

## CSA STAFF NOTICE 52-312

### AUDIT COMMITTEE COMPLIANCE REVIEW

As announced on May 6, 2005, staff of the securities regulatory authorities in Alberta, Saskatchewan, Manitoba, Ontario and Québec conducted a review of compliance with the provisions of Multilateral Instrument 52-110 *Audit Committees* (the Instrument). This notice outlines the results of our review.

#### The Instrument

The Instrument came into force on March 30, 2004 in every jurisdiction in Canada except British Columbia and Québec. In Québec, it came into force on June 30, 2005. With limited exceptions, the Instrument applies to all reporting issuers. Issuers subject to the Instrument were required to comply with its requirements beginning on the earlier of: (i) the issuer's first annual meeting after July 1, 2004, and (ii) July 1, 2005.

The Instrument prescribes four broad sets of requirements:

- an issuer must have an audit committee that complies with the Instrument;
- all members of the audit committee must be independent and financially literate (venture issuers are exempt from these requirements);
- an audit committee must have a written charter that includes prescribed responsibilities; and
- an issuer must include certain disclosure in its AIF, management information circular or MD&A.

#### The Review Program

A sample of 95 issuers was selected from across the country. The selection criteria included the issuer's head office location, its industry sector, and its listing status. The sample included 40 issuers listed on the TSX on an exempt basis (exempt TSX issuers); 23 issuers listed on the TSX on a non-exempt basis (non-exempt TSX issuers)<sup>1</sup>; and 30 issuers listed on the TSX Venture Exchange and 2 other issuers which did not have securities listed or quoted on any of these markets (collectively, venture issuers).

The review focused on each issuer's compliance with the Instrument's requirements regarding audit committee composition and responsibilities. Each issuer was requested to provide us with a copy of its audit committee charter together with the following

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<sup>1</sup> An exempt issuer is an issuer that is at a more advanced development stage based on factors such as higher levels of profitability, cash flow, net tangible assets and market capitalization as outlined in the TSX original listing requirements for exempt issuers. As a result, exempt issuers are entitled to reduced filing requirements in some circumstances. Non-exempt issuers are subject to additional TSX oversight, as provided in Part 5 of the TSX Company Manual, for any proposed material change in its business or affairs.

information:

- for each member of the audit committee, all direct or indirect relationships that the member had with the issuer and the basis upon which the member was determined to be independent or non-independent;
- for each member of the audit committee, the basis upon which the member was determined to be financially literate; and
- any exemptions that were being relied upon in connection with audit committee member independence or financial literacy.

## Results

The statistical results of the compliance review are included in Appendix A.

All section references are to the Instrument as it read prior to amendments that came into force on June 30, 2005.

### *Audit Committee Responsibilities*

Overall, 64% of the audit committee charters reviewed set out all of the responsibilities prescribed by the Instrument. This included 68% of exempt TSX issuers, 57% of non-exempt TSX issuers, and 66% of venture issuers. In our view, a 64% overall compliance level is inadequate. It appears that many issuers were either unaware of the provisions of the Instrument or were at least unaware of its transition provisions.

While the non-compliance was broadly dispersed across all responsibilities, the responsibilities that were most commonly excluded from non-compliant charters were the responsibility to establish procedures for the handling of complaints and employee concerns regarding accounting or auditing matters (s. 2.3(7)) (17 instances of non-compliance) and the responsibility to review and approve the issuer's hiring policies for partners and employees of the issuer's current and former auditors (s. 2.3(8)) (20 instances of non-compliance).

Three other responsibilities were commonly excluded from the audit committee charters of non-exempt TSX issuers. The charters of 5 issuers did not include the requirement to directly oversee the work of the external auditor (s. 2.3(3)); the charters of 6 issuers did not include the requirement to review the issuer's financial statements, MD&A and annual and interim earnings press releases prior to their release (s. 2.3(5)); and the charters of 6 issuers did not include the requirement that the audit committee satisfy itself as to the adequacy of review procedures for other financial information (s. 2.3(6)). Additionally, 4 venture issuers did not have an audit committee charter.

In several instances, issuers asserted that their audit committee charter complied with the Instrument because certain responsibilities not specifically enumerated were implied by

the language in the audit committee's charter. In other instances, the audit committee was provided with discretion in its charter as to whether or not to assume certain of the responsibilities outlined therein.

In our view, neither position is justifiable. In order to satisfy the provisions of the Instrument, the prescribed responsibilities must be directly and clearly set out in the audit committee's charter. Further, the audit committee must not be provided with discretion as to whether or not to assume certain of the responsibilities.

Where we identified non-compliance during the course of a review, the audit committee charter was generally amended prior to the completion of the review. In several instances, however, an undertaking was filed by the issuer to amend the charter within a specified period of time prior to the date of the issuer's next annual meeting.

#### *Audit Committee Member Independence*

92% of TSX issuers had audit committees comprised solely of independent directors.

All 5 TSX issuers that did not have fully independent audit committees had only one member who was not independent. The basis for the determination of non-independence in each instance was that the individual received, directly or indirectly, a consulting, advisory or compensatory fee from the issuer which is a deemed material relationship under s. 1.4(3)(f)(i). In this regard, there appeared to be confusion as to the interpretation and application of s. 1.4(7)(b). That section deems an individual to be in receipt of indirect compensation if they are a partner of a law, accounting or consulting firm that receives fees from the issuer.

In 3 instances of non-compliance by TSX issuers, the individual was the issuer's counsel or was a partner in a law firm that received fees from the issuer. The individual in one instance provided accounting services to the issuer. In the remaining instance, the individual's consulting firm received fees from the issuer. In one of these instances, the issuer responded that its board had determined that a director contravened s. 1.4(3)(f)(i) but was nonetheless independent. It should be noted that s. 1.4(3) does not provide a board with this discretion.

In 4 instances where we determined that a member of the audit committee of a TSX issuer was not independent, the member was replaced by an independent director prior to the completion of the review. In one instance, however, an undertaking was filed by the issuer to replace the member within a specified period of time prior to the date of the issuer's next annual meeting.

Interestingly, notwithstanding that venture issuers are not required to comply with the audit committee independence requirements of the Instrument on the basis of the exemption included in Part 6, 31% of venture issuers had audit committees comprised solely of independent directors.

Of the 22 venture issuers that did not have fully independent audit committees, 13 had one member who was not independent while 9 had two members who were not independent.

In 18 instances where a member of the audit committee of a venture issuer was determined not to be independent, the member was an employee or executive officer of the issuer which is a deemed material relationship under s. 1.4(3)(a). In 15 of those instances, the individual was the CEO of the issuer. In one instance, a member was determined not to be independent as the individual was an immediate family member of an executive officer which is a deemed material relationship under s. 1.4(3)(b). The basis for the determination of non-independence in 9 instances was that the individual received, directly or indirectly, a consulting advisory or compensatory fee which is a deemed material relationship under s. 1.4(3)(f)(i). In 3 of these instances, the individual was the issuer's counsel or was a partner in a law firm that received fees from the issuer; in one instance, the individual was a partner of an accounting firm that received fees from the issuer; and in 5 instances the individual received fees from the issuer for providing consulting or investment banking services.

#### *Audit Committee Member Financial Literacy*

We did not find any instances where an issuer determined that an audit committee member was not financially literate. This finding is particularly noteworthy for venture issuers as they are not required to comply with the audit committee financial literacy requirements of the Instrument on the basis of the exemption included in Part 6.

We note that, in several instances, the assertion by an issuer of the financial literacy of an audit committee member was the subject of further scrutiny in our review. In several instances it appears that, although an audit committee member was ultimately determined to be financially literate, the matter had not been carefully considered by the issuer prior to our enquiry. The financial literacy of each director should be carefully assessed prior to that individual's appointment to the audit committee. The assessment should generally be supportable on the basis of the individual's relevant education and/or experience.

#### Future Reviews

In our view, the level of compliance by issuers with the provisions of the Instrument was unacceptable. We were particularly concerned to learn that even the largest issuers, exempt TSX issuers, were not fully compliant.

We expect issuers to fully comply with the Instrument.

We intend to conduct additional reviews of compliance by issuers with the Instrument in the near future. We will actively follow up on deficiencies identified in those reviews and will pursue appropriate remedies where we deem it appropriate.

Date: January 13, 2006

# Audit Committee Compliance Review

## Summary of Compliance

