

CORPORATE GOVERNANCE: A CANADIAN FOCUS

Presented by:

**The Canadian Centre for Ethics & Corporate Policy
&
The Canadian Institute of Chartered Accountants**

Sponsored by the Bank of Montreal

When: Tuesday, May 22, 2001

Where: The Ontario Club, Commerce Court South, 30 Wellington Street West, Toronto
- Engineer's Room (lunch in Canadian Room)

Times: 8:30 a.m. - 4:30 p.m.

Price: \$125.00 - member, \$150.00 - non-member

PROGRAM

- 8: 30 a.m. Registration & Breakfast
- 9:00 a.m. Welcome from the hosts
- 9:15 a.m. Corporate Social Responsibility Week
George Khoury, Conference Board of Canada
- 9:30 a.m. Current Trends and Issues
Roger Parkinson, Past Chairman & Publisher, Globe & Mail
- 10:00 a.m. Report on Corporate Governance Committee
Guyline Saucier, Chair, Joint Committee on Corporate Governance
- 10:30 a.m. Break
- 11:00 a.m. The Impact of Corporate Governance Committee Report
Glorianne Stromberg, Former Commissioner, Ontario Securities Commission
- 11:30 a.m. Public Interest and Integrity: Research findings
"Protecting the Public Interest: The Role of the CA Profession"
Bob Lord, Chairman, Canadian Institute of Chartered Accountants
- 12:00 noon Lunch
- Luncheon Address
David Beatty, Director, Clarkson Centre for Business Ethics
- 1:30 p.m. Case Studies and plenary discussion followed by panel response
Facilitator: David Simpson, Director, Interpraxis Consulting
- Panelists: Response to the case studies and speakers comments
Simon Chester, Partner, McMillan Binch
Bill Riedl, Past President, Fairvest Securities Corporation
Rob Yalden, Partner, Osler, Hoskin & Harcourt
- 4:30 p.m. Wrap up

To register please call **The Canadian Centre for Ethics & Corporate Policy**,
416-348-8691 or e-mail ethicctr@interlog.com.

NEW CORPORATE GOVERNANCE GUIDELINES FOR CANADA

A Speech By Guylaine Saucier, CM, FCA Chair Joint Committee on Corporate Governance Presented at the conference "Corporate Governance: A Canadian Focus" May 22, 2001.

Thank you.

It is a pleasure to be here today to discuss Corporate Governance with you, and I thank the Institute and the Centre for Ethics and Corporate Policy for assembling such a distinguished audience and thoughtful panel of speakers to address the issue. Corporate governance is, of course, an issue that has preoccupied me personally for some time – not only since the Joint Committee on Corporate Governance was created last summer, but before that as Chair of the Institute of Chartered Accountants and through my own participation over the years on various boards of directors, both as Director and Chair. Being able to work on the Joint Committee was at once a great privilege, and a great challenge – a privilege, because if corporate governance is one of the most important issues facing the modern corporation, and I believe it is, then it is an honour to be asked for your opinion. The challenge was to follow in Peter Dey's footsteps. How were we to take the Dey Report a step farther – especially when critical aspects of that report have still not been fully implemented by corporate Canada?

How? Well, our response, of course, is now a matter of public record. "Beyond Compliance," the initial report of our Joint Committee, was released two months ago, and we are in the "Comment" period until the end of this month. To judge by the feedback so far, we either went too far with our recommendations, or not far enough – so I guess when you upset everybody equally, it's safe to say that you have delivered a balanced report!

Our job, over the summer, will be to digest the feedback on the report – as well as the responses to our questionnaire – then prepare a final report and recommendations by September. Your questions and comments throughout the day today will be valuable contributions to this process. I encourage you to share your views with me today – and, if you have not already done so, to submit your comments in writing through our website.

Much of the public comment on our report so far has focused on one or two of the recommendations perceived to be the most controversial – for example, the question of separating the roles of Chair and CEO. I don't intend to dwell on this today – in part, because I think the reasoning behind it has already been widely discussed, but also because I would like to spend time on some of the other recommendations that have not attracted as much public attention, yet are extremely important.

I would also like to deal with the overall context of the report and the philosophical premise on which it was based. Let me deal with the philosophical issue first.

The report is entitled, "Beyond Compliance," for a reason. My fellow committee members and I decided early on that we had to go beyond the structural issues. Our task, we decided, was not about suggesting new rules and regulations to force corporations to change their ways; rather, it was about encouraging a cultural change – a shift to a culture of good corporate governance.

As we said in the report, "there are no regulatory or structural remedies that can deal with the culture of governance. What is required is a common appreciation by management and the board of their respective roles, a mutual respect for each party in carrying them out, continuing open dialogue and communication, and strong leadership within the board." What we tried to do in the report was describe these respective "roles" more clearly and define more precisely what form this "strong leadership" should take.

Some of the criticism leveled against the report has focused on our failure, in the critics' view, to prescribe ways to enforce good governance or to punish those who fail to abide by the guidelines. To that charge, we plead "guilty." We deliberately chose to focus on behaviour, rather than structure; disclosure, rather than audit; carrots, rather than sticks. We worry, in fact, about perpetuating the view that "governance" issues are "compliance" issues. In a compliance culture, we tend to be looking in the rear-view mirror – watching where we've been, rather than where we're going.

Rather than looking back – examining past behaviour, checking boxes and providing assurances – boards of directors should be looking forward – considering strategic developments that affect the business, and understanding the business risks and how they are being managed.

That said, how can we encourage corporate Canada to develop a culture of good governance? What changes to the practice of corporate governance can we propose to increase the likelihood that the cultural change will occur? The fundamental thrust of our report and the improvements we propose revolve around the issue of board independence – independence of thought, and independence of action. Independence of thought relates directly to the individual – who are the directors? Who does the choosing? What skills and insights does the individual director bring to the table? Independence of action on the other hand is about the group – and is, once again, a cultural issue. The board must be able to build a strong and cohesive culture that facilitates independent action. In our judgment, this culture develops under two conditions: when there is strong and effective leadership within the board, and when independent members of the board can meet regularly, by themselves, without management. We recommend in the report that there be an opportunity as part of each board of directors meeting, for such a meeting of the outside directors to take place. And if the CEO happens to chair the Board of Directors, that means a meeting without him or her.

On leadership, the starting point, we believe, is to define the role of the board chair – by that, we mean a position description that spells out the chair's responsibilities to provide leadership to enhance board effectiveness; to manage the board; to liaise between the board and management; and to represent the organization externally. In the report, we asked whether we can reasonably expect some of these responsibilities to be carried out effectively when a chair is also the CEO, and we questioned how serious this is for the independence of the board... but I said I wasn't going to dwell on that issue in my remarks today! Questions of independence were also behind our recommendations regarding the role of the audit committee, and the role of the board in terms of risk management.

I don't think there is any debate about the need for the audit committee to be comprised of outside directors, as the current guideline sets out – and, more particularly, that they be unrelated directors. Nor do I think there should be any debate about the need for this group to be financially literate to know what questions to ask. In our report, we spent a fair amount of time

spelling out the role of the audit committee and its relationship with the auditors. One of the points we raise, that I would like to stress this morning, is the need for audit committees to get behind the auditors' reports.

Thus, we recommend that the external auditors not only present their views about the acceptability of the financials, but also their opinion about the quality of the process – in particular, how management performs when making judgments and applying accounting principles to prepare their estimates. We also suggested there is a role for the audit committee when it comes to risk management. I think the board's views on the management of risk within the corporation are at the heart of good corporate governance – and perhaps second only to its involvement in discussions about the overall business strategy of the corporation. However, while risk management is already identified as a board responsibility in the current TSE guidelines, this appears to be one of the less-developed governance activities. Only a few boards have established accountabilities and processes around this issue. We believe the board should be involved not only in assessing the risks and monitoring their impact, but, more importantly, defining what risks are acceptable to the corporation in the first place, and what systems are in place to manage the risks. We also proposed that the system of internal controls to manage those risks should be evaluated by the external auditors and reviewed by the audit committee. We have, frankly, had some contrary views on whether the auditors should become involved in risk management, so I would value your views on the subject.

There is one other recommendation in the report that I would like to highlight, and that is the need for more qualified directors. To put it bluntly, I'm not sure we have an adequate pool of candidates who are ready to assume the role of director – or at least to assume the role as we describe it in our report. As many as one-third of all current directors will reach mandatory retirement age within the next 3-4 years. The demand for directors will be greater still if proposed changes to the governance regime for mutual funds are adopted. I think this presents us with a real opportunity to develop a new generation of board candidates, better suited to fulfil the more rigorous standards the investing public will demand of public companies in future.

Nothing of course can replace the experience, maturity, wisdom and judgment acquired in an active and successful career. However, educational programs can play a distinct role in preparing directors for their board responsibilities. And as boards become smaller, and the demands on their members become greater, the need for specialized programs – focused on real and practical issues, and delivered quickly and efficiently – will grow as well.

Our committee hasn't called for a formal program of courses and seminars, as we have seen in the US and the UK – not that we would be opposed to such a development. Instead, we have called on the Institute of Corporate Directors, in partnership with professional organizations like the Institute of Chartered Accountants – and associations like the Centre for Ethics and Corporate Policy – to consider such an approach and, if deemed appropriate, set it in motion. Personally, I would be happy to see us evolve to a point where being a director required some form of certification (although I appreciate that, first, we need to put in place a successful program of continuing education).

Good directors lead to good governance; the link is that direct and that simply stated. And good governance, we believe, can and does make a difference to corporate performance. In Canada,

we need to be on the leading edge of good governance – perhaps more so than elsewhere, thanks to the number of subsidiaries and boards controlled by majority shareholders.

This phenomenon presents some unique challenges for us in Canada – issues addressed for the first time, I believe, in our report. Having a majority shareholder – be it an individual or another corporation – presents some clear restraints on the unrelated directors, yet they retain the same legal obligation to carry out their fiduciary duties. If anything, their responsibility seems to me to be greater, at least in terms of their accountability to (other) minority shareholders.

Simply spelling out those constraints in a board charter would be a positive step forward. Shareholders, in this case minority shareholders, could then decide if their interests are likely to be adequately represented by the board. Naturally, this implies that the issue first be addressed head on. I am hopeful that this will become a topic of discussion in boardrooms across the country – and I would be happy for it to become a topic of discussion here today.

IMPACT OF THE CORPORATE GOVERNANCE COMMITTEE REPORT

Remarks of Glorianne Stromberg At the Program on Corporate Governance: A Canadian Focus Presented by The Canadian Centre for Ethics & Corporate Policy And The Canadian Institute of Chartered Accountants The Ontario Club
Toronto Canada May 22, 2001

I've been asked this morning to talk about the impact of the Joint Committee Report on Corporate Governance. In fairness to the Committee, it is somewhat premature to talk about the Report's impact given that the Committee has not yet issued its final Report.

So what I thought I would do is talk about some of my reactions to the thoughts expressed in the interim report and in the background papers. I also have some observations and suggestions that are intended to stimulate thinking related to creating and sustaining an effective governance regime.

OBSERVATIONS

Synthesis of Current Thinking: The Joint Committee's interim report is an interesting synthesis of current thinking about corporate governance. If words alone were what is needed to re-energize the corporate governance movement, the interim report certainly has them. But words alone are not going to achieve the Joint Committee's stated goal of re-energizing the movement nor will they help ensure that Canada has strong, vibrant and internationally competitive corporations - which is the stated reason for the commissioning of the Joint Committee in the first place.

Walking the Talk: There's a need to move beyond the words and to translate them into action. "Walking the talk" is another way of expressing this thought. The Joint Committee flirts with this idea when it talks about the need to concentrate more on function and behaviour and less on structure. Unfortunately, the Joint Committee does not sustain its focus on behaviour. Nor does it appear to have considered the causal linkage among structure, function and behaviour.

The recommendations for drafting charters, prescribing roles, and calling for assessment procedures – meritorious as these measures are – do not translate into changing behaviour. These measures (which are both functional and structural in nature) may help in identifying behavioural expectations but they do not by themselves fill the gap between the expectation and the reality.

Consequences: When there is a gap between expectation and reality, there has to be some means of identifying it at an early enough stage to remedy it. Shareholders and other stakeholders should not be the last to know that there are problems with devastating consequences. There has to be some consequence for behaviour that falls short of expectations.

Behaviour: Although the Joint Committee discusses at great length the mandate of the board of directors and the desirability of separating the role of the Chair of the Board and that of the CEO, it does not address the behavioural dynamics that all too frequently reflect what directors actually do. These dynamics are very effectively illustrated in the all-too-typical scenarios contained in Roger Martin's background paper titled, Board Governance & The Responsibility Virus.

If you want to know the answer to questions like "Where were the directors?" and "With all those powerful directors and all the governance procedures in place, why didn't the board do something? Anything?" – read Roger Martin's paper. He talks about the "responsibility virus", the "norm of acquiescence" and why it is an increasingly daunting task for a director to question the CEO on management initiatives. He very cogently explains why directors tend to keep concerns to themselves and to act as passive followers despite their formal authority and their personal seniority.

This fundamental reluctance of directors to question management or committee initiatives has all too often undermined and will continue to undermine so many well-intentioned governance measures. This reluctance exists whether the board is chaired by a non-executive Chair or by the CEO with a lead director. This reluctance is also likely to taint the frankness and usefulness of assessments of the board's effectiveness as a whole or of the effectiveness of individual directors.

Accordingly, if any headway is going to be made on improving governance, directors and management need to gain a better understanding and awareness of behavioural dynamics and they need to recognize the role – to use Roger Martin's language – that adopting new governing values and techniques can play.

Lest anyone think I am impugning the ethics or abilities of directors and officers, I hasten to say that the "new governing values" of behaviour that Roger Martin advocates include replacing the traditional governing value of "win, don't lose" with the alternative value of "informed choice". He would replace the obsession of "maintaining control" with a new governing value focused on "generating internal commitment". In this respect, he observes that it is the desire for control that causes people to make choices unilaterally, without consulting with those who have valuable insight to add. He points out (at page 28) that:

The resulting sub-optimal outcomes are numerous. First, the distribution of responsibilities is rarely close to ideal. Second, choices are made without the benefit of potentially valuable insights of others. Third, when choices are made unilaterally to maintain control, the result is weak commitment to choices because the other party (or parties) commits only in response to external pressure. Martin also highlights the need to convert the traditional behavioural governing value of "avoid embarrassment" into a value based on the "open testing" of the choices we are called on to make, our performance and our perceptions.

RECOMMENDATIONS

Behavioural Dynamics: In order to maximize the impact of the Joint Committee's Report, I suggest that the Joint Committee take a closer look at the whole subject of behavioural dynamics. I suggest that it consider broadening its recommendations on the need for director education, awareness and training initiatives to include a focus on the decision-making process, its motivators, and on techniques and approaches to encourage more effective involvement. The background paper, Agency Theory and the Design of Efficient Governance Mechanisms provided to the Joint Committee offers useful insights into the kinds of skills that are needed.

Scope of Training Initiatives: I believe that this training initiative should extend both to executive and non-executive directors and it should place special emphasis on the need for CEOs and lead directors to develop leadership skills that will foster more effective organizational

decision-making and a more constructive sharing of responsibility. Both of these elements are crucial to optimizing the governance culture of an organization.

Reading the Joint Committee Report and Background Papers: Anyone who is a director or officer of any corporation or who is contemplating becoming one would benefit greatly from reading the Joint Committee's Report and the background papers that I have mentioned. They are a good "first step" in raising awareness and building on the ability that each person brings to the organization to enhance effective decision-making.

Proactive Role of the CICA, Stock Exchanges and Others: If the Joint Committee's Report is to have an impact, it is important that the CICA and the Stock Exchanges that sponsored the Report – together with the Institute of Corporate Directors and the Canadian Securities Administrators – take a proactive role in encouraging directors and officers to actually read the Report and evaluate it in the context of their own organizations. All too often, reports of this nature – that are intended to stimulate creative thinking and meaningful action – get distilled into a one-page summary. The summary then receives cursory attention and a notation in the minutes before being shelved as people move on to what they perceive to be more important issues.

Accordingly, part of the initiatives of the CICA and the Stock Exchanges in this respect should be directed at involving the respective members of these associations by encouraging them to take a proactive role in their business and professional relationships with clients to ensure that their respective client organizations have effective governance mechanisms in place that are working effectively.

Periodic Evaluation and Reporting: A natural extension of this recommendation is to encourage periodic evaluation of the governance structure and processes together with public disclosure of the same. Here, I believe that a combination of self-assessment, external evaluation and reporting would prove most effective. This combination should help solve the problem mentioned earlier – of the need to identify gaps between expectation and reality at an early enough stage to remedy resulting problems and to avoid nasty surprises for shareholders and other stakeholders. This evaluation and disclosure process should be an effective self-policing mechanism that should enable free market forces to work effectively by producing market-generated positive consequences for behaviour that meets expectations and market-generated negative consequences for behaviour that falls short of expectations.

Here, it will be important that the evaluation and disclosure process is truly thorough and meaningful. It will be important to use this process as a core management tool designed to produce continuous improvement in quality assurance endeavours. All too often when disclosure – and sometimes when evaluation – is involved, the result is a lot of platitudes and meaningless boilerplate. It will be important to make sure that this does not happen.

Benchmarking: Perhaps one means that will help avoid the trap of platitudes and meaningless boilerplate that no-one reads, is the development of an objective system for benchmarking that will enable meaningful analysis and comparative governance ranking. This would be a constructive and effective corporate tool. It would also serve to identify in a more timely manner weaknesses and strengths in organizational structures. It is small comfort to shareholders and other stakeholders to learn after the fact that board structures and corporate processes are fundamentally flawed or that compensation systems are skewed towards rewarding short-term performance and encouraging questionable earnings management. An example of what I am

talking about is the dawning realization that stock options are skewing the alignment of board members' own interests with those of other shareholders.

Independent Analysis and Reporting: There is a role for independent analysts to play here. There is also a role for the Institute of Corporate Directors. The impact of the Joint Committee Report would be enhanced if independent analysts and the Institute were to encourage and facilitate the development of corporate governance benchmarking and ranking. The development of an effective benchmarking system would also assist and encourage institutional shareholders in taking a proactive stance in relation to governance issues.

MD&A Disclosure: Another way of increasing the impact of the Joint Committee's Report would be for the Canadian Securities Administrators to require meaningful governance evaluation and disclosure information to be contained as part of the mandatory MD&A continuous disclosure requirements. In addition to encouraging corporations to "get serious" about creating and sustaining an effective governance regime, this measure should provide a foundation for ongoing research and analysis in the area of corporate governance. It should also address the question of how useful monitoring requirements are without corresponding reporting requirements to shareholders on the results of the monitoring activities. One needs to "drill down" below the surface of statements such as "we have monitoring procedures".

Structure, Function and Behaviour: I am going to return to the subject of "structure, function and behaviour" that I talked about earlier. I find the words in the title of the Joint Committee's Report – "Beyond Compliance" somewhat puzzling, as we never seemed to have been in a compliance mode. Similarly, I find the Joint Committee's apparent assumption that structure, function and behaviour are not linked to be somewhat problematic. If we are going to encourage good governance, the causal linkage between structure, function and behaviour is something that needs to be examined. There is a need to consider to what degree structure and functions determine or permit behaviour that encourages or discourages an effective governance regime.

Appropriate Inter-Action: There are some other questions or areas that need to be explored in this context if we are going to maximize the impact of the Joint Committee Report. For example, what is the appropriate inter-action between individual board members and management personnel? Is there any difference if there is a non-executive Chair of the board or if there is a lead director? How conducive are board committees to enhancing decision-making and building an effective governance process? Do board committees operate to fragment the decision rights of the board as a whole?

Modern Corporate Theory: Has modern corporate theory perhaps gone too far in separating the responsibilities of management and of directors? Would we be better served by having a board of managing directors combined with some other "fairness mechanism"? Is the current focus on defining roles and dividing responsibility among management, directors, and shareholders producing some absurd results? Are current expectations of non-executive directors realistic given the informational asymmetry that exists between non-executive directors, executive directors and management? How accountable is professional management? How aligned are their interests with those of shareholders in ensuring the ongoing viability of an enterprise? Not so long ago, there used to be a stigma to screwing up. Now it just seems to serve to increase the size of the severance package leaving the dregs for shareholders and other stakeholders.

Narrow Focus: Is the Joint Committee's focus on how boards function and the role of the board too narrow? After all, corporate governance is not just about board process or how a board actually works and functions. It is about how the corporation as a whole actually works and functions. The board function/process is just one of the many processes that determine the effectiveness of how a corporation or other enterprise as a going concern actually works and functions.

Disclosure: How conducive is the Joint Committee's reliance on disclosure as a measure of building a governance culture? I realize that questioning "disclosure" is a little like questioning motherhood and I hasten to declare that I am certainly in favour of both. However, there are four aspects to disclosure that perhaps undermine its effectiveness as an incentive in building a governance culture.

1. Disclosure works best when people have a basic ability to comprehend information that is communicated to them and to identify and understand its relevancy to their own circumstances. Unfortunately, a lot of people lack this ability.
2. A strategy that relies heavily on disclosure without focusing on how to ensure that people have the ability to assess the implications and relevancy to them of the information that is provided is bound to fall short of what is needed.
3. Disclosure has the tendency to become "boilerplate" – a lot of words with very little real meaning – or with meaning that is only understood by investment professionals. The goal is not to draft and publish board and committee mandates but to focus on what is actually being done and how effective it is.
4. Another drawback of relying on disclosure as a core strategy is that it does little to change behaviour. In fact, it often reinforces questionable conduct as people are deemed to have received the information, consented to it and waived their rights to complain.

These issues concerning the usefulness of disclosure as a strategy need to be addressed to increase the impact of the Joint Committee Report. Some of the suggestions that I have made earlier about the need for an evaluation and reporting process combined with effective benchmarking should help in this respect.

CONCLUSION

I hope that these remarks provide a framework to stimulate further thinking that will enhance the impact of the Joint Committee's Report and will foster the growth in Canada of strong, vibrant and internationally competitive corporations. Thank you for the opportunity to share these thoughts with you today.

PUBLIC INTEREST AND INTEGRITY

A Speech By Bob Lord

FCA Chair The Canadian Institute of Chartered Accountants
Presented at the conference "Corporate Governance: A Canadian Focus"

Canadian Centre for Ethics and Corporate Policy and Canadian Institute of
Chartered Accountants
Toronto, Ontario May 22, 2001

Ladies and Gentlemen,

It's my pleasure to join you today at this forum. Along with the Canadian Centre for Ethics and Corporate Policy, CICA is pleased to host this event. As our previous speakers have all noted, corporate governance is an issue that is fundamental to the success of all businesses today. It's a key element in corporate social responsibility, and it's integral to developing corporations that can compete on the world stage. Clearly, good corporate governance is a team effort. One of the major players on this team is the chartered accountant.

Rightly or wrongly, the accounting profession and particularly auditors have been in for a healthy share of criticism by media and regulators in the past year. Questions have been raised about our role and responsibility in corporate financial reporting, and about our ethics and independence.

Over the last year we've heard the concerns about "creative accounting" and followed the SEC hearings in the United States regarding auditor independence and conflict of interest issues. As chair of the CICA Board of Directors and as a CA ... I and members of my profession do not take such criticism lightly.

In Canada we wanted to get an accurate measure of how our profession is perceived to be doing its job in fulfilling its public interest mandate. If there were issues, we wanted to fix them. I've said it before and I'll say it again – ethics and integrity are what my profession is all about. This is pivotal for the CA profession, yes, but also for the financial health of the global business community.

The CA profession has many stakeholders – investors, lenders, regulators, governments, employees and customers – all of whom rely on assurance provided by auditors. Capital markets rely on credible, reliable and transparent financial reporting.

Imagine for a moment that there was no audit. How would the capital markets function?

The reliability and credibility of financial reporting is essential to their effectiveness and security. Auditors play a vital role in enhancing the stability of capital markets, in promoting liquidity, and in lowering the cost of capital. For auditors to perform this role, their objectivity and independence must be without question.

We It's important to rememberforget that, 99 per cent of the time, financial reporting standards are followed properly. But it's a different world out there. Business has changed, ever since 1990 when Harvard's Michael Porter exhorted us all to think globally and act locally In a world of constant change and growing complexity, effective corporate governance is a global imperative. There have been high-profile cases of business failure ... from Robert Maxwell to Russian money launderers. Increasing calls for accountability and corporate social responsibility Merger frenzy. Dot-com hype. Today, there are increasing calls for accountability and corporate social responsibility.

In this environment, the role of the CA profession in protecting the public interest is critical. We wanted to find out how we're perceived by those we serve.

So we asked Kroll Worldwide, a firm specializing in due diligence and risk analysis, to ask more than 2000 Canadians how we were doing and what we could do better. What is our reputation for ethical practices? How would they rate the quality of audited financial reporting? What in their view is the role of the auditor? Are there any misconceptions and knowledge gaps?

The result is the most substantive and comprehensive public opinion research about the CA profession's public interest role in Canada.

Scope and Purpose

Let me begin with the scope and purpose of our study. Then I'll talk about the key findings their implications, and some of our current initiatives.

The research was conducted by Kroll from November 2000 to February 2001. The scope of our research project was national and broad-based to obtain substantive and reliable information. We focused on more than 2000 stakeholders right across the country, including business leaders, regulators, institutional and individual investors, business media, financial analysts and members of the CA profession.

We wanted to get a read on what the public thought about the objectivity, integrity and independence of CAs, and about how well we are fulfilling our public service mandate. This project was intended to provide useful information for planning, issues management and communication... to give us a clear reading of what our stakeholders think and how we can move to close any gaps.

Our research included telephone interviews, multi-segment surveys, as well as a review of the public statements of Canadian securities regulators, the Canadian stock exchanges and the Canadian Securities Administrators over a 15-month period, from August 1, 1999 to October 31, 2000 – a time when accounting and auditing matters were particularly in the spotlight.

Highlights

Now, let me give you some of the highlights of our research results. They are both encouraging and challenging. They indicate high public regard for the ethics and integrity of the CA profession and solid investor confidence in the quality of financial reporting. But they also indicate some gaps in understanding among certain stakeholders about auditing and accounting matters and the role of auditors and audit committees. These pose some challenges – but also opportunities – for all of us interested in corporate governance.

Let me give you some of the specific highlights. I'll discuss them from three perspectives: reputation for ethical practices, quality of financial reporting and understanding of roles and responsibilities.

Perceptions of the profession

The research results show that the business community ranks CAs as the highest of all business among ten professions professionals on ethics and integrity. The ten Ten professions

were rated are – CAs, actuaries, bankers, business editors, executives, doctors, lawyers, politicians, brokers and professors. Among retail investors, CAs placed among the top three professions, right after doctors and professors.

The quality of financial reporting was also rated highly, which is reassuring, because it speaks to the confidence of the business community in Canadian audited financial statements. Eighty-six percent of the business community see the quality of financial reporting as high and improving over the past five years. In the context of this study, the business community includes business leaders of TSE 300 companies, managers, owners, professionals, executives, institutional and retail investors, and financial analysts.

Improvements in financial reporting were usually attributed to higher professional standards and more complete guidelines. This may also indicate that we're on the right track in our work to converge standards on a North American and global basis.

This study also shows that there's a high degree of investor confidence in audited financial statements. Retail investors cite audited financial statements as their second most important source of information for making investment decisions, after their stockbroker. For francophone Canadians, audited financial statements rate first place with stockbrokers as the most important source of information.

Another interesting finding is that, when it comes to the issue of professional judgment, the study found only a minority of business people – 15 per cent to be exact – and retail investors – only eight percent - believe that auditors have a lot of flexibility in using judgment. Most believe that auditors use a combination of set practices and case-by-case procedures. This finding, along with national confidence in the quality and reliability of financial reporting, puts the issue of "creative accounting" in perspective. As does a statement by the Financial Advisory Council of the Alberta Securities Commission " that 99% of the time, standards are followed appropriately."

However, there's another useful piece of information here, because this finding also shows that the latitude for professional judgment is perceived to vary by sector. Specifically, a significant proportion of the business community ... 44 per cent ... believes that accounting standards offer greater scope for judgment in knowledge-based industries than in traditional sectors such as manufacturing.

I'd like to talk about this finding for a moment, because it's very much in the news. I'm referring to the recent OSC report on the revenue recognition practices of 75 public companies.

Let me say that we welcome this report. While it is supportive of current Canadian reporting standards and recognizes that both US and Canadian GAAP treat revenue recognition in a similar fashion, it does call for significant improvement in disclosure. It also calls for additional guidance on how revenue is presented. This report is currently being analyzed by the Accounting Standards Oversight Council and CICA's Accounting Standards Board.

If additional guidance is needed, then the CICA's Accounting Standards Board will likely want to work towards an internationally converged solution. The Kroll study also points to enormous pressures from financial markets on public companies and their auditors to manage earnings, with consequent pressures on auditors. . Such pressures challenge – and demand – reliable financial reporting and effective corporate governance. In such a competitive global

environment, all players in the corporate governance system must work collectively. These players include management, the board of directors, the audit committee, the auditor and regulators.

The next finding further emphasizes this joint responsibility. A majority of Canadians see the credibility of financial statements as a shared responsibility. Sixty-seven per cent of investors see boards and executive management as highly responsible, 51 per cent view auditors in the same vein, and 31 per cent perceive regulators as highly responsible.

Understanding of Auditor's Role

Our results show that the business community is in tune with the auditor's role. Most (84 per cent) understand "unqualified audit" to mean statements are "reasonably reliable." Only a minority –14 per cent – think auditors are "fully responsible" for detecting fraud. Also significant is public assessment and understanding of the role of audit committees. About 81 per cent of the business community and a majority of our members agreed that audit committees can play a determining role in the quality of audited financial statements.

However, the glitch is that the role of the auditors and audit committees is still not well understood. Among other key groups, most notably business media and retail investors. Responses from 77 prominent business journalists suggest that the business media are not well equipped to inform the public on audit-related issues. For example, only 40 per cent of journalists rate the business media's understanding of the auditor's role highly. The study shows only 19 per cent of CAs agree that business media understand the role and accountabilities of the auditor. Also disturbing is the finding that almost one-third of media respondents were unable to offer a view on the role of audit committees.

While almost three-quarters of the business community investors say they have some understanding of the auditor's role, almost half only 49 per cent of retail investors say so. As well, only 26 per cent of retail investors said they had minimal rated highly their knowledge of what audit committees do.

Furthermore, there is a gap in understanding about what constitutes an unqualified audit opinion. While three-quarters of the business stakeholders (76 per cent) understand it to mean audited statements are "reasonably reliable," a significant minority – 23 per cent – believe that an unqualified audit opinion means that the figures are 'completely accurate.' And significantly, very few retail investors (14 per cent) had heard the term.

And finally, there are also gaps in knowledge about who's accountable for detecting fraud. Most business people understand it's the role of the auditor to detect material misrepresentations but a significant minority, 23 per cent, do not. This group believes that auditors are 'fully responsible' for detecting fraud. And 49 per cent of retail investors believe that auditors are responsible for detecting fraud.

All these findings – on the confusion surrounding the role of auditors and audit committees, an unqualified audit opinion and fraud detection – need to be addressed. Particularly given that more than 50 per cent of Canadians own stocks and have a direct interest in the quality of Canadian corporate governance and financial disclosure. Couple this with the previous finding about the increased pressure to manage earnings faced by public companies and auditors, and the

perceived latitude in disclosure practices for new-economy companies, and we do have some significant challenges to address. Clearly there is a need for more dialogue and education about roles and responsibilities – of boards of directors, executive management, auditors and audit committees.

With respect to the CA profession, the research provides cogent comments from some of our business leaders, such as: "The public needs to be educated about what an audit opinion means." "I believe the accounting profession has to get its message across to the public. Accountants are unfairly looked upon as the 'easy defendant' or the deep pocket when something goes wrong. Auditing is a very difficult task."

Auditor Independence

his brings me to the research results on auditor independence. This is a thorny issue for my profession and, as I mentioned earlier, has occupied the media a great deal in the last year. The question at hand is whether the selling of consulting services to audit clients can give audited companies "the ability to pressure their auditors."

What we found was that 61 per cent of the business community and 65 per cent of our members either disagreed or were neutral on whether selling non-audit services to the same client creates conflict of interest and compromises independence.

However, about a third of our business respondents and our members did express concerns about conflicts of interest in this situation. Recommendations from our 2000 plus research respondents fall into three main categories: strengthening existing safeguards and communicating them to investors, regulators and media; expanding training programs; and restricting and disclosing all business relationships between an audit firm and an audited company.

This is a complex issue and we're working to address it. Our stakeholders have made numerous specific suggestions. We are spending taking considerable time care in analyzing their input and taking planning appropriate action. The question of auditor independence is a critical one for us all. These then are the highlights of the Kroll study.

TAKING ACTION

And now, let me tell you a bit about what we've done and what we are planning to do.

The Kroll study has proved very timely for the progress of another critical initiative – the Public Interest and Integrity Committee. During the last year, this committee has been developing new guidance regarding conflict of interest, reviewing the rules of professional conduct, and developing a Canadian framework for a conceptual approach to independence issues.

In 2000, under the auspices of this committee, the Conflict of Interest Task Force, made up of leaders of the CA profession, government, and the legal and investment communities, studied the issue conducted a study " to ensure public interest is appropriately protected where actual or perceived conflicts of interest arise in relations with clients."

In respect of conflict of interest, this committee released a task force report last November, which recommends improvements to our rules of professional conduct to specifically address issues relating to confidential client information and conflicts of interest. The report provides

guidance to CAs in dealing with conflicts that may arise from time to time. In some cases, this may mean declining a potential engagement because the conflict with an existing client cannot be managed.

The Public Interest and Integrity Committee is also holding an all-day forum on independence on June 4th to get input from key stakeholders – including investors, regulators, senior members of our profession, the academic community as well as auditors from large and small firms – to ensure the highest safeguards and standards to protect the public interest.

This forum will seek input concerning draft proposed international standards on independence, which were issued in April by the International Federation of Accountants. Independence is a global issue, and our Forum in two weeks' time will consider how this new proposed standard can be applied in Canada.

Note: Jan Munro is verifying the date and the above information.

Now, I'd like to talk about other ways in which we are acting on the research findings and share some of our early ideas. We are expanding our media relations efforts to build broader and deeper knowledge of accounting, auditing and financial reporting matters among business media, from both a Canadian and international perspective.

We are developing information materials and want to work with others interested in investor education and protection to increase knowledge and understanding of corporate governance and financial reporting matters. We plan to increase communications and dialogue with financial analysts, particularly with regard to new developments. And we plan to continue to work closely with our regulatory colleagues to ensure we meet our common goal: to protect the public interest and contribute to excellent corporate governance.

Conclusion

The Kroll research shows that the CA profession in Canada has broad-based and high public confidence in its ethics and integrity, the quality of its financial reporting and its dedication to the public interest. Let me conclude by saying that the issueserving the of public interest and acting with integrity is fundamental to a profession such as my own, and it is our every intention to take the steps that we must, to ensure it is upheld.

These research results will prove invaluable in moving ahead and taking the necessary actions. And now, I understand we have about 10 minutes for questions. So over to you!

The 3 TenorRS: Yali, Clarkson & Drucker Changing the Definition of Total Returns to Shareholders

David R. Beatty O.B.E. , MA (Cantab), CFA, Professor of Strategic Management & Director of Clarkson Centre for Business Ethics Rotman School of Business University of Toronto
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Each of these three men are thrilling performers. Audiences have delighted in their accomplishment, learned from their experience and wisdom. They have changed the way the world works. Today I am delighted to welcome Madelaine Clarkson to our lunch. Madelaine's husband Max founded the Clarkson Centre for Business Ethics at the Rotman School after Max was Dean of the School from 1975-1980. Madelaine and Max always insisted that social responsibility was an integral part of being in business.

Most of you will know Peter Drucker the father of modern management. Like Max Peter is an icon in the business community. If Max was builder Peter was and remains the observer. But who was Yali ?

Introduction

Yali is a Papua New Guinean who was the genesis of Jared Diamond's remarkable book: "Guns, Germs and Steel – The Fates of Human Societies". Jared Diamond was a biologist who studied the magnificent Birds of Paradise in PNG. Jared Diamond was walking on a beach on the New Guinea coast with a prominent 'big man' named YaliYali asked Jared the following question:

"Why is it that your people have developed so much cargo while my people have so little cargo?" 'Cargo' being the pidgin word for material goods of any kind.

Jared Diamond launches into an incredible sweep of biology, climatology and geography to answer the question of how material goods arose in some parts of the world and not others.

Yali's question

Yali's question was a simple question yet disturbingly profound for if Yali had observed the social impact of our material success he might well have asked:

"When you get richer with cargo do you get poorer in community?"

Papua New Guinea society was and is tribal. Everything revolves around the tribe. What we would call civic responsibility is the cornerstone of existence. Tribe first, everyone else later. So, did we get the material goods? Yes, in incredible abundance and variety. Have we lost our civic sense of belonging to a broader community? Oftentimes it would seem we have.

Are there forces changing the balance we have between material abundance and community responsibility?

My answer:

YES. There are powerful forces at work which will change the balance and which will offer rich opportunities to those companies that have the insight to respond to these forces.

Corporate strategy based on Total Returns to Shareholders (TRS) and corporate accountability to broader social goals are merging to give a new meaning to Total Returns. The pressures from consumers, from shareholders and from employees are forcing top management and Boards of Directors to look at their enterprises from a much more holistic viewpoint.

Background: Corporate Social Responsibility Today

Most of America's 500 largest corporations boast a code of ethics and 80% of the FTSE 350 in Europe do as well. Ethics Officers Associations and Compliance Officers Associations abound.

Max Clarkson working with Richard Leblanc, Andrew Stark, Michael Deck and Len Brooks sponsored a number of initiatives including the Redefining the Corporation series of books and conferences. In addition, under Max's guidance the codes of over 200 firms were collated and a handbook on Codes of Ethics was published by the Society of Management Accountants of Canada.

Thomas Donaldson, a partner with Max in this endeavour and a distinguished Professor at Wharton, recently wrote:

Corporate ethics programs were like hummingbirds in the 1950s. You didn't see one often and when you did it seemed too delicate to survive....now we have the equivalent of a Brazilian aviary."

So we have a place to start: where are we headed?

The Gathering Storm:

Pressures To Transform are Growing Relentlessly

External forces are mounting a relentless pressure on all companies, and hence on all Boards, to transform paper driven codes into people driven practises and to broaden the scope and scale of those codes. There are 3 major forces:

1. Consumer action
2. Shareholder & market pressures
3. Knowledge worker preference

Let me review each of these in more detail.

1. The internet has enabled massive consumer power to judge and act upon corporate social behaviour

On Max's 75th birthday, the 10th anniversary of the Clarkson Centre, he listed the celebrated global catastrophes of Union Carbide and Bhopal; Exxon and Valdez, Shell and Nigeria, Johns Manville, Dow Corning.... each disaster resulted in consumer boycotts and profound reputational damage to the companies involved.

Celebrated incidents continue to occur. In Canada, the RoB, over the last 6 months, has yielded a cornucopia of egregious behaviour in the financial services industry. These transgressions are not buried on the bottom of page 6 but trumpeted in the headlines. Yet beyond the isolated incidents something systemic is occurring. There is a new and powerful convergence of forces that seek out, illuminate and punish deviant behaviour. To the investigative reporter and the pressure group we have added the internet and global reporting through CNN, Fox, Time Warner/AOL ... the convergence revolution.

The result is a hugely powerful fusion of interests capable of promoting socially responsible behaviour and punishing socially irresponsible behavior. As the risks of being caught out rise so do the costs. It takes decades to build a brand and a reputation; it takes but days to reduce that reputation to rubble when the world finds out at once. For example, Nike's line: "JUST DO IT" projected the image that its customers were:

- respectful of self
- achievement oriented
- responsible members of the planet
- with it

while, at the same time, it used sweatshops to make its products. Consumers flailed the company. Monsanto thought it stood for 'food-health-hope' and ended up in the pillory for its Genetically Modified seeds which sowed only fearful prospects. From a Board and top management point of view the nature and extent of the risks to any company franchise are increasing as are the costs of a failure increasing.

In Value-At-Risk terms, the banking based language of risk management, the maximum expected losses are increasing while the possibility of a major financial catastrophe (the stress test on the tail of the probability distribution) is becoming terrifyingly large.

2. The owners of company shares are vigorously expanding the pressure for socially responsible behaviour

The owners of common stocks are increasingly institutional investors, the pension funds and mutual funds of our lives. In Canada, these institutions have been increasing their pressure on Boards of Directors in a number of areas via their proxy power and the powers of moral suasion.

Potent forces on the 'buy' side include the behaviour of these funds, the growth of socially screened fund, and the Dow Jones Sustainability Group Index which provides core data and investment alternatives to individuals and groups. If you measure it and publicize it you can influence it!

In the UK the Pensions Act of 1995 has a new Statutory Instrument that requires all Pensions schemes from July 2000 to include a Statement on Socially Responsible Investment as part of their publicly proclaimed Statement of Investment Principles.

Every fund manager is instructed in writing to consider the following when selecting shares:

"A company run in the long-term interests of its shareholders will need to manage effectively relationships with its employees, suppliers and customers, to behave ethically and to have regard for the environment and society as a whole."

As pension funds control a huge and growing percentage of equity markets in the UK it will be a foolish Board indeed that ignores its social responsibilities. And it won't be long, I trust, before the Caisse de Depot, Teachers, OMERs and others begin to flex their muscles in this direction. Anticipating the coming boom in increased social reporting and corporate transparency Robert Herz, David Phillips and Mary Keegan of PriceWaterhouseCoopers among others have written *The Value Reporting Revolution: Moving Beyond the Earnings Game*. (ISBN: 0471398799 Wiley, 2001).

Shareholders are demanding to know more and more things about the company's operations and intangible assets and liabilities. From a Board and top management point of view the shareholder is getting more discriminating in the returns he/she wants so that Total Returns to Shareholders is taking on an entirely new meaning... not just profit but planet as well.

3. The knowledge workers who form the core of the modern corporation are increasingly demanding high standards of ethical performance

Let's return to our third tenor Peter Drucker: "When I ask my students why they volunteer, far too many give the same answer: "Because in my job there isn't much challenge, not enough achievement, not enough responsibility; and there is no mission, there is only expediency."

"Within 15 years you can be certain to expect a shift from creating shareholder wealth as the first priority of business to creating an environment that attracts, retains and motivates knowledge workers."

From a Board and top management point of view the rise of the knowledge worker as the great productive force in our society will force all corporate enterprise to think, talk, work and act in accordance with a broader view of society.

Consumer action, shareholder pressure and the preferences of knowledge workers will transform the meaning of Total Returns to Shareholders.

The Hinge of Fate:

Boards Will Determine The Route To Be Taken

Companies are living shorter lives. In a new book by Richard Foster and Sarah Kaplan called *Creative Destruction* the authors state that in 1920 a company on the S&P index (some 90 companies) would survive 68 years. Looking forward from today's S&P 500 they estimate 10 years as an average life.

CEOs have shorter tenures. One estimate is that the average CEO of a North American public company survives but 4 years in office. Directors, on the other hand, average over 11 years experience. Therefore, Boards alone have the perspective, the mandate, the interest and the possibility to respond to these relentless pressures. Boards will work with top management to determine the policies for the socially responsible behaviour of the company and the Board will seek assurance that these policies are the basis of all corporate behaviours.

There are really only two basic strategic responses of a company to the gathering impacts of socially responsible behaviour:

1. Follow the leaders
2. Create the future

Ignoring the challenges from consumer, investor and employee is not an option. Boards that ignore those challenges will see their companies fail.

1. Follow the Leaders

Boards can follow leaders. There are many celebrated companies such as J&J, P&G, New York Life, Mountain Equipment Co-op and The Body Shop which have always been vision led and socially responsible. There are now many 'born again' companies many from the extractive industries -Royal Dutch/Shell, BP Amoco, BHP and Texaco, but many from consumer goods industry like Philip Morris and Nike ... which have used the burning platform of their public humiliation (and plummeting market cap) to change their entire set of policies with respect to their social responsibilities.

There are new coalitions such as the CAUX roundtable (Max was a delegate), and CERES with the Global Reporting Initiative (GRI). Professional firms are at the front lines of the "war for talent". We need look no further than McKinsey, Monitor, BCG, PriceWaterhouseCoopers to see the scale and scope of change in attracting, retaining and motivating gifted talent.

Rajat Gupta, the McKinsey boss, opined at a recent conference of the firm's partners:

"I believe strongly that we must constantly talk about our values to sustain their vitality, and that these stories help to instill a deeper understanding of our values as much more than abstract concepts."

PriceWaterhouseCoopers now boasts the tag line: "Join us. Together we can change the world."

So, by following the leaders with incrementally adaptive policies Boards may yet weather the storm and be able to attract the knowledge workers that are the core of their future and avoid the catastrophe of ethical failure.

2. Create The Future

The truly innovative company will turn the challenge of ethical risk and corporate social responsibility into an opportunity. There are many definitions of strategy today but the one I like best is Michael Porter's:

"Strategy is the creation of sustainable, long term, differentiated competitive advantage"

One problem with this definition is that in today's world, long-term advantage might be a week long! So, a lot of academic thought on strategy has poured into the notion that the long term competitive advantage all firms so desperately seek lies in people. Markets change, products change, competition changes it will be the skill sets of the dedicated employees that will lengthen the odds of survival. That's where Foster and Kaplan land.

Why not have a more comprehensive humanistic value system at the core of your company's strategy?

If Elsie Maio is right the consuming public will move to products and services that come from companies with high ethical reputations. Elsie Maio is writing a book on how to do this.... that will be called: Soulbranding; Riding the Coming Tsunami of Corporate Accountability. Elsie is a hard headed ex-McKinsey consultant who has worked for Lou Gerstner at IBM and recently at Rio Algom here in Toronto. If Peter Drucker is right such a company will be able to attract, retain and motivate the best knowledge workers available.

Drucker + Maio = long term sustainable, strategic differentiation

The Clarkson Centre for Business Ethics Will Continue at the Rotman School of Business to do 3 things: Build our relationships with the ethical thought leaders of our times – that's all of you here today – to continue to work with you to celebrate the leaders, direct the confused and to illuminate the dimensions of the future.

1. Teach business ethics at Rotman, an integral part of all the MBA programs, and an emerging opportunity in executive education.

2. Expand into Board effectiveness where the new leverage lies ... in this way we can become the Clarkson Centre for Business Ethics and Board Effectiveness ... CC(BE)2

Yali, Clarkson and Drucker ... three wise voices. Three profound observers. Three who together give us insight, hope and guidance in building a more integrated and healthy communities. Corporate accountability and corporate strategy merged!

Let's make it happen.