CANADIAN
AUDIT COMMITTEE NETWORK
VantagePoint

August 8, 2008

TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

Keeping pace in times of rapid change

Introduction

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading Canadian companies. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the evolving audit environment.

The seventh meeting of the network, which was held in Toronto on July 14, 2008, focused on techniques audit committees use to keep pace with technical and market developments in times of rapid change.

This document reflects a synthesis of the key issues that emerged from the meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly this information can be disseminated to board directors, management executives, and their advisers, the greater the value created for all.

Between them, the members of the network who participated in the meeting sit on the boards of over 30 large-, mid-, and small-cap public companies. Those members participating in the meeting were:

- Mike Boychuk, Audit Committee Chair, Yellow Pages Income Fund
- Beverley Briscoe, Audit Committee Chair, Goldcorp
- John Caldwell, Audit Committee Chair, IAMGOLD
- Gary Colter, Audit Committee Chair, Canadian Imperial Bank of Commerce
- Denis Desautels, Audit Committee Chair, Bombardier
- Don Fullerton, Audit Committee Chair, Husky Energy
- Krystyna Hoeg, Audit Committee Chair, Sun Life Financial
- Tom O'Neill, Audit Committee Chair, BCE
- Barbara Stymiest, Audit Committee Chair, Research in Motion

Attending the meeting from Ernst & Young Canada were:

- Colleen McMorrow, Senior Client Service Partner and Greater Toronto Area Leader, Technology, Communications and Entertainment Industry Practice
- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services

VantagePoint reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from comments made by Canadian Audit Committee Network members.

Executive summary

The discussion among members was wide-ranging, focusing on issues including historical and current periods of economic instability, the challenge of getting a clear picture of company performance, and the role of the audit committee during challenging times.

- **Keeping pace with technical accounting changes** *(Page 3)*

  Audit committee chairs are buried under an onslaught of technical accounting changes – IFRS, MI 52-109, FAS 157, FAS 141R/160, FIN 48, and more – changes coming in such rapid succession that one member referred to it as *"an endless stream."* In an effort to keep up-to-date on changes, members report turning to their CFOs, external auditors, and other outside consultants for advice. While there's no shortage of information available to them, most audit committee chairs have a strong desire for more tailored information – relevant to their role as an audit committee chair and specific to their industry and company.

- **Staying on top of changes in the broader market** *(Page 5)*

  In addition to the challenges of technical accounting changes, audit committees must consider the implications of global economic uncertainty. What's an audit committee to do? Focus on cash, the balance sheet, liquidity, and the fundamentals of the business. Many directors feel let down by the financial models that have been in place and by the external rating agencies that have relied on historical data, ignoring the truth that you can't see the future in a rearview mirror. Some companies have created company-specific ratings and other metrics for internal use and guidance, but others continue to use external advisers and firms to help them determine the path forward.

- **Understanding the impact of these changes on the audit committee's role** *(Page 7)*

  While directors know that their fundamental role is an oversight one, they also recognize that there are times – such as the current period of economic uncertainty – when they need to advise management more actively. As one member noted, *"Many management teams are young enough not to have seen these downturns [before]."* Members also see an important role for the audit committee in ensuring that compensation metrics reward appropriate but not excessive levels of risk, prevent manipulation of the numbers, and recognize good performance in bad times.

Keeping pace with technical accounting changes

Over the last few years, a number of significant accounting changes and pronouncements have come from regulators in Canada and the United States. Some of these changes are now in effect or will take effect this year. Others loom on the horizon, including a shift in 2011 from Canadian GAAP to International Financial Reporting Standards (IFRS). As one network member noted, *"The volume of changes is one challenge, and the complexity is another."* Another member agreed: *"With the volume and rapidity of changes, there's no time for a breather. It's an endless stream."*

Major accounting changes audit committees are addressing in both Canadian and U.S. marketplaces include:

- **IFRS.** The decision in Canada to shift from Canadian GAAP to IFRS was made with the intention of harmonizing financial reporting around the globe. Canadian companies have a conversion date of 2011, but reporting multi-year financial statements means that companies need to have IFRS-converted financial information going back to 2009.[1]
- **MI 52-109: disclosure.** The Canadian Securities Administrators (CSA) expanded MI 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings) to stipulate that "the CEO and CFO of a reporting issuer, or persons performing similar functions, will be required to certify in their annual certificates that they have evaluated the effectiveness of the issuer's internal control over financial reporting as of the end of the financial year and caused the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting."[2]
- **CICA accounting standards** on "Comprehensive Income," Handbook Section 1530, "Financial Instruments-Recognition and Measurement," Handbook Section 3855, and "Hedges," Handbook Section 3865. These Canadian standards can be intimidating both in their breadth and complexity as they apply to almost all financial instruments. Implementation of the Standards is further complicated because the Standards were developed based on the language in IAS 39, in light of the convergence of Canadian reporting standards to IFRS, while trying to minimize conflicts with U.S. GAAP.
- **FAS 141R/160: transaction accounting.** Financial Accounting Standards No. 141R (Business Combinations) and No. 160 (Noncontrolling Interests in Consolidated Financial Statements) were published on December 4, 2007, and will take effect in 2009. Although the standards will not impact the cash cost of deals, certain provisions are *"eyebrow-raisers"* for audit chairs, among them the "requirement that transaction fees related to an acquisition be expensed as incurred and included on the income statement, rather than capitalized and amortized over time on the balance sheet."[3] Additionally,

[1] For more information on International Financial Reporting Standards, see Ernst & Young, "IFRS: a strategic opportunity," available online at http://www.ey.com/GLOBAL/content.nsf/International/Assurance_-_IAS_Overview.

[2] Canadian Securities Administrators, *CSA Notice 52-313: Status of Proposed MI 52-111 Reporting on Internal Control over Financial Reporting and Proposed Amended and Restated MI 52-109 Certification of Disclosure in Issuers' Annual and Interim Findings* (Montreal: Canadian Securities Administrators, 2006), 1. Available at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/csa_20060310_52-313_status-52-111.pdf.

[3] Tammy Whitehouse, "The New Accounting for M&A Deals," *Compliance Week,* January 29, 2008, 11. Available at http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=3923. FAS 141R is available at http://fasb.org/pdf/fas141r.pdf, and FAS 160 is available at http://fasb.org/pdf/fas160.pdf.

"while financing costs will continue to be capitalized, fees related to bankers, attorneys, accountants, valuation specialists, and others will be expensed each period as they are incurred – even if incurred before a prospective acquisition is announced publicly."[4]

- **FIN 48: uncertainty in income taxes.** FASB Interpretation No. 48, which was issued July 13, 2006, is intended to increase the transparency of tax information in financial statements. It applies to all entities – both taxable and tax-exempt – "that issue GAAP financial statements for fiscal years beginning after December 15, 2006 … Initial recognition of the financial statement effects of a tax position occurs when the identified tax position has a 'more-likely-than-not' probability – a more than 50 percent chance – of being sustained on examination."[5]

There are a number of ways audit committees stay up to date

Audit committee chairs have a number of methods for staying on top of emerging accounting pronouncements, utilizing both resources inside the company and outside advisers. Many members noted that they survey the environment for emerging topics, with one remarking that these topics then *"become a focus of continuing education programs. On my board, during the quarterly CFO report, there's a section for emerging developments, things coming down the tracks."* The member noted that while these discussions are beneficial, *"there's a challenge of timing the learning, determining when is it the perfect time to engage"* on an issue.

Additionally, another member noted that *"a management presentation is not the same as a learning environment. You have to ensure you have an environment to learn and retain information, to ask questions. We've not quite cracked that nut [in committee discussions]."*

Another member reported that in addition to board education sessions, *"I look at all the Big Four literature. We're very well served with written material."* Others agreed that that the accounting firms are a good source of information. *"I rely on the Big Four for their sessions and perspectives,"* one member remarked. *"There are always a variety of free breakfast and lunch sessions on accounting topics [that explain] not only the issue, but how it affects a company."*

Directors want more tailored information

While they are well served with material, many audit committee chairs report that much of it is of a technical nature and not written for an audit committee member's perspective. Members worry about becoming *"too immersed in the details and miss[ing] the overall impact"* of what is being addressed. *"As an audit committee chair, I don't have to know everything, but I must understand [what it means for the company]."*

---

[4] Tammy Whitehouse, "New Accounting for M&A Deals," 11.

[5] Edward R. Jenkins Jr., Narjit S. Bhogal, and Matthew D. Melinson, "FIN 48 from Different Perspectives," *Pennsylvania CPA Journal,* Summer 2007. Available at http://www.accountingweb.com/cgi-bin/item.cgi?id=103625&d=883&h=884&f=882&dateformat=%25o%20%25B%20%25Y. FIN 48 is available at http://www.fasb.org/pdf/fin%2048.pdf.

For members, this means that not only would they prefer to receive the material that is aimed at directors, but also that they would like to receive guidance from their audit partner on how the issue is likely to affect their specific company. *"We want a business-level approach to the issue versus a technical discussion. Don't dive into the hows and whys,"* remarked one audit chair. Another member agreed, recommending that the audit partner *"translate the material so it resonates. Some partners aren't quite as strong in this. It can be like talking with an actuary about pensions."* One member said, *"The [audit] partners who are good at client service are the best at this."* Such partners are *"proactive"* in addressing the issues that are important to audit committee chairs.

Financial statements sometimes fail to reveal true business performance

Many members struggle with an issue that some would assume was clear-cut: just how well is the business performing? This happens because *"people confuse economics and accounting, especially [around issues such as] mark-to-market. Some rules are counterintuitive."* But regardless of appearances, it's vital that companies make decisions that are *"the right economics, and that they don't let the accounting get in the way … if a decision is right for the business, let the accounting fall as it may."*

Members were able to offer a number of examples of good decisions having an adverse accounting effect. Hedge accounting was one such example: *"You want to avoid [the negative accounting impact of hedging] in the quarterly report. But, if this were a private company, [hedging would be] done in a heartbeat."* One audit committee chair reported fearing *"less-than-ideal economic decisions"* because of their accounting treatment. Additionally, members raised concerns about recurring "unusual items" and speculated that there may be some misunderstanding in the marketplace around "other comprehensive income" (OCI), which one member jokingly described as *"incomprehensible income."*

Members stressed that management and the board must focus on the real value of the company and not simply on the accounting statements. The true measure of business performance lies in the strength of the balance sheet, the quality of earnings, and the key drivers of profitability.

Staying on top of changes in the broader market

A 2006 Ernst & Young global survey of audit committees revealed that of the five risks boards felt were most significant, market dynamics came last.[6] Times change. Today, audit committees are facing both new accounting standards and policies and an unpredictable and rapidly changing market environment. On April 10, the *Economist* declared, "Evidence is mounting that the [U.S.] economy has slipped into recession – and this time consumer weakness is to the fore … The unemployment rate rose to 5.1% in March [and to 5.5% in May and June], while the private sector lost jobs for the fourth month in a row … The IMF now officially predicts an American recession in 2008; many at the Federal Reserve think output is contracting."[7]

[6] The first four were regulatory issues; mergers, acquisitions, and divestitures; information technology; and people/HR issues. See Ernst & Young, *Audit Committee Perspectives: 2006 Audit Committee Survey and Industry Insights* (New York: Ernst & Young, 2007), 1. Available at http://www.ey.com/Global/Assets.nsf/Luxembourg_E/Audit_Committee_Perspectives_06/$file/EY_Audit_Committee_Perspectives%202006.pdf.

[7] "The Great American Slowdown," *Economist*, April 10, 2008. Available at http://www.economist.com/opinion/displaystory.cfm?story_id=11016333.

For its part, the Canadian unemployment rate is sitting at 6.1% in June – a higher rate than the United States is experiencing, but still one of the lowest levels in the past 30 years.[8]

To date, the impact of the credit crisis on audit committees has varied widely, primarily by industry, with those in financial services facing greater immediate challenges. Some members are worried about how the crisis will impact the Canadian economy, how much credit will be available in the future, and what this could mean for companies' liquidity.

In difficult times, cash is king

Members stressed the need to focus on *"cash, the balance sheet, and liquidity"* during times of crisis. *"Good managers have a cash fixation,"* one member said. *"The company is cash viable or it isn't. The rest is junk."* In difficult economic times, a cash fixation can be a clear focus for a company and a central metric to rally around. Advanced planning in good times can help tremendously in the bad times: *"Focus on the fundamentals of the business,"* and *"Do what you do best. Focus on the core business,"* members urged. Another member said that *"strengthening the balance sheet is a good move in good times. Keep it strong when you don't need it. [It's the right move,] but it can be a tough decision for a board to make."*

You can't see the future in the rearview mirror

Many audit committee chairs highlighted the importance of conducting *"sensitivity analysis"* and *"scenario testing"* on a company's financial projections as a way to avoid future problems. And yet, members also noted that in the current credit crisis, those tools have not been as helpful as members had hoped they would be. One member remarked, *"Financial institutions do a ton of stress scenarios. But, if you look back on the debt crisis, they apparently were woefully inadequate. We need to understand [what happened and what went wrong.]"*

Models also failed to predict the exceptionally high cost of oil and the growing issues with pension obligations. *"With $140 barrels of oil, I'm not sure how [the economy] is going to make it,"* one member said, and the consequences of soaring oil prices are evident and sobering: another member observed, for example, that with the rapid drop in sales of trucks and SUVs, *"right now, General Motor's market value is equal to what it was in 1955, and it's going in the wrong direction."* The rapid increase in the price of oil and the lack of contingency plans for this specific scenario has left many companies scrambling to determine their next course of action.

At the same time, a large number of companies are struggling to deal with pension obligations and the related issue of the rising cost of health care. While few, if any, companies are creating new defined benefit plans, many are saddled with the burden of old plans and their growing costs: *"a problem that won't go away for at least 30 years."* Again, few financial models predicted the steep rise in the cost of health care for current employees, let alone pensioners. Many companies with strong current financial performance are uncertain about their future financial obligations.

---

[8] Statistics Canada, "Latest release from the Labour Force Survey," July 11, 2008. Available at http://www.statcan.ca/english/Subjects/Labour/LFS/lfs-en.htm.

Members blame ratings agencies, but alternatives are hard to come by

As the housing market started to slide into decline last fall and banks faced tremendous difficulty (and, in some cases, failure) this spring, many experts pointed to the rating agencies as a primary source of the problem. *"A lot of systems are based on those ratings,"* one member noted. *"The ratings agencies let us down."* Members felt that the agencies also relied too heavily on historical data in setting their ratings.

To avoid similar problems in the future, at least one member has instructed finance staff to create their own ratings system, internally. For many companies, that is not a viable option as they lack the staff, expertise, or other resources to institute such a function; for these companies, outside advisers and consultants will remain a necessity. Members were clear, however, that in addressing these issues, *"you pick the space you want to address and find the best people to help you with that."*

Understanding the impact of these changes on the audit committee's role

Members looked back on history and some of the economic downturns of the last century and noted that downturns are coming at an increasing pace. Additionally, in a pre-meeting discussion, one member discerned four common threads running through historical downturns and the current crisis:

- **The problem originated in a new business area or with new financial tools.** The situations were not ones in which companies had a depth of experience or well-developed practices and procedures.
- **Relevant management experience was lacking.** The people in charge of the business area where the problem emerged did not have directly related experience; their experience was in other business areas.
- **Incentives and risk were misaligned.** Executives and employees were compensated based on the income generated by the business. Risk management best practices were degraded or ignored in an effort to maximize profit.
- **Small changes had a cumulative effect and dramatic consequences.** Small, incremental decisions compounded over time to create substantial consequences.

Several members were most concerned about the fact that senior executives don't always have experience dealing with downturns. *"Many management teams are young enough not to have seen these downturns,"* one member pointed out. Younger managers may not recognize warnings signs in advance and may not know how to work their way out of trouble once they're in it.

These concerns make many board directors jumpy about even the slightest economic bad news. One member remarked, *"I get up in the morning and turn on the TV. I see what's happened overnight, overseas, and I immediately get on the phone with the CFO. 'Can this happen to us?' It's just a crazy environment. You think there can be nothing more, and then something happens."*

There is a role for an active audit committee in difficult times

Members debated the proper course of action for the board and audit committee in these situations: be proactive and step in ahead of time, or provide guidance once a problem occurs? They agreed that dire financial and economic conditions present a clear need for the full board to increase its hands-on involvement with management and its guidance and oversight of the operations of the company. Even when the economy is doing well, the scope of a particular undertaking may also necessitate the active assistance and guidance of the audit committee.

In the eyes of many members, the upcoming conversion to IFRS represents one of those undertakings. *"Management is responsible,"* one member said. *"With the scale of changes, management, the audit committee chair, and the audit committee members all need to have a satisfactory project plan in place, with milestones, properly scoped and sized. The audit committee can be helpful in that."*

Another member agreed, but said the role of the audit committee in a project like conversion to IFRS can vary depending on how the change will impact the company. *"For management at a company where IFRS will have a profound impact, they're on top of things. In other companies, they're slow off the start. In those situations, as an audit committee chair, you tend to be proactive and offer assistance."*

Incentives must not encourage unduly risky behavior

The concern over senior management's *"incentives and risk [being] misaligned"* is that this misalignment could lead some executives to *"try and produce funny results"* in order to get a larger bonus. As one member noted, *"So much emphasis has been placed on pay-for-performance, and that's all well and good, but in the end, it can produce some bad behavior."*

Boards need to ensure that *"there is an appropriate measure of performance."* In many companies, this involves both the compensation committee (to set compensation) and the audit committee (to oversee the metrics of company performance). Cross membership between the committees can ensure proper collaboration, but many audit committee chairs supported the view that *"if you have more than one committee, you need to know who is responsible"* in order to avoid confusion and conflict between the committees.

Difficult economic periods offer an additional challenge for pay-for-performance schemes. A company may be losing money but still outperforming competitors who are losing even larger sums, which may be proof of strong performance by executives. Directors find themselves in a Catch-22 situation: it's difficult to reward executives in bad times, but failing to reward them can lead to their being hired away by competitors.

Are audit committees retreating to purely financial reporting responsibilities?

Within the rapidly changing world, members wondered whether audit committees are being forced to retrench to their financial reporting responsibilities, with little time for anything else, such as focusing on what the financials might look like in the future or ensuring risks are properly identified, evaluated, and mitigated. At the same time, although being restricted in their purview is a worry, many directors recognize that the expansion of the audit committee's responsibilities has led to *"a huge overlap between the audit committee and the board [as a whole]."* This was made clear to one member who realized that *"the CFO was giving the same presentation to the audit committee and the full board."* In order to draw a sharper distinction, the audit committee asked the CFO to *"present to the audit committee with a focus on financials, estimates, complex quarterly results, and the like,"* since that is what the committee focuses on, and to present to the full board on issues related to the company's performance.

Some members worry that the board will decide to completely *"separate disclosure from performance management,"* and *"simply rely on the audit committee for disclosure"* and little else. For others, this retrenchment would make sense: *"There's scope to shrink because the current workload is so heavy with technical issues."* Members were adamant that if the audit committee does not have time to address performance management issues, then the board as a whole should take up those issues.

Conclusion

Companies around the world are being impacted by current economic and credit market conditions in ways they did not predict and for which they are largely unprepared. *"We hear a lot of false stories about how we're not affected because we're Canadian,"* one audit chair remarked, but members report the contrary. They are being challenged to keep on top of the current economic situation, the impending conversion to IFRS, disclosure responsibilities, and the myriad other obligations that come with their job. Without crossing the bright line into management's sphere, the audit committee and board as a whole must offer all possible aid to ensure the company successfully rides out the current economic turbulence.