mindful of the implications of increased disclosures and ensure they are not undertaking so many responsibilities that they cannot be reasonably accomplished, or that may subject the committee to future liability.

Audit Committee Composition

The size of the audit committee will vary depending upon the needs and culture of the company and the extent of delegated responsibilities to the committee. The objective is to allow the committee to function efficiently, all members to participate, and an appropriate level of diversity of experience and knowledge. Committees of three to six individuals are generally most appropriate to achieve those objectives. Terms of two to four years, with staggered expiration dates to ensure continuity, are common in business today. Most companies have no set policies for rotating committee members but depend on weighing a member's experience against the risks of complacency. Without a rotation policy, it is important for the board of directors to evaluate an audit committee member's performance to see that it meets both the board's and committee's expectations.

Audit committee independence is the cornerstone of the committee's effectiveness, particularly when overseeing a company's financial reporting integrity and evaluation of areas where judgments and decisions are significant.

An outside director is a director who is not an officer or employee of the corporation, and an unrelated director is independent of management and is free from any interest (other than shareholding) that could, or could reasonably be perceived to, materially interfere with the director's acting in the best interest of the corporation. It is up to the board to assess the integrity and independence of an audit committee candidate, so every member's appointment is an occasion for careful deliberation. The board should have a strong understanding of the definitions of independence and how a lack of independence occurs and is interpreted in practice. Independence issues are most prevalent with respect to business relations. The board should also be cognizant and mindful of situations in which the definition of independence is met, yet perceived conflicts of interest may still arise.

Audit committee members must be adept at communicating with management and the auditors and ready to ask key, probing questions about the company's financial risks and accounting and financial reporting.



Audit committees should be composed solely of outside directors who are also unrelated.



All audit committee members should be financially literate, and at least one member should have accounting and financial expertise.

Audit committee members should be financially literate and at least one member should have financial expertise.

Financial literacy is broadly equated to the ability to read and understand basic financial statements. Each board should determine the definition of, and criteria for, financial literacy. Financial expertise ordinarily comprises past employment experience, or certification, in finance or accounting or related service that may include experience as a CEO, with financial reporting oversight responsibilities, or CFO. It is often the chairperson who has this expertise. The member who is designated as having “financial expertise” should be aware of this role. For companies who have or will raise capital in foreign jurisdictions, audit committees should consider having at least one member of the audit committee with accounting or financial management expertise in that foreign country.

Every member should have experience in some area pertinent to the business. At least one member, and ideally multiple members, will have experience with the company's industry. A committee's effectiveness in performing its mission is certainly enhanced by, and is often dependent upon, the members' experience, knowledge and competence in business matters, financial reporting, internal controls and auditing.

All members should seek periodic continuing professional education both inside and outside the boardroom. Management, internal and external auditors, and general counsel are sources of background information and training for audit committee members. Periodic briefings, reports and presentations by management, external auditors and internal auditors for audit committee members should cover operational and financial issues specific to the company and the industry, and updates on new accounting and auditing standards. Companies should offer, and committees should insist on, the kind of training that will enhance their financial literacy and make it possible for them to fulfill their fiduciary responsibilities. This is especially true of new members, who should receive a complete orientation that allows them to function effectively from the very beginning.

Audit Committee Meetings

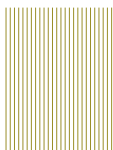
A detailed agenda is vital for keeping the committee focused. Effective agendas are set with input from the CEO, CFO and the internal and external auditors. The audit committee chairperson, however, should maintain accountability for the agenda and not delegate it to management. The audit committee agenda for the year should ideally originate from a detailed work plan. In turn, the detailed work plan would originate from the mandate. We present in Appendix I—Exhibit 2 a sample of audit committee agenda topics that should be considered when developing detailed audit committee agendas for the year. A sample audit committee agenda for the year is presented as Appendix I—Exhibit 3.

The audit committee should meet as frequently as necessary, generally a minimum of four meetings per year for publicly traded companies, and should be free to hold special meetings as needed. There should be sufficient time permitted to cover all agenda items and allow time for all parties to ask questions or provide input. There should also be sufficient time for the committee members only to have a private session at each meeting.

A management advisor to the committee, usually the CFO, should attend all of the committee meetings. The CEO should attend the meetings on an invitation-only basis. The CEO often has vital insights to share; however, the chairperson should ensure that the CEO does not inhibit open discussion at the meeting. Management should be expected to discuss key accounting estimates and subjective adjustments for each interim period. Private executive sessions should be held with management at least twice a year. The external auditors should receive notice of, and normally attend, all committee meetings. External auditors should periodically discuss the appropriateness of accounting, including accounting alternatives and choices made by management. Private executive sessions should be held with the external auditors at least once a year. Leading practice would also have the director of internal auditing attend all meetings and also have private executive sessions as needed.

Formal minutes should be prepared, circulated to external and internal auditors as appropriate, approved by the audit committee and then reviewed by the full board of directors. Important documents related to the meeting should be attached to the minutes, including the agenda.





Communications Policies

The content, timing and manner in which information is released both internally and externally by the company requires levels of accountabilities and approvals that should be defined, documented and approved by the board. Such policies should consider guidelines to help ensure communications are not selective. Policies should also consider crisis communications and electronic communication risks and controls. While the board may largely set these policies, the audit committees should at a minimum be actively involved in setting the policies as they relate to communication of financial information.

Audit Committee Compensation

Audit committee members must be adequately compensated for their services. In most public companies, deciding on the amount of compensation is usually the responsibility of the board's compensation committee or finance committee. It is reasonably well established in practice that the committee chairperson usually receives more remuneration than the members, reflecting his or her increased responsibilities. Moreover, the board may acknowledge that the audit committee service warrants higher compensation than other board committees in recognition of the responsibilities and increased time commitment. In addition to a yearly fee, some companies may offer payment for each meeting attended.

While the practice is controversial, board members may be offered stock-based compensation and benefits. Depending upon the company, these may include stock options, medical and dental plans, insurance, and retirement plans. A number of companies also offer a deferred compensation plan.

Remuneration for service can sometimes pose a dilemma for both management and committee members. While compensation should be enough to recognize the time commitment required and the liabilities accepted in order to attract good and responsible directors, the amount should not be excessive such that a conflict may be perceived.

Assessing Audit Committee Effectiveness

There are three assessments that should take place annually on a formal basis, and during the year as needed: the effectiveness of the committee, the members and the chairperson. The board should ask for feedback on the committee's performance from top management, and the internal and external auditors. In addition, the audit committee may assess its effectiveness and the adequacy of its mandate, work plans, and forum of discussion and communication by:

- questioning the board about its satisfaction with the committee's performance;
- comparing the committee's activities to the recommendations of the Joint Committee and the guidelines of the relevant securities exchanges;
- comparing the committee's activities to leading practices;
- comparing the committee's activities to the mandate and any other objectives the board set for the committee; and
- consulting with external auditors on ways to improve the audit committee's performance.

Each of these steps would not necessarily be performed annually, but all steps should be performed every two to three years.

The chairperson of the audit committee should assess the performance of individual committee members on an annual basis. The audit committee in conjunction with the board should develop a formal assessment process. This process may include interviews with the member being assessed, self-assessment by the member and the assessment of members against standard criteria. *What marks a member who is successful?* Someone who is dedicated to the committee's work and responsibilities, someone who is willing to devote the time necessary to understand the company and prepare for, attend and participate in meetings and deliberations, someone with an inquiring attitude, objectivity, independence and sound judgment.

The result of this assessment should be a recommendation to the board as to whether the member should be appointed for an additional term. The evaluation of the chairperson would be done by the board based upon similar criteria. Evaluations that are well performed demonstrate the committee's intention and commitment to achieve its responsibilities in an effective and diligent manner.



A regular assessment of the effectiveness of the audit committee against its mandate should be conducted and reported to the full board.





Current and Emerging Issues

Current and Emerging Issues

The need to address current and emerging issues is a fundamental requirement for effective management because the issues can have a direct or indirect affect on a company's control environment, financial reporting, and the audit process.

Understanding how the organization responds to the challenge is fundamental to an audit committee in discharging its responsibilities. An audit committee must be mindful of what is happening within a company now and, at the same time, what may happen in the future. In today's global economy and formidable business environment, being prepared—staying ahead of the curve—is a major ingredient for success.

Audit committee members do not need a crystal ball to be aware of the many business issues that could influence a company's future and thus the committee's work. While the issues, including their nature and relative importance, vary by company, we believe that the questions in the box to the right should, at a minimum, be on every audit committee's radar screen. With intense interest from both regulators and the investing public in the financial reporting process, prudent audit committees are sharpening their focus on current and emerging issues and responding accordingly.





Current and emerging issues shaping the audit committee agenda

Is the board of directors adequately overseeing management's process for identifying and monitoring principal business risks? What risks are acceptable to the company, and through what process are they being managed? Is enterprise risk management being used to manage an organization's key business risks and opportunities with the intent of maximizing shareholder value?

Is the audit committee contributing to a "no surprises" environment? Is the audit committee alert to the indicators contributing to the company's risk profile?

Is management reporting operations in a clear and responsible way? Could the company satisfactorily respond to a securities regulator inquiry into earnings management?

Is the audit committee alert to factors increasing the risk of fraud and illegal acts? Does the audit committee understand how to minimize the risk of loss arising from fraud?

Have management and the audit committee remained abreast of recent developments in financial reporting and recent regulatory actions? Have the complexities of new financial reporting requirements been fully understood and evaluated in the context of the company's business and business transactions?

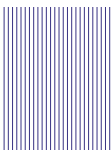
Do the processes and controls adequately support the organization's complexity and international reach? Are controls and systems keeping pace with the company's growth?

Have the control implications for enterprise-wide solutions been adequately addressed? Have controls been enhanced through the introduction of new systems?

Is a dominant entrepreneur or executive adequately governed?

Does the audit committee tailor its responsibilities to reflect specific industry considerations? Has management addressed specific industry regulations and requirements?

Are members of the audit committee fulfilling their responsibilities as directors and thereby mitigating potential liability?



Enterprise Risk Management

Is the board of directors adequately overseeing management's process for identifying and monitoring principal business risks? What risks are acceptable to the company, and through what process are they being managed? Is enterprise risk management being used to manage an organization's key business risks and opportunities with the intent of maximizing shareholder value?

As business leaders seek new ways to build shareholder value, they are discovering a connection between value management and risk management. Enterprise risk management (ERM) has emerged as an important means of identifying the critical risks the organization faces—including, for example, reputation, ethics, e-business and health, safety and environmental risks (not just financial or insurable hazards)—and then managing and optimizing that portfolio of risks such that commensurate financial rewards are realized.

Business risks that are not managed have clear consequences for an organization—potential shareholder wealth erosion, exposure to the viability and success of the organization, and exposure to financial consequences of unexpected events—all of which can affect the financial reporting of the company. ERM can provide businesses with tools for monitoring the processes in place to identify significant business risks at the organization, ensuring that those risks are being managed and reporting the organization's risk management activities to shareholders.

Emerging ERM model

Early models of risk management viewed risk as a market imperative—something to be understood and analyzed for its own sake. The new models are clearly linked to the organization's business strategy—which encompasses an organization's vision, mission, and objectives; its process for defining operational imperatives; and its philosophies, policies, plans and initiatives for growth and development. Emerging ERM models, such as the one outlined below, can provide an organization with new action steps they may use to enhance business decision-making and, potentially, shareholder value.

- **Risk strategy**—Aligning ERM resources and actions with the business strategy are necessary to maximize organizational effectiveness. Both the board and senior management must understand strategic-level risks and related systems of control. Risk management should always be on the board agenda, and a formal risk and control review should be performed at least annually.





- **Risk portfolio**—A “risk portfolio” represents the range and degree of business risks appropriate for the organization at any given time. Processes must determine whether the risk portfolio is consistent with the designs of the board and senior management.
- **Risk optimization**—An appropriate level of risk can help achieve corporate objectives. Risk optimization involves evaluating and adjusting the risk response currently being made by the organization. When benchmarked against risk appetite, an optimization model can identify where the best “return on control investment” can be achieved.
- **Measuring and monitoring**—Measuring and monitoring to enhance value should be an ongoing means of understanding and reporting on the status and impact of risks. A strong process for capturing information and reporting it to management and the board of directors is essential to an ERM approach. Measuring and monitoring activities could include using performance measures, tracking risk management investment, using the internal audit function as an objective quality assurance yardstick and use of technology to access key business indicators.
- **Risk structure**—Once an organization understands its risk strategy and gives risk “top-down” priority, the organizational structure must often be adjusted to ensure that it can respond. For example, a well-defined risk structure will incorporate an assessment structure, where management is able to assess risks across the organization’s divisions, regions, functions and hierarchy.

How can the audit committee help in this regard? Audit committees can assist the board and management through its diagnosis of risk management activities. By asking probing questions in regard to risk management, the audit committee can help bring clarity to the assessment of the processes used to manage risk:

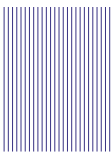
Is risk management always on the board agenda? Has ERM education been provided at the board level? Is there clear “ownership” of risk management oversight by the board?

Has management created a high-level risk strategy (policy) aligned with strategic business objectives? Has a risk management framework been established with clear reporting lines and assignment of responsibilities for risk management?

Does the company have a common risk culture, including the use of common risk language and concepts? Are communications about risk using appropriate channels and technology?

Are risk management activities embedded into ongoing business processes?

Are appropriate measurements and monitoring of risks being performed? Have key performance indicators and critical success factors related to risk been identified and success measures for risk strategy and activities established?



Risk Indicators

Is the audit committee contributing to a “no surprises” environment? Is the audit committee alert to the indicators contributing to the company's risk profile?

The environment in which an organization operates can have a direct impact on the way a company is managed. By understanding the environment and the pressures the organization and its management are facing, the audit committee can evaluate whether risks are being identified and, most important, being mitigated. Such an approach enables the committee to exercise its responsibilities in an active rather than a reactive manner, and minimizes “surprises.”

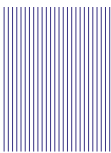
What influences the company's environment? Every company is different and will be subject to its own risks, but the risks will be driven by a number of basic factors. The interaction of many elements—the organization's control environment; management's capabilities; the industry, market conditions and expectations; the organization's operating and financial stability; and the nature of its assets—all contribute to a unique risk profile. This profile directly affects the audit committee's core responsibilities—assessing the company's processes relating to its risks and control environment, overseeing its financial reporting, and evaluating its internal and independent audit processes.

What are the indicators to look for? Some examples are contained in the box to the right. To facilitate identifying risk indicators, the company's senior executives should meet regularly with the audit committee and board of directors to keep them informed of the risks and exposures facing the company. In addition, the committee should be briefed on the company's strategic objectives, procedures for achieving them, and evaluations of the progress toward meeting them. Such meetings will often be at the full board level; however, where appropriate, we encourage audit committees to request additional meetings to address issues of importance to their responsibilities, or to obtain a more detailed understanding. The committee should also seek the observations of the internal and independent auditors, and draw upon its members' own business acumen.



Examples of Risk Indicators

- Inappropriate “tone at the top.”
- Frequent organizational changes.
- High turnover of senior management.
- Lack of succession plans.
- Inexperienced management.
- Lack of management oversight.
- Management override.
- Autocratic management.
- Untimely reporting and responses to audit committee inquiries.
- Excessive or inappropriate performance-based compensation.
- Unrealistic earnings expectations by the financial community.
- Ambitious growth goals.
- Unusually rapid growth.
- Inappropriate focus on the importance of maintaining trends and achieving forecasts.
- Unusual results or trends.
- Lack of transparency in the business model and purposes of transactions.
- Exposure to rapid technological changes.
- Industry “softness” or downturns.
- Interest rate and currency exposures.
- Overly complex organizational structures or transactions.
- Ongoing or prior investigations by regulators or others.



Earnings Management

Is management reporting operations in a clear and responsible way? Could the company satisfactorily respond to a securities regulator inquiry into earnings management?

Recent high-profile irregularities reported in the press have been attributed to various earnings management practices. These include questionable revenue recognition and gain recognition; inappropriate deferral of expenses; and incorrect recognition, reversal, or use of reserves without events or circumstances to justify such actions. These practices have piqued the interest of securities regulators and others in companies' accounting policies and procedures and have led to questions about the quality of reported earnings.

The pressure to achieve earnings targets can place a heavy burden on senior management, in terms of both job security and remuneration. Unfortunately, this pressure can all too often lead to the consideration of aggressive and sometimes incorrect financial reporting interpretations. Given the complexity of certain transactions and the subjectivity of various accounting measures, it is imperative that the audit committee fully understands a company's critical accounting policies and procedures.

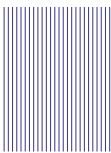
How should audit committee members respond? Audit committee members must fulfill their fiduciary responsibility; they should understand the company; they should be briefed and stay up to date; they must ask insightful questions; and they must be active participants in the oversight function.



Earnings Management

Specific areas of accounting “hocus-pocus” that may obscure financial volatility and adversely affect the quality of reported earnings are on the radar screens of all securities regulators.

- **Revenue Recognition.** Recognizing revenue before the earnings process is complete, for example, before the product has been delivered or while the customer can still cancel the sale.
- **Abuse of the Materiality Concept.** The intentional recording of errors under the assertion that their impact on the bottom line is not significant; however, given the market's reaction to small changes in earnings per share, what is significant and what is not?
- **Capitalization and Deferral of Expenses.** Capitalizing and deferring costs that should be accounted for as a cost of the period through, for example, ambiguously defined capitalization criteria for property, plant and equipment and intangible assets, unreasonable amortization periods, or through the capitalization of costs for which future economic benefits are not reasonably assured.
- **Creative Acquisition Accounting.** The use of “merger magic,” avoiding future earnings charges through excessive purchase accounting reserves.
- **“Big Bath” Charges.** One-time restructuring charges are discounted by analysts and investors who focus on future earnings. By overstating these restructuring charges, companies create “reserves” that are used to offset future operating costs.
- **Miscellaneous “Cookie Jar” Reserves.** The use of unrealistic or overly “conservative” assumptions when establishing reserves in the “good times” and using these to shore up earnings in the “bad times.”



Fraud and Illegal Acts

Is the audit committee alert to factors increasing the risk of fraud and illegal acts? Does the audit committee understand how to minimize the risk of loss arising from fraud?

The nature of fraud risk is expanding. The globalization of business means that management may find it is doing business with people it doesn't know in countries it has never visited, employing cultural standards it does not understand. As well, technological advances have changed the speed and ways business transactions are recorded; these advances have enhanced opportunities for fraud and have greatly increased the potential quantum of losses arising fraud.

The National Association of Corporate Directors Best Practices Council identified four basic principles for protecting shareholders against fraud and other illegal acts:

- Setting the tone at the top through conduct and communication;
- Director commitment and independence;
- Explicit focus on fraud risk; and
- Effective communication process.

In the update to the Toronto Stock Exchange guidelines issued by the TSE and the Institute of Corporate Directors in a document entitled *The State of Governance in Canada*, it is stated that "the Canadian marketplace has sustained some notorious scandals." The Canadian marketplace has seen significant corporate failures and restructuring, arising as a result of widespread frauds, and the manipulation of financial statements arising as a result of collusion among senior management.

How can the audit committee ensure that the four basic principles enunciated by the National Association of Corporate Directors are in place to minimize the risk of losses arising from fraud? Unpalatable though it may be, the audit committee has to address the risk of fraud head-on. The identification of the risk of losses arising from fraud through diagnostic studies of the risk of fraud and misconduct in the business should be considered an important first step. Also, it is important that staff at all levels receive some training in fraud awareness relevant to their business sector. A common theme arising from the investigation of the "notorious scandals" in the Canadian marketplace is the fact that many people in the affected organization knew or suspected that irregularities were occurring, but were not given the skills to identify the signs of fraud or provided with an opportunity to communicate their concerns.



Financial Reporting Environment

Have management and the audit committee remained abreast of recent developments in financial reporting and recent regulatory actions? Have the complexities of new financial reporting requirements been fully understood and evaluated in the context of the company's business and business transactions?

Recent years have been marked by rapid and widespread developments in financial reporting. These developments reflect the increasingly complex and innovative business transactions in today's business world, and address the growing information needs of the users of financial statements. In addition, changes in financial reporting have also been promulgated by the international harmonization and convergence of accounting standards as a result of globalization.

Staying abreast and fully understanding the implication of developments in financial reporting has become increasingly difficult, especially for companies that engage in a wide variety of business transactions or have reporting responsibilities in both Canada and the U.S. For example, a company that employs stock-based compensation, engages in derivative or off-balance sheet transactions, sells products through innovative sales channels, and that has recently completed one or more business acquisitions faces stringent and complex accounting requirements – with even more on the horizon. In addition to new accounting developments, securities regulators similarly are expanding the reporting requirements of public companies, for example, the SEC is focusing on the adequacy of disclosures associated with material risks and uncertainties, current and trend information, critical accounting policies, and transactions with related parties.

Audit committees must satisfy themselves that management has devoted sufficient attention to understanding recent developments in financial reporting and that the application of new requirements is appropriate in light of the nature of the company's business and significant transactions. *What steps can the audit committee take in preparing for this challenge?* First and foremost, audit committee members must educate themselves appropriately – this is often achieved by asking management or the external auditors to describe and explain recent developments in financial reporting. Armed with this knowledge, audit committees should ask probing questions of management of how new reporting standards influence and affect the financial reporting of the company, and how any unique or unusual aspects of significant transactions are being captured and portrayed in the company's financial statements and earnings releases.

Complex Corporate Structures

Do the processes and controls adequately support the organization's complexity and international reach? Are controls and systems keeping pace with the company's growth?

Mergers, acquisitions and reorganizations often involve melding organizations not only with distinct corporate cultures but also from different industries and different areas of the world. In today's business environment, companies frequently cross borders for every aspect of their business. This environment presents management and the audit committee with unique oversight challenges. While governance practices in such environments are slowly evolving, the influence of global business needs to be carefully considered. A number of questions may need answering:

How are management's reporting, control, and compliance responsibilities integrated? Is there effective oversight of local boards? How are domestic and international audit results, both internal and independent, evaluated by the committee? How does management ensure compliance with various countries' rules and regulations?

Reorganizations often mean downsizing and outsourcing. In a downsizing, controls are often removed or weakened. As companies focus on core competencies, non-core activities and specialized skills are often outsourced to third-party providers. *Has your organization carefully evaluated the ongoing internal control impact of such decisions?*

Audit committees' responsibilities do not stop at national or organizational boundaries—they extend to the company as a whole. There needs to be coordination and communication between audit committees of parent companies and subsidiaries. There should be a common appreciation of the control frameworks and cultures of the entities, and substantial sharing of information.



Enterprise Package Solutions

Have the control implications for enterprise-wide solutions been adequately addressed? Have controls been enhanced through the introduction of new systems?

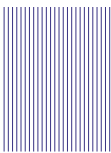
For the last several years, enterprise resource packages (ERPs) have dominated large information technology (IT) departments and affected functional areas. Implementing ERPs—for example, SAP, Oracle, BaaN, and PeopleSoft—usually involves significant business process re-engineering, technology infrastructure replacement, data conversions, interfaces to remaining legacy systems, and information security challenges at the application, database, operating system and network levels.

Certainly, ERP solutions can provide a high degree of integration that can significantly increase a company's operational efficiency and improve the quality of information for management decision-making. But in the press to implement an ERP, the material impact on existing system operations and process controls is often overlooked. As systems are replaced, the established financial and operational controls are also replaced with the generic controls supplied by the ERP vendor. These changes raise many control issues, including:

- redesigning and coordinating existing processes and controls with those of the new systems;
- optimizing and tailoring the controls associated with streamlined business processes;
- adequately training and transitioning employees to the new processes and systems;
- ensuring the effective use of the control features of the ERP;
- obtaining the new IT skills and processes required to administer and operate different computer platforms and networks; and
- controlling the creation, maintenance, and security of data during conversion and on the new system.

The issues affect the company's controls, its financial reporting process, and its audit process—fundamental areas of focus for the audit committee. The committee should assure itself that management has addressed these issues and that appropriate, though not excessive, controls are in place.





Emerging Companies

Is a dominant entrepreneur or executive adequately governed?

Fast-growing entrepreneurial companies often lack a formalized management structure and may not have well-established corporate governance programs. Policies, procedures, and processes may be evolving haphazardly to meet demands. The dominant role of an individual executive also may overshadow the need to foster a strong control environment and can potentially affect the financial reporting and audit processes.

As companies grow, a more standardized corporate governance process becomes a necessity, regardless of the entity's public aspirations. For companies considering an initial public offering, the need for a formalized structure becomes obvious. While the risks described in this publication represent important issues in today's marketplace for public companies, they also apply to entrepreneurial and other companies that remain private. Responding to these risks is equally important to companies that wish to deter fraud and improve the quality of their financial reporting.

Dominant or autocratic management can also be a cause for concern in an established company. Such leadership can put a strain on the enterprise's controls and corporate governance processes and set the wrong "tone at the top." Ensuring that management fosters an atmosphere that supports a strong control environment is a core audit committee responsibility.



Specialized and Regulated Industries

Does the audit committee tailor its responsibilities to reflect specific industry considerations?
Has management addressed specific industry regulations and requirements?

Companies may operate in one or several industries. The more diverse the company, the more attuned the audit committee should be to different industry risks, accounting practices, laws, regulations, and reporting and disclosure requirements. An audit committee must consider management's response to the risks inherent in these specialized practices and incorporate them into its agenda. While the core responsibilities described in this publication are relevant to just about any audit committee, the manner of their execution and the specifics of audit committee activities should be tailored to meet the needs of each specific industry. An understanding of the industry and the organization will enable the audit committee member to identify and react to industry-specific requirements such as those in depository institutions, health care organizations, not-for-profit organizations, investment companies, insurance companies, or governmental entities.

In considering industries that are regulated, audit committees should be acquainted with the scope of the regulation and the authority of the regulators. In Canada, certain activities may be subject to federal or provincial regulation and even, in some instances, by both levels of government. For example, banking is regulated federally while investment dealers fall under the authority of the provinces. Insurance or trust companies may be either federally or provincially regulated depending upon their statute of incorporation and the location of their activities.



Directors' Liability

Are members of the audit committee fulfilling their responsibilities as directors and thereby mitigating potential liability?

There are many compelling reasons to be a director, including business, professional and personal motivations. Serving as a director is a privilege that carries with it substantial obligations.

The legal obligations of corporate directors in Canada are derived from a variety of sources, primarily corporate and securities law. A wide array of provincial and federal statutes impose a myriad of responsibilities on directors. In some circumstances, directors' liability may range from payment of company debts to fines and, in severe situations, directors may face imprisonment or civil lawsuits for serious corporate offences. Many of the common safeguards, such as directors' and officers' liability insurance and indemnity clauses contained in companies' bylaws, may provide only limited security. The understanding of, and ability to fulfill, the responsibilities as a director are critical in mitigating potential liability.

A corporate director has fiduciary obligations to the corporation and its shareholders. A director's fiduciary obligation usually has two components—a duty of loyalty and a duty of care. In general terms, the duty of loyalty and the duty of care require a director to act honestly and in good faith with a view to the best interests of the corporation, and to exercise the care, diligence and skill that a reasonably prudent person would in comparable circumstances.

Provincial securities laws also create legal obligations for directors. Failure by a corporation to either file the informational documents or adequately provide disclosure in the documents themselves may attract liability for directors. For example, any purchaser of securities issued under a prospectus containing a misrepresentation may bring an action against the issuer and all of its directors for damages. However, securities legislation does generally provide directors with a due diligence defense. To minimize risk, a director should perform investigative procedures sufficient to provide reasonable grounds to evaluate the truth of statements made in any public document.

Recent amendments to the *Canada Business Corporations Act* (CBCA), which governs federal corporations, provide directors with a "due diligence" or "acting reasonably" defense against certain liabilities. The amendments also introduce a regime of modified proportionate liability for claims for financial loss arising out of an error, omission or misstatement in respect of financial information that must be provided under the CBCA.





Appendices

Appendix I:

Audit Committee Toolkit

Audit Committee Mandate

Audit committees play a critical role in a Company's financial reporting system by overseeing and monitoring management's and the external auditors' participation in the financial reporting process. It is expected that the preparation and disclosure of the audit committee mandate will help shareholders assess the role and responsibilities of the audit committee and help committee members focus on their responsibilities.

An example audit committee mandate is included in Exhibit 1 of this appendix. Our intention is not to advocate an exhaustive mandate. Rather, this example mandate is intended to help audit committees, and senior management, in evaluating the completeness of their mandates in relation to their specific circumstance. Audit committees should also be mindful of the increasing demand for disclosure of corporate governance practices. Accordingly, care in crafting the mandate must be exercised so that audit committees are not exposing themselves to undue liability.

All audit committees should establish mandates that not only meet the minimum requirements, but are also tailored to their specific needs and circumstances. Audit committees governing smaller companies, for example, may require fewer meetings per year and may not need to address certain responsibilities for oversight of internal audit or monitoring compliance with a code of ethics if these items are not a part of the Company's governance structure. Accordingly, the mandate should be 'tailored fit' to the circumstances of the entity.

Audit Committee Agenda

A comprehensive agenda helps members stay focused on their mission. However, the nature of audit committee responsibilities and the ever-changing environment in which the company operates make it difficult to determine a set agenda for each meeting. The committee should assess what is currently important and develop its agenda accordingly. An example audit committee agenda is included in Exhibit 2 of this appendix.

Audit Committee Meeting Agenda for Year

It is important to review the completeness of the audit committee mandate as well as the agenda established for each meeting. Exhibit 3 of this appendix provides an example of topics that could be covered in each audit committee meeting for a committee that meets four times per year.



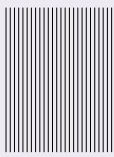


Exhibit 1:

Example Audit Committee Mandate



Mandate of the Audit Committee of the Board of Directors

I. Audit Committee Purpose

The Audit Committee is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Audit Committee's primary duties and responsibilities are to:

- Identify and monitor the management of the principal risks that could impact the financial reporting of the Company.
- Monitor the integrity of the Company's financial reporting process and system of internal controls regarding financial reporting and accounting compliance.
- Monitor the independence and performance of the Company's external auditors and internal auditing department.
- Provide an avenue of communication among the external auditors, management, the internal auditing department, and the Board of Directors¹.

The Audit Committee has the authority to conduct any investigation appropriate to fulfilling its responsibilities, and it has direct access to the external auditors as well as anyone in the organization. The Audit Committee has the ability to retain, at the Company's expense, special legal, accounting, or other consultants or experts it deems necessary in the performance of its duties.

II. Audit Committee Composition and Meetings

Audit Committee members shall meet the requirements of the Canada Business Corporations Act² and the stock exchange³. The Audit Committee shall be comprised of three or more directors⁴ as determined by the Board, each of whom shall be outside directors who are unrelated⁵, free from any relationship that would interfere with the exercise of his or her independent judgment.⁵ All members of the Committee shall be financially literate⁶, being defined as able to read and understand basic financial statements⁶, and at least one member of the Committee shall have accounting or related financial management expertise^{7,8,9}.

[√] As recommended by the Joint Committee.

¹ Other overall responsibilities could also include:

- Report to the Board of Directors.
- Encourage adherence to, and continuous improvement of, the Company's policies, procedures, and practices at all levels.
- Monitor compliance with legal and regulatory requirements.

² If incorporated under a provincial corporations act, amend accordingly and specify the relevant act.

³ Toronto Stock Exchange (TSE), Canadian Venture Exchange (CDNX), etc.

⁴ The *Canada Business Corporations Act* and the provincial corporations acts require audit committees to be comprised of at least three directors if the corporation has publicly held securities. Leading practices suggest no more than six members; the mandate may establish a maximum number of members as well.

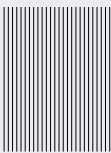
⁵ If applicable, consider inserting the Board's definition of "independence."

⁶ Each board should determine the definition of and criteria for "financial literacy."

⁷ If applicable, consider adding "and the regulatory requirements of the Company's industry."

⁸ Committee members are encouraged to enhance their familiarity with finance and accounting by participating in seminars, conferences, roundtables, and other educational programs conducted by the Company or an outside organization.

⁹ The mandate may be more specific in defining the background and experience requirements and any other criteria for selection of audit committee members i.e., backgrounds in finance, investing, marketing, or the industry in which the Company operates.



Audit Committee members shall be appointed by the Board on recommendation from the nominating process. If an audit committee Chair is not designated or present, the members of the Committee may designate a Chair by majority vote of the Committee membership.¹⁰

The Committee shall meet at least four¹¹ times annually, or more frequently as circumstances dictate. The Audit Committee Chair shall prepare and/or approve an agenda in advance of each meeting.¹² The Committee should meet privately in executive session at least annually with management, the director of the internal auditing department, the external auditors, and as a committee to discuss any matters that the Committee or each of these groups believe should be discussed.^{13 14} In addition, the Committee, or at least its Chair, should communicate with management and the external auditors quarterly to review the Company's interim financial statements and significant findings based upon the auditors' review procedures.¹⁵

III. Audit Committee Responsibilities and Duties

Review Procedures

1. Review and reassess the adequacy of this Mandate at least annually and submit the mandate to the Board of Directors for approval.¹⁶
2. Review the Company's annual audited financial statements and related documents prior to filing or distribution. Review should include discussion with management and external auditors of significant issues regarding accounting principles, practices, and significant management estimates and judgments.
3. Annually, in consultation with management, external auditors, and internal auditors, consider the integrity of the Company's financial reporting processes and controls. Discuss significant financial risk exposures and the steps management has taken to monitor, control, and report such exposures.¹⁵ Review significant findings prepared by the external auditors and the internal auditing department together with management's responses.¹⁶
4. Review the effectiveness of the overall process for identifying the principal risks affecting financial reporting and provide the Committee's view to the Board of Directors.

10 Consider disclosing the role of the Audit Committee Chair.

11 Most mandates require three to five meetings per year. Leading practices suggest that the meetings be free of time constraints as well.

12 The Chair should develop the agenda in consultation with management, other committee members and external auditors. The agenda should be consistent with this mandate.

13 The mandate may also encourage executive sessions at every meeting, thereby providing a regular forum for candid discussion and reducing the pressure (in particular with internal audit) to request such a meeting.

14 The Committee may ask members of management or others to attend meetings and provide pertinent information as necessary.

15 The mandate may also request inquiry as to the adequacy of such internal controls to identify any payments or procedures that might be deemed illegal or improper.

16 Consider adding "including the status of previous recommendations."



5. Review with financial management and the external auditors the company's quarterly financial results and related documents prior to the release of earnings and/or the company's quarterly financial statements prior to filing or distribution.¹⁷ Discuss any significant changes to the Company's accounting principles. The Chair of the Committee may represent the entire Audit Committee for purposes of this review.¹⁷

External Auditors

6. The external auditors are ultimately accountable to the Audit Committee and the Board of Directors, as representatives of the shareholders.¹⁸ The Audit Committee shall review the independence and performance of the auditors and annually recommend to the Board of Directors the appointment of the external auditors or approve any discharge of auditors when circumstances warrant.¹⁸
7. Approve the fees and other significant compensation to be paid to the external auditors.
8. On an annual basis, the Committee should review and discuss with the external auditors all significant relationships they have with the Company that could impair the auditors' independence.
9. Review the external auditors' audit plan¹⁸ – discuss and approve audit scope, staffing, locations, reliance upon management, and internal audit and general audit approach.¹⁹
10. Prior to releasing the year-end earnings, discuss the results of the audit with the external auditors.²⁰ Discuss certain matters required to be communicated to audit committees in accordance with the standards established by the Canadian Institute of Chartered Accountants.²¹

17 In some cases, an Audit Committee Chair may not wish to be the only audit committee member participating in conference calls, and, accordingly, may request that the entire committee participate.

18 Consider adding "and engagement letter."

19 Audit committees should review the external auditors' audit plan to see that it is sufficiently detailed and covers any significant areas of concern that the audit committee may have.

20 Audit committees may inquire about changes to the audit plan, restrictions on scope of activities, observations of control weaknesses, etc.

21 The communication may be in writing or oral and may take place before or after the financial statements are issued. Items to be communicated include:

- The auditor's responsibility under Canadian Generally Accepted Auditing Standards (GAAS);
- Weaknesses in internal controls;
- Fraud, illegal acts and related-party transactions;
- Significant accounting principles and policies;
- Management judgments and accounting estimates;
- Significant audit adjustments;
- Other information in documents containing audited financial statements;
- Disagreements with management, including accounting principles, scope of audit and disclosures;
- Consultation with other accountants by management;
- Major issues discussed with management that influence audit appointment; and
- Difficulties encountered in performing the audit.

11. Consider the external auditors' judgments about the quality and appropriateness of the Company's accounting principles as applied in the Company's financial reporting.

Internal Audit Department and Legal Compliance

12. Review and approve management's decisions related to the need for internal auditing.^{v22}
13. Review the mandate, budget, plan, changes in plan, activities, organizational structure, and qualifications of the internal audit department, as needed.²³
14. Review the appointment, performance, and replacement of the senior internal audit executive.
15. Review significant reports prepared by the internal audit department together with management's response and follow-up to these reports.
16. On at least an annual basis, review with the Company's counsel any legal matters that could have a significant impact on the organization's financial statements, the Company's compliance with applicable laws and regulations, and inquiries received from regulators or governmental agencies.²⁴

Other Audit Committee Responsibilities²⁵

17. Annually assess the effectiveness of the committee against its Mandate and report the results of the assessment to the Board.^v
18. Prepare and disclose a summary of the Mandate to shareholders.^{v26}

22 The assessment of the need for internal audit should be performed as circumstances facing the entity change; for example, significant growth through acquisitions or expansion of operations into global markets. If the function is outsourced, consider adding the responsibility to approve the supplier.

23 Consideration should be given to clarifying the reporting role of the senior internal audit executive. For example, "The internal audit department shall be responsible to senior management, but have a direct reporting responsibility to the Board of Directors through the Committee. Changes in the senior internal audit executive shall be subject to committee approval."


24 Consider adding the following: "Review all reports concerning any significant fraud or regulatory noncompliance that occurs at the Company. This review should include consideration of the internal controls that should be strengthened to reduce the risk of a similar event in the future."

25 Other:

- Develop an annual plan responsive to the "responsibilities and duties" detailed herein with input from management and other key committee advisors. The annual plan shall be reviewed and approved by the full board.
- Have committee meeting agendas prepared by the Committee Chair with input from committee members. It is expected that the Chair would also ask for management and key committee advisors, and perhaps others, to participate in this process.
- Report at least semi-annually, or as deemed necessary, to the full board. In addition, summarized minutes from Committee meetings shall be distributed to each board member at least one week prior to the subsequent Board of Directors meeting.

26 Consider disclosing the full mandate.



- 
19. Perform any other activities consistent with this Mandate, the Company's by-laws, and governing law, as the Committee or the Board deems necessary or appropriate.
 20. Maintain minutes of meetings and periodically report to the Board of Directors on significant results of the foregoing activities.

Other Optional Mandate Disclosures

21. Establish, review, and update periodically a Code of Ethical Conduct and ensure that management has established a system to enforce this Code.²⁷
22. Periodically perform self-assessment of audit committee performance.²⁸
23. Review financial and accounting personnel succession planning within the company.
24. Annually review a summary of director and officers' related party transactions and potential conflicts of interest.

27 Additional requirements could include "Review management's monitoring of the Company's compliance with the organization's Ethical Code and ensure that management has the proper review system in place to ensure that the Company's financial statements, reports and other financial information disseminated to governmental organizations and the public satisfy legal requirements."

28 While not required, activities could include:

- Review, discuss and assess its own performance as well as the committee roles and responsibilities, seeking input from senior management, the full board and others if needed.
- Review each member's contribution to the committee through the use of a self-assessment form, which is then evaluated by the Chair of both the Audit Committee and the Board.

Exhibit 2: Example Audit Committee Agenda

Our experience suggests that the following topics deserve consideration when establishing the detailed agendas for the audit committee meetings during the year.

Risk Assessment

- ✓ Risk management process and control (particularly financial reporting risks)
- ✓ Operating reviews
- ✓ Budget reviews
- ✓ Industry and market updates
- ✓ Review financial community expectations
- ✓ Information technology changes
- ✓ Legal briefings
- ✓ Understand senior management compensation programs
- ✓ Executive sessions with appropriate senior management
- ✓ Current and emerging risk issues

Assess Processes Relating to the Company's Control Environment

- ✓ Compliance with code of ethical conduct
- ✓ Control policies and procedures (including earnings management, error and fraud)
- ✓ Management's assessment of key third-party providers
- ✓ Internal and external auditor internal control observations and recommendations
- ✓ Compliance with specific industry regulations

Oversee Financial Reporting

- ✓ Financial statements and earnings releases
- ✓ Recommend approval of financial statements to Board of Directors
- ✓ Periodic reports and filings
- ✓ Management overview of financial results for quarter/year
- ✓ Critical accounting policies (including appropriate application of GAAP)
- ✓ Significant and unusual transactions and accounting estimates
- ✓ Current developments in auditing, accounting, reporting, and tax matters
- ✓ Executive session with senior management





Evaluate the Internal and External Audit Processes

- √ Coordination of the internal and external audit effort and definition of responsibilities
- √ External auditors
 - Engagement letter
 - Audit engagement team
 - Independence letter
 - Consider all significant non- audit services to be performed by the external auditor
 - Scope, procedures, and timing
 - Audit results
 - Audit reports
 - Quarterly review results
 - Executive sessions
- √ Internal Audit Department
 - Assess need for internal auditing
 - Mandate and objectives
 - Appointment and compensation of chief auditor
 - Budget, staffing, and resources
 - Scope, procedures, and timing of the audits
 - Audit results
 - Audit reports
 - Executive sessions

Audit Committee Structure

- √ Update mandate
- √ Assess audit committee performance

Exhibit 3: Example Audit Committee Meeting Agenda for Year

This example assumes a December year-end company that schedules four audit committee meetings in connection with quarterly earnings releases. This sample meeting agenda is reconciled to the sample mandate included in Exhibit 1 of this appendix.

Scheduled Meetings


Mandate step	April	July	October	January
I. Audit Committee Purpose				
Conduct special investigations	*	*	*	*
II. Audit Committee Composition and Meetings				
Assess independence and financial literacy of audit committee		X		
Establish number and timing of meetings		X		
Audit Committee Chair to establish meeting agenda	X	X	X	X
Enhance financial literacy update on current financial events	X	X	X	X
Private executive session with external auditors		X		X
Private executive session with internal auditors		X		X
Private executive session with committee members	X	X	X	X
Private executive session with senior management		X		X
III. Audit Committee Responsibilities and Duties				
Review mandate	X			
Review annual financial statements – discuss with mgmt, auditors – recommend approval to Board				X
Review external audit plan		X		
Review external auditors' report				X
Review regulatory reports				X
Consider internal controls and financial risks	X		X	
Review interim financial statements and external auditors' findings and recommend approval of financial statements to Board	X	X	X	
Recommend appointment of auditors				X
Approve audit fees		X		
Review independence letter and discuss auditor independence				X
Discuss year-end audit results				X
Discuss the appropriateness of accounting principles, critical accounting policies and management judgments and estimates	X	X	X	X
Review internal audit plan			X	
Review appointment, performance of internal audit executive			X	
Review significant internal audit reports	*	*	*	X
Review legal matters with counsel	*	*	*	X
Perform other activities as appropriate	*	*	*	*
Maintain minutes and report to Board	X	X	X	X
Review Code of Conduct		X		
Perform self-assessment of audit committee performance and its members			X	
Prepare report of audit committee effectiveness to the Board				X
Review the disclosure of the audit committee mandate to the shareholders			X	
Review financial personnel succession planning	X			

X = Recommended Timing
* = As Needed



Appendix II: Complete Text of Joint Committee Recommendations Pertaining to Audit Committees

51



This section provides a listing of the final recommendations of the Joint Committee that relate specifically to audit committees.

Audit Committee Composition and Mandate

i) Independence

Audit committees be composed solely of outside directors who are also “unrelated”. The definition of “unrelated” and the obligation on boards to disclose and explain their interpretation of “unrelated” should remain as now set out in Guidelines 2 and 3. We further recommend that some flexibility with regard to related directors, but not outside directors, be provided by CDNX for Tier 2 companies that have small boards.

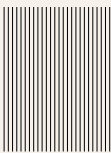
ii) Financial Literacy

All members of the audit committee be “financially literate” and at least one member should have accounting or related financial expertise. The definition of and criteria for “financial literacy” should be determined by each board.

iii) Mandate

Audit committees should adopt a formal written mandate that is approved by the full board and that sets out the scope of the committee’s responsibilities. This mandate should be disclosed to shareholders, and a regular assessment of the effectiveness of the committee against the mandate should be conducted and reported to the full board. The audit committee mandate should set out explicitly the role and responsibility of the audit committee with respect to:

- its relationship with and expectations of the external auditors;
- its relationship with and expectations of the internal auditor function;
- its oversight of internal control;
- disclosure of financial and related information; and
- any other matters that the audit committee feels are important to its mandate or that the board chooses to delegate to it.



Audit Committee Oversight Roles

i) Internal Auditors' Oversight

The audit committee should periodically request from management a review of the need for an internal audit function and, on the basis of this review, determine whether such a function should be instituted.

ii) External Auditors' Oversight

Audit committee mandates should explicitly affirm that the external auditor is accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholders' representatives have the ultimate authority and responsibility to select, evaluate and, where appropriate, recommend replacement of the external auditor.

Auditors must recognize that their ultimate client is not management, and work constructively and meet regularly with audit committees to build an effective relationship.

iii) Financial Statements Oversight

The OSC should revise its regulation to make it clear that either the audit committee or the board should review quarterly financial reports and related financial documents before any public disclosure of the information. Audit committees, as a matter of best practice, should ask external auditors to review this material before considering it.



Appendix III: Comparison of the Joint Committee Recommendations Pertaining to Audit Committees to the Recommendations of the U.S. Blue Ribbon Committee

This section provides a summary comparison of the recommendations of the Joint Committee that relate specifically to audit committees to the recommendations of the U.S. Blue Ribbon Committee. We have provided additional commentary to highlight differences where appropriate. Some of the U.S. Blue Ribbon Committee recommendations were modified when “enacted” by the stock exchanges and the SEC.

Blue Ribbon Committee

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation.

A director who has such a relationship may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required in the best interests of the corporation and its shareholders. The board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Large NYSE and the NASD listed companies should have an audit committee comprised solely of independent directors.

Large NYSE and the NASD listed companies should have an audit committee comprised of a minimum of three directors, each of whom is financially literate or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee and, further, that at least one member of the audit committee have accounting or related financial management expertise.

Joint Committee

Comment:

The Joint Committee does not recommend amendment to existing TSE guidelines with respect to audit committee “independence” and does not propose any change to the current definitions of “outside” and “unrelated.”

Audit committees be composed solely of outside directors who are also “unrelated.”

All members of the audit committee be “financially literate” and at least one member should have accounting or related financial expertise. The definition of and criteria for “financial literacy” should be determined by each board.

Blue Ribbon Committee

The NYSE and the NASD should require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Joint Committee

Audit committees should adopt a formal written mandate that is approved by the full board and that sets out the scope of the committee's responsibilities. The audit committee mandate should set out explicitly the role and responsibility of the audit committee with respect to:

- its relationship with and expectations of the external auditors;
- its relationship with and expectations of the internal auditor function;
- its oversight of internal control;
- disclosure of financial and related information; and
- any other matters that the audit committee feels are important to its mandate or that the board chooses to delegate to it.

The Securities and Exchange Commission (SEC) should require the audit committee to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The audit committee mandate should be disclosed to shareholders, and a regular assessment of the effectiveness of the committee against the mandate should be conducted and reported to the full board.



Blue Ribbon Committee

Comment:

The Blue Ribbon Committee recommendations are silent in this regard.

The NYSE and the NASD should require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the outside auditor.

Joint Committee

The audit committee should periodically request from management a review of the need for an internal audit function and, on the basis of this review, determine whether such a function should be instituted.

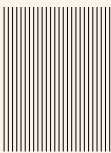
Audit committee mandates should explicitly affirm that the external auditor is accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholders' representatives have the ultimate authority and responsibility to select, evaluate and, where appropriate, recommend replacement of the external auditor.

Auditors must recognize that their ultimate client is not management, and work constructively and meet regularly with audit committees to build an effective relationship.

The NYSE and the NASD should require that the audit committee charter specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Comment:

The Joint Committee recommendations are silent in this regard. The Joint Committee report, however, comments that "the audit committee needs to assure itself that the [external] auditors are independent. It must have access to all information about the audit firm's relationship with the corporation that is necessary in order to come to a reasonable conclusion".



Blue Ribbon Committee

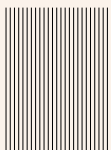
Generally Accepted Auditing Standards (GAAS) should require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

Joint Committee

Comment:

The Joint Committee recommendations are silent in this regard. The Joint Committee report, however, comments that "the audit committee needs to assure itself that the external auditors are satisfied that the accounting estimates and judgments made by management, and management's selection of accounting principles, reflect an appropriate application of GAAP."





Blue Ribbon Committee

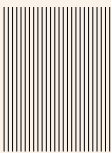
The SEC should require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee believes that the company's financial statements are fairly presented in conformity with GAAP in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation.

Joint Committee

Comment:

The Joint Committee recommendations are silent in this regard.



Blue Ribbon Committee

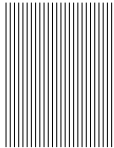
The SEC should require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

SAS 71 should be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chair, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications with the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

Joint Committee

The OSC should revise its regulation to make it clear that either the audit committee or the board should review quarterly financial reports and related financial documents before any public disclosure of the information. Audit committees, as a matter of best practice, should ask external auditors to review this material before considering it.





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

Recognizing the importance of audit committees, KPMG has created the Audit Committee Institute (ACI) 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, ACI 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 ACI at any time for help and advice or to share knowledge. The ACI can be reached via e-mail at auditcommittee@kpmg.com, or visit the ACI at [www.us.kpmg.com/audit committee](http://www.us.kpmg.com/audit_committee).

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Québec City
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Regina
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(819) 762-6521

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Saint John
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Sault Ste. Marie
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Sudbury
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Sydney
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Toronto
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Toronto-North York
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