



Sox-ing up the north - the regulation of audits and certification of financial statements in Canada

At the end of June, as a Canadian response to the *Sarbanes - Oxley Act* and related rules adopted in the United States, the Canadian Securities Administrators, further to an initiative of the Ontario Securities Commission, published a trilogy of proposed Multilateral Instruments designed to regulate public auditors, audit committees and financial statement reporting in Canada.

Multilateral Instrument 52-108 proposes to establish a new audit supervision body called the Canadian Public Accountability Board. Its functions are not yet defined, but presumably it will play a role in establishing and enforcing standards for the conduct of audits by public auditing firms. Any auditing firm which desires to sign audit reports for public companies will have to become a member of this board and execute a participation agreement. It is anticipated that this agreement will impose certain restrictions and obligations upon such firms not unlike the rules recently adopted by the United States Securities and Exchange Commission.

Multilateral Instrument 52-109 proposes to impose a certification regime in Canada similar to the one required of companies by the United States Securities and Exchange Commission. Each of the Chief Executive Officer and the Chief Financial Officer of a public issuer (or those persons who perform similar functions) will have to sign a form certifying, both with respect to the annual and each of the interim financial statements, that the financial statements present fairly, in all material respects, the financial condition, results of operations and cash flows of the issuer. In addition, the certification will confirm that none of the Annual Information Form, Management's Discussion and Analysis (MD&A) and financial statements contain, to the knowledge of such person, an untrue statement of a material fact or omit to state a material fact required to be stated so as not to make a statement misleading. Furthermore, the certification mandates confirmation by such officers that the issuer has established internal disclosure controls and procedures to ensure that material information about the issuer and its subsidiaries is made known to them and that the financial statements will be fairly presented according to GAAP and that such officers have made the proper mandated disclosures of such procedures, including disclosure of any deficiencies and fraud, no matter how small the amount at issue. The certification requirements are set out in a form which must be executed by the named executives without

modification and filed at the same time as the filing of the continuous disclosure documents to which they relate.

Of note is the fact that: (i) there is no attempt (unlike in the United States) to define what constitute appropriate internal disclosure controls and procedures, so as to provide companies of different sizes and in different industries with diverse complexities the flexibility to strike such balance as is deemed appropriate by each such issuer; and (ii) the declaration that the financial statements present fairly the financial condition of the public issuer is deliberately not qualified by any reference to GAAP, in order to prevent management from relying entirely upon the fact that financial statements are prepared according to GAAP as a defence and therefore direct management's attention to other elements such as the selection of appropriate accounting policies, their proper application and the nature and degree of detail of financial disclosure.

Lastly, Multilateral Instrument 52-110 proposes new standards and an expanded role for the audit committee of public companies. The audit committee will have to adopt a written charter setting out its mandate and responsibilities, as defined by this Instrument. The role of recommending the auditing firm as well as their remuneration for approval by shareholders now falls upon the audit committee. The audit committee must also pre-approve all non-audit services to be rendered by the issuer's auditors. In a marked departure from the U.S. approach, there are, for the moment, no prohibitions on the types of non-audit services which can be rendered. The primary role of the audit committee in the review of financial statements and the MD&A is confirmed by the Instrument and the audit committee is given the further role of supervising and establishing internal complaint procedures to allow anonymous complaints to be made and properly followed up, as well as setting out the proper procedures for the employment by the issuer of the employees of the present or former auditors of the issuer.

The audit committee must have at least three members and all members must be directors of the issuer and independent from it. Independence casts a wide net, since its definition excludes any "direct or indirect material relationship" with the issuer. This includes business relationships, such as providing legal or financial services or advice, as well as family links or links with entities which are affiliated to the issuer, unless a certain period of time has elapsed since such link ceased (which, after a transitional period, shall be

three years). The members of the audit committee must also all be financially literate, meaning that they must be able to read and understand financial statements of companies such as those of the issuer on whose board they serve. There are limited exemptions from the independence requirements in the case of initial public offerings (for a period of 90 days thereafter), or if a member ceases to be independent for reasons beyond such person's reasonable control, or in the event of death disability or resignation (until the later of the expiry of six months or the next annual shareholders meeting). The audit committee must also have the power to retain the advice of independent legal and other advisors and to pay for such services (implying therefore that audit committees will also be responsible for setting their own budgets, which the board as a whole and management will have difficulty rejecting in cases where there is no abuse of discretion) as well as the power to communicate directly with the external auditors. Companies whose shares are listed on the TSX Venture Exchange are exempted from the requirements in connection with the composition of the audit committee.

Issuers will also have increased reporting requirements as a result. An issuer must make detailed disclosure in its Annual Information Form (with the appropriate cross-reference in its proxy circular) of the audit committee's charter, its composition and whether or not a member is independent (including the reasons why that is so) or a financial expert (being someone who has experience with the audit of public companies) and, if there is no financial expert on the audit committee, the issuer must state why that is so. Disclosure must also be made if there has been reliance upon an exemption from any of the requirements of the Instrument and, if a particular recommendation of the audit committee to nominate or compensate auditors has not been followed. Finally, an issuer must disclose whether any specific pre-approval policies have been adopted (including a description thereof) with respect to the engagement of non-audit services and, in table format, the remuneration paid to the external auditors, breaking out those fees paid in respect of auditing, audit-related, tax and other services. Issuers listed on the TSX Venture Exchange have similar disclosure obligations, only adapted to those requirements of the Instruments which apply to them. The disclosure requirements are set out in forms attached to the Multilateral Instrument (Form 52-110 F1 and F2).

Of note is the fact that, unlike in the United States, (i) the audit committee is not the one who appoints the external auditors (this is driven by our corporate laws which entrust this to shareholders); and (ii) there are no minimum wait periods imposed before employees of past or present external auditors can be hired by an issuer. Great pain is taken in the accompanying draft lease Companion Policy to point out that courts should not subject a financial expert to greater scrutiny simply because such person has been so

designated under the Instrument, as opposed to imposing on such person such standard of conduct as would be appropriate under any circumstance given that person's qualifications.

As can be seen from the above summary of proposed new regulations, our proximity to the United States guarantees that the *Sarbanes - Oxley Act* will echo in Canada. In a more typically Canadian approach, however, our regulators have expressed the intention to avoid the more onerous, detailed regulations of conduct and standards of behaviour which are the hallmarks of recent U.S. Securities and Exchange Commission rules on the same topic. The trilogy of Multilateral Instruments has been published for comments and are set to come into force as of January 1, 2004.

This update is intended to provide general comment only and should not be relied upon as legal advice.

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