

The background of the entire page is a photograph of a Gothic-style building facade. It features a large, dark wooden Gothic archway on the left, which is open to reveal a sunlit path leading through a green landscape. To the right of the archway, there is a stone wall with a small, ornate window and a decorative shield-shaped plaque. A blue bicycle is parked on the sidewalk in the bottom right corner.

KPMG'S
AUDIT COMMITTEE
UPDATE
SPRING 2002

IN THIS ISSUE:

1	Preface
3	Current Issues Dominating the Audit Committee Agenda
3	The Current Economic and Business Environment: A Call to Action; a Time for Introspection
6	Financial Reporting Updates
6	Regulatory and Other Developments
9	Accounting Developments
12	Auditing Developments
14	Audit Committee Evolving Issues— A Spotlight on Corporate Governance
14	Recommendations of the Joint Committee on Corporate Governance
15	Enterprise Risk Management—The Audit Committee Link
17	Audit Committee Resources
19	About KPMG

We are pleased to provide you with the first issue of KPMG's *Audit Committee UPDATE* in Canada.

As you are likely well aware, the financial reporting environment — the environment in which audit committees operate — continues to evolve at an unprecedented pace. Significant changes continue to occur in accounting standards and regulatory requirements, as well as in the guidance pertaining to effective corporate governance practices. The effectiveness of the audit committee — the key group within a company's governance structure promoting the integrity of published financial information — in discharging its oversight responsibilities continues to be at the forefront of the minds of investors, regulators and shareholders. The increasingly important role of audit committees is now taking centre stage in the face of the Enron collapse, recent high-profile financial statement restatements, and the 2001 economic downturn and its impact on financial reporting.

We recognize that audit committees need support and resources now more than ever in preparing themselves for the challenges ahead — and that we have a fundamental role in supporting this process. KPMG's *Audit Committee UPDATE*, published semi-annually in the spring and fall, is intended to inform audit committees of recent events and matters of interest, and to provide a summary of some of the key issues that audit committee members should consider when establishing their next meeting's agenda.

We begin this issue with a highlight of some of the current topics dominating audit committee agendas — much of which, not surprisingly, resulted from the collapse of Enron. This section explores the influence of the current economic and business environment on audit committees, and what changes to their practices they may consider to better diagnose and safeguard against potential exposures.

PREFACE

The section also addresses how to meet the heightened challenge of preparing and disseminating high-quality, transparent financial reports.

To appreciate some of the challenges pertaining to financial reporting that lie ahead, the Financial Reporting Updates section summarizes some of the broader changes occurring in the Canadian and U.S. financial reporting and regulatory landscape — an environment characterized by rapid and widespread changes. Regulators and market participants clearly are expecting expanded financial disclosures in 2002 and also expect audit committees to give these disclosures close scrutiny. Beginning on page 6, we highlight recent and proposed regulatory changes that are shaping the landscape of financial reporting. On page 9, we also provide an overview of developments in Canadian accounting and auditing standards. We highlight the new accounting standards on business combinations, goodwill and intangibles, and stock-based compensation — standards that will have a profound effect on how and what businesses account for in their financial statements. For insight into the direction in which standards are moving, we also discuss current and future projects underway regarding new guidance, including development in the U.S. On page 12, we highlight the new auditing standards on materiality, fraud and communication with those responsible for oversight of financial reporting — standards that will undoubtedly influence and govern the responsibilities of, and communications between, external auditors and audit committees.

We believe that issues of corporate governance are a common theme underscoring many of the changes described above. With the very foundation of the capital markets shaken, the spotlight now, perhaps as never before, is on the total system of corporate performance, evaluation,

and oversight, and on the bodies that are responsible for such oversight. Accordingly, the Audit Committee Evolving Issues section covers the recommendations of the Joint Committee on Corporate Governance pertaining to audit committees, and how Enterprise Risk Management, an emerging model for risk management, can assist audit committees in fulfilling their oversight responsibilities.

In the Audit Committee Resources section beginning on page 17, we highlight some of the resources that we offer to assist audit committees in meeting the challenges in today's environment.

KPMG is committed to provide ongoing assistance to support audit committee members by communicating accounting and regulatory changes, addressing current and emerging issues that audit committees must be aware of and react to, and sharing audit committee leading practices. We hope you find this publication useful in providing a comprehensive perspective on the financial reporting process and the audit committee's role in it, and that it provides you with relevant, timely information for your decisions.

We encourage all the participants in the financial reporting process — management, internal auditors, external auditors and the audit committee of the board of directors — to discuss the financial reporting and other matters included in this issue of Audit Committee UPDATE. While the ultimate impact of certain recommendations may be subject to various regulatory and standard-setting bodies' due process, other elements can be evaluated and implemented, as appropriate, by individual participants in the financial reporting process.

CURRENT ISSUES DOMINATING THE AUDIT COMMITTEE AGENDA

This section explores current issues and recent events and their implications for audit committees. In this issue, we look at the influence the current economic and business environment is having on audit committees and how committees can react accordingly.

The Current Economic and Business Environment: A Call to Action; a Time for Introspection

In the post-Enron environment, chief executives, audit committees and boards of directors are seeking, with renewed vigour, reassurance about the integrity of financial information, the transparency of disclosures and the external audit firms providing audit opinions on this information. Responding to these challenges will be neither quick nor easy, but rather requires an extended dialogue among all participants — management, external auditor and members of the audit committee.

With the role of the audit committee central to ensuring the integrity of financial information on which investors rely, audit committees are expected to be actively involved in overseeing financial reporting, satisfying themselves that the company's financial reports are comprehensive, reliable, understandable and responsive to the needs of the investment community. These demands require even greater diligence by audit committees and external auditors than ever before. In some cases, audit committees must consider how to “reinvent” themselves, as a business and risk management necessity, to ensure they are well prepared to act as effective watchdogs. To understand what reforms, if any, may be necessary, each audit committee must understand from where it is starting, and have a clear vision of what it needs to be — *an audit committee that is effective, that understands the environment in which it operates and that is appropriately focused on the matters critical to quality financial reporting.*

A review of audit committee effectiveness

As the front line defence for shareholder protection, the audit committee needs to be effective. While there are many facets to effectiveness, some aspects need to be considered right away:

- Is there an appropriate mandate governing the responsibilities of the audit committee? Do the members fully understand their mandate, roles and responsibilities?
- Is the audit committee composed of members with the proper qualifications for the job?
- Does the audit committee agenda reflect topics of highest risk and importance, as well as encompass all matters to which consideration needs to be given?
- Is sufficient time provided and used to achieve an adequate understanding of what the company's financial statements represent, to consult with experts if necessary, to ask tough and incisive questions, and to understand the answers?
- Are audit committee best practices understood and adopted where appropriate?
- Is there an appropriate relationship between the audit committee, the external auditor, management and the internal auditor?

A review of the audit committee's understanding of the company and its environment

Business structures and transactions can be highly complex, challenging even the most seasoned professionals. Nevertheless, audit committees should be sure they understand the industry environment in which their company operates, the basic structure of transactions, their business purpose and the significant implications. Warning signs are obvious — a lack of understanding of a business transaction paired with explanations that are elusive. At the same time, audit committees should understand the company in relation to the current economic environment, challenging matters that may previously have been considered a “non-issue.”

CURRENT ISSUES DOMINATING THE AUDIT COMMITTEE AGENDA

Consider, or reconsider:

- What is the “tone at the top,” and is it appropriate?
- Does the audit committee understand the potential economic and operational effects of economic downturn on the company? How has management reacted to changes in the company’s business environment?
- Are the business purpose, economic rationale, and implications of significant or complex transactions or structures adequately understood by the audit committee? What exposures are present from existing or proposed structures, and is additional information needed to fully evaluate their implications?
- Has management recently re-evaluated the company’s current internal controls in light of changes in the company’s business environment? Have enhancements been requested where appropriate?

A review of financial reporting practices

High-quality financial reporting has become “priority one” for the majority of companies and investors. Accounting and reporting practices that are questionable, or appear to be, are now a significant competitive disadvantage. Echoing this sentiment, David Brown, Chairman of the Ontario Securities Commission (OSC), stated in a recent speech that “the market puts a premium on open and transparent disclosure” and will penalize companies whose financial reporting is suspect or lacking. Accordingly, audit committees have to take a more active role in requiring proper disclosure and question what is being provided to the marketplace. *What’s the track record?* The OSC recently reported that more than half of the public companies examined in a recent study filed inadequate financial information in 2001, a finding that has heightened concerns over the state of governance and disclosure practices at some of the largest Canadian corporations.

When addressing the quality of financial reporting, audit committees should consult two recent publications. The first is the American Institute of Certified Public Accountants’ (AICPA) and the Big 5 accounting firms’ joint report, *Impact of the Current Economic and Business Environment on Financial Reporting*, released in January 2002. This report may be found on the AICPA web site at http://ftp.aicpa.org/public/download/news/risk_factor.doc. It provides timely information about the current financial reporting environment; an assessment of risk factors that may be important for financial statement preparers, auditors, and audit committees to consider during the current reporting cycle; and recommendations for actions that can be taken to enhance financial reporting. Second is the Canadian Institute of Chartered Accountants’ (CICA) Canadian Reporting Initiatives Board (CPRI Board) draft report, *Management’s Discussion and Analysis (MD&A): Guidance on Preparation and Disclosure*, available on the CICA web site at www.cica.ca/cica/cicawebsite.nsf/public/E_MD&A. Released for public review in December 2001, the publication is intended to help companies improve the usefulness of disclosures in their MD&A reports. The guidance builds on and, in places, goes beyond what is called for under existing regulatory requirements. The publication identifies seven general disclosure principles, encourages companies to structure and integrate their MD&A disclosures within a broad organizational reporting context and disclosure framework, and makes a number of recommendations to improve reporting practices.

One of the most important aspects in overseeing financial reporting is not only to rely on information provided but also to challenge, analyze, interpret, and evaluate the information — to “get in the ring and go a few rounds” with what

CURRENT ISSUES DOMINATING THE AUDIT COMMITTEE AGENDA

management is providing to the audit committee.

Consider whether the following is part of your regimen:

- Does the audit committee appropriately challenge management briefings, especially on critical issues? Has a complete and adequate understanding of the information been obtained before concurrence by the audit committee?
- Have the implications of the economic environment been addressed with respect to financial reporting, including its impact on results and on provisions in guarantee, commitment or financing agreements?
- Has the appropriateness of adopted accounting principles and disclosures been critically analyzed? Has particular attention been placed on those accounting policies in which management has made key judgment decisions and whether the policy disclosures convey clearly to an outside reader the substance of the choices made?
- Where accounting alternatives exist, have the most informative and representationally faithful ones been selected?
- Is the MD&A truly helpful to investors, not simply boilerplate? Put yourself in the place of an investor and consider whether information disclosed communicates clearly the substance of the company's financial position and operating results and how they are reflected in the financial statements.

The quality of the external audit process

Any questioning of the effectiveness of the audit committee and of the appropriateness of the financial statements also leads to questions about the role of the external auditor and the effectiveness of the external audit process. While regulators look to the independence of external auditors and the need for an effective and transparent system for oversight and discipline of external auditors of public companies, audit committees also need to examine two important aspects that relate specifically to the circumstances of the company:

- Is the right level and extent of audit examination being brought to bear with due regard to financial reporting risk by an audit team with the appropriate skills and experience to match the profile of management?
- Is the external auditor independent?

In this regard, one issue being addressed is whether non-audit services provided in addition to audit services enrich the external auditor's understanding of the business, and as a result, enhance the quality of the audit, or whether such services impair, or are perceived to impair, external auditor independence. While the level of fees for non-audit services has attracted most of the attention, the more relevant implications to independence relate to the nature of the non-audit services provided. Thoughtful consideration needs to be given to this issue; for example, design and installation of large-scale information technology systems may not be a service compatible with external auditor independence. On the other hand, risk management and tax planning work often is a service best integrated with the audit to the benefit of both the external audit and the company.

Considerable judgment may be required to reach a conclusion regarding the appropriateness of engaging the external audit firm to provide a specific non-audit service. Audit committees should ensure that all the participants in the discussion of external auditor independence are well informed and prepared for substantive and open dialogue regarding the specific facts of each decision. Another aspect often overlooked in the discussion of auditor independence relates to who really makes the decision about appointment or removal of the external auditor and who decides on the auditor's compensation. Historically, for the most part, it has been management who makes these decisions. In future, these are decisions for the audit committee to clearly assume.

FINANCIAL REPORTING UPDATES

In this section, we highlight recent and proposed regulatory and other changes that are shaping the landscape of financial reporting. We also explain significant recent accounting and auditing developments in Canada and the U.S., as well as future projects, that may be of broad interest to audit committees as they set their meeting agendas. This summary is of a general nature intended solely to increase awareness of financial reporting developments. Individual readers should consult the original pronouncements and their own financial advisors for detailed guidance on the application of these standards.

Regulatory and Other Developments

Significant changes in regulations and practices are expected to impact companies and their boards, auditors, debt-rating agencies, analysts and other parties involved in preparing and disseminating financial information to investors. Broad changes include enhanced disclosure requirements, enhanced regulation and oversight, changes in accounting pronouncements and the standard-setting process, and possible enhancements to the oversight framework governing the accounting profession.

The changing landscape of financial reporting

In Canada, regulatory and accounting reaction to the current economic and business environment has been one of thoughtful consideration, gauging and evaluating the implications of events in the Canadian context.

In the U.S., regulatory and accounting changes are unprecedented in both magnitude and speed. Many of these changes reflect the initiatives of the Securities and Exchange Commission (SEC) in strengthening the financial reporting process, which include overarching proposals of public company disclosures of significant “trend” and “evaluative” data; conscientious identification and assessment by public companies and their external auditors of critical accounting

policies; an effective and transparent system of self-regulation for the accounting profession; and more meaningful investor protection by audit committees.

Recent regulatory changes and proposals, as well as guidance of particular interest, include:

Non-GAAP Earnings Measures

In January 2002, the Canadian Securities Administrators (CSA) issued a Staff Notice, entitled *Non-GAAP Earnings Measures*, to address concern over issuers publishing measures of earnings other than those prescribed by generally accepted accounting principles (GAAP). Examples of non-GAAP measures include “pro forma earnings,” “cash earnings,” “EBITDA” and “earnings before one-time charges.” The CSA staff is concerned that investors may be confused or even misled by non-GAAP earnings measures, particularly when they are not accompanied by adequate disclosure.

The CSA staff expects issuers who choose to publish non-GAAP earnings measures to define the measure clearly, demonstrate its relevance and ensure that it does not have the potential to mislead investors. The Staff Notice provides additional specific guidance surrounding the disclosure to be associated with non-GAAP measures. In addition, the CSA staff expressed its view that it is not appropriate to present non-GAAP earnings measures in financial statements prepared in accordance with Canadian GAAP.

The CSA Staff Notice is available at www.osc.gov.on.ca/en/Regulation/Rulemaking/Notices/csano tices/csa_list.html.

New Corporate Disclosure Rules (U.S.)

In February 2002, the SEC announced that it intends to propose changes in corporate disclosure rules as the first in a series of steps designed to improve the financial reporting and disclosure

FINANCIAL REPORTING UPDATES

system. Specifically, the SEC intends to propose rules, among others, that will accelerate reporting by companies of transactions by company insiders in company securities; accelerate filing by companies of their quarterly and annual reports; expand the list of significant events requiring current disclosure; and require disclosure of critical accounting policies in MD&A contained in annual reports. The SEC will issue proposals on these matters and solicit public comment with the intent to adopt new rules as quickly as possible.

Critical accounting policies and practices (U.S.)

In December 2001, the SEC issued a cautionary advice regarding disclosures about “critical” accounting policies and practices. The advice identifies critical accounting policies as “both most important to the portrayal of the company’s financial condition and results, and they require management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.” In summary, the SEC alerts public companies to the importance of employing a disclosure regimen along the following lines:

- Management and its external auditors should evaluate the appropriateness of the selection and use of critical accounting policies. “Management should be able to defend, and the auditors should satisfy themselves thoroughly regarding their selection, application and disclosures.”
- Management’s disclosures in MD&A should be “balanced and fully responsive.” Management is “encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail.”
- Audit committees are encouraged to be proactive and to review the selection, application, and disclosure of critical accounting policies with management and the external auditors prior to finalizing and filing annual reports.

The cautionary advice is available on the SEC’s web site at www.sec.gov/rules/other/33-8040.htm.

In May 2002, the SEC proposed a disclosure requirement for companies to include a separately captioned section regarding the application of critical accounting policies in the MD&A section of annual reports, registration statements and proxy and information statements. The section, entitled “The Application of Critical Accounting Policies”, would encompass both disclosure about the critical accounting estimates that are made by the company in applying its accounting policies and disclosure concerning the initial adoption of an accounting policy by a company. Specifically, the proposals would require the following information in the MD&A section:

- A discussion that identifies and describes the estimate, the methodology used, certain assumptions and reasonably likely changes;
- An explanation of the significance of the accounting estimate to the company’s financial condition, changes in financial condition and results of operations and, where material, an identification of the line items in the company’s financial statements affected by the accounting estimate;
- A quantitative discussion of changes in line items in the financial statements and overall financial performance if the company were to assume that the accounting estimate were changed, either by using reasonably possible near-term changes in certain assumption(s) underlying the accounting estimate or by using the reasonably possible range of the accounting estimate;
- A quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years, the reasons for the changes, and the effect on line items in the financial statements and overall financial performance; and

FINANCIAL REPORTING UPDATES

- A statement of whether or not the company's senior management has discussed the development and selection of the accounting estimate, and the MD&A disclosure regarding it, with the audit committee of the company's board of directors.

The proposal is available on the SEC web site at www.sec.gov/rules/proposed/33-8098.htm. Comments are due on this proposal to the SEC by July 19, 2002.

Earnings Press Releases (U.S.)

In December 2001, the SEC released a cautionary advice regarding the disclosure of earnings and results of operations on the basis of methodologies other than GAAP, often referred to as "pro forma financial information" in press releases. Companies were encouraged to consider and follow the earnings press release guidelines jointly developed by the Financial Executives International (FEI) and the National Investor Relations Institute (NIRI).

- Companies were reminded that the antifraud provisions of the securities laws apply to a company issuing "pro forma" financial information, and therefore companies should be particularly mindful of their obligation not to mislead investors when issuing this information. "Pro forma" financial information can mislead investors if it obscures results determined under GAAP, for example, a presentation of financial results addressing a limited feature of a company's overall financial results (e.g., earnings before interest, taxes, depreciation and amortization) that is not accompanied by clear disclosure of the basis of its presentation and comparable information about other periods;
- A presentation of financial results before "unusual or non-recurring transactions" that does not describe the particular transactions and the kind of transactions that are omitted; or

- Statements about a company's financial results that are literally true, but nonetheless are misleading because they omit material information.

The cautionary advice is available on the SEC's web site at www.sec.gov. The FEI/NIRI guidelines are available at www.fei.org/news/FEI-NIRI-EPRGuidelines-4-26-2001.cfm.

Management Discussion & Analysis (U.S.)

In January 2002, the SEC published a Financial Reporting Release (FRR) that sets forth certain views regarding disclosures that should be considered by registrants in preparing MD&A. A central concept in the Release is the "reasonably likely" standard for MD&A disclosure, such that known trends or uncertainties reasonable likely to have a material effect on financial condition or results of operations must be disclosed. The SEC notes that the threshold for "reasonably likely" is lower than "more likely than not." Disclosure matters addressed include liquidity and capital resources including off-balance sheet arrangements, certain trading activities that include non-exchange traded contracts accounted for at fair value, and relationships and transactions with persons or entities that derive benefit from their relationship with the registrant or the registrant's related parties.

The FRR reminds registrants of existing disclosure requirements and suggests steps registrants should consider in meeting those requirements. The FRR does not create new legal requirements, or modify existing legal requirements.

The FRR is available on the SEC's web site at www.sec.gov/rules/other/33-8056.htm.

FINANCIAL REPORTING UPDATES

Accounting Developments

We highlight here new accounting standards that will have a profound effect on how and what businesses account for in their financial statements. For insight into the direction in which standards are moving, we also discuss current and future projects underway regarding new guidance, including developments in the U.S.

Recently Issued Guidance

Business Combinations, Goodwill and Other Intangible Assets.

In August 2001, the Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA) issued CICA *Handbook* Section 1581, *Business Combinations*, and *Handbook* Section 3062, *Goodwill and Other Intangible Assets*. The new Sections are consistent with the new U.S. standards on the same topic, except for certain remaining GAAP differences, including the accounting for acquired in-process research and development (IPR&D). In combination, the new Sections will have a profound effect on how entities account for business combinations and for the acquisition of goodwill and other intangible assets.

Business Combinations

Business Combinations changes the current standards for the accounting for business combinations in two important aspects. First, all business combinations initiated after June 30, 2001, must be accounted for using the purchase method. Once effective, the new standard precludes the use of the pooling-of-interests method for business combinations initiated after that date. Second, *Business Combinations* changes the accounting for the initial recognition of intangible assets that a company acquires in a business combination by establishing criteria that a company must apply to determine whether it should record an acquired intangible asset apart from goodwill. The new standard is effective for business combinations initiated on or after July 1, 2001.

Goodwill and Other Intangible Assets

Goodwill and Other Intangible Assets makes equally sweeping changes in accounting for goodwill and other intangible assets after a company initially records those assets. It requires a departure from the long-standing practice of amortizing goodwill and other intangibles over their estimated useful lives. A company that acquires goodwill in a purchase business combination will no longer amortize goodwill; instead, goodwill is tested for impairment at the reporting unit level (a new concept) rather than at an acquisition-specific or enterprise-wide level. This new approach will require identifying reporting units and assigning assets (including goodwill) and liabilities to the reporting units for purposes of the impairment test only. The subsequent accounting for identifiable intangible assets other than goodwill will depend on whether that asset has a definite or indefinite life.

Goodwill and Other Intangible Assets is effective for years beginning on or after January 1, 2002. However, entities other than public enterprises, co-operative enterprises, deposit-taking institutions and life insurance enterprises may defer the application for one year.

Stock-Based Compensation and Other Stock-Based Payments

In December 2001, the AcSB issued new CICA *Handbook* Section 3870, *Stock-Based Compensation and Other Stock-Based Payments* ("*Stock-Based Compensation*"). This new Section establishes new standards for the recognition, measurement and disclosure of stock-based compensation and other stock-based payments made to employees and non-employees in exchange for goods and services. It also harmonizes Canadian GAAP with that of the U.S.

Stock-Based Compensation requires a fair value based method of accounting for all awards granted to anyone other than employees (non-employees), and for certain, but not all,

FINANCIAL REPORTING UPDATES

awards granted to employees. This accounting method effectively results in the recognition of the value of the award as an expense in the income statement. For all other types of awards granted to employees (exempt awards), a company may elect as a matter of policy a method of accounting other than the fair value based method, which usually would not result in an accounting expense for awards granted to employees if the exercise price is the fair market value of the stock at the date the award is granted.

Stock-Based Compensation is effective for fiscal years beginning on or after January 1, 2002, and applies to awards granted on or after the date of adoption. Certain types of awards granted prior to, but remaining outstanding at, the date of adoption, however, will be captured within the scope of the new standard.

Foreign Currency Translation and Hedging Relationships

In November 2001, the AcSB issued final amendments to CICA Handbook Section 1650, *Foreign Currency Translation* that eliminate the deferral and amortization of foreign currency translation gains and losses on long-lived monetary items. Accordingly, companies will lose their ability to avoid fluctuations in earnings arising from foreign currency translation gains and losses on items such as foreign-denominated long-term debt unless an effective hedging program is in place.

This change is required to be applied to all financial statements for fiscal years beginning on or after January 1, 2002, with retroactive restatement of prior periods. This eliminates a major GAAP difference between Canada and the rest of the world. The amendments also add a requirement to disclose exchange gains and losses.

With the release of amendments to *Foreign Currency Translation*, the AcSB simultaneously issued Accounting

Guideline No. 13, *Hedging Relationships*, which establishes new criteria for hedge accounting. The new, more stringent criteria that must be met before hedge accounting can commence include the requirement for the identification, designation and documentation of the hedging relationship and an assessment of the effectiveness of the hedging relationship. The requirements of the Guideline are applicable to all hedging relationships in effect for fiscal years beginning on or after July 1, 2002. Retroactive application is not permitted; the entity assesses all hedging relationships as of the beginning of the first year of application to determine whether the hedging criteria in the Guideline are met. Hedge accounting is discontinued for any hedging relationships that do not meet the requirements of the Guideline. In such circumstances, hedge accounting is not applied to gains, losses, revenues or expenses arising subsequently. Any gains, losses, revenues or expenses previously deferred as a result of applying hedge accounting continue to be carried forward for subsequent recognition in income in the same period as the corresponding gains, losses, revenues or expenses associated with the hedged item.

It is possible, perhaps probable, that most companies' documentation of their existing hedging relationships will not meet these new requirements.

Projects to Develop Guidance

Reporting Financial Performance

In January 2002, the AcSB approved a project proposal on reporting financial performance to provide better and more meaningful information to investors and creditors. The project is to be undertaken in close consultation with the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which have similar projects on their agendas. The primary objective of the

FINANCIAL REPORTING UPDATES

project is to improve the quality of information displayed in annual and interim financial statements so that the public is better able to evaluate a company's performance. This project is especially timely because the proliferation of alternative and inconsistent financial performance measures is viewed as undermining high-quality financial reporting.

The project will deal primarily with the display and presentation of items that are reported, at present, in the income statement. However, it will also consider the display and presentation of items in the cash flow statement, as well as whether certain items that are not presently recognized in the income statement should be recognized in a statement of financial performance. The AcSB intends to issue a document for comment in Canada no earlier than the end of 2002.

Impairment of Long-Lived Assets

In December 2001, the AcSB approved an Exposure Draft (ED) on accounting for the impairment or disposal of long-lived assets. If approved as a *Handbook* Section, the guidance will supersede the current accounting standards for writedown and disposal provisions. The ED is substantially consistent with the U.S. standard on this topic issued in October 2001.

Changes to existing practice under the ED include the determination of impairment for assets held for use under a two-step process; the first step determines when an impairment is recognized using undiscounted cash flows, and the second step measures the amount of the impairment using fair value. In addition, the ED defines discontinued operations as a disposal of a component of an entity, a broader definition than previously used. A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the enterprise. Accordingly, a greater number of disposals will meet the definition of, and require accounting under, the rules relating to discontinued operations.

The proposed standards are expected to be applied for years beginning, or disposals occurring, on or after April 1, 2003.

The ED was issued in the first quarter of 2002 with responses due by May 31, 2002.

Asset Retirement Obligations

In January 2002, the AcSB approved a proposal and work plan for a project to develop a Canadian standard corresponding to the existing U.S. standards on the same topic. The standard will replace the current Canadian guidance on accounting for future removal and site restoration costs and will eliminate a significant Canadian/U.S. GAAP difference created by the issuance of the U.S. standard.

The U.S. standard focuses on the recognition and measurement of liabilities for obligations associated with the retirement of property, plant and equipment when those obligations result from the acquisition, construction, development or normal operation of the assets. It requires the recognition of any statutory, contractual or other legal obligation, normally when incurred. The obligations are measured at fair value and the resulting costs are capitalized into the carrying amount of the related asset. The AcSB expects to publish an ED on this topic in mid-2002 and plans to issue the final standard in 2003.

* * *

In addition, the AcSB has been closely monitoring U.S. developments on guidance relating to the consolidation of special purpose entities and the disclosure of guarantees. In March 2002, the AcSB approved a project to develop Accounting Guidelines addressing these two matters. It expects to approve the draft Accounting Guidelines for public exposure in June 2002 and issue final Guidelines in September 2002. The AcSB will likely issue guidance that is consistent with that of the U.S. The following summarizes the nature and status of the related U.S. projects:

FINANCIAL REPORTING UPDATES

Accounting for Special-Purpose Entities (SPEs)

In February 2002, the FASB began discussion of an exposure draft of an Interpretation of Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, that would address issues related to identifying and accounting for SPEs. The proposed accounting would require the consolidation by the primary beneficiary (a new concept being introduced into the SPE consolidation decision) of an SPE unless the SPE has sufficient independent economic substance. Independent economic substance would require demonstration, among other factors, that the SPE, based solely on its own financial standing and formation documents, can fund or finance its operations without the support of the primary beneficiary, and that the owners of the SPE are independent of the primary beneficiary, bear the risks and rewards of ownership, have substantive residual equity at risk, and make management decisions.

Under the planned Interpretation, if the equity owner is not at risk for the first dollar of loss, the entity does not have sufficient economic substance and, accordingly, the primary beneficiary would be required to consolidate the SPE. The concept of first-dollar loss would be a very significant change from current practice and would result in the consolidation of many existing SPEs, especially SPE lease transactions.

The exposure draft is scheduled for May 2002, with a final Interpretation expected in August 2002. The Interpretation does not apply to those who transfer assets to SPEs that meet the criteria for Qualifying Special Purpose Entities (QSPEs) ordinarily used in financial asset securitizations such as credit card, mortgage loan and auto loan securitizations. A transition period is planned up to December 31, 2002, to bring existing SPEs in compliance with new requirements.

Guarantor's Accounting and Disclosure Requirements for Guarantees

In February 2002, the FASB began discussion of a proposed Interpretation on guarantors' reporting of guarantees. As the issuance of a guarantee imposes on the guarantor certain obligations, the FASB has tentatively decided that at the time a guarantor issues a guarantee, subject to certain conditions, it should recognize a liability at fair value for its obligation to stand ready to perform under the guarantee. In addition, the FASB tentatively decided to require a guarantor to make additional specified disclosures about its guarantees. The FASB expects to issue an ED of the proposed Interpretation by mid-May 2002.

Auditing Developments

We highlight here new standards on auditing that will influence and govern the responsibilities of, and communications between, external auditors and audit committees.

Materiality

In January 2002, the Assurance Standards Board (ASB) issued a revised Auditing Guideline on *Applying Materiality and Audit Risk Concepts in Conducting an Audit*. The revisions, effective on issuance of the Guideline, include new guidance on assessing both qualitative factors that affect materiality and identified misstatements. The Guideline contains substantial new and revised guidance that significantly impacts the external auditor's professional judgment regarding the evaluation of the materiality of financial statement misstatements. It also provides guidance on determining materiality for audits of financial statements with financial reporting periods of more or less than one year.

FINANCIAL REPORTING UPDATES

Audit Committees

In March 2002, the ASB issued a new CICA *Handbook* — Assurance Section, *Communications with Those Having Oversight Responsibility for the Financial Reporting Process*. The new Section updates the guidance in Assurance and Related Services Guideline AuG-11, *Communications with Audit Committees (or Equivalent)*, to reflect recent pronouncements in Canada and internationally by standard setters and other bodies. It expands upon current guidance to emphasize the importance of the external auditor's relationship with those charged with oversight responsibility for the financial reporting process, and aligns the standard more closely with U.S. and international standards. Two of the key features of the new Section are requirements for the auditor to communicate:

- matters that bear on the auditor independence, and confirm in a written communication to the audit committee that, in his or her professional judgment, he or she is objective; and
- the auditor's judgments on the qualitative aspects of accounting principles used in the entity's financial reporting, including items that have a significant effect on the understandability, relevance, reliability and comparability of the financial statements.

The new Section is effective for communications arising from both audit and review engagements relating to financial statements for periods ending on or after December 15, 2002.

The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements

In February 2002, the ASB approved a revised Canadian standard on the external auditor's responsibility to consider fraud and error in an audit of financial statements, revisions that harmonize Canadian standards more closely with the equivalent international and U.S. standards. The changes update and expand on the existing guidance, particularly with respect to the auditor's consideration of fraud risk factors and procedures to be performed in response to such factors. The standards now require auditors to obtain management's assessment of the risk of fraud and the controls in place to prevent and detect fraud and error. In addition, the revised standards clarify the discussion of the inherent limitations of an auditor's ability to detect error and fraud, particularly management fraud. The revised standard is applicable for fiscal periods beginning on or after December 15, 2002.

AUDIT COMMITTEE EVOLVING ISSUES — A SPOTLIGHT ON CORPORATE GOVERNANCE

The importance of a healthy governance culture in promoting strong, viable and competitive corporations cannot be overemphasized. The audit committee is the key group within any company's governance structure in promoting the integrity of published financial information and managing the relationship with the external auditors. What audit committees do, and how they do it, is fundamental to effective governance. In this section, we highlight the recommendations of the Joint Committee on Corporate Governance and discuss Enterprise Risk Management; an emerging tool that audit committees are finding has great value.

Recommendations of the Joint Committee on Corporate Governance

In November 2001, the Joint Committee on Corporate Governance, established by the CICA, the Toronto Stock Exchange and the Canadian Venture Exchange (TSX), released its final report entitled *Beyond Compliance: Building a Governance Culture*. The final report recommends changes to a number of the TSX guidelines for corporate governance, some additional disclosure requirements and an ongoing examination of corporate governance issues. Echoing the view expressed in the 1994 report of the Dey Committee, the Joint Committee recommends that companies be required to disclose their corporate governance practices against revised governance guidelines.

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 proposals of the U.S. Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. In broad terms, the recommendations emphasize the strengthening of audit committees through a focus on audit committee independence and competency,

effective mandates, a renewed focus on the audit committee's relationship with external auditors and consideration of the internal audit function. The recommendations effectively codify some of the leading audit committee practices occurring in the marketplace and help further define the three fundamental responsibilities of audit committees: oversight of the process relating to financial reporting and internal controls, financial reporting, and the internal and external audit process. The final report is an important milestone in shaping corporate governance practices in Canada, and will likely continue the evolution of Canadian audit committees.

For a summary of the Joint Committee's audit committee recommendations, their implications to audit committees, and how these and other leading practices comprise the building blocks to effective audit committees, please see our *Shaping the Canadian Audit Committee Agenda* publication, as described in this issue's *Audit Committee Resources* section. The final report of the Joint Committee is also available at www.jointcomgov.com.

In April 2002, the TSX announced proposed changes to its Guidelines for effective corporate governance. In making these changes, the Toronto Stock Exchange recognized the importance of the Joint Committee's recommendations, particularly in the current environment with its attention to corporate governance arising from the Enron collapse.

The principal changes include adoption of a number of the Joint Committee's recommendations pertaining to the roles and responsibilities of the board of directors in corporate governance, including expanding the role of the board in adopting a strategic planning process and the importance for boards that do not have a non-executive chair of appointing a director who is responsible for managing the board independently of management.

AUDIT COMMITTEE EVOLVING ISSUES — A SPOTLIGHT ON CORPORATE GOVERNANCE

With respect to audit committees, the proposed Guidelines will recommend that all members of the audit committee be “financially literate,” and that at least one member of the audit committee should have accounting or related financial expertise. Practice notes are expected to be added to the Guidelines, which will provide guidance to issuers on specific corporate governance guidelines.

Disclosure of corporate governance practices will now apply to non-corporate TSX issuers, such as trusts and limited partnerships. It is anticipated that the amended Guidelines will apply to TSX issuers commencing with issuers having a year-end on or after December 31, 2002. The changes to the Guidelines have been published for comment for a 30-day comment period ending May 25, 2002, and are available at www.tsx.ca/en/tradingServices/docs/2450Apr26-02_Request_for_Comments.pdf.

Enterprise Risk Management — The Audit Committee Link

There has been a marked increase in the number of CEOs and board members who are giving significant consideration to overall risk management issues, with a heightened awareness generated by recent events. While traditional categories of risk — strategic, financial, operational and reputational — remain unchanged, new risks are proliferating within these categories. How companies view risks and, more importantly, the manner in which they manage those risks, requires a new perspective that centres on the potential impact across the enterprise.

Leaders are seeking to ensure that they are taking both the *right* risks as well as the *right* amount of risk — compared with their own organization’s risk tolerance or “appetite” and benchmarked against others in their markets and industries. Organizations determine their risk appetite and capacity for taking on additional risks in much the same way individual

investors determine their own tolerance for various financial risks. Risk management activities, accordingly, are moving well beyond risk mitigation (using controls to manage exposure to problems) toward risk optimization (determining the organization’s risk portfolio, seizing opportunities within defined parameters, and capitalizing on the rewards that result).

In this context, enterprise risk management (ERM) has emerged as an important new business trend. ERM is a structured and disciplined approach aligning strategy, processes, people, technology, and knowledge with the purpose of evaluating and managing the uncertainties an enterprise faces as it creates value. ERM is a top-down approach, integrated and future-focused, that draws on the organization’s strategy to find new ways to manage and optimize the risks of highest importance to the board and management.

Most organizations are initially uncertain about exactly how to translate the concept of ERM into concrete action steps that will help them create a more risk-aware culture to drive business behaviour. ***Of particular concern to audit committees is the question of how ERM fits into their oversight responsibilities and how such a tool can be used to assist in matters important to their mandates.***

The audit committee or the board as a whole should have the responsibility of reviewing and obtaining reasonable assurance that the organization has developed and established an Enterprise Risk Management framework to measure and manage all aspects of risk, including financial and operational. Such a framework:

- Provides a consistent means of identifying risks, resulting in a better ability to protect and enhance the organization in fulfilling its vision and objectives;
- Provides a common business risk language, helping to overcome varying risk perceptions across the organization;

AUDIT COMMITTEE EVOLVING ISSUES — A SPOTLIGHT ON CORPORATE GOVERNANCE

- Contributes to building a greater degree of focus to risk considerations in decision-making;
- Lays the groundwork for capturing and analyzing internal and external risk data; and
- Leverages improved understanding of risks to exploit opportunities and reduce uncertainty through mitigation planning, control and monitoring processes.

The framework should be designed to provide a more comprehensive approach to integrating risk management into the overall strategic management process. In particular, it should provide guidance on the use of systematic approaches to risk management, to help to build a risk-aware workforce and to establish a set of common risk management processes that can be adopted throughout the organization.

Audit committees must then understand the interrelationship of overall risk management and the reporting of financial results. The process related to the identification and management of the company's risks, as a part of the company's overall control environment, influences the identification and management of financial risks that can impact the company's financial reporting — a matter of critical importance to the audit committee. A thorough understanding of business risks support a full understanding of financial reporting risks; in fact, that is why external auditors spend, or should be spending, time understanding the business and its risks and how they are managed.

While management is responsible for designing and implementing an effective system of internal control, the audit committee must determine that management has implemented practices 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. By understanding the principles surrounding ERM, and by applying them to the audit committee "universe," audit committees can ask meaningful questions that can drive previously unseen improvements in internal controls. In fact, these new models seek to translate the risk assessment into specific action steps that drive behaviour of the organization.

Arguably, one of the most important components of ERM is the risk strategy. Audit committee involvement in the development of the risk strategy relating to financial reporting is critical — involvement can help set the tone for risk management activities, dictate how measuring and monitoring can be carried out and provide the bird's-eye view of risk needed by management and the board. The risk strategy should be executed by a risk structure, which many organizations are using to embed ERM into the entity. These structures encompass the roles and responsibilities for managing risk, overall and on a risk-specific basis, and they help define accountability for that risk management process.

Audit committees need not wait for ERM to be adopted and implemented by other business leaders of the organization — in fact, audit committees can act as the catalyst for such risk management initiatives. While such initiatives ideally are deployed through under a comprehensive, enterprise-wide risk management program, audit committees need to communicate how a risk management program can influence the effective discharge of their responsibilities — responsibilities that are interdependent with the responsibilities and mandate of those charged with overall corporate governance.

AUDIT COMMITTEE RESOURCES

KPMG is committed to assisting audit committee members in fulfilling their responsibilities by communicating accounting and regulatory changes and by sharing audit committee leading practices.

In each issue of *Audit Committee UPDATE*, we feature recent publications and other valuable resources pertaining to audit committees. The following resources may be of particular interest:

KPMG's Shaping the Canadian Audit Committee Agenda

KPMG's *Shaping the Canadian Audit Committee Agenda* is designed to assist audit committees in examining what they are doing and how they are doing it, with a view to becoming more effective in discharging their responsibilities. In this publication, we share leading audit committee practices that can help audit committees identify and react to current and future economic events, as well as accounting and regulatory changes.

Shaping the Canadian Audit Committee Agenda identifies and describes the fundamental building blocks of effective audit committees: an appropriate structure and foundation, reasonable and well-defined mandate and responsibilities, and an effective agenda. The publication's appendices include an Audit Committee Toolkit, comprising an example Audit Committee Mandate and Audit Committee Agendas. As a backdrop, *Shaping the Canadian Audit Committee Agenda* also summarizes the recently issued recommendations of the Joint Committee on Corporate Governance pertaining to audit committees, which will likely continue the evolution of Canadian audit committees.

As audit committees continually strive to improve their effectiveness, we believe they can benefit by comparing their own practices against those described in this publication.

For an electronic copy of the publication, please visit the Audit Committee Institute web site at www.us.kpmg.com/auditcommittee.

KPMG's Audit Committee Quarterly

Focusing primarily on developments in the U.S., *Audit Committee Quarterly* provides a summary of some of the key issues that audit committee members should consider when establishing their next meeting's agenda. In addition to U.S. financial reporting updates and discussion of numerous current issues and resources pertinent to audit committees, *Audit Committee Quarterly* also provides some of the survey results from the Audit Committee Institute's semi-annual Audit Committee Roundtable series, providing insights into perceptions of today's leading audit committee members, directors and senior officers into matters affecting audit committees.

For an electronic copy of the publication, please visit the Audit Committee Institute web site at www.us.kpmg.com/auditcommittee.

KPMG's Focus on Financial Reporting

Focus on Financial Reporting is published annually by KPMG and provides an overview of recent financial reporting developments in Canada, the U.S. and internationally. Our most recent addition, published in September 2001, reflects accounting pronouncements released prior to September 2001 and those anticipated to be finalized by December 31, 2001.

For an electronic copy of *Focus on Financial Reporting*, please visit our web site at www.kpmg.ca.

KPMG's Audit Committee Institute — A Resource for Audit Committee Members

Developed by KPMG, the Audit Committee Institute (ACI) was created to serve and educate committee members. Wholly sponsored by KPMG, the Institute provides complimentary guidance and increases awareness for corporate audit committee members who need to keep up with their evolving responsibilities. The Audit Committee Institute web site at www.us.kpmg.com/auditcommittee contains in-depth coverage of many topics pertaining to audit committees, including current and past issues of *Audit Committee Quarterly* and *Audit Committee UPDATE*, published articles from the ACI, regulatory and technical content, audit committee "hot topics" and additional resources.

KPMG's Audit Committee Roundtables

The Audit Committee Institute, in conjunction with local KPMG member firm offices, facilitates roundtable sessions designed to provide a forum for the exchange of views and insights on topics of interest to members of audit committees. Audit Committee Roundtables have been a feature of KPMG' Audit Committee Institute in the United States for several years. Feedback from audit committee members attending these roundtables has been consistently positive and enthusiastic – many participants say these are the best forums they have attended to help them do their jobs more effectively.

In 2002, KPMG's roundtable sessions are planned to be held in Toronto, Montreal, Calgary and Vancouver. With the theme *Audit Committee Effectiveness in the Current Environment*, they will explore the issues currently facing audit committee members. For more information on these roundtable sessions, please contact your local KPMG office.

* * *

All of KPMG's publications are also available in hardcopy. If you or someone you know would be interested in obtaining copies, please contact the KPMG office near you.

ABOUT KPMG

KPMG is the global professional services organization whose aim is to turn understanding of information, industries and business trends into value. With more than 100,000 people worldwide, KPMG member firms provide assurance, tax and financial advisory services from more than 750 cities in 152 countries. KPMG's Canadian web site is www.kpmg.ca

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/auditcommittee.

If you want to learn more, need assistance or have any questions, please contact the managing partner at one of the KPMG offices listed below.

KPMG OFFICES ACROSS CANADA

National Office (416) 777-8500	Kamloops (250) 372-5581	New Westminster (604) 527-3600	Saint John (506) 634-1000	Vancouver (604) 691-3000
Abbotsford (604) 854-2200	Kelowna (250) 763-5522	North Bay (705) 472-5110	Saskatoon (306) 934-6200	Vaughan (416) 366-KPMG
Calgary (403) 691-8000	Kingston (613) 549-1550	Ottawa (613) 560-0011	Sault Ste. Marie (705) 949-5811	Vernon (250) 503-5300
Chatham (519) 352-0550	La Sarre (819) 333-2392	Penticton (250) 492-8444	Sudbury (705) 675-8500	Victoria (250) 480-3500
Chilliwack (604) 793-4700	Lethbridge (403) 380-5700	Prince George (250) 563-7151	Sydney (902) 539-3900	Waterloo (519) 747-8800
Edmonton (780) 429-7300	London (519) 672-4880	Québec City (418) 681-5764	Toronto (416) 366-KPMG	Windsor (519) 251-3500
Fredericton (506) 452-8000	Mississauga (416) 366-KPMG	Regina (306) 791-1200	Toronto- North York (416) 366-KPMG	Winnipeg (204) 957-1770
Halifax (902) 492-6000	Moncton (506) 856-4400	Rouyn-Noranda (819) 762-6521	Val d'Or (819) 825-4101	
Hamilton (905) 523-8200	Montréal (514) 840-2100	St. Catharines (905) 685-4811		

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

