TABLE OF CONTENTS

1.0 Executive Summary

Over the past decade, the expectations of Boards of Directors, and most especially their Audit Committees, have increased. In today's environment, Audit Committees are widely recognized as the cornerstone of a Board of Directors' oversight process. Audit Committees are considered to have critical governance responsibilities related not only to public financial reporting, internal controls, and management of financial risks, but also to the oversight of an organization's values and ethics. Ultimately, the Audit Committee plays a vital role in assisting the Board of Directors in fulfilling its governance role of overseeing and objectively assessing the overall performance of their organization.

While much attention has been focused on the Audit Committees of private sector organizations, an effective Audit Committee is equally as important to the governance oversight by Boards of Directors of public sector organizations. An effective Audit Committee plays a vital role in ensuring the integrity and reliability of financial information in the public sector, and in ensuring that public entities operate efficiently within their legislative mandate. No public sector organization can afford doubt about the quality of its financial reporting or its accounting processes. Transparency of disclosure and integrity of financial reporting are factors that significantly affect the public's trust and confidence in public sector organizations.

This report provides a discussion of leading Audit Committee practices, and outlines the responsibilities, relationships, and structures of an effectively functioning Audit Committee in the public sector. The critical elements of an effective Audit Committee have been organized into the following four broad areas:

1. **Audit Committee Structure and Operations**
    a. Operate under a written Charter (Terms of Reference) that is reviewed and updated, as necessary.
    b. Have independent, financially-literate members.
    c. Provide an orientation, as well as ongoing education, to Audit Committee members.
    d. Meet regularly throughout the year with a pre-determined agenda.
    e. Report regularly to the Board of Directors.
    f. Assess Audit Committee performance annually.

2. **Oversight of the Financial Reporting Process**
    a. Oversee the financial reporting process and credibility of the organization's financial information.
    b. Understand the organization's financial/business risks, and oversee management's internal control framework.
    c. Review the Management Discussion and Analysis (MD&A) report.
    d. Have unrestricted access to information required to fulfill Audit Committee duties.

3. **Effective Communication and Relationships with Auditors**
    a. Hire and manage the relationship with the External Auditor, ensuring independent communication, as necessary.
    b. Direct and review the work of the Internal Auditor, ensuring independent communication, as necessary.

4. **Compliance with Laws, Regulations and Internal Policies**
    a. Ensure compliance with legislation, regulations, and public sector reporting requirements.
    b. Ensure adherence to internal policies, such as codes of conduct and conflict of interest policies.
    c. Establish policy and procedures for "whistle-blowing".

A detailed discussion of each of these elements is provided in **Section 3.0** of the report. As the size, mandate, and complexity of public sector organizations vary considerably, there is no single "one-size-fits-all" approach for an Audit Committee to meet its responsibilities. Rather, each entity's Board of Directors and Audit Committee must exercise judgment in developing and carrying out its responsibilities in a manner that fits their organization's unique structure and mandate.

We believe this report provides the framework within which Audit Committees in Manitoba's public sector can develop and enhance their practices to support the integrity of the financial reporting process of their organization and the objective oversight of their Board of Directors.

We encourage all public sector Boards of Directors to establish a stand-alone Audit Committee, and to review and consider the Audit Committee practices outlined in this report in light of their organization's own unique context. Hence, recommendations contained in **Section 4.0** of this report are provided as a point of reference for self-assessment and enhancement of practices by Manitoba's public sector Audit Committees.

2.0 Introduction

Intense media and public attention on the corporate scandals and financial collapses of corporations in both Canada and the United States have served to highlight the essential corporate governance and oversight responsibilities of a Board of Directors. In the wake of these events, the expectations of stakeholders and the scrutiny by regulators have never been greater, and there has been an unprecedented focus by Boards of Directors on ensuring their Audit Committees are performing their roles effectively. Numerous guidelines have been published in recent years to assist Boards of Directors in strengthening the effectiveness of their Audit Committees and in enhancing their accountability over the financial reporting process.

While much of the attention has been focused on the Audit Committees of private sector organizations, an effective Audit Committee is equally as important to the governance oversight by Boards of Directors of public sector organizations. Effective Audit Committees are necessary to ensure the integrity and reliability of financial information in the public sector and the operational effectiveness of public entities within their legislative mandate. No public sector organization can afford doubt about the quality of its financial reporting or its accounting processes. Transparency of disclosure and integrity of financial reporting are factors that significantly affect the public's trust and confidence in public sector organizations.

> *"Qualified, committed, independent, and tough-minded Audit Committees represent the most reliable guardians of the public interest..."*
>
> Arthur Levitt
> SEC Chairman, 1999

This report provides a discussion of leading Audit Committee practices, and outlines the responsibilities, relationships, and structures of an effectively functioning Audit Committee in the public sector. We believe this report provides the framework within which Audit Committees in Manitoba's public sector can develop and enhance their practices to support the integrity of their organization's financial reporting process, and the objective oversight provided by their Board of Directors.

As the size, mandate, and complexity of public sector organizations vary considerably, there is no single "one-size-fits-all" approach for an Audit Committee to meet its responsibilities. Rather, each entity's Board of Directors and Audit Committee must exercise judgment in developing and carrying out its responsibilities in a manner that fits their organization's unique structure and mandate.

We encourage all public sector Boards of Directors to establish a stand-alone Audit Committee, and to review and consider the Audit Committee practices outlined in this report in light of their organization's own unique context. The recommendations contained in **Section 4.0** of the report are provided as a point of reference for self-assessment and enhancement of practices by Manitoba's public sector Audit Committees.

2.1 WHAT IS AN AUDIT COMMITTEE?

In order to effectively fulfill its corporate governance and oversight responsibilities, many Boards of Directors establish an Audit Committee as a Standing Committee of the Board. Over the past decade, the role and requirements of an effectively functioning Audit Committee have increased. In today's environment, Audit Committees are widely recognized as the cornerstone of the Board's oversight process. Audit Committees are considered to have critical governance responsibilities related not only to public financial reporting, internal controls, and management of financial risks, but also to the oversight of an organization's values and ethics. Ultimately, the Audit Committee helps the Board of Directors ensure that it fulfills its governance role of stewardship, leadership, responsibility, and accountability for the organization.

The Sarbanes-Oxley Act defines an Audit Committee as: *"A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer; and audits of the financial statements of the issuer."*

Audit Committees operate at the junction between the Board of Directors and its external auditors, its internal auditors, and its executive management. Audit Committees, therefore, need to ensure that all those involved in the financial reporting and internal controls process understand their roles, and carry out their responsibilities in an efficient and effective manner.

In order to provide effective and proactive oversight, the Audit Committee's responsibilities should include monitoring the processes related to: accounting and financial reporting; internal control; external audit; internal audit; and compliance with laws and regulations, as well as internal code of conduct, conflict of interest, and whistle-blowing policies.

Given the critical governance role and functions of an Audit Committee, leading practices strongly encourage the formation of a stand-alone Audit Committee; that is, one that meets separately from any other Board Standing Committee. In some organizations, the responsibilities of the Audit Committee have been combined with those of a Finance Committee. However, each Committee carries distinct responsibilities and fulfills quite different functions for the Board of Directors. A Finance Committee generally focuses its attention on budgeting processes, financial variances, and approving any strategies, policies or actions related to corporate finance, such as investments, capital expenditures, etc. The Audit Committee focuses its attention on the integrity of the organization's public financial reporting to all stakeholders, as well as the adequacy of the internal control processes, and the oversight of the organization's values and ethics.

3.0 Practices for an Effective Audit Committee

We based our criteria for an effectively functioning Audit Committee on a literature review of best practices, as well as recommendations provided by regulators of Canadian and foreign capital markets. A bibliography of key sources of information regarding Audit Committees is provided in **Appendix A**.

We considered the differences between public and private sector organizations, and have developed what, in our opinion, are critical elements of an effective public sector Audit Committee. We have organized these elements into four broad areas that encompass the structure, relationships, and functions that we consider to be desirable for an effective Audit Committee in the public sector:

1. **Audit Committee Structure and Operations**
    a. Operate under a written Charter (Terms of Reference) that is reviewed and updated, as necessary.
    b. Have independent, financially-literate members.
    c. Provide an orientation, as well as ongoing education, to Audit Committee members.

   d. Meet regularly throughout the year with a pre-determined agenda.
   e. Report regularly to the Board of Directors.
   f. Assess Audit Committee performance annually.

2. **Oversight of the Financial Reporting Process**
   a. Oversee the financial reporting process and credibility of the organization's financial information.
   b. Understand the organization's financial and business risks and oversee management's internal control framework.
   c. Review the Management Discussion and Analysis (MD&A) report.
   d. Have unrestricted access to information required to fulfill Audit Committee duties.

3. **Effective Communication and Relationships with Auditors**
   a. Hire and manage the relationship with the External Auditor, ensuring independent communication, as necessary.
   b. Direct and review the work of the Internal Auditor, ensuring independent communication, as necessary.

4. **Compliance with Laws, Regulations and Internal Policies**
   a. Ensure compliance with legislation, regulations, and public sector reporting requirements.
   b. Ensure adherence to internal policies, such as codes of conduct and conflict of interest policies.
   c. Establish policy and procedures for "whistle-blowing".

3.1 AUDIT COMMITTEE STRUCTURE AND OPERATIONS

This section discusses leading practices for the establishment and structure of an effective Audit Committee.

3.1.1 Operate Under A Written Charter

Leading practices call for the Audit Committee to operate under a written Charter (or Terms of Reference) that clearly articulates the role, composition, and specific responsibilities that the Audit Committee will perform. This ensures that all parties involved (the Board, senior management, external auditors, and other stakeholders) are clear on the role the Audit Committee will play in the Board's oversight process, as well as the expectations and assurance that can be placed on the Audit Committee.

An Audit Committee's Charter should document the purpose and scope of the Audit Committee's responsibilities, detailing its requirements and processes for: accounting and financial reporting; internal controls; external auditing; internal auditing; and compliance with legislation and corporate policies. The Charter should also outline the structural components of the Audit Committee, including items such as the composition of the Audit Committee, the number of members, the membership qualifications, the independence requirement for Audit Committee members, the frequency of meetings, and the process for appointment of an Audit Committee Chairperson. A sample Audit Committee Charter is provided in **Appendix B**. However, as the Audit Committee for each public sector organization will differ based on their size, mandate, and complexity, so too will their Charter differ to reflect their unique circumstances and requirements.

Toronto Stock Exchange Guideline 13: *"...the board should adopt a charter for the Audit Committee which sets out the roles and responsibilities of the Audit Committee which should be specifically defined so as to provide appropriate guidance to Audit Committee members as to their duties."*

A comprehensive and well-articulated Charter is a key contributor to developing effective relationships between the Audit Committee and senior management, the external auditors, as well as the Board of Directors. The Audit Committee's Charter must be approved by the Board of Directors. It should be reviewed on an annual basis to ensure that it continues to reflect the requirements of the Board and the operating context of the organization.

The Charter also serves as the basis for evaluation of the Audit Committee's performance and effectiveness, which should be done annually by the Audit Committee and the Board of Directors (see **Section 3.1.6**).

3.1.2 Have Independent, Financially-Literate Members

Independence

The Audit Committee must carry out its responsibilities in a manner that maintains independence from management and avoids any situations that may impair its objectivity in performing its oversight duties. Hence, the Audit Committee must be comprised of a majority of independent Board members. An independent Board member is one who is not an employee of the organization, does not discharge any management or executive functions, is not affiliated with the organization or its management in any way, and does not have significant transactions with the organization which would benefit their private interests.

Toronto Stock Exchange defines an unrelated director as one *"who is independent of management and is free from any interest and any business or other relationship which could, or could reasonably be perceived to materially interfere with the director's ability to act with a view to the best interests of the corporation..."*

The Board of Directors must ensure that the majority of members selected to the Audit Committee are independent of management and day-to-day management activities. The issue of ensuring independent Audit Committee members is more applicable to private sector organizations, as some Boards of private sector corporations may include non-independent members such as senior management personnel and/or family members. The Boards of public sector organizations are generally appointed by government from the community, and do not generally include senior management. Hence, selection of Audit Committee members from public sector Boards of Directors is generally less problematic as most Board members would pass the independence test.

In a public sector context, the Audit Committee is ultimately acting on behalf of the public to ensure accountability of the organization to the citizens. Audit Committee members must therefore have, and be seen to have, the independence and the courage to ask questions, raise tough issues, and to challenge management assertions of the risk and associated control assurance processes that have been put in place. This enhances the ability of the Audit Committee to advise the Board on whether improvement in these areas is possible, and to hold both senior management and the auditors, whether external or internal, accountable for fulfilling their responsibilities.

Financial Literacy

The effectiveness of an Audit Committee in performing its responsibilities is dependent on the financial knowledge and expertise of its members. The responsibilities of an Audit Committee require that Audit Committee members assess management's financial and accounting practices, oversee internal control processes, and consider the views and assurances of auditors. To achieve this, Audit Committee members need the financial skills to successfully understand and deal with issues of corporate finance, accounting, financial risk, and control. Although it is not necessary for all members of an Audit Committee to be financial experts, leading practices recommend that at least one member possess accounting or related financial management expertise, and that all Audit Committee members be financially-literate.

The Board is responsible for ensuring that Audit Committee members possess the necessary skills to function effectively. If not all Audit Committee members are financially literate, steps should be taken to remedy the deficiency through the provision of financial training to members. If the Audit Committee does not have at least one member with financial management expertise, the Board could consider appointing an external individual to the Audit Committee with such expertise. Alternatively, the Board of Directors could invite, or contract with, an external resource to advise and provide expertise to the Audit Committee in an ex-officio, non-voting capacity.

The Chair of the Audit Committee must also be an independent member of the Board, with strong financial skills. The Chair of the Board should not also serve as the Chair of the Audit Committee. In most instances, the Chair of the Board acts as an ex-officio (non-voting) member of the Audit Committee, as this serves to keep them informed of Audit Committee activities and to attend Audit Committee meetings when desired.

Financial Literacy: *"signifies the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and a cash flow statement."*

Financial Management Expertise: *"is demonstrated by past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities."*

Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

3.1.3 Provide An Orientation, As Well As Ongoing Education, To Audit Committee Members

As the Audit Committee performs a vital and specific governance function in terms of oversight of the organization's financial reporting process, all members should be provided with an orientation to the Audit Committee's duties and functions, when first appointed. As well, ongoing training and development opportunities should be provided to all Audit Committee members, as there is continual change in financial reporting requirements, accounting standards, and risk management practices.

To enable Audit Committee members to contribute effectively as quickly as possible when appointed to the Audit Committee, an orientation session for new members is an excellent opportunity to discuss in detail the Audit Committee's operations, functions and duties. The orientation should provide specific information regarding the organization's accounting policies, its financial statements, its internal control processes and fraud prevention strategies, as well as the key risk factors affecting the organization. Such an orientation should be provided regardless of how long the individual may have served as a Board member, or whether they have served on any other Audit Committees.

Providing ongoing training and development opportunities for Board members is important to good governance and even seasoned Board members benefit from continual upgrading in key governance competencies, such as risk management, strategic planning and financial literacy. Such ongoing training is even more vital for Audit Committee members, as the requirements and expectations of Audit Committees continually evolve, as do financial reporting requirements and accounting standards. Audit Committee members should also be provided with ongoing training on key issues related to the organization's unique financial situation and risk environment. This will help ensure that the Audit Committee can effectively carry out its monitoring and oversight duties.

3.1.4 Meet Regularly Throughout The Year, With A Pre-determined Agenda

Regularly scheduled Audit Committee meetings provide for the timely review of financial information received from both external and internal auditors, as well as from management. The number of meetings to be held by an Audit Committee is largely dependent on the size and complexity of the organization and its financial responsibilities. Leading practices generally recommend Audit Committee meetings be held on a quarterly basis. **Appendix C** provides a sample quarterly meeting schedule for Audit Committees.

Many Audit Committees have a pre-determined schedule for meetings in order to ensure full attendance, and that enough time is allocated to fulfill all duties noted in the Charter. Audit Committee meetings should be scheduled well enough in advance of Board of Directors meetings, in order to adequately discuss and resolve issues that may arise. Given the responsibilities of the Audit Committee, all members should attend all of the meetings scheduled throughout the year, and at a minimum, a quorum must be in attendance at all meetings.

The responsibility for developing the Audit Committee's meeting agenda rests with the Chair of the Audit Committee. While management provides input and information into the Audit Committee agenda, it should not be set by management, as the agenda should reflect the priorities and issues of the Audit Committee, not of management. The Chair would communicate with senior management, the internal auditor, and the external auditor prior to each Audit Committee meeting in order to set the agenda, and agree with management on the briefing information required for Audit Committee members.

The meeting agenda, along with any relevant briefing information, should be distributed to Audit Committee members far enough in advance of the meeting to allow them adequate time to read and consider the information provided. This ensures that all members are able to contribute effectively at the meeting.

The Audit Committee should maintain minutes of its meetings in sufficient detail to document the discussion held and the decisions made. The minutes should provide an appropriate record of the Audit Committee's fulfillment of its governance responsibilities.

3.1.5 Report Regularly To The Board of Directors

An Audit Committee does not operate in isolation of the Board of Directors, and all Board members need to have a general awareness and understanding of the financial practices and risk management issues facing the organization. The Audit Committee should function as an important source of information for the Board of Directors. The Board of Directors should receive regular written reports from the Audit Committee, along with verbal updates and copies of the Audit Committee's minutes. Audit Committees should provide the Board of Directors its written recommendations for any required changes or decisions taken, for the Board's consideration and approval.

3.1.6 Assess Audit Committee Performance Annually

On an annual basis, the Audit Committee should assess their performance in fulfilling the duties and responsibilities set out in the Audit Committee Charter. A structured and formal evaluation of the Audit Committee's functioning can help the Audit Committee continually enhance its processes and the efficiency in which it carries out its duties. The evaluation may be a self-assessment, or may involve facilitation or review by an external party. It may also include input from key contributors to the Audit Committee such as management or the external auditor.

The assessment process should examine the performance of the Audit Committee as a whole, as well as the contribution and participation of the individuals that comprise the Audit Committee, including the Chair of the Audit Committee. The Audit Committee should provide a written report on its performance to the Board of Directors, who should ensure appropriate action is taken to enhance the Committee's performance, if required.

3.2 OVERSIGHT OF THE FINANCIAL REPORTING PROCESS

One of the broad responsibilities of an Audit Committee is to oversee the integrity of the financial reporting process. This responsibility includes a number of aspects, which are discussed in the following section. Together, these activities help to ensure that the financial information produced for and about the organization is reliable, relevant, and transparent.

3.2.1 Oversee the Financial Reporting Process and Credibility of the Organization's Financial Information

One of the key responsibilities of the Audit Committee is to review the financial statements and oversee the integrity and reliability of the organization's financial reports. The Audit Committee needs to fully understand the financial statements, and critically scrutinize any and all financial information that is provided to external stakeholders, on behalf of the Board of Directors.

The mere provision of financial information and its acceptance at face value is not sufficient in ensuring reliability of the financial reports. The Audit Committee must carefully scrutinize financial information, question any issues that are unclear, and follow-up on matters of concern. While the level of scrutiny may depend on the organization's particular environment and the Audit Committee's level of comfort with the overall financial and risk management processes, the Audit Committee should, at a minimum, focus on unusual and/or complex transactions, new or risky initiatives being undertaken, as well as those financial/business areas where significant judgment is required.

The Audit Committee must also be aware of management's application of accounting policies, principles, judgments, and significant estimates in the creation of the financial statements. Such policies and procedures should accurately reflect the underlying economic circumstances of the financial reports to ensure the integrity of the information. External and internal auditors can provide valuable assistance to the Audit Committee in this regard by independently corroborating information provided by management. Both are good resources of information concerning the reason(s) for the application of certain accounting policies and procedures, and in detecting potential errors in their application. The Audit Committee should review and discuss with management and the auditors the key accounting principles as well as significant judgments utilized in preparing the financial statements, and ensure the underlying economic circumstances of the corporation are portrayed in the clearest light possible.

Effectively performing their responsibility for financial oversight requires that the Audit Committee maintain clear lines of communication with senior management, and that a constructive working relationship exist between the Audit Committee and the Chief Financial Officer. Senior management should provide adequate explanations of all significant financial decisions and judgments made, as well as any significant variances and/or deviations from approved strategic plans and budgets.

The Audit Committee's information requirements should be set by the Audit Committee and its Chair. As the information that the Audit Committee needs to fulfill its governance role is not necessarily the same as the management information required to manage the day-to-day activities of the organization, the Audit Committees should carefully consider what information is required and provide an outline of its information expectations to senior management. This would include the Audit Committee's expectations as to the quality, accuracy and timeliness of information to be provided. In addition, the Audit Committee should provide formal feedback to senior management, both positive and constructive, on a periodic basis as to whether the information received by the Audit Committee serves to meet its requirements and expectations.

3.2.2 Understand The Organization's Financial/Business Risks and Oversee Management's Internal Control Framework

In order to do its job effectively, the Audit Committee must understand and assess the organization's financial and business-related risks. The Audit Committee should obtain information on management's assessment of the financial and business risks to the organization, as well as management's plans to mitigate those risks. This information should include management's assessment of the organization's industry conditions, as well as its financial climate. Management should also provide information on any changes or proposed changes to industry-related legislation/regulations, and how these changes might impact the organization.

It is senior management's responsibility to design and implement effective internal control systems that safeguard organizational assets and ensure efficient operations. The Audit Committee's responsibility is the oversight of these internal control systems. In many cases, an organization's financial information is generated from a process that places reliance on the internal control practices. Hence, the Audit Committee must understand management's internal control practices, and ensure that internal control systems are functioning as intended in order to gain assurance that the financial information produced by the organization is reliable.

The system of internal control includes controls over financial accounting systems and records, computer controls and security, fraud prevention programs, and any procedures in place to ensure compliance with legislative requirements and internal control policies. Poorly functioning internal controls may adversely impact the financial information of the organization and may result in financial information containing misstatements due to undetected deficiencies in the control systems. Any issues that may negatively affect the information generated from the financial reporting process should be brought to the Audit Committee's attention.

Audit Committees can look to the internal and external auditors for corroboration as to the completeness and adequacy of internal control practices. The Audit Committee should also ensure it has an understanding of the nature and extent of testing on the internal control systems performed by both the internal and external auditors, so that they do not place undue reliance on the auditor's testing. Should the internal or external auditor report a control weakness or breakdown in internal control, the Audit Committee must review management's assessment of the impact of this control weakness/breakdown, and ensure that an adequate course of action be taken to correct the weakness/breakdown. The Audit Committee should also ensure it follows-up on the implementation of such corrective measures.

3.2.3 Review the Management Discussion and Analysis Report

The Management Discussion and Analysis (MD&A) document is a component of the organization's annual report that is attached to the audited financial statements in order to help external readers better understand the organization's business and its performance. The MD&A provides information that helps in the evaluation of management's risk assessment and business strategies.

Given that the Audit Committee is responsible for the accurate publication of the financial information in the organization's published annual report, and that the MD&A is one of the two main components of such financial disclosure, it is imperative that the Audit Committee review the MD&A to ensure that it is clear for external readers and is consistent with the financial statements.

3.2.4 Have Unrestricted Access To Information Required To Fulfill Audit Committee Duties

Information is critical to an Audit Committee effectively performing its duties. Audit Committees should be provided with unrestricted access to all documents and personnel of the organization as may be required to fulfill its responsibilities. The Audit Committee should not hesitate to request any reports, background information, or presentations from internal staff or external experts as it deems necessary.

As today's business environment is complex and ever changing, Audit Committees may also require external assistance in discharging their responsibilities. This may include seeking independent external advice, or contracting for external expertise at the organization's expense, to provide specific information or services to the Audit Committee (for example, legal advice, actuarial services).

Further, should it be necessary, the Audit Committee should be free to conduct its own investigations and reviews into any management practice or organizational activity. This may range from requesting that the internal or external auditor provide assurance that management has provided complete and accurate information, to requesting that the scope of the external auditor's review be expanded to a particular area, or even, to contracting with an external investigator or forensic auditor to review allegations brought to the Audit Committee regarding financial mismanagement.

"…it is the CEO's duty to state clearly his or her expectation that nothing less than a cooperative attitude in dealing with the Audit Committee will be tolerated. This is not to say that disagreements will not be tolerated - constructive disagreement is bound to happen and is, in fact to be desired. What is not to be tolerated is withholding information or miserly doling out a bare minimum of information."

Integrity in the Spotlight

3.3 EFFECTIVE COMMUNICATION AND RELATIONSHIPS WITH AUDITORS

Developing an effective working relationship with both external and internal auditors is essential for an Audit Committee to effectively fulfill its oversight responsibilities. Audit Committees form many of their judgments of management's performance based largely on the information and feedback obtained from internal and external auditors, who should have direct reporting relationships to the Board and its Audit Committee. The following section discusses practices to ensure a productive and frank working relationship is developed between the Audit Committee and the auditors.

3.3.1 Hire and Manage Relationship With External Auditor, Ensuring Independent Communication, As Necessary

The external auditor is hired by and retained by the Board of Directors, not management. As a result, the relationship with the external auditor must be one of direct reporting to the Board of Directors and its Audit Committee. The external auditor acts in the best interests of the Board of Directors, and the Audit Committee can look to the external auditor to provide assurance as to the completeness and accuracy of the financial information management has provided. This is also the case in situations where the external auditor is the Office of the Auditor General, appointed under an Act or through Order-In-Council.

The process and procedures for the appointment and termination of the external auditor should be documented in the Audit Committee Charter. In retaining an external auditor, the Audit Committee should satisfy itself that the external auditor and their team are appropriately independent of management.

The Audit Committee should meet regularly with the external auditor. At a minimum, the Audit Committee should meet with the external auditor twice per year; once before the external audit is conducted to review the auditor's scope and approach, and once after completion of the audit to review findings. However, communication between the external auditor and the Audit Committee could occur at various stages of the audit, including[1]:

- A meeting at the pre-engagement stage in which the Audit Committee and the external auditor discuss the auditor's independence, industry experience, and the scope of the audit services to be provided.
- A meeting at the planning phase of the audit, so that Audit Committee members can familiarize themselves with, and provide input into, the planned audit approach. This ensures that the audit is not only meeting generally accepted auditing standards (GAAS), but fulfilling the expectations of the Audit Committee as well. It also provides the Audit Committee with an opportunity to raise any areas of concern that they would like the external auditor to review.

[1] From CICA Generally Accepted Auditing Standards, Section 5751: *Communications with those having oversight responsibility for the financial reporting process.*

- Meetings could take place during the audit, in order to keep the Audit Committee informed on a timely basis of any audit concerns or findings. If any significant issues arose during an audit, the external auditor should meet with the Chief Financial Officer and Audit Committee Chair to determine the course of action to be taken.
- A meeting after the completion of the audit, so that the Audit Committee and external auditor can discuss any findings and issues. The external auditor would also provide a management letter to the Audit Committee (as well as the Board of Directors) detailing any concerns and suggested improvements.

To ensure open and candid discussion of any concerns, the Audit Committee should always be provided with the opportunity to meet with external auditors *in camera*, (in other words, without the presence of any management). Leading practices suggest that an *in camera* session be included as part of every meeting with the external auditor. Establishing an *in camera* session as part of all meetings with the external auditor also avoids unease that may occur if such discussions are only held when a specific issue arises.

After reviewing the external auditor's findings and recommendations, the Audit Committee should establish a follow-up process to monitor management responses to any significant matters raised, and to ensure that any required changes are implemented.

The Audit Committee should, with input from management, annually evaluate the performance of the external auditor in conducting the audit. This would help inform the appointment process of the external auditor for the following year. A regular review of the independence of the external auditor in relation to the organization should also be conducted and considered during the appointment process.

3.3.2 Direct and Review Work Of Internal Auditor, Ensuring Independent Communication, As Necessary

In fulfilling its oversight role, the Audit Committee also places strong reliance on the organization's internal audit function, if one exists. The Audit Committee should receive reports from the internal auditor on any matters that have an impact on the internal control system, the quality of financial information, or compliance with legal/legislative requirements and the organization's internal policies. The Audit Committee may also request the internal auditor to perform special projects, investigations or provide other services on matters of interest or concern to the Audit Committee.

In order for the internal audit function to maintain its independence from management, the internal auditor should have a direct reporting relationship to the Board of Directors, as well as to the Chief Executive Officer or equivalent. The internal auditor's objectivity in reviewing the financial reporting process and internal control systems may be compromised if the reporting relationship is only to the Chief Executive Officer.

The Board of Directors usually delegates its oversight of the internal audit function to its Audit Committee, and hence the Audit Committee is responsible for ensuring that the internal auditor is fulfilling its mandate, and meeting both the needs of the Board of

Directors, as well as management. The Audit Committee should have a clear understanding of the mandate of the internal audit function, and ensure it is documented in a written Charter, detailing the purpose, authority and reporting relationships of the internal audit function. The Audit Committee should also be involved with and approve the appointment and/or removal of the Chief Internal Auditor. If the Chief Internal Auditor resigns or is reassigned, the Audit Committee should hold an *in camera* exit meeting with the individual to determine the basis for departure.

The Audit Committee should, on an annual basis, review and approve the internal auditor's work plan and the scope of planned audits, as well as their staffing and financial budgets. The internal auditor should also provide the Audit Committee with information related to its activities, including projects completed, projects in progress, and updates on the status of any previous recommendations.

All completed internal audit reports should come before the Audit Committee for review. The Audit Committee should also ensure that management takes appropriate corrective action in response to recommendations made in internal audit reports. Similar to the external auditor, the Audit Committee should routinely meet *in camera* with the internal auditor to allow for open and candid discussion.

If the organization does not have an internal audit function, the Audit Committee should consider the size and complexity of the organization and whether one is required.

3.4 COMPLIANCE WITH LAWS, REGULATIONS, AND INTERNAL POLICIES

Public sector organizations are expected to demonstrate a strong commitment to lawful and ethical behavior. Through their actions and words, the Board of Directors and senior management are responsible for creating an environment of integrity. Ensuring the organization's compliance with laws, regulations, and legislative mandates is hence a key governance function for a public sector Board of Directors. This also includes ensuring the organization's compliance with any internal policies established or approved by the Board, such as Codes of Conduct or conflict of interest policies. These responsibilities, which are commonly delegated to the Audit Committee, are discussed in the following section.

3.4.1 Ensure Compliance With Legislation, Regulations, and Public Sector Reporting Requirements

Management has the primary responsibility for ensuring that the organization complies with relevant legislation and behaves with high standards of integrity. The Board of Directors, often through its Audit Committee, is required to monitor the organization's compliance with legislation, regulations and any legislative mandates or ministerial directives.

Management should provide the Audit Committee with periodic updates on the status of compliance with any legislation and regulations that affect the organization. The Audit Committee should review management's assertions and assessments of compliance. Audit Committees can also choose to receive reports from external or internal auditors that include reviews of compliance with legislative requirements. Audit Committees should ensure the resolution of any significant acts of non-compliance that is brought to their attention.

Public sector reporting requirements often require the publication of an annual report, which in some cases must be tabled in the Legislative Assembly. It may also require the public reporting of the organization's corporate plan, its budgets, or other public financial reports. Audit Committees usually review, prior to release, all published financial or other reporting information provided to government or to the public. The review should ensure that any public reporting portrays a complete, accurate and balanced picture of the organization's performance and financial situation.

3.4.2 Ensure Adherence to Internal Policies, such as Codes of Conduct and Conflict of Interest Policies

The Board of Directors and management are responsible for operating public sector organizations in an effective and ethical manner. Through their actions and words, the Board of Directors and management should serve to demonstrate and foster high standards of behavior within the organization and ensure that an appropriate "tone at the top" is set for the organization. Creating an ethical culture of honesty and integrity involves establishing internal policies such as Codes of Conduct or conflict of interest policies, which apply to all staff, management, as well as the Board of Directors. Such internal policies and guidelines, as well as the required and expected behaviors, must be formally communicated to all staff, management and Board members.

The Board's Audit Committee is often delegated the responsibility to ensure the organization's Code of Conduct, conflict of interest policies, and guidelines for acceptable business practices are adhered to and periodically reviewed. This may include receiving periodic updates from management (and/or internal legal counsel) on the status of internal compliance. Management should establish procedures for monitoring compliance with the code of conduct and ethics policies, and demonstrate that unacceptable behavior and practices will result in swift and meaningful sanctions.

To reinforce their strong interest in ethical standards, Audit Committees should request management to report periodically on how its processes and internal policies encourage and maintain high ethical standards. The Audit Committee should also review and approve expenses and perquisites of the Chief Executive Officer or equivalent, as well as approve any expenses or perquisites incurred by the Chair or any Board members.

Personal interests should never be in conflict with, or take precedence to, the best interests of the organization. Conflict of interest declaration forms should be completed on an annual basis by all Board members and senior management. Any issues, concerns, or questions with respect to conflicts of interest should be reviewed by the Audit Committee. As a result, members of the Audit Committee should ensure that they (and their immediate family) are free from any conflicts of interest or economic relationships with the organization prior to agreeing to serve on the Audit Committee.

3.4.3 Establish Policy and Procedures For "Whistle-Blowing"

The implementation of a process for employees and other stakeholders to report concerns or suspicions of accounting improprieties, unethical behavior, or possible illegal activities emphasizes an organization's commitment to avoiding possible misconduct or fraud. This process is often termed "whistle-blowing". The Audit Committee is often delegated the responsibility to ensure that the organization has established an appropriate whistle-blowing policy, and adopted procedures that allow such matters to be resolved and acted upon confidentially and objectively.

In the United States, the Sarbanes-Oxley Act of 2002 requires Audit Committees of publicly-traded corporations to "*establish procedures for*:

(a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
(b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters".

It is prudent for all organizations to establish a whistle-blowing policy that encourages employees to report not only illegal acts, but those that contravene the organization's internal policies, procedures or code of conduct and ethical standards. Whistle-blowing procedures should allow for the confidential and anonymous submission by employees or other stakeholders of any concerns regarding such matters. Confidentiality is critical to ensuring that employees are unafraid to voice concerns and are as forthcoming as possible, and that the rights of those suspected of violations are respected. For whistle-blowing procedures to be effective, employees must also feel that they will be free from retribution for raising concerns, and that the organization takes reported incidents seriously and acts upon cases of misconduct or fraud in a consistent and fair manner.

Whistle-blowing policies and procedures must be clearly communicated to all employees. Some organizations are establishing external 'hotlines' to facilitate submissions from employees and others. However, the procedures adopted should be designed considering the organization's culture, size and structure, bearing in mind that what might be appropriate for a large or geographically-diverse public organization may be quite different than those of a smaller public organization. Whatever the process, the individual in receipt of the concerns or allegations must be independent of management (for example, the Internal Auditor, the Audit Committee, or an external hotline). A follow-up process must review, investigate, and resolve the concerns in a confidential manner.

Association of Fraud Examiners 2002 Report to the Nation noted:

- *46% of fraud is uncovered by whistleblowers.*
- *Organizations with confidential fraud hotlines reduced losses by 50%.*

Regular reports that include a summary of complaints should be presented to and reviewed by the Audit Committee. The Audit Committee should have the power and resources to investigate any matter brought to their attention that they feel warrants their review (for example concerns specifically related to Executive conduct or to financial reporting). In doing so, the Audit Committee should be provided full access to all records, facilities, and personnel of the organization and should be provided with the power to access any external advice or expertise required. If considered necessary, the Audit Committee would recommend to the Board any procedural or policy changes required to handle complaints or concerns related to the conduct of the organization.

4.0 Recommendations

These recommendations are provided as a point of reference for self-assessment and enhancement of practices by Manitoba's public sector Audit Committees. We encourage all public sector Boards of Directors to review and consider the Audit Committee practices and recommendations below in light of their own organization. As the size, mandate, and complexity of public sector organizations vary considerably, each Board of Directors and their Audit Committee should tailor these practices to meet the unique circumstances and specific needs of their organization.

We recommend:

- That, given the vital role of an Audit Committee in overseeing the reliability of the financial reporting process, all public sector organizations consider establishing a stand-alone Audit Committee. A decision by a Board-governed public sector organization to not establish an Audit Committee should be clearly documented, discussed with the sponsoring ministry, and disclosed to the public in the organization's annual report. Smaller Boards of Directors may choose to have the Audit Committee comprised of all Board members, however meetings should be held separately from regular Board meetings and should be specifically designated and devoted to Audit Committee functions.

Audit Committee Structure and Operations

- That all public sector Audit Committees develop and operate under a comprehensive written Charter.
- That the Audit Committee Charter be reviewed regularly in order to ensure Audit Committee functions continue to reflect the organization's environment and reflect evolving corporate governance requirements and leading practices.
- That Audit Committee members be appointed by the Board of Directors (or by a Nomination Committee if in existence) based on their skills and competencies. Financial expertise should be a significant consideration in selecting members.
- That Audit Committees be comprised of members who are all financially-literate, with at least one member possessing financial management expertise.
- That Audit Committees be chaired by an independent, financially-literate Board member, who is not also serving as Chair of the Board.
- That all Audit Committees establish an orientation program for new Audit Committee members to ensure that they are provided the necessary information and financial training to contribute to the Audit Committee's mandate and to effectively carry out their duties.
- That ongoing financial and risk management training be provided to all Audit Committee members, as there is continual change in financial

reporting requirements and the risks affecting an organization. Even Audit Committee members with significant financial expertise (for example, professional accountants) should be provided ongoing training, as many risks or finance issues can be industry-specific and they may not be familiar with the unique circumstances and requirements affecting a particular industry or organization.

- That Audit Committee meetings be held on a regularly scheduled basis, to deal with specific Audit Committee functions. While we recommend that a separate Audit Committee be established, we suggest that even if the Audit Committee is combined with other Committees, that a certain number of meetings be specifically designated to deal with Audit Committee issues.
- That Audit Committee meetings be held one to two weeks prior to the full Board of Directors meeting. Holding an Audit Committee meeting directly before a Board meeting (or even the day before) is not a sufficient amount of time for the Audit Committee's deliberations and recommendations to be processed and brought before the full Board of Directors.
- That Audit Committee meeting agendas be set by the Audit Committee Chair, in consultation with management and auditors, rather than developed solely by management.
- That Audit Committees establish an annual calendar of pre-determined meetings in order to ensure all duties required by the Charter are fulfilled. An annual calendar of items avoids the risk of omission and also serves to benchmark the Audit Committee's annual performance.
- That Audit Committee members be provided their information package at least a week prior to the meeting in order to provide sufficient preparatory time to read and consider the information prior to attendance at the meeting.
- That Audit Committees regularly report to the Board of Directors in a written format, in conjunction with providing verbal updates and copies of meeting minutes, so that all Board members are aware of the Audit Committee's activities with respect to the organization's financial and risk management issues.
- That Audit Committees conduct a formal assessment of their performance on an annual basis, in order to continuously enhance their contribution to the organization and improve their processes as necessary.

Oversight of the Financial Reporting Process

- That Audit Committees provide senior management with a written outline of their information expectations and requirements in order to ensure the Audit Committee has complete and relevant information in the performance of their duties.

- That Audit Committees review the adequacy of the information received from senior management to ensure it represents an accurate and complete exchange of information that meets the needs of the Audit Committee. In order to continually improve the information process, formal, written feedback should be provided to management on a periodic basis.
- That Audit Committees regularly review information related to the organization's financial and business risks in order to ensure good understanding and awareness amongst all Audit Committee members of risk-related issues.
- That Audit Committees review management's internal control processes on a regular basis, and ensure the systems are operating as intended.
- That Audit Committees ensure they understand the nature and extent of testing on the internal control systems being conducted by both internal and external auditors.
- That Audit Committees review the Management Discussion and Analysis (MD&A) to ensure that the information is clearly presented and is consistent with the financial statements.
- That Audit Committees ensure that unrestricted access is provided to them with respect to information required to fulfill their oversight responsibilities. Further, Audit Committees should assess their information requirements and ensure that, as needed, external and/or independent expertise is provided.

Effective Communication and Relationships with Auditors

- That Audit Committees hold regularly scheduled meetings with the external auditor that includes the entire Audit Committee, not just the Chair.
- That Audit Committees review the external auditor's audit approach and scope prior to the audit to ensure that it sufficiently addresses any concerns or issues they may have.
- That Audit Committees establish an *in camera* component to meetings with the external auditor to ensure opportunities for frank discussion.
- That Audit Committees regularly assess the independence of the external auditor in relation to the organization, and annually evaluate, with input from management, the performance of the external auditors.
- That if an internal audit function exists, it report directly to the Board of Directors (or Audit Committee). Dual reporting with the Chief Executive Officer is appropriate, but the internal audit function should not report to the Chief Financial Officer.
- That Audit Committees ensure an Internal Audit Charter exists and is reviewed on a regular basis, to ensure it accurately reflects the duties, function and mandate of the internal audit function.

- That Audit Committees receive appropriate written reports from the internal auditor on all matters that affect internal control processes, quality of financial information, and compliance with legal/legislative requirements, as well as the organization's internal policies. The Audit Committee should also receive status reports from the internal auditor outlining projects completed, projects in progress, and follow-up on management's implementation of recommendations.
- That Audit Committees meet *in camera* with the internal auditor on a regular basis to ensure open and candid discussion.
- That Audit Committees ensure management provides written follow-up of internal audit recommendations.
- That Audit Committees review and approve the appointment of the Internal Auditor.
- That Audit Committees monitor the internal audit function on an annual basis to ensure it is fulfilling its mandate, and meeting the needs of the Audit Committee, as well as management. The Audit Committee should also obtain management's evaluation of the performance of the internal audit function as part of this review.
- That, if no internal audit function exists, the Audit Committees review the size and complexity of the organization and determine whether the establishment of an internal audit function is required.

Compliance with Laws, Regulations and Internal Policies

- That Audit Committees establish a process to ensure regular review of the organization's compliance with relevant legislation, regulations, as well as legislative mandates and policy directives.
- That Audit Committees ensure all public sector reporting requirements are met and that they review all public reporting by the organization to ensure it portrays an accurate and balanced picture of the organization's performance and financial situation.
- That Audit Committees monitor compliance with internal policies such as Codes of Conduct and conflict of interest policies. A detailed conflict of interest policy for the Board of Directors and annual conflict declaration forms should also be in place and monitored by the Audit Committee.

Whistle-blowing Policy and Procedures

- That Audit Committees ensure that the organization establishes a process that allows for the receipt, retention and treatment of concerns/complaints from employees or other stakeholders by someone who is independent of management. In addition, the process should ensure that those who bring forth complaints are free from retribution, and that their concerns are held in confidence. Whistle-blower policies and procedures should be documented and clearly communicated to all personnel.

BIBLIOGRAPHY OF KEY RESOURCES

Appendix A

American Institute of Certified Public Accountants (AICPA), *Audit Committee Toolkits*, www.aicpa.org/audcommctr/homepage.htm

Auditor General of Alberta, *Assessment of the Performance of Public Sector Audit Committees, 2003 Report*, July 2003. www.albertaoag.ca

Canadian Institute of Chartered Accountants (CICA), General Assurance and Auditing Section 5751, *"communications with those having oversight responsibility for the financial reporting process"*, CICA Standards and Guidance Collection, 2005. www.cica.ca

CCAF-FCVI and Government of Alberta, *Proposed Guidance for Audit Committees in the Public Sector*, August 2005. www.ccaf-fcvi.com

The Conference Board, *Corporate Governance Best Practices: A Blueprint for the Post-Enron Era*, Global Corporate Governance Research Centre, 2002. www.conference-board.org

The Conference Board, *Corporate Governance Handbook 2005: Developments in Best Practices, Compliance and Legal Standards*, Global Corporate Governance Research Centre, 2005. www.conference-board.org

HM Treasury U.K., *The Audit Committee Handbook*, 2003. www.hm_treasury.gov.uk/media/8d2/62/audit_committee_handbook2003.pdf

IIA Research Foundation and Pricewaterhouse Coopers, *Audit Committee Effectiveness – What Works Best, Third Edition*, 2005. www.theiia.ca and www.pwc.com/extweb/pwcpublications.nsf/docid/AC69AD1832098EB585257045005267B1

KPMG's Audit Committee Institute (ACI)–Canada, *Shaping the Canadian Audit Committee Agenda*. www.kpmg.com/aci

National Association of Corporate Directors (NACD) Blue Ribbon Commission on Audit Committees, *Audit Committees: A Practical Guide*, 2004. www.nacdonline.org

New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD), *The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 1999. www.nasd.com

Ontario Securities Commission, *Multilateral Instrument 52-110 Audit Committees, Companion Policy 52-110CP, and National Policy 58-101 Corporate Governance Guidelines*. www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040326_52-110-audit-comm.jsp

Sabia, Maureen J. and James L. Goodfellow, *Integrity in the Spotlight: Audit Committees in a High Risk World, Second Edition*, The Canadian Institute of Chartered Accountants, 2005.

Treasury Board of Canada Secretariat, *Guidelines for Audit Committees in Crown Corporations and other Public Enterprises*, July 2003. www.tbs-sct.gc.ca/pubs_pol/opepubs/TB_71/ccgac-ldse_e.asp

Appendix B

SAMPLE AUDIT COMMITTEE CHARTER

The Audit Committee Charter (or Terms of Reference) should clearly articulate the role, composition, and specific responsibilities and duties that the Audit Committee will perform. All Audit Committee meeting procedures should also be clearly outlined in the Charter, including items such as the frequency of meetings, the achievement of quorum, the appointment of the Chair, the setting of agendas, and reporting back to the full Board of Directors. The Audit Committee Charter should be reviewed and approved by the Board on a periodic basis (usually annually) to ensure that it appropriately reflects the requirements of the Board and the operating context of the organization.

While the specifics will be unique to the size and complexity of each organization, an Audit Committee Charter is commonly organized into several key areas:

I. Audit Committee Mandate

II. Audit Committee Composition & Independence

III. Audit Committee Meetings & Meeting Procedures

IV. Audit Committee Responsibilities and Duties

- Financial Reporting
- Accounting Policies
- Risk Management
- Internal Controls
- External Auditor
- Internal Auditor
- Compliance with Laws and Regulations
- Other Responsibilities

V. Audit Committee Authority

- Access
- Special Investigations

VI. Audit Committee Accountability, and Reporting

VII. Audit Committee Assessment & Review of Charter

Several of the key resources noted in **Appendix A** provide various examples of Audit Committee Charters (see Sabia and Goodfellow, *Integrity in the Spotlight*). Audit Committee Charters are a requirement for many publicly-traded companies, and in both the United States and UK, Charters must be disclosed on a publicly-traded company's website. Hence, Audit Committees looking to adopt or improve their Charter should have no difficulty in finding numerous examples.

SAMPLE AUDIT COMMITTEE SCHEDULE/AGENDA

Appendix C

Leading practices suggest linking the responsibilities and duties noted in the Audit Committee Charter to the meeting schedule and agendas. Using a scheduling calendar such as the sample below allows the Audit Committee to plan and schedule its activities throughout the year. The key advantage to such an approach is that it provides assurance that the Audit Committee is fulfilling all responsibilities and duties over the course of the year, while balancing the workload across meetings. It also allows the Audit Committee to take remedial steps in the event items are missed or more meetings are required.

Example of Audit Committee's Annual Meeting Agenda

Audit Committee Responsibilities and Duties	Scheduled Meetings			
	April	July	October	January
Establish number/date of meetings		X		
Review Charter		X		
Review quarterly results and findings	X	X	X	X
Review annual financial statements - discuss with management, auditors				X
In camera session with auditors, internal audit, management, committee	X	X	X	X
Consider internal controls and financial risks	X		X	
Recommend appointment of auditors	X			
Review external auditor plan		X		
Discuss quality of accounting principles	*	*	*	X
Review internal audit plan			X	
Review internal audit reports	*	*	*	*
Review legal matters with counsel	*	*	*	*
Perform other activities as appropriate	*	*	*	*
Report to Board	X	X	X	X
Conduct special investigations	*	*	*	*
Review Code of Conduct		X		
Review director and officer expenses and related party transactions	X			
Assess Audit Committee performance			X	
.... etc.				

Source: Adapted from KPMG's Audit Committee Institute

X = Recommended timing * = As needed