

POLICY STATEMENT TO REGULATION 52-110 RESPECTING AUDIT COMMITTEES

PART 1 GENERAL

1.1. Purpose

We, the Canadian Securities Administrators (the CSA), adopt *Regulation 52-110 respecting Audit Committees* (the Regulation) to encourage reporting issuers to establish and maintain strong, effective and independent audit committees. We think that such audit committees enhance the quality of financial disclosure made by reporting issuers, and ultimately foster increased investor confidence in Canada's capital markets.

This policy statement (the Policy) provides information regarding the interpretation and application of the Regulation.

1.2. Application to non-corporate entities

The Regulation applies to both corporate and non-corporate entities. Where the Regulation or this Policy refers to a particular corporate characteristic, such as a board of directors, the reference should be read to also include any equivalent characteristic of a non-corporate entity. For example, in the case of a limited partnership, the directors of the general partner who are independent of the limited partnership (including the general partner) should form an audit committee which fulfils these responsibilities.

Income trust issuers should, in applying the Regulation, recognize that certain functions of a corporate issuer, its board of directors and its management may be performed by any or all of the trustees, the board of directors or management of a subsidiary entity of the trust, or the board of directors, management or employees of a management company. For this purpose, references to "the issuer" refer to both the trust and any underlying entities, including the operating entity.

If the structure of an issuer will not permit it to comply with the Regulation, the issuer should seek exemptive relief.

1.3. Management companies

The definition of "executive officer" includes any individual who performs a policy-making function in respect of the entity in question. We consider this aspect of the definition to include an individual who, although not employed by the entity in question, nevertheless performs a policy-making function in respect of that entity, whether through another person or otherwise.

1.4. Audit committee procedures

The Regulation establishes requirements for the responsibilities, composition and authority of audit committees. Nothing in the Regulation is intended to restrict the ability of the board of directors or the audit committee to establish the committee's quorum or procedures, or to restrict the committee's ability to invite additional parties to attend audit committee meetings.

PART 2 THE ROLE AND COMPOSITION OF THE AUDIT COMMITTEE

2.1. The role of the audit committee

An audit committee is a committee of a board of directors to which the board of directors delegates its responsibility for oversight of the financial reporting process. Traditionally, the audit committee has performed a number of roles, including

- (a) helping directors meet their responsibilities,
- (b) providing better communication between directors and the external auditor,

- (c) enhancing the independence of the external auditor,
- (d) increasing the credibility and objectivity of financial reports, and
- (e) strengthening the role of the directors by facilitating in-depth discussions among directors, management and the external auditor.

The Regulation requires that the audit committee also be responsible for managing, on behalf of the shareholders, the relationship between the issuer and the external auditor. In particular, it provides that an audit committee must have responsibility for

- (a) overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or related work; and
- (b) recommending to the board of directors the nomination and compensation of the external auditor.

Although under corporate law an issuer's external auditor is responsible to the shareholders, in practice, shareholders have often been too dispersed to effectively exercise meaningful oversight of the external auditor. As a result, management has typically assumed this oversight role. However, the auditing process may be compromised if the external auditor views its main responsibility as serving management rather than the shareholders. By assigning these responsibilities to an independent audit committee, the Regulation helps to ensure that the external audit will be conducted independently of the issuer's management.

2.2. Relationship between the external auditor and shareholders

Subsection 2.3(3) of the Regulation provides that an audit committee must be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, including the resolution of disagreements between management and the external auditor regarding financial reporting. Notwithstanding this responsibility, the external auditor is retained by, and is ultimately accountable to, the shareholders. As a result, subsection 2.3(3) does not detract from the external auditor's right and responsibility to also provide its views directly to the shareholders if they disagree with an approach being taken by the audit committee.

2.3. Public disclosure of financial information

Issuers are reminded that, in our view, the extraction of information from financial statements that have not previously been reviewed by the audit committee and the release of that information into the marketplace is inconsistent with the issuer's obligation to have its audit committee review the financial statements. See also *National Policy 51-201 Disclosure Standards*.

2.4. Composition of the audit committee

An audit committee should be composed of an appropriate number of independent directors who are unrelated to any control person or significant shareholder.

PART 3 INDEPENDENCE

3.1. Guidance for assessing independence

When assessing independence, the board of directors should review closely the director's business and other relationships with the issuer or its executive officers. The board of directors should apply in its analysis of such business and other relationships materiality thresholds that are appropriate for the issuer and the directors.

A director's independence could be affected if he or she

- (a) has been employed by the issuer;

- (b) is, or has been, employed by an affiliate of the issuer;
- (c) has a close association with an executive officer of the issuer or is actively involved in the day to day management of the issuer;
- (d) has family ties with an executive officer of the issuer;
- (e) has, or had, a significant contractual or other business relationship with the issuer or an affiliate of the issuer, other than as a director, or is a partner, shareholder, director, executive officer or employee of an entity that has such a relationship;
- (f) is, or was, a significant professional advisor or consultant to the issuer or an affiliate of the issuer, an executive officer or director of such advisor or consultant, or an employee of such advisor or consultant significantly associated with the service provided; and
- (g) receives, or has received, significant compensation from the issuer, other than compensation for acting as a member of the board of directors or of any board committee or fixed amounts of compensation under a retirement plan.

PART 4 FINANCIAL LITERACY, FINANCIAL EDUCATION AND EXPERIENCE

4.1. Financial literacy

For the purpose of the Regulation, a director 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 reasonably comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements. In our view, it is not necessary for a member to have a comprehensive knowledge of GAAP and GAAS to be considered financially literate.

4.2. Relevant education and experience

Item 3 of Forms 52-110F1 and 52-110F2 requires an issuer to describe any education or experience of an audit committee member that would provide the member with, among other things, an understanding of the accounting principles used by the issuer to prepare its financial statements. The level of understanding that is requisite is influenced by the complexity of the business being carried on. For example, if the issuer is a complex financial institution, a greater degree of education and experience is necessary than would be the case for an audit committee member of an issuer with a more simple business.

Item 3 of Forms 52-110F1 and 52-110F2 also requires an issuer to describe any experience that the member has, among other things, actively supervising persons engaged in preparing, auditing, analyzing or evaluating certain types of financial statements. The phrase active supervision means more than the mere existence of a traditional hierarchical reporting relationship between supervisor and those being supervised. An individual engaged in active supervision participates in, and contributes to, the process of addressing (albeit at a supervisory level) the same general types of issues regarding preparation, auditing, analysis or evaluation of financial statements as those addressed by the individual or individuals being supervised. The supervisor should also have experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised. An executive officer should not be presumed to qualify. An executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not be exercising the necessary active supervision. Active participation in, and contribution to, the process, albeit at a supervisory level, of addressing financial and accounting issues that demonstrate a general expertise in the area would be necessary.

PART 5 NON-AUDIT SERVICES

5.1. Approval of non-audit services

Section 2.6 of the Regulation allows an issuer to satisfy, in certain circumstances, the

approval requirements in subsection 2.3(4) by adopting policies and procedures for the engagement of non-audit services. The following guidance should be noted in the development and application of such policies and procedures:

(a) Monetary limits should not be the only basis for the approval policies and procedures. The establishment of monetary limits will not, alone, constitute policies that are detailed as to the particular services to be provided and will not, alone, ensure that the audit committee will be informed about each service.

(b) The use of broad, categorical approvals (e.g. tax compliance services) will not meet the requirement that the policies must be detailed as to the particular services to be provided.

(c) The appropriate level of detail for the approval policies will differ depending on the facts and circumstances of the issuer. The approval policies must be designed to ensure that the audit committee knows precisely what services it is being asked to approve so that it can make a well-reasoned assessment of the impact of the service on the auditor's independence. Furthermore, because the Regulation does not permit the audit committee to delegate its responsibility to management, the approval policies must be sufficiently detailed as to particular services so that a member of management will not be called upon to determine whether a proposed service fits within the policy.

PART 6 DISCLOSURE OBLIGATIONS

6.1. Incorporation by reference

Regulation 51-102 respecting Continuous Disclosure Obligations permits disclosure required to be included in an issuer's information circular or AIF to be incorporated by reference, provided that the referenced document has already been filed with the applicable securities regulatory authorities. Any disclosure required by the Regulation to be included in an issuer's information circular or AIF, as the case may be, may also be incorporated by reference, provided that the procedures set out in *Regulation 51-102 respecting Continuous Disclosure Obligations* are followed.