

September 23, 2003

Mr. John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 1900, Box 55  
Toronto, Ontario  
M5H 3S8

Denise Brosseau, Secretary  
Commission des valeurs mobilières du Québec  
Stock Exchange Tower  
800 Victoria Square  
P.O. Box 246, 22nd Floor  
Montréal, Québec  
H4Z 1G3

Dear Mr. Stevenson and Ms Brosseau:

On behalf of The Canadian Institute of Chartered Accountants (CICA), I am writing in response to the proposed investor confidence rules issued on June 27, 2003 by securities regulators in Canada. We applaud the initiative and are generally supportive of the proposed new rules.

The CICA recognizes the vital importance of confidence in Canada's capital markets and has undertaken a number of initiatives over the past year that are aimed at bolstering investor confidence. We were pleased to take an active role together with regulators and government in the creation last year of the Canadian Public Accountability Board (CPAB). A description of other equally important initiatives we have carried out are outlined in Appendix A. Several of these are directly related to and support the thrust of the regulators' proposals and underlying objectives discussed in our response.

Our comments focus on the proposals related to auditor oversight, certification of annual and interim filings and audit committees. Our detailed comments are provided in the attachment to this letter. The primary thrust of our response addresses the need for clear implementation guidance to assist CEOs and CFOs in carrying out the certification process. Equally important, we note the need for clear and formal definitions of key

**The Canadian Institute  
of Chartered Accountants**  
277 Wellington Street West  
Toronto, Ontario  
Canada M5V 3H2  
Tel.: (416) 204-3225  
Fax: (416) 204-3405

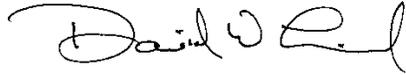
**L'Institut Canadien  
des Comptables Agréés**  
277, rue Wellington Ouest  
Toronto (Ontario)  
Canada M5V 3H2  
Tél.: (416) 204-3225  
Fax: (416) 204-3405

**David W. Smith, FCA**  
President & CEO  
Direct Line: (416) 204-3457  
Fax: (416) 204-3405  
david.smith@cica.ca

terms and concepts such as financial condition, material fact, presents fairly, internal control and disclosure controls.

We appreciate the opportunity to respond to the draft proposals on investor confidence and would be pleased to discuss further any of the issues contained in our response.

Yours truly,

A handwritten signature in black ink, appearing to read "David W. Smith". The signature is written in a cursive style with a large, stylized initial "D".

David W. Smith, FCA  
President and CEO

Ref:DWS015/amq

## ATTACHMENT

### CICA RESPONSE TO INVESTOR CONFIDENCE PROPOSALS

Our comments focus on the three areas covered by the proposed investor confidence rules -- auditor oversight, CEO/CFO certification, and audit committees.

#### **1. Auditor Oversight (proposed Multilateral Instrument 52-108)**

As already indicated, Canada's chartered accountants take the erosion of investor confidence very seriously and as a profession we have moved quickly to respond to the legitimate concerns that exist. Together with federal and provincial regulators, we were pleased to participate in the July 2002 announcement of the creation of the Canadian Public Accountability Board (CPAB) to provide new independent public oversight for auditors of public companies in Canada. We believe that the set of requirements outlined in Proposed Instrument 52-108 will contribute significantly to the integrity of financial reporting by promoting high quality, independent auditing and we encourage their adoption as soon as possible.

#### **2. Certification of Disclosure in Companies' Annual and Interim Filings (proposed Multilateral Instrument 52-109, proposed Companion Policy 52-109CP and proposed Forms 52-109F1 and 52-109F2)**

The comments which follow focus on the need for implementation guidance on the new CEO/CFO certification of disclosure role as well as clarification of the meaning of key terms such as "financial condition" and "fair presentation".

##### **A. Need for Implementation Guidance on CEO/CFO Certification**

The proposed rules regarding certification of annual and interim filings will place new, increased demands on CEOs and CFOs. Beginning January 2004 they will be held accountable to certify that "based on their knowledge" there are no misrepresentations in filing documents and that those filings fairly present the financial condition of the company.

Then, beginning January 2005, CEOs and CFOs will be further required to provide a more complete certification, which will require them to implement, maintain and annually evaluate the effectiveness of their internal controls and disclosure controls and procedures. However the proposed rules do not provide clear guidance on significant areas including:

- a definition of "financial condition"
- a definition of "presents fairly"
- a definition of internal control
- a definition of disclosure controls and procedures

- a suitable framework(s) for assessing internal control
- definitions of “significant deficiency” and “material weakness”
- a certification process, or a process to design, assess, implement or evaluate the effectiveness of internal controls and disclosure controls and procedures.

These matters are discussed further below.

In many cases, the interpretation of the proposed rules is left to the interpretation of the issuer. In the absence of implementation guidance, including definitions of key terms, there will likely be little consistency and comparability among issuers.

Issuers are not required to file a complete certificate in which they have implemented and evaluated the effectiveness of internal controls and disclosure controls and procedures until January 1, 2005. However, we believe it is clearly advantageous to issuers to begin the process for designing and putting control procedures in place, and documenting and testing their systems of internal control immediately to be able to ensure the accuracy of the information they are certifying.

The CICA is planning to develop guidance to assist CEOs and CFOs to carry out the certification process. We believe that such guidance is necessary to the work effort required to certify the financial condition of the company and to design, assess and evaluate internal control over financial reporting and disclosure controls and procedures. We believe that such guidance can and should be harmonized with the US attestation/audit standards, in which key terms and guidance on procedures/extent of work is already provided.

The CICA has previously issued a framework (the Criteria of Control — CoCo — framework) from which elements can be used as the basis for assessing internal control over financial reporting. The CICA also has a task force of CFOs in place that will provide valuable direction for the creation of guidance materials. However, we believe securities regulators must provide clear definitions of “financial condition,” “material fact,” “fairly presents,” “internal control” and “disclosure controls and procedures”. Without unambiguous clarification as to the intent of these terms, it will be difficult to provide truly useful and valuable guidance.

Such guidance on CEO/CFO certification must go beyond helping CEOs and CFOs comply with the proposed rules. It is important that the focus be on helping issuers view the certification process as a valuable activity that will enhance a company's ability to provide accurate and useful information to investors.

## **B. Management's Certification Regarding Controls**

We note that although the Proposed Instrument does not require auditor attestation to, and reporting on, management's assessments of internal controls as envisaged by the Sarbanes-Oxley Act, Canadian regulators are studying the rules recently adopted by the SEC in this regard. We put forward the following comments in this light.

### ***B.1 General Comment***

The certification regime outlined in the Proposed Instrument is a new development in Canada. In the US a similar reporting regime has been in place for some years in respect of financial institutions under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requirements. Thus, there is some degree of understanding, practice and guidance about key terms, work effort and reports. Notwithstanding the established practice and terminology in the US, the final SEC Rule, "Management's Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports", contains useful and necessary discussion and guidance on how the final rules will be applied, and about the SEC's rationale in developing the final rules. Therefore, it is particularly important in Canada that sufficient guidance be provided to those who will be charged with implementing the final rules.

#### *Content of filings to be certified*

The Proposed Instrument defines "annual filings" (i.e. the disclosures to be certified) as including the annual Management Discussion & Analysis (MD&A) and the Annual Information Form (AIF) as well as the annual financial statements. The AIF and the MD&A are defined in 52-109 by reference to what is called for in NI 51-102. The CPR Board's August 15, 2003 comments to the Canadian Securities Administrators (copy attached) regarding proposed NI 51-102 Continuous Disclosure Obligations indicate the need for greater clarity as to the purpose of the AIF as distinct from that of the MD&A and accordingly what information should be provided in each. Clarity is needed as to the expected content of the AIF and MD&A, aligned appropriately with the intended purposes of these documents, so that there is clarity as to the nature and scope of the information to be covered under Parts 2 and 3 of MI 52-109 and the related forms 52-109F1 and F2 (the latter covers the interim MD&A and financial statements, not the AIF).

Further, the AIF is not required to be distributed to shareholders and is not required to be prepared and filed by venture (typically smaller) issuers as defined under NI 51-102. If, as seems to be the case, the certifications in paragraphs 2 and 3 of Form 52-109F1 regard the AIF as being necessary in order for disclosures not to be misleading and to present fairly, how would CEOs and CFOs of venture issuers be able to provide the required certifications of filings that do not include the AIF? Also, there are, under NI 51-102, circumstances where the AIF would include information about executive compensation that other issuers would provide in their information circular. Again, this seems to present a possible inconsistency in what information would be covered by the certifications.

## ***B.2 Internal Control and Disclosure Controls and Procedures – Definitions***

### *Background*

The Proposed Instrument requires a CEO and CFO to certify that their company has adequate internal and disclosure controls and procedures. As already noted, it does not, however, contain definitions of these critical terms. We believe that the Proposed Instrument needs to provide a clear definition and scope for the terms “internal control” and “disclosure controls and procedures” in order to ensure consistency and comparability among the certifications.

US securities legislation has for a number of years contained a definition of internal control over financial reporting. Thus, US issuers and their auditors are more likely to be familiar with this term. Nevertheless, the final SEC Rule contains a detailed definition of the term as well as the SEC’s rationale for using the definition to assist issuers and their auditors in uniformly applying the SEC Rule. We believe it is equally if not even more important to be clear with respect to key definitions in Canadian legislation, where the experience with the definitions, and with reporting on internal control over financial reporting is much less advanced than it is in the US.

It should also be noted that the Auditing and Assurance Standards Board is in the process of developing Canadian assurance standards to enable auditors to provide assurance on internal control over financial reporting that will be consistent with the US standards. The new standards will use terminology consistent with that in the US standards and the Sarbanes-Oxley Act of 2002.

### *Internal Control over Financial Reporting*

We disagree with the conclusion in the Request for Comment that a formal definition of internal controls is not necessary since representation 4(b) defines the outcome that internal controls are designed to achieve. We recommend the final Rule use the more limiting term “internal control over financial reporting” and that a definition of that term be included, consistent with the US definition.

First, the term “internal controls” differs from current Canadian usage. Existing Canadian literature (e.g., the CICA’s *Criteria of Control*, and auditing standards in the CICA Handbook) do not use that term. Rather, they use “internal control”. Moreover, the term used in the Proposed Instrument differs from the more specific term in the final SEC Rule (i.e., “internal control over financial reporting”). This inconsistency in terminology may cause confusion and lack of consistency and comparability among certifications, particularly with respect to those of issuers that qualify for exemption under Part 4 of the Proposed Instrument because they comply with US federal securities laws implementing Sarbanes-Oxley.

In the event that the regulators ultimately decide to implement an audit requirement around management’s certification of internal control, we believe it is important to limit

the definition of internal control to internal control over financial reporting, and to provide appropriate guidance on what this includes.

The final SEC Rule contains a detailed discussion of why it has chosen the term internal control over financial reporting”, rather than the broader “internal control”. The discussion notes that:

- the term “internal control over financial reporting” is the predominant term in use and best encompasses the objectives of the legislation
- the more expansive definition of internal control would impose substantial additional reporting and cost burdens on companies
- auditors’ responsibilities with respect to reviewing and testing internal control in financial statement audits has traditionally not extended beyond those controls that relate to financial reporting

In addition, the final SEC Rule contains the following additional explanation:

The Commission’s definition of the term "internal control over financial reporting" reflected in the final rules encompasses the subset of internal controls addressed in the COSO (Committee of Sponsoring Organizations of the Treadway Commission) Report that pertains to financial reporting objectives. The Commission’s definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements.

We do not see any compelling reason why the same arguments do not apply in the Canadian context. Also, in the event that the regulators ultimately decide to implement an audit requirement around management’s certification of internal control, we believe it is important to limit the definition of internal control to internal control over financial reporting, and to provide appropriate guidance on what this includes.

The final Rule should clearly define the term, “internal control over financial reporting” (or if the suggestion above is not accepted, of “internal control”) that is consistent with common usage and application. The final SEC Rule contains a comprehensive definition of “internal control over financial reporting” that could be used as the basis:

A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

### *Disclosure Controls and Procedures*

For the same reasons indicated above, we disagree with the conclusion in the Request for Comment that a formal definition of disclosure controls and procedures is not necessary since representation 4(a) defines the outcome that disclosure controls and procedures are designed to achieve. While the final SEC Rule does not expressly define the term “disclosure controls and procedures”, there is a useful discussion about the term that may provide some guidance in preparing the certification.

### ***B.3 Management’s Assessment and Report***

We recommend additional guidance should be provided on what management’s report on internal control must include. Specifically, we believe the final Rule should clearly indicate that management must reach a conclusion on the effectiveness of internal control over financial reporting.

Paragraph 4(d) of the Proposed Instrument requires the certification to indicate that the certifying officers have disclosed in the annual MD&A their conclusions about the effectiveness of the disclosure controls and procedures and internal controls. The content of the certification itself is not, however, clearly defined.

The final SEC Rule requires specific disclosures in the report regarding management’s assessment of the effectiveness of the company’s internal control over financial reporting. The assessment must include a statement about whether the company’s internal control over financial reporting is effective.

It is not clear whether the expectations for management’s certification under 4(d) of the Proposed Instrument are the same as those under the final SEC Rule (i.e., whether management must state its conclusion about the effectiveness of internal control over financial reporting).

#### ***B.4 Significant Deficiencies and Material Weaknesses***

##### *Definitions*

We recommend the final Rule include definitions of the terms, “significant deficiency” and “material weakness”. We also recommend that such definitions be consistent with the SEC definitions to promote consistent usage and understanding of the terms.

The terminology for distinguishing degree of severity of internal control deficiencies in paragraph 5 of the Proposed Instrument is consistent with that in the final SEC Rule (i.e., significant deficiency and material weakness). However, the terms are not defined in the Proposed Instrument, nor are they understood in the same sense in Canada as they were in the US when Sarbanes-Oxley came into force — certain US regulatory requirements and US audit standards already used that terminology. Moreover, the final SEC Rule specifically refers to the AICPA definitions. This ensures consistent usage and understanding of these important terms.

##### *Impact of a Material Weakness on Management’s Conclusion with Respect to Effectiveness*

We recommend the final Rule clearly indicate that management may not conclude that the company’s internal control over financial reporting is effective if there are one or more material weaknesses in the company’s internal control over financial reporting.

The Proposed Instrument does not contain guidance about the impact of a significant deficiency on the certification. The final SEC Rule notes that management may not conclude it has established effective control if one or more material weaknesses are present.

...management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

For purposes of the final SEC Rule, the term "material weakness" has the same meaning as in the definition under Generally Accepted Auditing Standards (GAAS) and US attestation standards.

#### ***B.5 Framework for Evaluating Internal Control***

We recommend the final Rule provide more guidance to issuers with respect to suitable frameworks for assessing internal control, to promote consistency in issuers’ assessments. We also recommend the final Rule require management’s certification of internal control

to specifically refer to the framework used, to allow readers to better assess management's certification.

The Proposed Instrument does not contain a requirement for management to refer to a framework for assessing internal control. The final SEC Rule requires a company's annual report to include an internal control report of management that contains a statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting. The final SEC Rule that specifically pertains to management's evaluation also contains guidance on the characteristics of a suitable framework, as noted below:

... management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements. However, the final rules do not mandate use of a particular framework, such as the COSO Framework, in recognition of the fact that other evaluation standards exist outside of the United States,<sup>1</sup> and that frameworks other than COSO may be developed within the United States in the future, that satisfy the intent of the statute without diminishing the benefits to investors. The use of standard measures that are publicly available will enhance the quality of the internal control report and will promote comparability of the internal control reports of different companies.

Specifically, a suitable framework must: be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted.

## ***B.6 Changes in Internal Control***

We recommend the final Rule contain guidance requiring elaboration on any changes to internal control over financial reporting, similar to that described in the final SEC Rule.

The Proposed Instrument does not require an evaluation of the effectiveness of the issuer's internal controls and disclosure controls and procedures in the interim certifications. Form 52-109F2 in the Proposed Instrument requires the certification to indicate that the interim MD&A discloses whether there were significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls, made during the period covered by the interim filings, including any actions

---

<sup>1</sup> For example, the CICA's *Guidance on Assessing Control* would likely be considered a suitable framework for assessing internal control over financial reporting.

taken to correct significant deficiencies and material weaknesses in the issuer's internal controls.

However, the final SEC Rule requires a company's management, with the participation of the principal executive and principal financial officers, to evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter covered by the quarterly report (or the last fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. The final SEC Rule also notes that:

Although the final rules do not explicitly require the company to disclose the reasons for any change that occurred during a fiscal quarter, or to otherwise elaborate about the change, a company will have to determine, on a facts and circumstances basis, whether the reasons for the change, or other information about the circumstances surrounding the change, constitute material information necessary to make the disclosure about the change not misleading.

In addition, we recommend that the final Rule either distinguish between “significantly affect” (used in the Proposed Instrument) and “materially affect” (used in the final SEC Rule) if there is meant to be a difference in meaning, or use the same terminology to avoid confusion and promote consistency and comparability in reporting.

#### ***B.7 Extent of Work Required***

We recommend that the final Rule provide further guidance with respect to the nature and extent of the work that management must do when conducting an evaluation of internal control.

The final SEC Rule notes that the methods of conducting evaluations of internal control over financial reporting will, and should, vary from company to company, and that the nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. The final SEC Rule nevertheless specifies to some extent, the amount of work management must do. For example, it points out that enquiry alone generally will not provide an adequate basis for management's assessment.

The final SEC Rule also states that management must carry out procedures sufficient both to evaluate its design and to test its operating effectiveness, to make its assessment of internal control. In that regard, it specifies that controls subject to assessment include, but are not limited to:

- controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;
- controls related to the initiation and processing of non-routine and non-systematic transactions;

- controls related to the selection and application of appropriate accounting policies; and
- controls related to the prevention, identification, and detection of fraud.

### ***B.8 Need for Documentation***

We recommend the final Rule include broad, high-level guidance about the nature and extent of documentation management must maintain as evidence supporting its certification of internal control over financial reporting.

The final SEC Rule instructs issuers to maintain evidence, including documentation, to provide reasonable support for management’s assessment of the effectiveness of the company’s internal control over financial reporting. The evidence includes documentation, and should provide reasonable support:

- for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions;
- for the conclusion that the tests were appropriately planned and performed; and
- that the results of the tests were appropriately considered.

The final SEC Rule notes, in particular, that maintaining such evidence is an inherent element of effective internal controls.

### **C. Financial Condition**

We recommend the term “financial condition” be clarified in the context of MI 52-109.

This term has a broader connotation than “financial position” – a term that appears in form 51-102 (MD&A) called for by proposed NI 51-102. Financial position generally is used in referring to a balance sheet prepared in accordance with GAAP.

The CPR Board’s comments on NI 51-102 pointed out some inconsistencies in the use of this term in the proposed NI 51-102 and related Form 51-102F2. In some places it is used in phrases like “results of operations, financial condition, liquidity and capital resources” and in others such as “financial condition includes your company’s financial position (as shown on the balance sheet) and other factors that may affect your company’s liquidity and capital resources”. Further, the structure of Part 2 of the MD&A form 51-102F2 does not reflect a clear and consistent definition, by calling for example first for companies in their MD&As to “Provide an analysis of your company’s financial condition, results of operations and cash flows”. This is followed by requirements for further, more detailed, disclosures about Liquidity, Capital Resources and Off Balance Sheet Arrangements.

The certification requirements in Part 3 of the forms in MI 52-109 call for the information in the annual and interim filings, respectively, to present fairly in all material respects “the financial condition, results of operations and cash flows of the issuer as of the date and for the periods presented” in the filings. Does this mean that financial condition is as of a point in time, i.e. a strictly historical perspective of performance up to and position at a balance sheet date? Or does “financial condition” also connote a potential for achieving future results – after all, the MD&A is expected to indicate the likelihood that past performance may be indicative of future performance, and to provide insights into a company’s future prospects?

The intended meaning of “financial condition” is therefore central to applying the “presents fairly” and materiality tests when CEOs and CFOs have to address the requirements of Parts 2 and 3 of the MI 52-109 certification forms.

Finally, the definition of financial condition in MI 52-109 needs to be consistent with that in NI 51-102.

#### **D. Fair Presentation**

As noted earlier, we believe the final Rule needs to clarify the benchmark for judging “fair presentation” of the financial information to be certified.

For GAAP financial statements, fair presentation is currently judged in relation to GAAP in most circumstances. For other financial information, it is less clear what benchmark is appropriate. For example, is the intent of the Proposed Instrument “full, true and plain disclosure”, the prospectus requirement? Is it “not misleading in the circumstances”? Or, is it something different?

Part 4 of *Companion Policy 52-109CP to Multilateral Instrument 52-109 Certification of Disclosure in Companies’ Annual and Interim Filings*, indicates that the reference to GAAP has been specifically excluded from the Proposed Instrument “to prevent management from relying entirely upon compliance with GAAP procedures<sup>2</sup> in this representation, particularly where the results of a GAAP audit<sup>3</sup> may not reflect the financial condition of a company (since GAAP may not always define all the components of an overall fair presentation).”

The references to GAAP and fair presentation in relation to financial condition are confusing in that financial condition encompasses more than GAAP financial statements (see discussion above). As noted above, financial condition is broader than financial statements. However, the term “fair presentation” is generally associated with financial statements only. As a result, the sentence appears to suggest that, even for the financial

---

<sup>2</sup> No comment has been made to indicate that GAAP isn’t about procedures. This sentence seems to be confusing the accounting and audit requirements.

<sup>3</sup> It is not clear what a GAAP audit is — is the intent an audit of financial statements prepared in accordance with GAAP, or is it an audit conducted in accordance with GAAS?

statement component of the complete set of financial information being certified, GAAP may not be the benchmark. It should be noted that the CICA Handbook – Accounting, paragraphs 1400.03-.07 requires fair presentation in accordance with GAAP, so we believe GAAP is the appropriate benchmark relative to the financial statements for the purpose of the final Rule. If the intent is that GAAP is not the appropriate benchmark for judging fair presentation of the financial statements, the final Rule needs to clearly define the appropriate benchmark, and give more compelling arguments as to why GAAP is not appropriate. In our view, however, GAAP is the appropriate benchmark for the financial statement component of the financial information subject to certification. In any event, failing to clearly define what constitutes fair presentation overall could encourage a departure from GAAP in order to arrive at more desirable results.

For the other financial information referred to in Part 3 of Form 52-109F1, we suggest the final Rule refer to other OSC rules and policies that address the basis of presentation (e.g., the guidance on non-GAAP pro forma earnings information).

There is also a need for greater clarity as to the materiality test necessary for complying with paragraphs 2 and 3 of both the annual and interim certifications (ref. Forms 52-109F1 and F2). The materiality tests appropriate for judging the completeness and fairness of AIF and MD&A disclosures are not necessarily the same as the conventional GAAP materiality tests for financial statement disclosures. In the US there have been a few landmark legal cases about the fairness of forward-looking disclosures in MD&As, but until now in Canada there has been little authoritative or interpretive guidance about the concept of “presents fairly” applicable to MD&As beyond mere compliance with regulatory disclosure requirements. This point was noted in the CPR Board comments on NI 51-102.

The need for clarity as to what is “material” is all the greater in view of the fact that MD&As are expected to provide not only information to supplement and explain what is presented in historical financial statements but also disclosures of a forward-looking nature so as to inform investors about future prospects and future financial condition. In view of the proposal that CEOs and CFOs are to be required to certify that the filings as a whole “fairly present” without qualification by reference to GAAP (which relate only to financial statements), clarity as to the definition or test for materiality is particularly important.

This is so not only for the sake of enabling CEOs/CFOs, audit committees and boards to know what is expected in their exercise of due diligence in, respectively, certifying, reviewing and approving MD&As as well as financial statements, but also to assist management in designing and implementing disclosure controls and procedures at an appropriate level of rigour and reliability. The UK government and Accounting Standards Board are currently considering the issue of materiality in the Operating & Financial Review (equivalent to MD&A), so as to provide appropriate guidance to boards of directors. We recommend that regulators indicate the expected test for materiality in Canadian MD&As (see CICA MD&A Guidance 230.3 on this), if only by explicitly referring to or citing the relevant Instruction in NI 51-102.

**3. Audit Committees (proposed Multilateral Instrument 52-110, proposed Companion Policy 52-110CP and proposed Forms 52-110F1 and 52-110F2)**

What follows are comments related to the exemption for venture issuers, the need for two-way communication and dialogue between external auditors and audit committees, and the need for additional reporting by the external auditor to the audit committee.

*Venture Issuers*

We note that the audit committee proposals would provide an exemption for venture issuers, in acknowledgement that it may be difficult or impossible for many small issuers to comply with the independence and financial literacy requirements in the Proposed Instrument. We believe this exemption is an appropriate one which recognizes that one-size fits all policies often do not serve the needs of smaller companies. For example, we believe that such distinctions would assist small companies, particularly those just starting up, in achieving a foothold in their field. Complying with the proposals may also be difficult for smaller companies listed on the TSX. Having said this, we note that there are some fairly large issuers who meet the definition of venture issuer, and that their ability to comply with the audit committee proposals should be considered in the final analysis.

*Communication With External Auditors*

The external auditor and the audit committee play important roles in the financial reporting process. It is important that they engage in a dialogue in order to facilitate a deeper understanding of their respective roles. For example, the audit committee can play an important role in the external audit planning process by providing information and perspectives to assist the external auditor in updating the auditor's knowledge and understanding of the business and identifying additional areas of concern for the auditor to consider when undertaking the audit. The external auditor communicates with the audit committee aspects of the audit approach that the auditor believes would be helpful to the audit committee in discharging its responsibilities. The external auditor also communicates matters arising from the audit as set out under GAAS.

The Proposed Instrument requires the external auditor to report directly to the audit committee. It also requires the audit committee to have certain responsibilities with respect to the relationship with the external auditor and to have the authority to communicate directly with the external auditor. However, we believe that the proposed investor confidence rules could go further to strengthen the interaction between the auditor and the audit committee. The Proposed Instrument should include the following requirements:

1. the audit committee should be required to meet with the external auditor at least once per year;
2. the audit committee should disclose in the reporting forms the number of times during the year that it has met with the auditor and confirm that it has discussed with the

auditor the items discussed below under External Auditor Reports to Audit Committee.

### *External Auditor Reports to Audit Committee*

We note that Section 204 of the Sarbanes-Oxley Act requires the external auditor to make certain reports to the audit committee. We also note that proposed NI 51-102, sections 1.11 and 1.12, requires the MD&A to include specific information about critical accounting estimates and changes in accounting policies. In order to ensure that the audit committee has the information it needs in order to meet its responsibilities for reviewing the issuer's financial statements and MD&A, we recommend that the audit committee be required to discuss with the auditor his or her professional judgments with respect to the following:

1. All critical accounting policies and practices used by the issuer. This would include discussion of the reasons why accounting estimates or accounting policies are or are not considered critical, and how current and anticipated future events impact those determinations.
2. All alternative accounting treatments (accounting and disclosure) of financial information within generally accepted accounting principles for policies and practices related to material items that have been discussed with the issuer's management, including the ramifications of the use of such alternatives and the preferred treatment by the auditor.

We also recommend that the audit committee be required to discuss with the auditor other material written communications between the auditor and the issuer's management, such as any management letter or schedule of unadjusted differences.

As noted earlier, in 2002 the Auditing and Assurance Standards Board issued a standard entitled *Communications with those having oversight responsibility for the financial reporting process*. This standard requires the external auditor to communicate with the audit committee:

- matters set out in assurance standards concerning communications with the audit committee, such as fraud and misstatements arising from error, illegal or possibly illegal acts, significant weaknesses in internal control identified by the auditor, and certain related party transactions identified by the auditor;
- matters that have a significant effect on the qualitative aspects of accounting principles used in an entity's financial reporting; and
- other matters arising from the audit that are important and relevant to the audit committee.

The above proposals will effectively close the loop by requiring the audit committee to communicate with the auditor on such matters.

## APPENDIX A

### CICA INITIATIVES – INVESTOR CONFIDENCE

#### *GAAP Hierarchy*

The Accounting Standards Board recently completed a project aimed at establishing standards for financial reporting in accordance with generally accepted accounting principles (GAAP) which clarify the relative authority of various accounting pronouncements and other sources of guidance within GAAP. The main features of the new standard, issued in July 2003, are:

- It defines what constitutes the primary sources of GAAP in Canada and prioritizes them;
- When a matter is not dealt with explicitly in the primary sources of GAAP, the standard requires that an entity adopt accounting policies and disclosures that are consistent with the primary sources of GAAP and developed through the exercise of professional judgment;
- It provides guidance on some of the other sources to consult when selecting accounting policies and determining appropriate disclosures when a matter is not dealt with explicitly in the primary sources of GAAP
- It clarifies that a “fair presentation in accordance with GAAP” constitutes not only applying the new standard on GAAP, but also (i) providing sufficient information about transactions or events having an effect on the entity’s financial position, results of operations and cash flows for the periods presented that are of such size, nature and incidence that their disclosure is necessary to understand that effect; and (ii) providing information in a manner that is clear and understandable; and
- It removes the ability for an entity to depart from a Handbook Recommendation when following that Recommendation would result in misleading financial statements.

The standard also specifies the extreme interpretations of a source do not constitute evidence that the criteria for selecting a source of GAAP have been met if it is likely that most parties, exercising professional judgment, would reject them as not resulting in a fair presentation in accordance with GAAP of the financial position, results of operations or cash flows of the entity.

This is consistent with proposals by the Provincial Institutes/Ordre to adopt an expanded rule of professional conduct – Rule 206 – which will extend the requirement to comply with generally accepted standards of practice of the profession beyond members engaged in the practice of public accounting to members who are responsible for the preparation of an entity's financial statements. These proposals reflect the CICA Handbook requirement which states “extreme interpretations of a source do not constitute evidence that the criteria in paragraph 1100.44 have been met if it is likely that most parties, exercising professional judgment, would reject them as not resulting in a fair presentation

in accordance with GAAP of the financial position, results of operations or cash flows of the entity”.

### *Reporting on Controls*

The Auditing and Assurance Standards Board has initiated a project to develop Canadian standards on reporting on internal control over financial reporting that are harmonized with US standards. The project will establish assurance standards for reporting on internal control over financial reporting and revise the standard for reporting weaknesses in internal control in a financial statement audit.

### *Management’s Discussion and Analysis Guidance*

In November 2002 the CICA issued guidance on preparation and disclosure for Management’s Discussion and Analysis (MD&A) to assist reporting issuers in enhancing the quality and usefulness of their MD&As. The guidance breaks new ground by proposing six key principles and a five-part framework for MD&A disclosure.

On May 7, 2003 the CICA issued new guidance to help companies improve MD&A disclosure about off-balance sheet arrangements and related exposures. This new interpretive release is designed to encourage management to see MD&A as an opportunity to disclose more about its off-balance sheet arrangements than what may be included in the notes to the financial statements. Both these CICA guidance publications supplement existing regulatory requirements for MD&A disclosures.

On August 15, 2003, the CICA’s Canadian Performance Reporting (CPR) Board submitted comments to the Canadian Securities Administrators on Proposed National Instrument 51-102, *Continuous Disclosure Requirements*, a copy of which is attached for your reference.

### *Independence Standard*

In the fall of 2002 the Public Interest and Integrity Committee (PIIC) of the CICA issued a draft independence standard to apply to Canadian auditors and other assurance providers. The draft standard proposed a significant strengthening of Canada’s audit independence standard that would mandate a proactive approach to protecting auditor independence, based on clearly articulated principles. The proposed standard describes apparent and actual threats to auditor independence as well as safeguards that can be put in place to protect independence. It also recognizes that there are certain activities for which there cannot be adequate safeguards, so it prohibits auditors from providing a number of non-assurance services to their clients. The core principle of the new standard is that every effort must be made to eliminate any real or perceived threat to the auditor’s independence.

The draft independence standard is expected to be adopted by the Provincial CA Institutes/Ordre later this year, and to be in force in 2004.

### *Communications with Audit Committees*

In 2002 the Auditing and Assurance Standards Board issued a new standard dealing with communications with those having oversight responsibility for the financial reporting process entitled *Communications with those having oversight responsibility for the financial reporting process*. This standard provides guidance on the required communications with audit committees by auditors performing an audit of financial statements.

### *Policy Forum - CEO/CFO Certification and Audit Committees*

Earlier this month the CICA hosted a Policy Forum to provide feedback to regulators on the proposed investor confidence rules. One hundred leading CEO/CFOs and audit committee chairs were invited to provide David Brown their comments on the proposed rules.