ISSUES RELEVANT TO NEW ACCOUNTING STANDARDS IN A COMPLIANCE PROGRAMME

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Accounting standards are constantly changing to reflect evermore stringent compliance requirements. This paper will attempt to address some of the more recent changes in accounting standards, particularly from the perspective of the resulting compliance requirements.

Rules vs. Principles

In considering accounting standards and their impact on compliance programmes, it is important to consider whether accounting standards should be viewed as rules (i.e. whether they are mandatory or obligatory in nature) or whether they should be viewed as reflecting principles, in which event one would routinely look to the intent or object of the accounting standard.

To look at accounting standards from the perspective of the principles underlying them should be second nature to lawyers given that statutes are interpreted in a like manner.[1] Insofar as a "principle" reflects a moral attitude or a code of conduct, and insofar as one must interpret an accounting standard having regard to not just its strict wording but also the underlying principles, then one cannot give a literal interpretation to the accounting standard. Rather, one must interpret the accounting standard in light of the underlying intent, purpose or principles.

It is also worth noting that, from time to time, "principles" are effectively elevated to the status of "rules". For example, in a corporate law context one need only consider the oppression remedy.[2] That remedy encompasses an act or omission that is unfairly prejudicial to or that unfairly disregards the interests of a securityholder, which language in substance expresses a principle of fairness as distinguished from a strict rule of conduct. In the income tax context, similar comments pertain to the general anti-avoidance rule.[3] That rule seeks to regulate transactions that result in a tax benefit which are not undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. Again, the language is more consistent with reflecting a principle (namely transactions must be undertaken for bona fide purposes other than to obtain a tax benefit), rather than a precise rule of conduct.

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[1] See, for example, the *Interpretation Act* (Canada), R.S.C. Ch. I-21, s.12 which provides that, "Every enactment is deemed remedial, and shall be given such fair, large and liberal construction and interpretation as best insures the attainment of its objects."

[2] See, for example, s.241 of the *Canada Business Corporations Act*, R.S.C. 1985, c.C-44

[3] See s.245 of the *Income Tax Act*, R.S.C. 1985 (5th supp.), c.1, as amended

The debate as to a rules-based approach versus a principles-based approach has also been evident in corporate governance. For example, the *Sarbines-Oxley Act* of 2002[4] (the "SOX Act") is viewed as setting forth rules to be complied with regarding corporate governance. The Toronto Stock Exchange (the "TSX") was asked in August 2002 whether Canada should adopt similar measures to the SOX Act and legislate good corporate governance and mandatory requirements. The TSX responded by letter dated September 17, 2002, (the "TSX Letter") as follows:

> "As you know, our Canadian approach has been to set out comprehensive governance guidelines based on the paramountcy of the underlying principles that are involved. We then require that companies disclose the extent of their compliance with the guidelines and explain publicly why they may choose not to follow certain of them. In the U.K., European and Australian markets, a similar principles-based approach is preferred.
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> The effect of strong guidelines in combination with mandatory disclosure is to place in the hands of investors the information that they require to punish or reward companies, by their trading and pricing choices, for their governance practices.
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> The American approach, in contrast, has been heavily oriented toward a mandatory reliance with highly detailed legislation, regulation and stock exchange listing requirements, with a much greater emphasis on regulatory enforcement rather than voluntary compliance.
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> The U.S. legislative and regulatory changes over the last two months seem largely consistent with their past rules-based approach. The appeal of "strong action" in the face of unprecedented problems in their markets notwithstanding, I am convinced that our approach has been the more effective."[5]

The TSX view as expressed in the TSX letter is reflective of the approach internationally excluding the United States. For example, in 1999, the Organization of Economic Co-Operation and Development (the "OECD") issued a report entitled: "OECD Principles of Corporate Governance".[6] In the preamble, the following statements appear:

> "The Principles are non-binding and do not aim at detailed prescriptions for national legislation. Their purpose is to serve as a reference point. They can be used by policy-makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.
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> The Principles are evolutionary in nature and should be reviewed in light of significant changes and circumstances. To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new opportunities. Similarly, governments have an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function effectively and respond to expectations of shareholders and other stakeholders. It is up to governments and market participants to decide how to apply these Principles in developing their own frameworks for corporate governance, taking into account the costs and benefits of regulation."

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[4] PUB L. No.107-204,116 Stat.745 (2002)

[5] The full text of this letter can be found on the website of the TSX at www.tsx.ca

[6] The full text of this report can be found on the website of OECD at www.oecd.org

Similarly, the United Kingdom approach was also principles-based. Thus, in May 2000, the "Combined Code-Principles of Good Governance and Code of Best Practice" of the London Stock Exchange (the "UK Combined Code") was published.[7] A basic principle of the UK Combined Code is that a company listed on the London Stock Exchange will be required to report on how it applies the principles in the UK Combined Code and will be required to confirm either that it complies with UK Combined Code provisions or, where it does not, it will be required to provide an explanation. Shareholders will then be in a position to evaluate this information and make their voting and investment decisions in light of this information.

It is open to be argued that a rules-based regime is more stringent than a regime based upon principles. However, it is also open to be argued that a rules-based regime encourages strict compliance with the letter of the rule and nothing more. These arguments result in support from a number of other sources for a principles-based approach. For example, the Joint Committee on Corporate Governance (the "Saucier Committee") issued an interim report in March 2001, entitled "Beyond Compliance: Building a Governance Culture".[8] The Committee stated:

> "Regulation is appropriate where it is desirable to enforce certain minimum standards (for example, with respect to the role of audit committees) but there is no single, best model for effective governance. Different corporations will have different needs at different times and truly effective governance will find the best way to anticipate and meet those needs. Our view is that guidelines are preferable to regulations; and that meaningful disclosure of behaviour against guidelines is the best approach to improve governance over time."

One can also point to the remarks of Alan Greenspan and his speech to the Stern School of Business:

> "We have to be careful, however, not to look to a significant expansion of regulation as the solution to current problems, especially as price-earnings ratios increasingly reflect the markets perception of the quality of accounting. Regulation has, over the years, proven only partially successful in dissuading individuals from playing with the rules of accounting."[9]

On September 10, 2002, the Chairman of the British Columbia Securities Commission made a speech before the Economic Club of Toronto. He said:

> "In particular, we have learned that you don't protect investors by just passing a lot of rules to prescribe the conduct of securities market participants. Securities regulation is found upon some basic principles that define the responsibilities of key players in the market. You wouldn't know that, though, if you tried to find your way through the thousands of detailed requirements we impose."[10]

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[7] A copy of the UK Combined Code can be obtained from the website of the European Corporate Governance Institute at www.ecgi.de/codes/country-pages/codes-uk

[8] The full text of this report can be found at the website of the Saucier Committee at www.jointcomgov.com

[9] The full text of this speech can be found at the website of the Federal Reserve Board at www.federalreserve.gov

[10] The full text of this speech can be found at the website of the British Columbia Securities Commission at www.bcsc.bc.ca

Similarly, the Canadian Counsel of Chief Executives, in their September 2002 report entitled: "Governance, Values and Competitiveness - A Commitment to Leadership"[11] make the following comments:

> "Corporate governance is in the end an expression of values rather than a set of rules…rules-based standards can be very precise, but can only address specific known circumstances. Rules tend to lag as circumstances change, and this approach tends to encourage compliance with the letter of the law rather than its underlying principles. Standards based on principles leave more room to exercise judgement, but are both more effective in guiding behaviour as circumstances change and are much harder to evade than specific rules. The United States has traditionally favoured a rules-based approach; Canada, like most of Europe, has preferred standards based on principles."

One must also recognize that principles or guidelines tend to breed inconsistency as issuers pick and choose the extent to which they comply or as issuers interpret provisions that are non-mandatory in a way that undermines confidence in our capital markets. Thus, the Chairman of the Ontario Securities Commission made the following comments:

> "…it is also essential to spell out how the principles must be applied in at least a significant number of commonly encountered circumstances. Neither issuers nor investors should be expected to read our mind. Sometimes you simply need a bright-line test. Ambiguity must give way to clarity.
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> Some will argue that what we need is not new regulation, but merely new voluntary guidelines….that there is a limit to a market stability to correct itself especially in areas like audit quality, disclosure standards and conflict of interest. As we have seen, corporate executives don't always have the right incentives to follow the appropriate practices. Investors don't necessarily have all the information needed to police them. …only by codifying efforts in financial reporting in corporate governance can we ensure that they will spread to all public companies.
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> Only by codifying the forms can we avoid widening discrepancies in corporate behaviour."[12]

With a relatively seamless North American economy and with such a large American presence in the Canadian economy, another view to be considered is whether the interests of harmony and consistency should not take precedence to cause Canada to adopt a more rules-based approach, at least for larger companies, consistent with the approach reflected in the SOX Act. We cannot ignore that we in Canada compete for capital and that our accounting standards, corporate governance and financial statements must have integrity in order for us to be effective competitors for capital.

New Accounting Standards

With that background to whether a rules-based approach or a principles-based approach is more appropriate, it is now appropriate to look at some recent accounting standards issues. Effective March 30, 2004, three Multi-Lateral Instruments came into effect, Multi-Lateral Instrument Number 52-108 dealing with auditor oversight, Multi-Lateral Instrument 52-109 dealing with

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[11] The full text of this report can be found at www.ceocouncil.ca

[12] The full text of this speech appears on the OSC website at www.osc.gov.on.ca

certification of disclosure in issuers' annual interim filings and Multi-Lateral Instrument 52-110 dealing with audit committees. As well, National Instrument 50-102 came into force April 2, 2004 dealing with continuous disclosure obligations. While it is beyond the scope of this paper to engage in a detailed review of these Instruments, it is worthwhile to note some of the changes implemented by these instruments, particularly as they impact upon compliance issues.

National Instrument 52-108 - Auditor Oversight

The principal changes introduced by this National Instrument include the following:

- A participating audit firm is defined to mean a public accounting firm that has entered into a participation agreement, i.e. a written agreement with the Canadian Public Accountability Board ("CPAB") in connection with CPAB's program of practice inspections and the establishment of practice requirements.

- A public accounting firm that prepares an auditor's report with respect to the financial statements of a reporting issuer must be, as of the date of its auditor's report, a participating audit firm and in compliance with any restrictions or sanctions imposed by the CPAB.

- A participating audit firm appointed to prepare an auditor's report must provide notices to regulators and audit committees to relevant reporting issuers regarding, among other things, defects in its quality control systems, restrictions imposed by the CPAB that were intended to address defects in quality control systems, reasons why the participating audit firm was unable to address such defects, a complete description of sanctions imposed by the CPAB, etc.

- Prior to accepting an appointment to prepare an audit report, a participating audit firm must provide notice if the CPAB informed the participating audit firm within 12 months prior to the expected date of appointment that it failed to address defects in its quality control systems to the satisfaction of the CPAB or if it imposed sanctions on the participating audit firm within that period.

Multi-Lateral Instrument 52-109 - Certification of Disclosure in Issuer's Annual and Interim Filings

The principal changes introduced by this National Instrument include the following:

- Subject to transitional provisions, the provisions of this Instrument apply for both financial years and interim periods beginning on or after January 1, 2004 in respect of all reporting issuers other than investment funds.

- Annual filings mean an issuer's annual information form, annual financial statements and annual MD&A including all documents and information incorporated by reference in the issuer's annual information form.

- Interim filings refer to the issuer's interim financial statements and interim MD&A.

- Chief executive officers and chief financial officers will need to provide certifications in respect of annual filings and interim filings, the substance of such certifications being to the effect that the filings have been reviewed and that, based on the knowledge of the relevant officer, such filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated that is necessary to make a statement not misleading in light of the circumstances under which it was made and that the relevant financial statements together with the other financial information included in the filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer.

- After a transitional period, such certifications will also speak to the adequacy of disclosure controls and procedures and internal controls over financial reporting.

- The terms “disclosure, controls and procedures” and “internal control over financial reporting” are both defined in detail in the Instrument.

Multi-Lateral Instrument 52-110 - Audit Committees

The principal changes introduced by this National Instrument include the following:

- The Instrument implements a similar regime as is applicable under the SOX Act in respect of audit committees.

- Every issuer is required to have an audit committee that complies with the requirements of the Instrument.

- Every issuer must require its external auditor to report directly to the audit committee.

- The audit committee must have a written charter.

- The audit committee must recommend to the board the external auditor and its compensation.

- The audit committee must be directly responsible for overseeing the work of the external auditor.

- The audit committee must pre-approve all non-audit services (subject to de minimis exceptions).

- The audit committee must review the issuer’s financial statements, MD&A and annual and interim earnings press releases before the issuer publicly discloses same.

- The audit committee must be satisfied that adequate procedures are in place for the review of the issuer’s public disclosure and must periodically assess the adequacy of those procedures.

- The audit committee must establish procedures for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or audit matters and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

- The audit committee must review and approve the issuer's hiring policies regarding partners, employees and former partners and employees of present and former external auditors.

- Detailed provisions are contained in the Instrument regarding the appropriate composition of audit committees including regarding the extent to which members must be "independent", financial literacy, etc.

- The audit committee must have authority to engage independent counsel and other advisors, to pay the compensation for advisors employed by it and to communicate directly with internal and external auditors.

- While the Instrument came into force on March 30, 2004, it applies to an issuer commencing on the earlier of (i) the first annual meeting of the issuer after July 1, 2004 and (ii) July 1, 2005.

National Instrument 52-102 - Continuous Disclosure Obligations

The principal changes introduced by this National Instrument in an accounting standards/compliance programme context (the Instrument covers many other topics as well) include the following:

- This Instrument harmonizes continuous disclosure obligations across Canada in order to improve disclosure standards and covers financial statements, MD&A, annual information forms, etc.

- From the perspective of incorporating new accounting standards in a compliance program, the Instrument has changed filing deadlines for financial statements (non-venture issuers must file annual financial statements within 90 days of year-end and interim financial statements within 45 days of a quarter end).

- As has always been the case for annual financial statements, interim financial statements must now be approved by the board, although the board may delegate approval to the audit committee.

- Interim financial statements must be accompanied by a notice if the auditor has not reviewed them; if the auditor is unable to complete a review, the notice must explain why; if the review has resulted in a reservation, the review report must accompany the statements.

- Mandatory delivery of financial statements is eliminated (subject to corporate legislation).

- All issuers will be required to file MD&A with similar filing deadlines as apply to financial statements.

- MD&A must be approved by the board, although the board may delegate approval of the interim MD&A to the audit committee.

- There is no mandatory delivery of MD&A although a copy must be delivered if financial statements are delivered.

- MD&A disclosure must speak to trends, selected financial data and off balance sheet arrangements; as well, there are specific requirements regarding contractual obligations, critical accounting estimates and changes in accounting policies.

- Discussion of trends must consider provisions in contracts and commitments, market factors and other business circumstances as well as discussion of commitments, events, risks or uncertainties that are reasonably believed will materially affect future performance.

- MD&A discussion must speak to selected financial data including net sales or total revenues, net income or loss and total assets; data must be provided for the three most recently completed financial years; factors causing period to period variations must be discussed.

- If off balance sheet arrangements have, or are reasonably likely to have, a current or future effect on results of operations or financial condition, MD&A must discuss the business purpose of same, their economic substance, risks pertaining thereto and key terms and conditions.

- Excluding venture issuers, MD&A must speak to contractual commitments for each of the next five years and beyond, with presentation to be in tabular format.

- MD&A must specifically deal with such contractual commitments as long-term debt, capital lease obligations, operating leases and purchase obligations.

- Excluding venture issuers, MD&A must provide an analysis of critical accounting estimates including the methodology used, the assumptions underlying estimates that relate to uncertainty, known trends that may affect the methodology or assumptions, and line items in financial statements affected by the estimate and sensitivity analysis for overall financial performance in line items.

- Excluding venture issuers, MD&A must discuss changes in accounting policies including accounting policies expected to be adopted.

- The Instrument requires that proxy and solicitation and information circulars provide disclosure of executive compensation for chief financial officers regardless of the amount of their compensation.

- The Instrument contains specific disclosure requirements regarding business acquisition reports including financial statement requirements where significance tests apply.

Likely Issues that Will Emerge in Light of New Accounting Standards and Compliance Programs

While it is somewhat speculative, it is interesting to contemplate issues that may likely emerge in light of the new accounting standards and resulting compliance requirements set forth in the Instruments discussed above. It would not be surprising for the following issues to emerge:

Costs

The cost of compliance with new internal control rules will not be insignificant, particularly for smaller companies who may feel they lack the resources necessary to install an appropriate system of internal controls. Similarly, smaller companies trying to go public may encounter a new level of overheads in relation to these costs which will erode their values in a public offering. If these costs are considered excessive, the result may be that smaller reporting issuers may seek to privatize and that public markets will, in effect, be unavailable for smaller companies.[13]

Impact on Smaller Participating Audit Firms

Smaller participating audit firms may have difficulty in maintaining their position as auditors of public companies due to the increased requirements imposed upon them including such issues as partner rotation. It would not be surprising to see many smaller participating audit firms cease to act as auditors to reporting issuers.

Changing Role of Chief Financial Officers

While chief executive officers of a reporting issuer typically have power and prestige by virtue of their position, the fact that chief financial officers will now be obliged to provide certifications as discussed above will likely serve to boost their power and prestige as well as boosting the power and prestige of the internal audit function generally.

As a result, one might expect the chief financial officers will seek and receive greater resources and have greater influence. As well, one might expect their positions will compel higher salaries.[14]

Need to Encourage Employees to Report Regarding Compliance Issues

Employees will be in the best position to report wrongdoing, particularly with respect to accounting standards and compliance issues. It will be necessary for issuers to establish strong internal compliance programs. It should be noted that the existence of such programs may serve to mitigate any penalties that might otherwise flow from improprieties. Concerns will exist that

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[13] See Harvey Custin and Linda Leinicke, "Sarbanes Oxley: What It Means to the Market Place", Journal of Accountancy, February 2004, pages 43 - 47

[14] See Scott Leibs "New Terrain" *CFO*, February 2004, pages 40 - 48

employee hotlines may become forums for unfair criticisms and petty complaints. As well, concern may exist that such hotlines will create a "big brother" image problem.

In order to mitigate the impact of such an image problem, while at the same time strengthening compliance requirements, consideration will likely be given by many corporations to establishing and disseminating a corporate code of ethics to the extent they have not already done so. Not only could such a code of ethics outline an employee's responsibility for reporting regarding compliance issues but it might serve to feed arguments regarding whether the failure to report constitutes cause to terminate an employee.

A key issue regarding compliance issues will be the extent to which there is a simple reporting channel for the communication of potential improprieties and to whom such communications are received. Certainly, employees will wish to be assured of confidentiality and safety from retribution. Many corporations may prefer to out-source the process of receiving such communications in order to maximize the likelihood of anonymity so that employees will feel less inhibited about potential adverse affects from filing complaints.[15] The act of out-sourcing, in and of itself, may be considered to demonstrate how seriously a reporting issuer will consider complaints.

Outsourcing of Internal Controls

Many reporting issuers, when faced with the requirement to upgrade the resources available to internal auditors and chief financial officers as well as to upgrade internal controls generally, may look to outsource accounting standard compliance programs. Not only may such outsourcing provide chief executive officers and chief financial officers with greater comfort when it comes to signing their certifications but, in addition, such outsourcing may provide smaller accounting firms with an interesting source of new work to replace what may be a disappearance of audit work for reporting issuers.[16]

Testing the Adequacy of Internal Controls

As reporting issuers move to evaluate the adequacy of their internal controls over financial reporting, reporting issuers will have to give consideration to testing mechanisms in order to measure the adequacy of their control systems. For example, it is unlikely that simply adopting a corporate code of conduct will be sufficient for a reporting issuer. Rather, it will have to test and evaluate how effectively that code of conduct is understood and respected. One might envision that the following types of questions will routinely be put to senior management in terms of assessing the adequacy of internal controls:

- Has the employee observed any inappropriate conduct?

- Does the employee think senior management will react favourably to a report of unacceptable corporate conduct?

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[15] See Carol Johnson and Charlotte Wright, "Make it Easy, They will Come", *Internal Auditor* February 2004, pages 69 - 73

[16] See John Labate "Devising a New Auditing Regime at the 11th Hour" *Treasury and Risk Management*, April, 2004, pages 18 - 22

- Does the employee understand how his or her functions impact upon the internal control environment?
- Are internal controls an integral part of the reporting issuer's operations and an area where the employee has been directed to be vigilant?
- Are regular educational sessions held to educate the employee and others regarding internal control requirements?
- Does the employee have a copy of the reporting issuer's code of conduct?
- Does the employee understand the reporting issuer's code of conduct and his or her obligations in light of that?

Exposure to a Reporting Issuer where CPAB has Issues With a Participating Audit Firm

Envision the situation where a participating audit firm breaches restrictions or sanctions imposed upon it or fails to address defects in its quality control systems and fails to provide the requisite notice to regulators and relevant reporting issuers. The question arises whether such reporting issuers may become subject to class action litigation as a result. Class action litigators have not been shy to commence litigation with less substance. Thus, the question arises whether, as a minimum, a reporting issuer (or its audit committee) should require the participating audit firm to provide certifications as to its status, and whether it is in good standing, under National Instrument 52-108 in connection with quarterly review engagements and the annual audit.

Administrative Law Proceedings Affecting CPAB

From time to time, even provincial law societies have become subject to adverse court rulings in relation to non-compliance with administrative law requirements in connection with disciplinary proceedings against lawyers. One might suspect that the CPAB will be no more successful than law societies in dealing with administrative law issues relevant to decisions regarding public accounting firms or specific audit partners.

Non Audit Services

As noted above, Multi-Lateral Instrument 52-110 expressly requires audit committees to pre-approve non-audit services. One might expect that, where reporting issuers either give approval to non-audit services that were inappropriate in the circumstances or where, for example, such non-audit services exceed the de minimis threshold contained in the Instrument[17], the consequences may prove both extremely expensive and awkward. They may result in refiling of current or prior period financial statements, the need to appoint a different auditor, regulatory sanctions and potential litigation exposure.

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[17] See paragraph 2.4 of the Instrument

Concluding Remarks

There can be no question that the Instruments discussed above will compel boards of directors and, in particular, audit committees to take a much more active interest in the financial reporting process including accounting standards and resulting compliance programs. However, these Instruments are no panacea. Whether the Instruments are respected having regard to the specific rules contained therein or whether they are respected in terms of the principles underlying those rules will be affected by the ethical and moral behaviour of employees, particularly chief financial officers and internal audit staff; employees who are motivated to respect those principles will likely product a better compliance environment than employees who simply feel they must observe precise rules. One might also speculate that the trend in terms of accounting standards and compliance programs will be to move to an ever more stringent regime. The onus on reporting issuers to demonstrate they have incorporated new accounting standards and have a stringent compliance program will likely be ever greater in the future and the downside in the failing to do so will also be ever greater.