September 10, 2003

John Stevenson, Secretary,
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8
By E-mail: jstevenson@osc.gov.on.ca

Object: Comments on the Proposed Multilateral Instrument 52-110 – Audit Committees

Sir,

I studied the Proposed Multilateral Instrument 52-110 on the audit committee as well as the cost-benefit analysis prepared by the Office of the Chief Economist of the Ontario Securities Commission.

Attached are my comments on the on the Proposed Multilateral Instrument 52-110 – Audit Committees. These comments are based on my professional experience as a chair of an audit committee of a non private organisation, my teaching activities, and my research activities on the audit committees in Canada and the United States.

If you need more information or explanation, please do not hesitate to contact me.

Sincerely yours,

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Introduction

My comments are based on the results from two research projects on audit committee in which I have been involved over the last years. Both project's data are prior to the recent wave of corporate scandals. In the first project, we use three groups of 100 US firms for the year 1996 (one with positive aggressive earnings management, one with negative aggressive earnings management, and one with low levels of earnings management) to study the relationship between, on the one hand, the audit committee's expertise (financial, governance and firm-specific expertise), independence, and activities and, on the other hand, aggressive earnings management. This project was performed with Lucie Courteau and Sonda Marrakchi Chtourou. We report the results from this project in the following publication:

> Bédard, J., S. Marrakchi-Chtourou et L. Courteau. The Effect of Audit Committee Expertise, Independence, and Activity on Aggressive Earnings Management. Working paper, Université Laval (2003). (A previous version of this paper is available on the SSRN).

The second project is a field study in three large Canadian public corporations listed on the Toronto Stock Exchange. In each corporation we interviewed the following persons: CEO, CFO, chief internal auditor, partner in charge of the external audit engagement, chairperson of the audit committee and two audit committee members. We asked them questions about the process of audit committee meeting, the role of their corporation's audit committee, and the extent to which the committee fulfills its role. This project was performed with Yves Gendron and Maurice Gosselin. We report the results from this project in the following publications:

> Gendron, Y., J. Bédard., and M. Gosselin. Getting Inside the Black Box: A Field Study of Practices in Canadian Audit Committees. *Auditing: A Journal of Practice and Theory (*Forthcoming, March 2004)
>
> Gendron, Y. and J. Bédard. Making a Difference: The Construction of Audit Committee Effectiveness within Public Corporations. Working paper, University of Alberta (2003).

Comments on Proposed Multilateral Instrument 52-110 Audit Committees

Financial expertise

The Proposed Instrument does not require that every audit committee has a financial expert but require that the participation of a financial expert on the audit committee be disclosed and that if the audit committee does not have an audit committee financial expert, that fact must be disclosed and explained. The main reason for this is that "certain issuers may find it difficult to appoint audit committee financial experts to their audit committees".

The results from our study on 300 US firms of different sizes (median asset = $51 millions) suggest that the presence of at least one member with financial expertise is associated with a lower likelihood of aggressive earnings management. Thus, we find that having a financial expert on the audit committee reduces the probability of being in the positive (negative) aggressive earnings management group by 58% (31%). Also, our interviews with actors involved with audit committee of three large Canadian public corporations also indicates that members' profile of expertise plays a role in the perceived effectiveness of the audit committee. It also suggest that financial expertise allows members to ask challenging questions during meetings and generate feelings of self-confidence into AC members' mind, thereby possibly affecting their performance during meetings.

In conclusion, our results indicate that financial expertise is important for both small and large companies. Also, this effect is stronger than having a committee composed solely of independent directors. Consequently, I would suggest that the Proposed Instrument requires that every audit committee has a financial expert.

Responsibility of the Audit Committee

In our study of 300 US firms we find that the responsibility of overseeing both the financial reporting and the audit processes significantly decrease the likelihood of aggressive earnings management. Thus, we find that having these responsibilities reduces the probability of being in the positive (negative) aggressive earnings management group by 25% (18%).

Our results support the requirements of Part 2 of the instrument regarding the audit committee responsibilities.

Independence of the audit committee

Regarding the independence of the audit committee, in our study of 300 US firms we find that having a committee where every audit committee member is independent significantly reduces the probability of being in the aggressive earnings management groups by 15% We also examined the effect of having a majority of independent member and found no significant effect, suggesting that 100% independence may be the critical threshold for efficient monitoring.

These results support the requirement of Part 3 of the instrument to the effect that every audit committee member must be independent

Size of the audit committee

In our study of 300 US firms we also examined the effect of having an audit committee composed of a minimum of three members on the probability of a firm being in the positive or negative aggressive earnings management group. We find that the effect is not statistically significant from zero, suggesting that having a minimum of three members does not improve the effectiveness of the audit committee.

Our results do not support the requirement of Part 3 of the instrument that the audit committee be composed of a minimum of three members. As for the number of directors, the number of audit committee members depends among other on the size of the firm. Given these results, it seems that this requirement could be modified to take into account the size of the firm. For example, in the UK, a minimum of two members is required for non FTSE 350 and of three members for FTSE 350. Given the small size of the firms in Canada, a similar requirement could be made using the TSE 100 or 300 as a threshold.

Summary

Requirement	Supported by our research results	Suggestion
Expertise – Part 5 and Form 52-110F1 – does not require that every audit committee have an audit committee financial expert.	NO	Every audit committee should be required to have an audit committee financial expert.
Responsibilities – 2.3 Audit Committee Responsibilities	YES	
Independence – 3.1(3) – every audit committee member must be independent.	YES	
Size – 3.1(1) – An audit committee must be composed of a minimum of three members.	NO	Have a different requirement for small and large issuers (e.g. minimum of two members for small issuers and three for larger one)