



The changing face of the audit committee

Introduction

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading companies headquartered in Canada. 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 new audit environment.

The first meeting of the network was held in Toronto on August 1, 2006, and focused on the changing role of the audit committee, including the challenges facing audit committees and the skills and capabilities required to meet those challenges.

This document reflects a synthesis of key issues that emerged from the network meeting on August 1. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues. Anyone who receives this publication may share it with those in their own network. The more broadly we can disseminate this information to board directors, management executives, and advisers who will become systematically engaged in this dialogue, 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. The attendees were:

- John Caldwell, Audit Committee Chair, Cognos
- Gary Colter, Audit Committee Chair, CIBC
- Denis Desautels, Audit Committee Chair, Alcan
- Don Fullerton, Audit Committee Chair, Husky Energy
- Kerry Hawkins, Audit Committee Chair, Nova Chemicals
- Bob Luba, Audit Committee Chair, MDS
- Eileen Mercier, Audit Committee Chair, CGI Group
- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer, Ernst & Young Canada
- Ted Reevey, Audit Committee Chair, Aliant
- Maureen Sabia, Audit Committee Chair, Canadian Tire
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services, Ernst & Young Canada

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.



Executive summary

In their first meeting, members of the Canadian Audit Committee Network addressed the evolving role and composition of the audit committee and the board. The issues members found to be most important are highlighted below, with more detailed discussion on the following pages:

- **While the audit committee’s role is fundamentally unchanged, its responsibilities have grown** *(Page 3)*

As in the United States, audit committees in Canada are adjusting to increased regulation and investor expectations and to the recognition that the audit committee can address some issues better than the board as a whole.

While the role of the audit committee has not changed fundamentally, its work is now subject to greater scrutiny by regulators, investors, and others, and the activities required to fulfill its duties have expanded significantly. Audit committees are no longer simply reviewing and approving a company’s financial statements; now they must also oversee regulatory compliance and risk management activities, and they are more involved in reviewing and understanding the work of both internal and external auditors.

Good people are hard to find *(Page 4)*

In addition to shouldering expanded responsibilities, the audit committee requires a deeper commitment from its members. Members must be willing to review documents and spend the time necessary to understand certain accounting and auditing issues; they must have the courage to challenge management and auditors. Increasingly, audit committees are being expected to coordinate a myriad of relationships, so good relationship-building skills are critical.

Members agreed that financial expertise is important and stressed that this was different from the “financial expert” designation. Some network members have seen situations in which certain audit committee members were reluctant to be designated financial experts because of a perception that the expert will face increased liability. Members agreed that audit committee members should receive higher compensation than other directors because of heavier workload.

- **The board must rely on the right people** *(Page 5)*

Members recognized that despite the temptation to delve deeply into issues, the board should not cross the line into management. Members agreed that they “*make [their] bets on people*” and felt it was important to trust management to carry out its responsibilities. However, members also recommended turning to internal and external auditors to verify that their trust is well-placed.



While the audit committee's role is fundamentally unchanged, its responsibilities have grown

Although members feel that the audit committee's fundamental role is unchanged, they believe that the breadth and number of issues they are dealing with has expanded greatly. Members agreed that *"if you surveyed audit committee members, they would tell you that their number one job is accuracy in published financial documents."* The additional responsibilities that now fall to the audit committee – overseeing risk management and the relationship with the external auditor, for example – relate directly to that primary job; they make it possible to achieve the larger goal.

Members agree that the audit committee's workload has increased significantly over the past several years. One member said, *"Some audit committees have ten times the work we had ten years ago."* There appear to be two reasons for the increase in workload: increased scrutiny arising from the numerous corporate failures of the early 2000s and recognition of the fact that the audit committee is able to address some problems more effectively than the board as a whole.

Broad scope

The scope of the audit committee's work can be very broad, encompassing not only financial reporting, but also issues that have an impact on the long-term financial integrity of the company. One member read an excerpt from a committee charter detailing the committee's responsibilities, noting that it included such diverse items as *"integrity, [regulatory] compliance, external auditor management, internal and external auditor interaction, management oversight, risk management, pension funds, and environmental risks."* Another member wondered if it made sense for the audit committee to be responsible for *"every risk known to man."*

In addition to noting an expansion of issues under their purview, members acknowledged that some of the responsibilities now demanding their attention are ones that they should have been monitoring more closely in the past. For instance, one member pointed out that *"there was inattention to internal audit for many, many years."*

Good people are hard to find

Like any other committee, the audit committee is only as effective as its members. However, at least one audit chair has found that *"getting people [to serve] on the audit committee is a big problem."* Potential audit committee members fear legal liability and an excessive workload. This attitude may have increased in recent months with amendments to the Ontario Securities Act that allow shareholders to bring lawsuits against companies and individuals involved in continuous disclosure violations. Penalties can be stiff. According to Torys LLP, "For individuals, the cap is generally \$25,000 or half of that person's total compensation from the relevant companies (including affiliates) for the 12 months preceding the violation, whichever is greater. These caps will not apply to directors, officers, influential persons or experts who



authorize, permit or acquiesce in the continuous disclosure violation knowing it was a violation.”¹ As Torys has noted, “Being a public company director or officer just got a whole lot riskier.”²

Nevertheless, members say audit committee membership offers unparalleled insight into the company, and some companies make accommodations for those willing to make the commitment to serve. However, one member noted that “*you can’t just recruit to the audit committee. The board recruitment process is the most important piece.*” Ideally, the board recruitment can be done with committee needs in mind.

Financial experts or financial expertise?

Under the Sarbanes–Oxley Act, companies listed in the United States must designate at least one financial expert on the audit committee. However, one member expressed the network consensus that there is “*no clear definition of what ‘financial expert’ really means.*” Another member said that the financial expert designation “*is misleading in the extreme around [both] the term and the word [‘expert’].*” Furthermore, in reflecting upon the myriad issues listed in a typical audit committee charter, one member stated simply, “*There are no experts over the broad range of issues with which we deal.*”

Many audit committee chairs believe a diverse membership is critical. One member distinguished between financial expertise and the “financial expert” designation, saying, “*I’m not as concerned with financial experts as I am with financial literacy. The last thing I want to see [is nothing but] former accountants and auditors on the committee.*” Another member agreed: “*You can have a strong committee even if you don’t go out of your way to find ‘financial experts.’*”

Convincing people to join

Audit chairs described a variety of strategies for recruiting committee members. One audit chair said their company “*relieves audit committee members of other board requirements*” such as sitting on other committees. At one company, “*any new board member has to serve on the audit committee*” as a way to learn and understand the company’s financial reporting processes quickly. Interestingly, “*non-finance people tend to stay on [the committee] longer [than those with financial backgrounds].*” Another member supported this approach, stating, “*I tell people who join the board to join the audit committee. That’s where you see what is really going on.*”

If all other recruitment efforts fail, there is one remaining strategy that members have found very effective: “*Pay them more.*” While few people are motivated solely by the financial rewards of being a committee member, network members would like to feel they are fairly compensated. In our discussions, one chair noted that “*certainly the audit chair gets higher remuneration than chairs of other committees, both for the work and for the risk. And, in taking on more risk, you also get more work.*”

¹ Torys LLP, *Ontario’s new law on liability for public company disclosure proclaimed into force on December 31, 2005* (New York and Toronto: Torys LLP, 2005), 2. Complete pdf file available at <http://www.torlys.com/publications/pdf/CM05-38T.pdf>.

² Torys LLP, *Being a public company director or officer just got a whole lot riskier* (New York and Toronto: Torys LLP, 2005). Complete pdf file available at <http://www.torlys.com/publications/pdf/fpa05-37.pdf>.



Three necessities for effective audit committee membership

- **Time:** Audit committee members spend more time on their committee responsibilities than members of any other board committee. One member advised, *“Don’t serve on an audit committee if you don’t have the time to put into it.”*
- **Courage:** Committee members need to have the *“courage to confront the external auditor, management, and the board.”*
- **Independence:** Audit committee members must be financially independent of the company. However, members feel that it is just as vital for individuals to approach their responsibilities with *“an independence of judgment.”*

The board must rely on the right people

Members recognized that despite the temptation to delve deeply into issues, the board must not cross the line into management. Strong and effective relationships with both individual executives and departmental functions enable the audit committee to provide strong oversight; as such, it is of paramount importance to manage that network of relationships skillfully. One member stated, *“I make my bets on people.”* Another member agreed, explaining that in order to do their job effectively, *“I must have full confidence in the CEO, CFO, the financial function, strong internal auditor personnel, and all the people working on those teams.”* Members also noted that while they must trust management, they should also know how to draw on the expertise and perspectives of independent advisers, including the external auditor, to corroborate what they are being told.

The “art of the director”

Effectively managing relationships may also be described as the “art of the director.” Unable to investigate every possible matter, audit committees must be discerning about the topics on which they focus. Reliable individuals inside and outside the company can help committee members choose their area of focus. As one member said, *“One has to make up one’s mind about how deeply to dig. There are many ways to deal with this, but you have to trust in [other] people.”*

While members are mindful not to cross the bright line into management, they recognize the value of contextual insight. Members occasionally visit off-site locations to gain firsthand understanding of the company’s operations and to get to know employees. One member described the immense value of a trip to one of the company’s foreign facilities. Seeing things with one’s own eyes, this member noted, improves one’s ability to ask the right questions. Additionally, by meeting with facility leaders personally, the director was able to build relationships that will facilitate future audit committee interactions.

Trust, but verify

Because *“management can paint a picture that enhances [its] view of things,”* members noted that the audit committee can benefit immeasurably by using the external auditor to delve deeply into areas in which committee members need insight, clarification, or verification. External auditors provide an independent



view on matters committee members cannot explore directly. Members agreed that *“open, dynamic communication between the audit committee and the external auditor is absolutely key.”*

The relationship should also work both ways. One network member remarked to the group, *“The most significant test of the relationship with the external auditor [is whether] we both [get] out of it what we wanted.”* A clear understanding of the desires and expectations of the external auditor is important for a successful relationship. Ultimately, *“everybody should feel comfortable with the environment created.”*

Conclusion

Since the passage of Bill 198 in Canada and Sarbanes-Oxley in the United States, it has become increasingly difficult and, some would say, ever more risky to serve on the audit committee of a public company. However, the audit committee has never been more important, making the commitment of the audit committee chair a crucial component in effective corporate governance.

At the end of the first meeting of the Canadian Audit Committee Network, several members expressed a desire for this group to become a forum in which to identify leading practices for audit committee performance. At future meetings, members hope to explore in greater depth specific issues associated with internal audit, such as risk management, the relationship between the audit committee and other committees of the board, and the relationship between the audit committee and the external auditor.

The views expressed in this document represent those of the Canadian Audit Committee Network, a select group of audit committee chairs from Canada's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.

This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.