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Technical Report

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Audit Committees on Canada's "Big Board" fall into Line; Little Guys Continue to Lag

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* Regan Schmidt ABD CA, a Queen's doctoral student, managed the research team that collected the data that underlies this report. Without his leadership, this data would not have been collected. His comments on the final drafts of this manuscript are also appreciated.

Audit Committees on Canada's "Big Board" Fall Into Line; Little Guys Continue to Lag

After a rough introduction to the post-Sarbanes Oxley era, Canadian audit committees for TSX listed firms have mostly fallen into line with the reforms enacted by the Canadian Securities Administrators in 2004. A new study just completed shows that for a sample of over 450 Canadian companies that 90% or more complied with the regulatory requirements for Audit Committee member independence and financial literacy, assigned responsibilities acknowledged and audit firm fee disclosures.

All is not good news however. The study also found:

- TSX Venture companies continue to significantly lag TSX companies in required audit committee disclosures and in overall audit committee disclosures.
- Over 10% of TSX and TSX Venture companies have incomplete audit firm fee required disclosures.
- Nearly 10% of TSX Venture companies have a majority of non-independent directors on the audit committee in apparent violation of regulatory requirements.
- Nearly 10% of TSX companies do not provide support for the assertion that their audit committees are staffed with financially literate members as required.
- A majority of TSX Venture issues (57%) have a senior management member on the audit committee – an extremely poor governance practice as shown by realms of research studies and other regulator's rulings as it leads to a significantly less effective committee. [Note: This is not a regulatory requirement for Venture issuers.]

The 'made in Canada' approach of providing 'daylight' by requiring disclosure of poor governance practices hoping that it would lead to substantive changes quickly does not seem to be born out given the predominance of Venture firms having management members on Audit Committees despite several years of disclosure of this departure from 'best practice'. The lack of compliance in the area of mandated audit committee financial literacy disclosures among TSX companies is also problematic. 'Negotiations' among Canada's thirteen regulators lead to the requirement for a financial expert on the audit committee to be dropped and replaced with this disclosure - yet even that disclosure is not being uniformly followed. Compounding this is the practice of nearly 90% of Venture companies voluntarily disclosing they have financially literate audit committees but with almost a third not providing any information about how they support that assertion.

Nonetheless, the study concludes that the overall story is a good news one for Canadian regulators. In one of the rare cases where regulators went public with a strong statement of disapproval of the level of noncompliance in their first study and kept their promise to carry out the follow up study in the next fiscal year, corporate Canada as represented by those listed on the "Big Board" seemed to be convinced that the regulators were serious about enforcement of this regulation.

Audit Committees on Canada's "Big Board" Fall Into Line; Little Guys Continue to Lag

The Canadian Securities Administrators took the unusual step of publicly flogging corporate Canada in 2006 over the lack of compliance with the post Sarbanes Oxley audit committee reforms mandated by Multilateral Instrument 52-110 Audit Committees. The CSA participating administrators (Ontario, Quebec, Alberta, Saskatchewan and Manitoba with the 'usual' holdout of British Columbia¹) released a review on January 13, 2006 of fiscal 2004 disclosures and characterized "the level of compliance was unacceptable" and promised further follow-up reviews (see CSA 52-312). In contrast to the norm of significant delay between announcement of follow-up and the actual implementation of one, the follow-up review was carried out in the next fiscal year (CSA 52-318). In a report dated June 29, 2007 apparently the CSA was pleased with the improvement despite finding that some audit committee charters did not reflect mandatory assigned responsibilities at rates up to 28%.

The CSA conclusion that no further regulatory action was necessary other than the vague assurance that "We therefore intend to review issuers' compliance with the Instrument selectively as part of our ongoing continuous disclosure review program" was somewhat surprising to us. The 2004 study was based on 95 companies overall including only 30 Venture companies and the 2005 study based on 25 companies overall with 10 Venture companies. These small samples were somewhat worrisome given the difficulty of generalizing to a population based on such small samples. Hence, we started a research project that examined detailed audit committee disclosures for a random sample of 307 TSX listed companies (average total assets \$2 billion, median \$160 million; market cap mean \$918 million, median \$167 million) and 148 TSX Venture companies (average total assets \$19 million, median \$7.7 million; market cap mean \$65 million, median \$17 million) in fiscal year 2006. In our sample we note that nearly 20% (11%) of the TSX Venture firms based on market capitalization (total assets) are greater in size than the bottom 25% of the of the TSX sample. Nearly 40% (25%) of TSX Venture companies are greater in size than the bottom 10% of the TSX sample. Even after adjusting for the resource industry base of many Venture companies that inflates size measures; we are still examining many significant size companies in the TSX Venture sample. This feature of our sample influences our recommendations.

We examine our sample for the following items based on MLI 52-110 Audit Committees:

- An overall measure of audit committee disclosures compliance.
- Disclosures of independence of and qualifications of audit committee members.

¹ The British Columbia Securities Commission is a regular holdout in investor protection oriented regulations agreed to by other Canadian securities commissions. It seems to be a classic example 'captive' regulator responding more to the regulatees than the investors it is supposed to be there to protect (for a reasonably readable review of this literature see Ernesto D. Bo (2006) Regulatory Capture: A Review. *Oxford Review of Economic Policy*. 22(2), 203-225.).

- Audit committee charter disclosure, external and internal auditor direct reporting responsibility to audit committee and responsibility of audit committee for oversight of internal controls.
- An overall measure of audit firm fee disclosures and specifically audit fee disclosure.

We evaluated each company's disclosure and assigned it to one of the following categories:

- The company has not stated whether it complied with the requirement (i.e., no disclosure).
- Our investigation of public disclosures shows company did NOT comply with the requirement AND it did not disclose the non-compliance.
- The company did NOT comply with the requirement and gave a reason why (permitted previously under TSX guidelines but not permitted under 52-110).
- The company did NOT comply with the requirement and did not give any reason.
- The company complied with the requirement.
- Our investigation of public disclosures shows company DID comply with the requirement but it did not disclose their compliance (a strange but true category).

Two of these categories bear explanation; the ones lead of by the words 'our investigation'. As we have constructed a large data base of information about Canadian public companies and their directors we are able to evaluate some of the items required to be disclosed by the various regulations and will be able to evaluate more as the data base grows. Hence, where possible, we examine cases of non-disclosure to determine whether the company complied with the requirements of the regulation and classify the non-disclosure accordingly.

Highlights

Highlights of our findings are:

- Overall, a high level of compliance with the requirements of 52-110 was found. Compliance rates with requirements of 52-110 that applied to TSX and TSX Venture exchanges near 90% or more. See Section 1 for details.
- Significant differences are present in the disclosures of TSX and TSX Venture companies about audit committees due to the differences in the regulatory requirements as would be expected given some TSX requirements are not mandatory, but only recommended for Venture companies. See Section 1 for details.
- However, significant differences also occur between TSX and TSX Venture companies where the requirements are mandated for both. See Section 3.1 and 3.2 for examples.

- A majority (57%) of Venture companies persist with the practice of having management as members of the audit committee – something that almost all corporate governance research² finds leads to less effective audit committees and other regulators³ recommend or mandate against. See Section 2 for details.
- Nearly 10% of Venture companies have a majority of non-independent members of the audit committee – a finding not picked up on in the small samples used by the CSA in their investigations of compliance with 52-110. This finding appears to be a violation of 52-110 requirements. See Section 2 for details.
- 8% of TSX companies either do not disclose their financial literacy assessment or do not provide disclosures about the basis for their assessment (i.e. the educational and work experience that qualifies a member as financially literate), a rather high non-compliance rate for a mandatory requirement. This non-compliance is particularly problematic as this is a regulation that is already “watered down” from the original proposal that would have seen TSX companies having a financial expert on the audit committee (which most research supports as increasing audit committee value and effectiveness⁴) and clear definitions of what constitutes financial literacy (see 52-110 proposals for comments dated June 27, 2003)⁵. See Section 2.1 and 2.2 for details.
- 88% of TSX Venture companies voluntarily disclose their assessment that the members of their audit committees are financially literate. However, only 69% of those making the claim provide the recommended disclosures about education and professional experience to support the claim making it difficult to evaluate the claim of literacy. See Section 2.1 and 2.2 for details.
- Over 10% of the companies routinely omit required details about audit firm fee disclosures and 7% of companies on both the TSX and TSX Venture omit the required disclosure about audit fees themselves. Given the focus on audit firm fees and their effects on auditor independence in the last round of accounting scandals⁶ it appears strange that these disclosures are not routinely being made by companies and enforced by regulators. See Section 4.1 and 4.2 for details.

² For example, April Klein (2002). Audit committee, board of director characteristics, and earnings management. *Journal of Accounting & Economics*, 33(3), 375-400.

³ For example, in addition to the US requirements for audit committees that predate SOX (Sarbanes Oxley Act of 2002) for the New York Stock Exchange, requirements that no managers (executive directors) be on the audit committee are found in Australia, Singapore and the United Kingdom among others.

⁴ For example, Mark L Defond, Rebecca N Hann, Xuesong Hu. (2005). Does the Market Value Financial Expertise on Audit Committees of Boards of Directors? *Journal of Accounting Research*, 43(2), 153-193.

⁵ To be technically correct, the original proposal required all companies to report who the financial expert was if they had one and if they did not have a financial expert why they did not have one on their audit committee. Most observers concluded, including the CSA, that this would require most large TSX companies to have a financial expert.

⁶ For example, William R Kinney JR, Zoe-Vonna Palmrose, Susan Scholz. (2004). Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right? *Journal of Accounting Research*, 42(3), 561-588.

Recommendations

Based on these findings we recommend that the Canadian Securities Administrators consider the following with respect to MLI 52-110 Audit Committees:

1. Enforcement focus on three areas:
 - a. Enforcement of independence rules for audit committee members in Venture companies. Almost 10% of our sample of Venture companies featured audit committees committing this apparent clear breach of the regulation and of good governance practice.
 - b. Enforcement of compliance with the background disclosures of education and experience of audit committee members. This is a critical disclosure for markets to judge true financial literacy of audit committees especially given that the CSA has chosen to (i) not regulate what constitutes financial literacy but rather allow 'daylight' disclosure to allow users to determine if financial literacy is achieved by members and (ii) has not required that a financial expert be required on audit committees of at least larger issuers. The rate of non-compliance approaching 10% on the TSX should not be considered acceptable at this stage of implementation.
 - c. Audit firm fee disclosures be policed during continuous disclosure review as a low cost way of reminding companies that MLI 52-110 continues to be on the regulatory screen. Noncompliance with all or parts of the fee disclosure regulation exceeds 10% and again should not be considered acceptable at this stage of regulatory implementation.
2. Given that a majority of Venture companies have managers serving on the Audit Committee, and given that a substantial number of Venture companies are of a size comparable to TSX registrants, we recommend that a size test be developed instead of a blanket exemption for Venture companies with regard to having a manager on the Audit Committee. Governance research⁷ shows a major decline in the actual and the perceived effectiveness of an audit committee with a manager on it and with the increasing size of Venture companies and wider shareholder base, a size test would make more sense than a blanket exemption.
3. That Venture companies be prohibited from claiming that their audit committee members are financially literate unless they also provided the background disclosures about education and experience to support that assertion. Given the Canadian approach is one

⁷ Ibid see footnote 2.

of “daylight” rather than detailed definition of what financial literacy is, the assertion of financial literacy without the background information is essentially meaningless.

The data that lead to recommendations 2 and 3 call into question what might be called the “Dey” doctrine⁸ in Canadian securities regulation. That doctrine can be summarized as requiring disclosures of actual governance practices benchmarked against securities commissions’ endorsed “best” practices with the unstated but implied belief that the dissenters will move towards best practices. In neither case does the evidence in our research provide support that disclosure alone will provide much improvement. We expect to provide further evidence on this issue in the near future in our broader examination of corporate governance disclosures.

⁸ See the Dey Committee on Corporate Governance commissioned by the Toronto Stock Exchange in 1994 and its follow up report, *Five Years to the Dey*, in 1999.

Section 1. An overall measure of audit committee disclosure compliance

A combined measure of the 17 disclosure items we examined based on Multilateral Instrument 52-110 Audit Committee's requirements. All items are required disclosures for TSX companies whereas some items are best practice only recommendations for TSX Venture companies.

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	325	6%	181	7%
Our investigation shows company did not comply and did not disclose	8	0%	11	0%
Did not comply and gave reason for non-compliance	50	1%	14	1%
Disclosed non-compliance but did not give a reason	32	1%	173	7%
Complied and disclosed compliance	4779	92%	2136	85%
Our investigation shows company complied but it did not disclose compliance	14	0%	1	0%
TOTALS	5208	100%	2516	100%

Commentary: There is a highly significant difference ($\chi^2(5) = 275, p < 0.0001$), as would be expected when one set of companies must follow regulations and the other set must only follow a subset of the regulations, between the degree of compliance with the practices and the disclosures in 52-110 audit committees. Overall, however the rate of compliance is much higher than found in the original CSA study (52-312 2006) for both TSX firms and for TSX Venture firms which examined a more limited set of items except in one area. Hence, our overall conclusion was that by 2006 compliance with 52-110 has substantially improved especially for TSX firms.

Section 2. Independence of audit committee members

Requirement: 100% of audit committee members should be independent. This is a requirement for TSX companies and a recommended best practice for TSX Venture companies.

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	1	0%	0	0%
Our investigation shows company did not comply and did not disclose	4	1%	5	4%
Did not comply and gave reason for non-compliance	8	3%	7	1%
Disclosed non-compliance but did not give a reason	6	2%	74	50%
Complied and disclosed compliance	286	93%	62	45%
Our investigation shows company complied but it did not disclose compliance	2	1%	0	0%
TOTALS	307	100%	148	100%

Commentary: Consistent with prior research, the average size of an audit committee was just over 3 (3.30 on the TSX and 3.03 on the TSX Venture) with 97.39% of the TSX audit committees being 100% independent and 43.2% of the TSX Venture audit committees being 100% independent where such is not required by regulation. Even without statistics, it is obvious that Venture companies are highly statistically significantly different from the TSX companies in their compliance with this recommendation ($\chi^2(3) = 169, p < 0.0001$).

These independence results are similar to those found by the CSA study in 2006 for the TSX companies (98%) and a marked improvement for the Venture companies (31%); an improvement that is statistically significant ($\chi^2(2) = 6.16, p < 0.05$). Nonetheless, 19 Venture companies had 2 or more non-independent members of the audit committee and 14 of the Venture companies had audit committees that had a majority of non-independent directors on them – representing almost 10% of all Venture companies we examined.

This finding was not confined to the smallest Venture companies. Among those companies that we referred to earlier as meeting the 75% (90%) size test for market capitalization versus TSX companies we found that 100% (75%) had one manager and several had other non-independent members on the audit committee including three (four) companies that have a majority of non-independent directors on the audit committee.

In light of the overall significant improvement in Venture company voluntary compliance with 52-110 recommendation for 100% independent directors on the audit committee, this finding

suggests that the small CSA sample of Venture issuers (30 companies in the first study and 10 in the second) used by the regulators is not sufficient to draw reliable conclusions about the characteristics of the Venture companies' audit committees.

DRAFT FOR PUBLIC DISCUSSION

Section 2.1 Audit Committee Members Financial Literacy Disclosure

Requirement: Each company should evaluate and disclose that all members of the audit committee are financially literate. Required for TSX companies and recommended as a best practice for TSX Venture companies.

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	10	3%	10	7%
Our investigation shows company did not comply and did not disclose	0	0%	0	0%
Did not comply and gave reason for non-compliance	0	0%	1	0%
Disclosed non-compliance but did not give a reason	0	0%	7	5%
Complied and disclosed compliance	296	97%	130	88%
Our investigation shows company complied but it did not disclose compliance	1	0%	0	0%
TOTALS	307	100%	148	100%

Section 2.2 Audit Committee Members Education and Relevant Experience Disclosure

Requirement: To disclose the education and relevant experience to support the financial literacy determination. Required for TSX companies and recommended as best practice for TSX Venture companies.

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	21	7%	54	36%
Did not comply and gave reason for non-compliance	4	1%	2	1%
Disclosed non-compliance but did not give a reason	1	0%	2	1%
Complied and disclosed compliance	280	92%	90	61%
TOTALS	306	100%	148	100%

Commentary: The rate of disclosure of financial literacy of audit committee members (97%) and the supporting disclosure to back it up for TSX companies is high (95% of those disclosing). However, with the combined non-disclosure and non-background information to evaluate the disclosures' veracity reaching near 10% on the TSX it is troublesome. 52-110 was "watered down" from requiring a financial expert plus all members being financially literate with detailed prescriptions about how financial literacy was to be obtained to just all members being financially literate with disclosures of how the company made that determination to give companies flexibility in staffing their audit committees (see 52-110 Summary of Comments and Responses January 16, 2004 among others). Hence, more regulatory attention to this matter appears warranted, otherwise the assertion of financial literacy given its lack of definition in the instrument is relatively meaningless.⁹

The assertion of audit committee financial literacy by so many of the TSX Venture companies (88%) while welcome, is not backed up by disclosures in over 30% of the cases where financial literacy is claimed. Again, given the weakness of the regulation it seems problematic that the literacy claim can be made without the supporting back-up if it is to be of any value to regulators or investors.

⁹ 52-110 defines financial literacy as "an individual is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements." No requirements are given as to how it is to be obtained.

Section 3 Audit Committee Charter with Specific Responsibilities Disclosed

Requirement: All audit committees are required to have a charter that has specific responsibilities assigned to the committee from the Board of Directors. In this analysis we examine whether such a charter is disclosed with a list of enumerated responsibilities (but we did not check exhaustively for all responsibilities as laid out in 52-110).

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	5	2%	11	7%
Did not comply and gave reason for non-compliance	1	0%	0	0%
Disclosed non-compliance but did not give a reason	0	0%	1	1%
Complied and disclosed compliance	301	98%	136	92%
TOTALS	307	100%	148	100%

Section 3.1 External Auditor and Internal Auditor have direct access to Audit Committee

Requirement: To ensure that Audit Committee is perceived as the ‘client’ of both internal and external audit both auditors need to have direct access to the committee. Required for both TSX and TSX Venture companies

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	9	3%	16	11%
Did not comply and gave reason for non-compliance	0	0%	0	0%
Disclosed non-compliance but did not give a reason	0	0%	0	0%
Complied and disclosed compliance	298	97%	132	89%
TOTALS	307	100%	148	100%

Section 3.2 Audit Committee Assigned Specific Responsibility for Oversight of Internal Control

Requirement: 52-110 requires that the Audit Committee have oversight responsibility for internal controls. This disclosure is required of both TSX and TSX Venture companies

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	9	3%	15	10%
Did not comply and gave reason for non-compliance	0	0%	0	0%
Disclosed non-compliance but did not give a reason	1	0%	0	0%
Complied and disclosed compliance	296	97%	133	90%
TOTALS	306	100%	148	100%

Commentary: If an audit committee needs to use its charter to insist on holding management accountable, the audit committee is in the midst of a crisis. Nonetheless, the charter lays out the expectations of the Board of Directors for the areas that the audit committee is routinely expected to provide first line of oversight for on behalf of the Board. Hence, we examine the required disclosures for a Audit Committee Charter with specified responsibilities, and we look in particular for two responsibilities, direct assess of the committee to the external and internal auditor so the committee my effectively discharge its oversight of financial reporting and responsibility for oversight of internal control, a closely related area.

In all cases we find compliance at a high level, 97% and above for TSX companies and 89% and above for TSX Venture companies and in all cases we find that Venture companies have a statistically significant lower level of compliance (all p-values less than 0.01 for chi-squared tests). This was the largest area of concern from the two CSA studies and while our results are not directly comparable to theirs, it appears the concern is not as warranted for the TSX companies whereas the concern is still ongoing for the Venture companies, albeit at a lower level than before.

Section 4 Audit Fee disclosure and details supporting that disclosure

Section 4.1 Index of overall details of audit firm fee disclosures

Requirement: 52-110 requires details about audit fees, audit-related fees, tax fees and all other fees for services provided by the audit firm. This index is a combination of these items disclosures evaluated. All disclosures required for both TSX and TSX Venture companies.

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	244	11%	64	6%
Our investigation shows company did not comply and did not disclose	1	0%	0	0%
Did not comply and gave reason for non-compliance	30	1%	1	0%
Disclosed non-compliance but did not give a reason	17	1%	11	1%
Complied and disclosed compliance	1840	86%	960	93%
Our investigation shows company complied but it did not disclose compliance	9	0%	0	0%
TOTALS	2141	100%	1036	100%

Section 4.2 Audit Fee Disclosure

Requirement: Audit fees “the aggregate fees billed by the issuer’s external auditor in each of the last two fiscal years for audit services”. This disclosure is required for both TSX and TSX Venture companies.

Company Disclosure Analysis	TSX		TSX Venture	
	#	(%)	#	(%)
No disclosure found	19	6%	6	4%
Did not comply and gave reason for non-compliance	4	1%	1	1%
Disclosed non-compliance but did not give a reason	3	1%	3	2%
Complied and disclosed compliance	280	92%	138	93%
TOTALS	306	100%	148	100%