

Corporate Governance in Canada's Capital Markets
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While some exceptions can be isolated, Canada's capital markets can be said to operate under a *principles-based approach*. That is, an environment wherein mandatory compliance can be satisfied through full disclosure. The U.S. capital markets operate under a more rigid *rules-based approach*, which is commonly accepted as being more expensive and time-consuming to comply with. The current debate in public literature tends to suggest that the principles-based approach is more effective in establishing a "culture of compliance". Moreover, many practitioners and academics contend that it is a superior approach for our type of capital markets.

Recent changes to corporate governance system

In recent years, there has been a more cooperative effort among industry, government and regulators to improve four general aspects of the corporate governance system. These aspects embody:

Changes in enforcement

Legislative amendments to Criminal Code (*recognition of new offences, increased penalties, sentencing guidance, and concurrent jurisdiction provisions*);

And provision of:

New resources dedicated to investigating serious cases of capital fraud (*special investigator teams, forensic accountants and lawyers*); and

New resources to support prosecution of capital market fraud offences (*under the Criminal Code*).

Financial reporting and market disclosures

New accounting guidelines issued by the AcSB and the AASB since 2001 (*EIC-128 – Accounting for Trading or Non-Hedging Derivative Financial Statements; July 2002, AcG-14 – Disclosure of Guarantees; January 2003, AcG-15 – Variable Interest Entities; November 2004, and Amendments to Section 3870 – Stock-Based Compensation and Other Stock Based Payments; January 2004* ;

CSA has reviewed the regulatory framework and added new measures to strengthen continuous disclosure obligations of public companies;

CICA improved financial disclosures in 2003, including enhancements to MD&A disclosures of off-balance sheet arrangements and related exposure; and,

The Investment Dealers Association (IDA) has improved the quality and independence of research disseminated to investors.

Audit process

In response to Canada's self-regulatory framework in respect to audit practices, Canada has endorsed the creation of the AASOC (*Auditing and Assurance Standards Oversight Council*) and the CPAB (*Canadian Public Accountability Board*) to enhance the quality of objectivity and quality of the audit process.

CPAB provides a national system of oversight for public accounting firms and their auditors. The CPAB inspects audit firms and reviews their adherence to standards in public company audits. The Board also imposes penalties directly on auditors firms for violations and makes recommendations on accounting standards, assurance standards, rules of professional conduct and governance practices that are relevant to the professional institutes and/or standard-setting bodies.

Importantly, CGA-Canada and the CICA have evolved new, CPAB endorsed, auditor independence standards to ensure more comprehensive and wide-reaching regulatory practices.

Corporate governance and management accountability

Canada has continued to rely on principles and voluntary guidelines given the relative size of our typically smaller companies. That said, a number of new rules have been put in place:

In 2003, 12 of the 13 securities regulators agreed to the requirement that the CEO and CFO certify annual and interim disclosures, stipulate the role and composition of audit committees, and requiring public company auditors to be members in good standing with the CPAB;

and,

5 provinces formally adopted nine fundamental governance guidelines in 2005.

(which essentially provide for disclosure rules such things as whether or not there are position descriptions for the CEO and chairman of the board, whether or not there is a written mandate for the board, what process the board follows for determining executive compensation, what process the board uses to identify new director candidates for nomination, and whether or not there are board and director performance assessments).

Importantly also, it should be recognized that Canada is migrating, converging or otherwise meeting international standards in a number of these areas.

Is the present system working?

While Canada continues to call for governance improvement, there has been significant progress. We can be very pleased with recent movements.

The CICA indicated in their 2008 Corporate Reporting Awards that the quality of corporate reporting is improving – firms are making financial reports more comprehensive and inclusive, and are moving towards more electronic disclosure of documents

Canadian Business magazine reported in its annual corporate governance survey (*The Board Report 2007*) that Canadian directors have continued to clean up their act since the collapse of global enterprises in 2001 - 3-year share return, independence, accountability and disclosure policies have all improved drastically

In a recent study by CGA-Canada (*Measuring Up: A study on Corporate Sustainability Reporting in Canada*), we found that many companies saw opportunity in voluntary reporting and disclosure extending beyond that which is mandated. By, and in large, those motivations stemmed from the desire to reveal their sense of comprehension, transparency and/or commitment to their owners and customers.

What is more, is that companies fully understand the benefits of transparency and are prepared to compete for capital and market share on that basis. We would advocate therefore for a natural shaping of best practice in governance within corporate Canada over undue regulatory reform. Recognizing however that fraud or intentional misrepresentations constitute a different issue, diligence continues to be supported with the caveat that weak governance is not synonymous with deception.

We have found that some companies are better than others in corporate governance.

They typically possess:

A strong sense of commitment

A “culture of compliance”

Board members having strong sense of:

- 1) independence,
- 2) diligence,
- 3) competence, and
- 4) ethics

Effective boards have typically tasked themselves with having:

1. Good board structure (*in terms of size and leadership*);
2. Productive meetings that challenge the traditional way of doing things;
3. An adequate succession planning system to ensure that there is always a highly qualified team managing the company;
4. A financial reporting and risk management system, including an independent audit committee, to ensure the integrity of the company's financial reporting process;
5. A strategic information system to provide quality information to the board; and
6. A performance evaluation and compensation system that evaluates the overall corporate performance, the CEO's performance and the individual contributions of each board member.

There is still work to do, but encouragingly, many have moved in this direction.

Governance has been defined as the process by which organizations are directed, controlled and held to account. We should however be careful to not confuse governance with government.

Several principles of good governance apply to all organizations. These include:

- Setting direction: establishing organizational policy and budgets
- Ethics: instilling values in the organization; setting the tone at the top, with clear lines of accountability that hold people responsible for doing the right thing
- Overseeing results: oversight to ensure policies are implemented; monitoring that performance meets expectations

- Accountability reporting: good financial and performance reports, preferably subject to independent audit
- Correcting course: identifying problems; responding and taking corrective action - for instance, implementing auditors' recommendations.

While they used to be more particular to the public sector, we are seeing the emergence of renewed expectations, or principles in corporate Canada which include:

- Transparency: *Organizations need to maintain openness to its investors and customers*
- Probity: *Company agents/officers must act always with honesty and integrity*
- Equity: *Organization officials must exercise the power entrusted to them fairly. They must avoid the misuse of power, and corruption.*

Lack of transparency, probity or equity will erode public trust, undermine the organization's legitimacy and damage long-term sustainability.

The need for effective governance derives from the principal/agent relationship between appointed directors and officers and stakeholders or investors.

The role of regulatory oversight cannot be minimized in the design and execution of a governance oversight regime. Legislative and compliance regimes do provide legitimate direction and comfort but should not be seen as substitutes for voluntary corporate programs which help an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

But while oversight can be afforded through legislative arms of Canadian society, it must be enriched also by:

- Insight – improvements in efficiency and effectiveness; and,
- Foresight - identifying the risks facing the organization, and mitigating those risks. They can also identify opportunities.

Properly designed, a success governance methodology will allow a company to operate with greater transparency, probity and equity. Taken together, these things help reduce risk, improve accountability and maintain the public trust. To do so, we will however need to accentuate sustainability and moral values over the predominance of short-term profit. Companies are currently dealing with a “standards overload” and contending also with a financial bottom-line orientation. As a recent CGA study (*Tackling Compliance: Small Business and Regulation in Canada*) revealed, a majority of small publicly-listed entities are very concerned about the perceived excessiveness of regulation and the aggregate demand of compliance.

Investor education

One of our best chances of success therefore lies in altering the culture of commercial venture so that senior executives and boards of directors are rewarded and compensated for effective governance rather than predominantly on investor profit. That pill may be too big to swallow for some but those who navigate this challenge the best will fare best as public demands continue to swell.