The Institute of Internal Auditors

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

Denise Brosseau, Secretary
Commission Des Valeurs Mobilieres du Québec
Stock Exchange Tower
800 Victoria Square
P.O. Box 246, 22nd Floor
Montreal, Quebec, Canada H4Z 1G3

Re: Comments on Proposed Instruments 52-108, 52-109, 52-110

Dear Mr. Stevenson and Ms. Brosseau:

The Institute of Internal Auditors (IIA) applauds the efforts of the Ontario Securities Commission (OSC) and other securities regulatory authorities involved (the Participating Jurisdictions) to promote effective corporate governance in Canada. We recognize that the Canadian business environment is unique in several ways, and encourage the Participating Jurisdictions to adopt a made-in-Canada approach. The proposals make excellent strides in improving governance practices, in communicating the value of basic fundamentals, and in improving the international perception of the Canadian marketplace. Personally, I also appreciated the opportunity to meet, along with my IIA colleagues from Toronto, with Messrs. John Carchrae and John Hughes at the OSC's offices last February. The session proved to be educational and informative for everyone involved.

Established in 1941, The IIA is an international professional organization with world headquarters in Altamonte Springs, Florida. We have over 85,000 members worldwide in internal auditing, governance, internal control, IT audit, education, and security; many of which share membership with professional accountancy bodies. The IIA, with representation in more than 100 countries, is the acknowledged global leader in standards, certification, education, research, and technological guidance for the profession.

The IIA represents over 3,500 Canadian members in 11 chapters and is the principal voice of the internal auditing profession. Since 2000, The IIA has had a Strategic Alignment Agreement with the Canadian Institute of Chartered Accountants (CICA) to represent the interests of chartered accountants and others specializing in internal auditing in Canada.

The IIA is well positioned to offer unique insights into issues related to improving corporate governance, risk management, and control processes. The IIA maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*, which are recognized around the globe and support the internal auditing profession.

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Good governance and accurate financial reporting emanate from the balanced interaction of board members, executives, internal auditors, and external auditors. In December 1999, The IIA adopted the following definition of internal auditing that acknowledges the role of internal auditing in corporate governance:

> *Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.*

Since the adoption of this definition, The IIA has intensified its efforts to contribute to the reform of governance practices of public companies around the world. The IIA is pleased to provide our views regarding your proposed rules, released June 27, 2003, for public comment. Leading Canadian IIA members, including prominent chief audit executives, have contributed to developing our input for your consideration.

From the internal auditor's unique perspective as a key contributor to corporate governance, and as an independent observer of that process, The IIA offers the following comments.

1. Restoration of investor confidence must be founded on accepted principles of corporate governance that provide for a series of checks and balances effected by the distribution of authority among the representatives of management, shareholders, and regulators. Top-level control is best achieved when the four cornerstones of good governance — boards, management, internal auditors, and external auditors — are competent, adequately resourced, and coordinated in their efforts. We recommend the Participating Jurisdictions make it a requirement that listed companies adopt a standard set of governance principles and annually report compliance or disclose why not. Governance principles serve as a focal point to ensure that the four cornerstones are focused in a common direction.

2. Over the past several years, the business community in Canada has increasingly supported a broad definition of internal control. In Canada, this definition was developed by the CICA's Criteria of Control (CoCo) Board, recently renamed the Risk Management and Governance Board (RMGB). This broad definition should be acknowledged in the proposal and also be distinguished from financial controls and disclosure controls.

3. CEO/CFO certifications should be performed for interim as well as annual filings, perhaps with a transitional period before implementing the former. Future rules should ultimately incorporate the broad definition of internal control into CEO certifications.

4. Since audit committees are assigned primary responsibilities for assessing and monitoring governance practices, they must have the resources to fulfill these responsibilities. A financial expert should be required on all audit committees and be supported by a strong and adequately resourced internal auditing function. We recommend that all publicly held companies be required to establish and maintain an independent, adequately resourced, and competently staffed internal auditing function to provide management and the audit committee with ongoing assessments of the organization's risk management processes and the accompanying system of internal control. If an internal auditing function is not present, the board of directors should be required to disclose in the company's annual report why the function is not in place.

The enclosed document provides greater detail in the areas in which we believe the Participating Jurisdictions can enhance its final rules to further improve governance processes.

We have enclosed copies of two of our recent publications on governance, *Corporate Governance and the Board: What Works Best* and *Audit Committee Effectiveness: What Works Best.* We have numerous other publications that promote good governance practices, including the periodical *Tone at the Top*, which is specifically designed for directors who serve on audit committees. These other publications are available for review at our Web site — www.theiia.org.

We appreciate the opportunity to express our views on these important matters and welcome the opportunity to discuss any and all issues with your organization at any time.

Best Regards,

William G. Bishop III

Attachment

Detail Comments on the Proposal

Enclosures

1. *Corporate Governance and the Board: What Works Best* – An Institute of Internal Auditors Research Foundation report.
2. *Audit Committee Effectiveness: What Works Best* – An Institute of Internal Auditors Research Foundation report.

CC: Response Team Members:

- Brian G. Brown, CIA, Chief Audit Executive, AgriCore United Ltd., Canada
- Alphonse Galluccio, CIA, Chief Audit Executive, Le Groupe Jean Coutu (PJC) Inc., Canada
- Larry Harrington, Chief Audit Executive, Staples, USA
- Libby MacRae, Research Associate, CCAF, Canada
- Phil Moulton, CIA, Business Audit Services Manager, Parmalat Australia
- Mark Pearson, CIA, Chief Audit Executive, Boise Office Solutions, USA
- Carman Lapointe-Young, CIA, Past Chair of The IIA, Corporate Auditor, Canada Post Corporation, Canada

THE INSTITUTE OF INTERNAL AUDITORS

Detailed Comments on the Proposed Rules

September 2003

1. General Support

The Institute of Internal Auditors (IIA) is supportive of the Participating Jurisdictions proposals and the recommendations contained in the various instruments. The proposed rules will help those charged with governance responsibilities and increase the confidence of stakeholders. A strong and comprehensive plan of action for implementing the final rules will be vital in obtaining buy-in from the business community. Opportunities exist, however, for changes and additions to enhance the proposal. Our suggestions and answers to several questions posed in the *Requests for Comment* follow, with reference to the appropriate sections of the documents.

The IIA believes that promulgating a strong, uniform code for corporate governance and requiring board reporting on the extent of compliance with this code are vital steps toward strengthening corporate governance, improving transparency, and restoring investor confidence. Generally accepted governance principles would be of significant value as benchmarks against which to measure and report on the fulfillment of fiduciary duties by all parties in the governance process. A uniform code of corporate governance would also help foster the high levels of integrity expected of officials of all public companies.

2. Defining "Internal Control"

The term "internal control" requires definition to alleviate potential misinterpretation.

Its use in the proposed filings is intended to refer to only those internal controls that "*provide reasonable assurances that the issuer's financial statements are fairly presented in accordance with generally accepted accounting principles."* Current business and governance practices, as well as professional pronouncements in Canada and elsewhere, have endorsed a much broader definition of internal control. We recommend that the Participating Jurisdictions acknowledge the broader definition of internal control established by the Canadian Institute of Chartered Accountants (CICA), while distinguishing the specific internal controls over financial statements and disclosure procedures that are subject to certification, by their specific objectives (as is currently the case in the proposed wording of the certifications).

The Participating Jurisdictions should define internal control according to the definition established in 1995 by the CICA's Criteria of Control (CoCo) Board, now reconstituted as the Risk Management and Governance Board (RMGB), as follows:

> *"Control comprises those elements of an organization (including its resources, systems, processes, culture, structure and tasks) that, taken together, support people in the achievement of the organization's objectives. These objectives may fall into one or more of the following general categories:*
>
> - *Effectiveness and efficiency of operations;*
> - *Reliability of internal and external reporting; and,*
> - *Compliance with applicable laws and regulations and internal policies."*

The scope of the CoCo definition is consistent with definitions developed in other countries, such as Cadbury in the United Kingdom and COSO in the United States. It encompasses, but extends well beyond, accounting and financial reporting controls, reaching into all aspects of operations and risk management processes. The purpose of specific internal controls is delineated through the objectives they are intended to effect.

Defining internal control in this manner, and delineating those internal controls subject to certification through the objectives contained therein, supports the notion of greater accountability. In the current business environment, management and other stakeholders should be increasingly concerned with the quality of the broader range of internal controls — the control framework — in the organization, and not only those controls over financial reporting and disclosure procedures. While this may appear to be a small nuance in the context of the current proposals, greater clarity now would facilitate possible future regulatory initiatives demanding a broader interpretation of internal control.

3. Certification and Disclosure

The IIA supports the proposal for CEO/CFO certification of interim and annual filings. While critics doubt its value, the exercise of certifying filings and the related disclosure processes communicates accountability, promotes confidence and awareness, and establishes responsibility should the need for sanctions arise.

The certifications should include the broader definition of internal control while limiting the specific controls subject to certification to those affecting financial statements and disclosure procedures, as in the following example:

Extract from: OSC FORM 52-109F1 – CERTIFICATION OF ANNUAL FILINGS

4. The issuer's other certifying officers and I are responsible *for establishing and maintaining an effective system of internal control for the issuer*, and we have:

(a) designed those internal controls, or caused them to be designed under our supervision, and implemented those internal controls, to provide reasonable assurances that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the annual filings are being prepared, and that such material information is disclosed within the time periods specified under applicable provincial and territorial securities legislation;

(b) designed those internal controls, or caused them to be designed under our supervision, and implemented those internal controls, to provide reasonable assurances that the issuer's financial statements are fairly presented in accordance with generally accepted accounting principles;

(c) evaluated the effectiveness of the issuer's internal controls over disclosure procedures and financial statements described above as of the end of the period covered by the annual filings; and

(d) disclosed in the annual MD&A our conclusions about the effectiveness of the internal controls over disclosure procedures and financial statements as described above, in each case based on our evaluation as of the end of the period covered by the annual filings.

5. (No proposed change)

6. I have disclosed in the annual MD&A whether there were significant changes in the issuer's internal controls over disclosure procedures and financial statements or in other factors that could significantly affect internal controls over disclosure procedures and financial statements, made during the period covered by the annual filings, including any actions taken to correct significant deficiencies and material weaknesses in the issuer's internal controls over disclosure procedures and financial statements.

Ultimately, management should be required to certify the adequacy of the broader definition of internal control in order to provide solid assurance to the stakeholders. This additional disclosure could be the subject of future governance rules. However, for the time being, the limitation to internal controls over financial statements and disclosure procedures should be clear.

4. Audit Committees

The IIA supports the Participating Jurisdictions' proposed enhancements to the role and requirements for audit committees. Audit committees have critical governance responsibilities on behalf of the board and must be properly structured and adequately resourced.

In order to properly discharge their assigned responsibilities that typically include overseeing the assessment and monitoring of risk management and internal control processes, audit committees should be supported by strong internal auditing functions. The final proposal should include a robust case for internal auditing and its potential contribution toward improved corporate governance.

Part 2 – Audit Committee Responsibilities. We endorse the requirement for a written charter outlining the duties and responsibilities of the audit committee. A charter ensures clarity of roles and accountabilities and provides a basis for evaluating audit committee effectiveness. The requirement for review of publicly disclosed financial information and the whistle-blowing provision are also appropriate.

We also support the proposed relationship between the audit committee and the external auditor. It is imperative that the reporting relationship is direct and that the audit committee ensures the independence of the external auditor.

We propose an additional sub-point to this section titled, "**Relationship with the Internal Auditor.**" This section should include, at a minimum:

- The requirement that audit committees establish and maintain an internal audit function with the mandate and necessary resources to assess internal control, risk management, and governance processes within the organization.
- A direct reporting relationship between the chief audit executive (CAE) and the audit committee, including involvement in the appointment, evaluation, compensation, and removal of the CAE, and an administrative reporting relationship for the CAE to the chief executive officer.
- Responsibility for approving the internal audit plan and budget.
- The expectation that internal audit will provide to the audit committee at least annually an overall assessment of risk management and internal control, broadly defined.
- That internal audit should be performed in accordance with The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)*. These *Standards* are recognized globally and have been translated into over 20 different languages.

Where an internal auditing activity does not exist, the audit committee should annually assess whether its absence creates unacceptable risk for the organization. Every filing organization should have an appropriate system of internal control and an independent activity to provide ongoing assessments of its effectiveness.

Part 3 – Composition of the Audit Committee

The IIA supports the requirements included in Section 3.1. The definitions for independence, material relationships, and financial literacy are appropriate and consistent with other jurisdictions. However, since governance responsibilities include activities and controls broader than financial, such as risk management and strategic planning, many audit committees may require individuals with literacy in other subject areas beyond financial. It may be appropriate to point out this additional expectation in the final rules.

We disagree with the decision to exclude a requirement for an "audit committee financial expert." Financial statements and accounting requirements are increasingly complex. An important concept within today's environment is ensuring those charged with governance responsibilities have the skills and resources to meet those expectations. The presence of at least one recognized, experienced, independent "expert" is an important component of an adequately resourced audit committee. The proposal points out that certain organizations may have difficulty achieving an "audit committee financial expert" requirement. While this may be true, "difficulty" should not prevent stakeholders from expecting necessary resources to protect their interests. We recommend that a financial expert be required on all audit committees.

Part 4 – Authority of the Audit Committee

We concur with the points contained in this section. We do recommend in point 3.4.1 (c) that, at least annually, the audit committee meet privately and separately with the external auditors, internal auditors, and management. Internal audit should also have the ability to communicate directly with the chair of the audit committee throughout the year, if need be.

Part 5 – Reporting Obligations

The IIA believes disclosure and transparency are integral aspects of strong corporate governance. In addition to the information flow to stakeholders, this philosophy encourages organizations to comply with requirements or best practices to achieve positive public relations. In that regard, this section is key and appropriate. We concur with the proposals, but add the following.

Disclosing the complete text of an audit committee charter may prove impractical. Many organizations have developed comprehensive charters that may be superfluous to the needs of readers of public disclosures. The IIA recommends that the Participating Jurisdictions establish appropriate minimum requirements for audit committee responsibilities relevant to its interests and require the inclusion of a statement of the extent to which such minimum requirements are satisfied. Appendix B of the enclosed best practice report titled, *Audit Committee Effectiveness: What Work Best (2nd Edition),* provides an excellent sample audit committee charter.

The proposed disclosure requirements regarding identifying the "audit committee financial expert" may be unrealistic. Identifying the financial expert places a degree of public attention on one person who, in the event of a financial problem, would be disproportionately targeted for blame by the public and media, regardless of the proposal's attempts otherwise. Since the Participating Jurisdictions are not proposing a requirement for an expert, it is possible that experts would opt not to be identified as such. We recommend that the final rules require disclosure of the existence, or lack thereof, of a financial expert on the audit committee, without requiring specific designation of an individual. As mentioned previously, we recommend that at least one audit committee financial expert be required.

5. The Case for Internal Audit and Ensuring Internal Audit Independence

The IIA believes all publicly held companies should be required to establish and maintain an independent, adequately resourced, and competently staffed internal auditing function to provide management and the audit committee with ongoing assessments of the organization's risk management processes and the accompanying system of internal control. If an internal auditing function is not present, the board of directors should be required to disclose in the company's annual report why the function is not in place.

Internal auditors and audit committees are mutually supportive. Consideration of the work of internal auditors is essential for the audit committee to gain a complete understanding of an organization's operations. Contemporary internal auditing is based on the identification of strategic, operational, and financial risks facing the enterprise and the assessment of controls put in place by management to mitigate those risks within dynamically changing contexts. Included in the identification of these risks are issues such as:

- Related-party transactions, joint ventures, and partnerships;
- Restructurings, including mergers and acquisitions;
- New businesses, products, and systems;
- Vulnerability to interest rate changes or changes in cash flows;
- Information systems risks; and
- Reputation risks.

A process that includes the identification, understanding, and control of such risks and an assessment of the effectiveness of controls should help ensure consideration of the very items underlying recent governance and quality of earnings problems.

In establishing and providing oversight for an internal audit function, audit committees should also ensure that the function is structured in a manner that achieves organizational independence and permits full and unrestricted access to top management, the audit committee, and the board.

The IIA's *Standards* require that the CAE report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The IIA believes that to achieve necessary independence, the CAE should report functionally to the audit committee. For administrative purposes, in most circumstances, the CAE should report directly to the chief executive officer of the company.