

Enhancing Audit Quality: Canadian Perspectives



December 20, 2012

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Nova Scotia Securities Commission
New Brunswick Securities Commission
Prince Edward Island Securities Office
Office of the Superintendent of Securities, Government of Newfoundland and Labrador
Department of Community Services, Government of Yukon
Office of the Superintendent of Securities, Government of the Northwest Territories
Legal Registries Division, Department of Justice, Government of Nunavut

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Dear Ms. D'Aoust and Ms. Beaudoin:

**RE: CSA NOTICE OF REPUBLICATION AND REQUEST FOR
COMMENT REGARDING PROPOSED NATIONAL INSTRUMENT 51-103 ONGOING
GOVERNANCE AND DISCLOSURE REQUIREMENTS FOR VENTURE ISSUERS**

The signatories to this letter are experienced corporate directors who are actively involved in *Enhancing Audit Quality: Canadian Perspectives (EAQ)*; a consultation process being led by the Canadian Public Accountability Board (CPAB) and the Canadian Institute of Chartered Accountants (CICA) to gain stakeholder input on key issues emerging with respect to enhancing audit quality globally, and in Canada.

We are writing to express our concerns about the proposals put forward in NI 51-103 that would reduce the responsibilities of audit committees in Venture issuers and weaken their effectiveness.

The Enhancing Audit Quality Initiative

We suggest that any attempt to weaken the responsibilities of audit committees needs to be assessed in the context of other international audit reform proposals currently being put forward and debated. In the wake of the global financial crisis, various recommendations on enhancing audit quality have been put forward in the European Commission, the United Kingdom, the United States and other countries. These proposals are far reaching and range from mandating public companies to change their audit firm every six years, to mandatory tendering and audit only firms.

The EAQ working groups (Steering Committee chaired by David Brown, C.M, Q.C.; Independence Working Group chaired by Peter Mills, Q.C., ICD.D; Audit Committee Working Group chaired by Tom O'Neill, FCA) have studied these proposals and agree that while they might improve auditor independence to varying degrees, they are not likely to strengthen either audit quality or the governance of financial reporting. The EAQ working groups also think the disruption in the audit services marketplace these proposals would create, together with the increased costs that would be imposed on reporting issuers, would be disproportionate to the significance of the problem they are trying to fix and the benefits these international proposals hope to achieve.

The EAQ working groups are suggesting instead that the focus in Canada should be to continue to strengthen the governance of financial reporting in Canadian reporting issuers by providing more guidance to audit committees to help them discharge their existing responsibilities, and to implement a periodic comprehensive review of the external auditor's relationship with the issuer.

The EAQ's working group reports are currently being circulated to the public for comment and can be found at: <http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item64401.aspx>

Our Comments on National Instrument 51-103

The EAQ working groups believe that effective governance of an issuer's financial reporting is of critical importance to the reputation of our capital markets and is dependent on the responsibilities of three parties: management; the external auditor; and the audit committee. NI 52-110 sets forth the responsibilities of the audit committee for all reporting issuers in Canada and makes it clear that the audit committee is responsible for managing the relationship of the external auditor with the issuer, and for overseeing the work of the external auditor in conducting their auditing engagements. This requirement was introduced in 2003/2004 to ensure that the auditors would be accountable to a body independent of management. The cost of an external audit can only be justified if it is truly an independent review of management's work product.

The EAQ working groups are concerned that the proposals being put forward in NI 51-103 water down the responsibilities of the Audit Committee as set forth in NI 52-110, and in so doing impair the effectiveness of the audit committee in Venture Issuers - at a time when the focus should be on enhancing the effectiveness of the audit committee. Reducing this independent oversight will only serve to re-establish the authority of management over the external audit. Adopting new regulations that explicitly weaken the audit committee's oversight of the external auditor in an important segment of our capital markets will damage Canada's credibility internationally, and make it more difficult for Canada to influence how these international proposals are finalized.

Attached in Appendix 1 is a comparison of the current requirements of NI 52-110 with the proposals put forward in NI 51-103, together with some detailed comments on these proposed changes. We direct the CSA's attention to the following five major conclusions that arise from this analysis.

Our Conclusions

1. NI 51-103 proposes to delete the requirement for the audit committee to pre-approve non-audit services and the requirement for the audit committee to recommend the compensation of the external auditor. Both of these changes are significant reductions in the responsibilities of the audit committee in their own right, but in combination, they seriously weaken the independence of the external auditors for Venture Issuers. Management will thus be left with control over the amount of work the audit firm provides plus the remuneration it receives for both the audit and the often lucrative non-audit services.

NI 51-103 returns the oversight role for the external auditors to management which is precisely what NI 52-110 was trying to correct, as evidenced in the following quote from the Companion Policy to NI 52-110.

“The Instrument requires that the audit committee also be responsible for managing, on behalf of the shareholders, the relationship between the issuer and the external auditors. In particular, it provides that an audit committee must have responsibility for:

- (a) overseeing the work of the external auditors engaged for the purpose of preparing or issuing an auditor’s report or related work; and*
- (b) recommending to the board of directors the nomination and compensation of the external auditors.”*

“Although under corporate law an issuer’s external auditors are responsible to the shareholders, in practice, shareholders have often been too dispersed to effectively exercise meaningful oversight of the external auditors. As a result, management has typically assumed this oversight role. However, the auditing process may be compromised if the external auditors view their main responsibility as serving management rather than the shareholders. By assigning these responsibilities to an independent audit committee, the Instrument ensures that the external audit will be conducted independently of the issuer’s management.”

The changes proposed in NI 51-103 undo and impair the fundamental concept underlying NI 52-110, that the audit committee is the de facto client of the external auditor. NI 52-110 made it clear that while the external auditor has a responsibility to report to the shareholders, the auditor should be accountable to the audit committee - not management. NI 51-103 will diminish the auditor's independence and thus lessen the value of the external audit. It is not clear to us why the CSA wants to reverse such an important and fundamental principle. There are no cost savings to be had from these changes, so why are they being proposed?

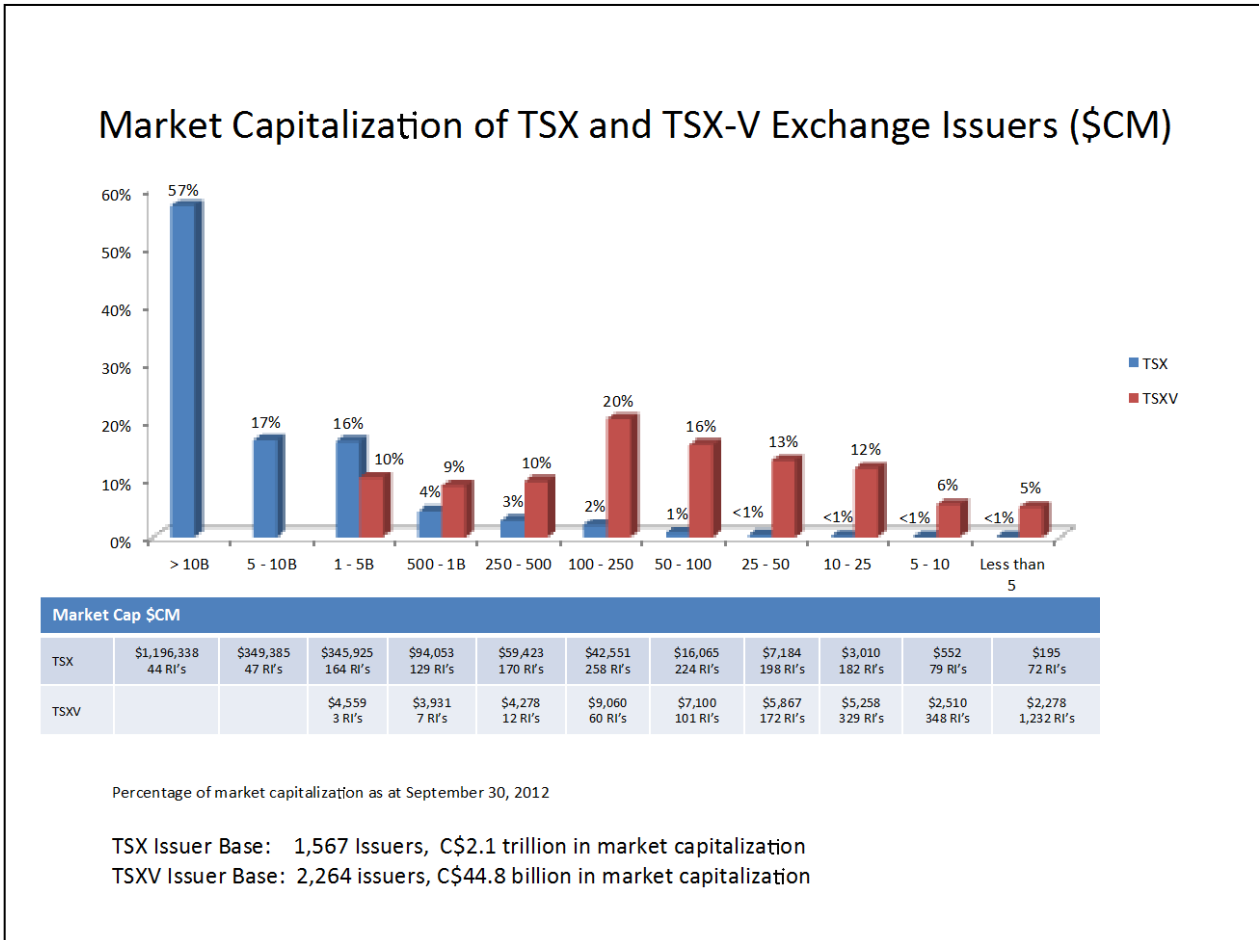
2. The change in overseeing the audit work performed by the external auditor to overseeing the services performed by the external auditor suggest the CSA wants to change the focus of the audit committee from overseeing the audit work performed by the external auditor to overseeing the performance of all services provided by the external auditor. This proposed change moves the oversight to a higher, less involved level, and shifts the focus of the audit committee oversight to the quality of service not the quality of the audit. There is a real danger that quality of service would then be

measured by service criteria like responsiveness, availability of audit staff etc., not the rigour of the audit – a situation that NI 52-110 was trying to prevent.

3. NI 52-110 is very clear that the responsibilities of the audit committee for overseeing the work of the external auditor are limited to engagements where the purpose is preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer. We are not convinced that there is merit in extending the oversight responsibilities of the audit committee for non-audit services beyond approving all non-audit services or is worth the time and effort involved. We point out, that the EAQ Audit Committee Working Group is proposing guidance for audit committees covering both large and small cap issuers to help them discharge this oversight responsibility. As a result, we believe that the current wording in section 2.3 (3) of NI 52-110 should not be changed.
4. While the introduction of independence standards for audit committees is, on the surface, a step forward, the proposals put forward in NI 51-103 still lag behind the requirements of NI 52-110, and only bring NI 51-103 in line with the independence requirements that already exist in the CBCA, the OBCA, and the TSX-V listing requirements.
5. Writing securities regulations in plain English and simplifying our disclosure requirements is a very worthwhile objective. However, having two sets of disclosure standards and responsibilities for audit committees of reporting issuers will, in our view, create confusion for both directors and investors, and increase the potential for regulatory arbitrage. Corporate directors can sit on the boards of both TSX and Venture issuers. Investors invest in both TSX and Venture Issuers. The governance of financial reporting and the responsibilities of audit committees should be consistent across all reporting issuers in Canada.

In summary, the EAQ working groups believe strongly that there should be only one single statement of responsibilities for audit committees of reporting issuers in Canada. If changes are needed to NI 52-110, then changes should be proposed, commented on, voted on by the CSA and NI 52-110 should be changed. There should not be competing sets of responsibilities that force directors, investors and litigants to make their own interpretations of what is meant by the use of different words or different requirements.

Finally, we point out that the assumption that all Venture issuers are small, simple organizations may not be valid. The following chart was developed from data collected by the Canadian Public Accountability Board and presented at the CPAB Audit Quality Symposium held on November 30th 2012.



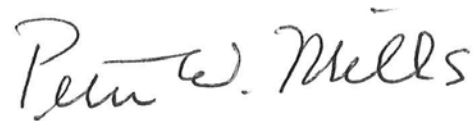
This data suggests that there is an overlap in size of issuer between the TSX and TSX Venture exchanges and that there are a number of companies listed on the TSX-Venture Exchange that are companies of size and substance - which creates the potential that all the CSA proposals in NI 51-103, not just the audit committee proposals, will encourage regulatory arbitrage, which would not be in the best interests of our capital markets.

We would be pleased to respond to provide additional information or explanations on any of the matters raised in this letter or respond to any questions that you might have.

Yours truly,

A handwritten signature in black ink, appearing to read 'DAB' followed by a long, sweeping horizontal stroke.

David A. Brown, EAQ Steering Group, Chair

A handwritten signature in black ink, clearly legible as 'Peter W. Mills'.

Peter Mills, EAQ Auditor Independence Working Group, Chair

A handwritten signature in black ink, clearly legible as 'Tom C. O'Neill'.

Tom O'Neill, EAQ Audit Committee Working Group, Chair

Comparison of Audit Committee Responsibilities

NI 52-110	NI 51-103	Comments
<p>2.3 (2) An audit committee must recommend to the board of directors:</p> <p>a) the external auditor to be nominated for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer; and</p> <p>b) the compensation of the external auditor.</p>	<p>"The audit committee of a venture issuer must do all of the following:</p> <p>a) make a recommendation to the board of directors for the appointment of an auditor;</p>	<ul style="list-style-type: none"> • NI Reference to "the external auditor" in NI 52-110 has been changed to just "an auditor" in NI 51-103 • 51-103 deletes the requirements of the audit committee to recommend the compensation of the external auditor. • See Conclusion 1 in our letter
<p>(4) An audit committee must pre-approve all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor.</p>	<p>(i) be informed of all the services provided by the auditor which are beyond the scope of the venture issuer's audit and the amount of fees charged for those services relative to the fees charged for the audit of the venture issuer's annual financial statements;</p>	<ul style="list-style-type: none"> • Requirement for pre-approval of non-audit services has been dropped in NI 51-103. The AC now just has to be informed. • NI 52-110 does not have a discussion of non-audit fees to audit fees. If this is needed then it should be included in 52-110. • See Conclusions 1 and 3 in our letter
<p>(3) An audit committee must be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, including the resolution of disagreements between management and the external auditor regarding financial reporting.</p>	<p>(b) oversee the performance of services provided to the venture issuer by the auditor and the auditor's interaction with the venture issuer's management, including by doing all of the following:</p> <p>(ii) meet annually with the auditors, independent of the executive officers of the venture issuer, before the board of directors' review and approval of the annual</p>	<ul style="list-style-type: none"> • The responsibility in NI 52-110 for overseeing the work of the external auditor in performing audit work has been changed in NI 51-103 to overseeing the performance of services provided to the venture issuer by the auditor. • See Conclusion 2 in our letter • NI 52-110 does not set forth any requirements for meetings with the external auditors. If this is needed then it should be included in 52-110.

	<p>financial statements, to determine whether there have been any disagreements or contentious issues between the auditor and the venture issuer's executive officers relating to the venture issuer's disclosure and whether those issues have been resolved to the satisfaction of the auditor;</p> <p>(iii) meet with the auditor at such other times as reasonably necessary;</p>	
<p>(8) An audit committee must review and approve the issuer's hiring policies regarding partners, employees and former partners and employees of the present and former external auditor of the issuer.</p>	<p>(iv) review and approve the hiring policies regarding employees and consultants that are currently, or were previously, employed by or partners of the venture issuer's auditor or predecessor auditor;"</p>	<ul style="list-style-type: none"> • Not sure what is meant in NI 51-103 by the reference to "employees and consultants"? Are these consultants to the audit firm that are not employees or are they consultants to the issuer, or both?
<p>3.1 Composition –</p> <p>(1) An audit committee must be composed of a minimum of three members.</p> <p>(2) Every audit committee member must be a director of the issuer.</p> <p>(3) Subject to sections 3.2, 3.3, 3.4, 3.5 and 3.6, every audit committee member must be independent.</p> <p>(4) Subject to sections 3.5 and 3.8, every audit committee member must be financially literate.</p>	<p>5.(1) The board of directors of a venture issuer must appoint an audit committee composed of at least 3 directors, a majority of whom are not executive officers, employees or control persons of the venture issuer or an affiliate of the venture issuer.</p>	<ul style="list-style-type: none"> • NI 52-110 requires all members of the audit committee to be independent which is required by the CBCA, the OBCA and the TSX-V Listing requirements. • NI 52-110 contains a more explicit definition of independence requirements (no direct or indirect material relationship with the issuer) and various bright line tests. • See Conclusion 4 in our letter • NI 51-103 does not contain any financial literacy requirements. Given the increasing complexity of financial reporting we believe that the governance of venture issuer audit committees would be strengthened by introducing a new requirement in 52-110 for at least one member of a venture issuer's audit committee to be financially literate.