CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

DIRECTORS' BRIEFING SERIES

Guidance for Directors:

Disclosure and Certification— What's at Stake?

James L. Goodfellow, FCPA, FCA

Alan D. Willis, CPA, CA

AUDIT COMMITTEES

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Preface

The Risk Oversight and Governance Board (ROGB) of the Chartered Professional Accountants of Canada (CPA Canada) commissioned this Directors' Briefing publication *Guidance for Directors: Disclosure and Certification — What's at Stake?* to help board members fulfill their disclosure oversight responsibilities through appropriate review of CEO and CFO certifications required under the regulatory corporate disclosure regime for publicly listed companies.

Directors and officers are at significant risk of personal civil liability under securities class action legislation in the event of misrepresentations in a company's public statements or failure to make appropriate, timely disclosures. Effective board oversight of corporate disclosures is key to mitigating this risk. This oversight role includes directors assuring themselves that the content and control certifications made by the CEO and CFO have been supported by a formal, documented certification support process. The objectives of the certifying officers are to ensure that the organization's financial filings are reliable, that there is effective internal control over financial reporting (ICFR) and there are effective disclosure controls and procedures (DC&P).

This Briefing sets out the elements of a certification support process and key questions for directors to ask the audit committee when reviewing the audit committee's report about the effectiveness of the certification process. It summarizes the steps directors can take to protect themselves and their companies regarding securities class actions for misrepresentations and failure to disclose. In addition, directors will find this Briefing useful in assessing their present approach to oversight of corporate disclosures more broadly and assessing whether the company is deriving the most value from the certification support process. The Briefing should prompt valuable discussions among directors and serve as a basis for useful dialogue between boards, audit committees, executives and internal and external auditors.

The companion Directors' Briefing *Guidance for Management: Disclosure and Certification — What's at Stake?* provides guidance to management on the implementation and execution of a formal, documented certification support process.

The ROGB thanks the authors, Jim Goodfellow and Alan Willis, and acknowledges the contribution of the CPA Canada Directors Advisory Group. Particular gratitude is extended to Juli-ann Gorgi, CPA Canada; Andrew McDougall and his colleagues at Osler Hoskin & Harcourt LLP; Dennis Lopes, Discovery Air Ltd.; Greg Armstrong, Canadian Tire Ltd.; and Mary Ann Finn, Deloitte, all of whom provided valuable input and reviews at various stages of the project.

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Introduction

Reliable reporting and disclosure is vital for the effective functioning of Canada's capital markets. It is also important to help companies build investor confidence and access the capital they need. Companies[1] that constantly revise, change or have to explain what they previously disclosed—or worse, need to restate their financial statements or re-file their Management Discussion and Analyses (MD&As)—risk losing the trust of markets, higher capital costs and greater exposure to legal liability for misleading disclosures.

CEO and CFO certifications of financial filings have been a regulatory requirement for publicly listed companies in Canada since 2004. These certifications aim to prevent fraudulent financial disclosures by emphasizing the CEO's and CFO's personal accountability for integrity in financial reporting. As a result of the US Sarbanes-Oxley Act, they are also exposed to civil and criminal liability if they sign false certificates for Securities and Exchange Commission (SEC) registrants.

In Canada, under statutory civil liability provisions in the Securities Acts, directors and officers of public companies face the risk of liability under class actions for misrepresentations and lack of timeliness in disclosures.[2] The average settlement in such claims resolved under civil liability legislation from 2006–2012 was $10.5 million.[3] The time costs and disruption of defending such actions are also substantial.

1 For readability and ease of reference, the word "companies" in this document refers to issuers of publicly listed securities unless otherwise noted.

2 See page 17 for a more detailed discussion of statutory civil liability risks for misrepresentations and failure to disclose, and what directors can do to protect themselves and their companies.

3 "Trends in Canadian Securities Class Actions: 2012 Update," *NERA Economic Consulting Report*, February 2013, at p 9.

The goals of the certification requirements match those of directors: namely, that interim and annual filings should fairly present in all material respects the company's financial condition, financial performance and cash flows. An effective, management-driven support process underpinning all elements of the certifications constitutes an important entity-level control.

The Canadian Securities Administrators' (CSA) reviews of issuers' MD&A disclosures related to CEO & CFO certifications suggest that many companies have yet to implement an effective process to support their certifications — whether due to lack of senior management attention, lack of understanding of the certification requirements or inadequate oversight by directors and audit committees. Since CEO/CFO certifications have been required for almost a decade, there is a further risk that the certification process can become just another quarterly routine with dwindling effectiveness.

An effective certification support process not only helps mitigate these risks but also provides:

- The foundation for avoiding surprises and building trust with investors, regulators and other stakeholders.
- The basis for a solid legal defence in the event the officers and directors are sued for misleading disclosure.
- A mechanism for continuously improving the effectiveness and efficiency of the certification support process.

This publication aims to help directors ensure that management implements and maintains an effective certification support process, usually through the guidance, review and approval of the audit committee. This Briefing will be especially important for new directors seeking to familiarize themselves with the certification requirements and their disclosure oversight responsibilities.

To this end, this publication features a high-level overview of certification obligations and risks, together with an overview of a recommended management process for certification support. We conclude by examining seven key questions that directors should focus on as part of their oversight of certification risk.

CPA Canada's companion Directors' Briefing publication, *Guidance for Management: Disclosure and Certification — What's at Stake?* sets out a more detailed discussion of the requirements and practical advice to help management establish and execute the policies, systems and processes needed to support the content and control certifications. Audit committee members may find it helpful to review the companion publication to deepen their understanding of this topic and decide which aspects of the certification support process they wish to enquire about in reviewing it with management.

What CEO and CFO Certifications are Required?

Canadian issuers are subject to different certification requirements, depending on where they are listed:

- **Canadian SEC registrants** adhere to the content and control certification requirements introduced in 2002 in the Sarbanes-Oxley Act.
- **Canadian reporting issuers (including TSX-listed issuers and venture issuers)** are required to provide "content certifications" on their interim and annual financial statements and MD&As under the CSA's NI 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings*.
- **TSX-listed issuers and other Canadian reporting issuers who are not venture issuers** must also comply with specified control certification requirements under NI 52-109 (venture issuers should consider the benefits of following these requirements voluntarily).

Control certifications under NI 52-109 relate to internal control over financial reporting (ICFR) and disclosure controls and procedures (DC&P). The CSA's definition of ICFR relates to the reliability of financial reporting, focusing on controls over the information contained in the financial statements, as well as on authorization of transactions and protection of assets. The overall purpose of ICFR is to provide reasonable assurance that financial statements prepared for external purposes are in accordance with the issuer's Generally Accepted Accounting Principles (GAAP).

The definition of DC&P is limited to required filings and does not pertain to voluntary reports, such as analyst briefings or the non-required components of annual reports. Since the definition covers continuous disclosure filings, which include the financial statements, we view ICFR to be a subset of DC&P. Therefore, issuers with a material weakness in ICFR probably also have a material weakness in DC&P.

The certifications required under NI 52-109 fall into three groups:

1. **Content certifications** about the completeness, accuracy and fair presentation of the financial information in the interim and annual filings (applicable to TSX-listed and venture issuers).
2. **Control design certifications** about the design of internal control over financial reporting (ICFR) and disclosure controls and procedures (DC&P) in the interim and annual filings (applicable to TSX-listed issuers).
3. **Control effectiveness certifications**, which report on the effectiveness of ICFR and DC&P, including the disclosure of any material control weaknesses and the communication of any fraudulent financial reporting incidents in the annual MD&A (applicable to TSX-listed issuers).

The table below summarizes the certification requirements for filings of interim and annual financial statements, MD&A and for TSX issuers, the Annual Information Form (AIF).

Summary — Certifications Required Under NI 52-109

	Content certifications	Control design certifications	Control effectiveness certifications
When is the certification required?	Interim and year-end filings	Interim and year-end filings	Annual filings
Which issuers must file the certification?	TSX and Venture issuers	TSX issuers	TSX issuers
What must the CEO/ CFO certify?	No material misstatements or material omissions Fair presentation of financial information (no reference to GAAP, which CSA says is not automatically fair presentation) Fair presentation of financial *condition,* not financial position (i.e., issuers' future ability to create value from resources on its balance sheet)	DC&P and ICFR are established and maintained DC&P and ICFR design meets specified reasonable assurance criteria Control framework used in designing DC&P and ICFR	MD&A discloses: • conclusions from certifying officers' annual evaluation of DC&P and ICFR's operating effectiveness • material weaknesses in ICFR, if any • material changes in ICFR, if any Communication to auditors and board or audit committee of any fraud involving management or other employees with significant role in ICFR

	Content certifications	Control design certifications	Control effectiveness certifications
What are the audit committee's due diligence and oversight responsibilities?	Review the financial statements, the MD&A and earnings press release and recommend them to board for approval before release[4] Discharging this responsibility requires review of the process followed by the certifying officers to support their certifications of financial information	Review the certifying officers' evaluation of DC&P and ICFR and disclosures of material weaknesses in the MD&A (as part of audit committee's overall MD&A review) Requires review and understanding of the certifying officers' process for forming their conclusions	

"No Misrepresentations" Certification

In the content certification, the certifying officers must assert that the filings neither contain an untrue statement of a material fact nor omit to state a material fact necessary to make a statement not misleading. This certification applies to all statements and disclosures contained in the filings, including the financial statements, the MD&A and, where applicable, the AIF.

"Fairly Presents" Certification

The certifying officers are required to certify that the information presented in the financial statements, together with other financial information included in the filings, fairly presents in all material respects the issuer's financial condition, results of operations and cash flows. This judgment is not restricted or limited to whether the financial statements are in compliance with the issuers' GAAP.

The assessment of "financial condition" is a different and more dynamic concept than "financial position" as reflected in the balance sheet. The CSA does not define financial condition except to state "the term 'financial condition' in the annual certificates and interim certificates reflects the overall financial health of the issuer and includes the issuer's financial position (as shown on the statement of financial position) and other factors that may affect the issuer's

4 Required by NI 51-102, *Continuous Disclosure Obligations*, and NI 52-110, *Audit Committees*.

liquidity, capital resources and solvency."[5] As we saw during the global financial crisis, liquidity problems can erode an enterprise's financial condition long before they are reflected in its financial position.

In addition to their own conclusions about the completeness, accuracy and fairness of presentation of the financial disclosures, directors need to understand how the certifying officers assessed the financial condition in order to sign the certificates. Directors must also understand how the issuer uses non-financial and non-GAAP financial performance measures in the MD&A to explain its financial condition and performance, and how that compares with others in its industry. Directors should understand the basis on which these measures are prepared, since most are not governed by recognized professional standards. Non-financial and non-GAAP financial performance measures must be carefully explained and reconciled to the issuer's GAAP-based performance measures.

The MD&A is central to the "fairly presents" assessment. For example, if the certifying officers conclude that the financial statements do not by themselves "fairly present" the results of operations, they may provide the appropriate disclosure in the MD&A so the two documents, together, constitute a fair presentation. Directors should ask the certifying officers whether any issues in the filings caused them or other members of management to question whether compliance with GAAP would constitute a fair presentation. If so, they may wish to ask what disclosures were put in the MD&A to alleviate these concerns.

Materiality

Audit committee members generally understand the concept of materiality in the preparation of financial statements. They would have agreed on materiality thresholds for financial reporting when they reviewed the external audit plan with the external auditors.

Determining what constitutes a "material fact" can be more challenging, especially when it is not part of the financial statements.

Canadian securities laws define a fact as material when it:

1. significantly affects the market price or value of a security; or
2. would reasonably be expected to have a significant effect on the market price or value of a security.

5 NI 52-109 Companion Policy Section 4.1(1).

The concept of a "material fact" includes changes in the issuer's affairs, such as its business, operations, assets or ownership that would reasonably be expected to significantly affect the issuer's market price or value of its securities. For management and directors, the challenge is determining the impact that specific information or disclosures could have on the market price or value of the issuer's securities. Retaining an investment banker or person with securities market expertise and a more objective perspective to help make this determination is often advisable.

The concept of materiality for the "fairly presents" certification is virtually undocumented. It remains to the certifying officers to judge when compliance with GAAP would not constitute a fair presentation, and it must be augmented by disclosures in the MD&A so the entire filing constitutes a fair presentation. Their decision and the supporting rationale should be carefully documented and reviewed with the audit committee.

Elements of a Certification Support Process

To support the certifications made by the CEO and CFO, directors should ensure their company has established a formal, documented process as an entity-level control appropriate to the company's size and business circumstances. This typically involves more people and procedures in larger companies than in smaller ones.

Five key elements, shown in the graphic and described below, should be common to every certification support process, even though they may be applied and implemented differently by individual companies.

Audit Committee's Report to the Board

Management is responsible for designing, implementing and monitoring the support process. Audit committee chairs normally provide a formal report to the board on the certification support process. This report is usually part of their quarterly and annual reports supporting the audit committee's recommendation for board approval of financial reports and earnings press releases. The report should include information about the audit committee's review of the certification support process, how it was conducted, what input they received from internal and external auditors, and lessons learned for future improvement of the process. The key elements of the certification process may provide a useful outline for organizing the audit committee's report.

1. Scope and Design of the Certification Support Process

Determining the scope of supported disclosures

For public companies, disclosures are complex and varied. They can include:

- Oral statements and other information in traditional and social media.
- Other corporate disclosures, for example, to stakeholders on their websites, to analysts and through Corporate Sustainability Reporting.
- CSA-required filings, including MD&A, AIF and proxy filings.
- CSA-required quarterly and annual GAAP financial statements.

Only the latter two disclosure types are subject to certification requirements. However, civil liability exposure for directors can arise in relation to all of the above disclosures. It is important to assess the disclosure risks in the non-financial information included in the filings and other public disclosures. Our experience suggests that these risks are often not as rigorously assessed as financial reporting risks.

In deciding whether to develop a process that covers disclosures beyond those required to support the CEO/CFO certifications, management (with subsequent review by the audit committee/board) should consider:

- The strength of the issuer's continuous disclosure policy, and the level of adherence and commitment to its implementation.
- The nature and frequency of the issuer's disclosures beyond the required filings.
- The level of risk associated with these disclosures.
- Perceived level of control currently exercised over disclosures.
- History of disclosure issues (e.g., letters from securities regulators) or indicators of disclosure problems (e.g., responses to the issuer's whistle blowing program).

Certifying officers, with audit committee approval, need to understand which documents are to be considered "core documents" and included in the certification process. "Core documents" are defined in secondary market civil liability legislation to include documents that issuers are required to file.

Certifying officers and directors should weigh the costs and benefits of going beyond what is required under NI 52-109 by treating non-core documents as core documents and including them in the certification process. Directors also need to ensure appropriate oversight is given to core documents not included in that process (e.g., by assigning accountability for executive compensation and governance disclosures to the board's compensation and governance committees).

Designing the process

In designing the certification support process itself, the primary objective should be to ensure that the CEO and CFO capture the information, assessments and assurances they need to prepare the filings and sign their certificates. Establishing the following can do this:

- ***A disclosure policy*** to ensure that all of the issuer's disclosures to its shareholders or the investment community are accurate, complete and timely.[6]
- ***A disclosure committee*** to develop and implement the disclosure policy, and review and evaluate the financial and other disclosures made in the filings and possibly outside them.
- ***A sub-certification process*** that sets out clear lines of responsibility and accountability for those involved in the financial reporting and disclosure process.
- ***Disclosure controls and procedures*** that provide reasonable assurance that the information the issuer is required to disclose is communicated to senior management and the certifying officers on a timely basis.
- ***Internal control over financial reporting*** that provides reasonable assurance that the financial statements are prepared and presented in accordance with the appropriate GAAP.

6 For an example of such a disclosure policy, see *Standards and Guidance for Disclosure and Model Disclosure Policy—Fourth Edition*, published by the Canadian Investor Relations Institute. This publication also provides more in-depth guidance for developing such a disclosure policy and best practices for handling a variety of disclosure situations.

2. Commitment and Resources

Two companies of similar size in the same industry may design similar processes to support their certifications. The effectiveness of each process may be very different, however, depending on top management's commitment to promoting and supporting the process and the capabilities and competencies of those involved in executing it. The process is demanding, performed quarter after quarter, and complacency is therefore a major risk.

The CEO and CFO are at the centre of the support process. NI 52-109 requires them to sign separate certificates, so both must exercise reasonable diligence in making their assessments. In practice, CFOs usually organize and manage the support process on a day-to-day basis. Directors should assess whether the CEO is sufficiently engaged in the process and provides the necessary "tone at the top" and leadership. The audit committee needs to be alert to any signals or "red flags" that might indicate the CEO's attitude or involvement in the support process may be inappropriate, since this could indicate wider problems with the organization's "tone at the top" and its control environment.

Directors need assurance that the people involved in the certification process have the right knowledge, skills and experience to perform their role and the right amounts of time, independence and financial resources to discharge their duties objectively and effectively.

Additionally, organizational changes that occur during a quarter may impact the control environment as well as the commitment and/or capability of those leading or supporting the support process. Changes in the composition of a disclosure committee may also affect the support process, and directors should be alert to the impact of these changes.

3. Interim Certifications

All issuers are required to provide content certifications in their interim certificates. At a minimum, all issuers should have a process that provides the certifying officers with the information they need to certify that there are no untrue statements of material fact or omissions of material facts necessary to make a statement not misleading and that the information in the filings is fairly presented.

The CEOs and CFOs of TSX issuers must also acknowledge that they are responsible for establishing and maintaining DC&P and ICFR, the essential purpose of which is, among other things, to provide reasonable assurance as to the reliability, timeliness and completeness of the financial statements (in accordance with the issuer's GAAP) and of other periodic filings or reports called for under securities legislation.

Thus, certifying officers should maintain a current assessment of major financial reporting and disclosure risks together with the controls in place to mitigate or minimize them, and audit committees should inquire as to their effectiveness. Risks that are not mitigated could represent a significant or even material design weakness in DC&P and/or ICFR.

Audit committees should be alert to other indicators of possible design weaknesses in DC&P, such as senior management being surprised at operating results or unexpected issues arising at business units or offshore locations, a lack of accountability for disclosures made on the corporate website, or a lack of control over regulatory filings.

CEOs and CFOs of TSX issuers also must certify that the issuer has disclosed in the MD&A any material change in ICFR that occurred during the quarter. Audit committees should inquire about changes in DC&P or ICFR during the quarter, including how the certifying officers evaluated the material impact of these changes and their disclosure.

4. Annual Certification of Effectiveness of DC&P and ICFR

Certifying officers of TSX issuers are required to certify the operating effectiveness of DC&P and ICFR in their annual certificates. Controls should be evaluated in a top-down manner, using a risk-based approach that focuses on entity-level controls that span all parts of an organization and its business units and processes.

Management is responsible for designing and annually assessing the effectiveness of DC&P and ICFR. It is the audit committee's responsibility to oversee how this is done and review the conclusions reached. Specifically, the audit committee's role is to assess:

- The reasonableness of management's evaluation and testing strategy.
- How the findings were evaluated and whether the resulting conclusions seem reasonable.
- The appropriateness of management's action plans to fix control weaknesses and deficiencies.
- The fairness of the disclosure provided in the MD&A.

In making this assessment, the audit committee should seek the views of the issuer's internal and external auditors.[7]

7 See page 25 for discussion of the external auditors' engagement in review of the certification support process.

The audit committee also should watch for "red flag" issues, which could be signs of deeper problems underlying the certification support process.

Red flag issues

In conducting its investigations, the audit committee should be on alert for these issues, which could indicate an ineffective certification support process.

- **Ineffective disclosure committee**, which has either not been established or is poorly organized or is not operating effectively.
- **Excessive embellishment of "good news" disclosures**, which could become "bad news" surprises if performance falls short in subsequent quarters.
- **Lack of care and attention to detail and sloppy wording**, which could lead to ambiguous disclosures or material misstatements.
- **Lack of understanding of the facts and circumstances**, which could result in management drafting inaccurate disclosures because they did not understand the substance of the facts being disclosed.
- **Highly technical disclosures with opaque and ambiguous statements about important risks or facts**, which should be redrafted so they are understandable to directors.
- **Excessive anxiety that disclosures will damage the company's competitiveness**, which could result in vague or ambiguous disclosures of important matters.
- **Disclosure "ain't my job" attitude**. Accurate and timely disclosure should be a part of every senior executive's job description. If disclosure is relegated to the corporate finance, legal and investor relations departments, certifying officers may not receive all the information they need or be able to fairly describe the business realities.
- **"My way or the highway" attitude**. The CEO dominates all aspects of disclosure, financial and control assessment issues.
- **Lack of resources** to support the issuer's financial reporting and disclosure processes in numbers and/or quality.
- **Economic stress**. Management concludes that the company cannot afford the time and effort to prepare full disclosures because of dire economic circumstances. (Full disclosure in such circumstances may actually provide significant protection from legal liability for officers and directors.)

Responding to discovered or suspected fraud

Certifying officers are required to disclose to the external auditors and audit committee or board of directors any fraud that involves management or other employees with a significant role in the issuer's ICFR. External auditors are required to assess fraud-related risks when conducting their audit and promptly communicate their discovery or suspicion of fraud to the audit committee.

When a potentially significant fraud is discovered or suspected, management, the internal and external auditors and the audit committee must act quickly and decisively to prevent further losses of assets, recover lost assets, determine the magnitude of the fraud, and identify who was involved and deal with them. In addition, longer-term issues must also be addressed, such as the design and effectiveness of the issuer's ICFR and its whistleblowing process.

If a fraud or fraud investigation implicates a certifying officer or other member of senior management, the audit committee should obtain legal and forensic advice, and will probably need to take direct charge of the investigation. The audit committee should consider establishing a separate board committee to oversee the investigation.

5. Learning & Improvement

Finally, conducting a high-level, experience-based consideration of each element of the process that supports the certifications will identify lessons that may be learned from its design and execution, opportunities for improvement, and the process's overall value to the organization. Part of this process should include rationalizing controls with the goal of having fewer, higher-level controls that require certification. The certifying officers should be responsible for carrying out such a review and for reporting the results to the board or audit committee.

Adapting the Process for Venture Issuers

The certifying officers of venture issuers must provide content certifications on the financial information contained in the interim and annual regulatory filings. While venture issuers are exempt from the DC&P and ICFR certifications, they still must put in place cost-effective controls to ensure that all financial information is captured, summarized and reported fairly in accordance with GAAP.

Audit committees and boards should ensure that the certifying officers have a reliable process in place to support their content certifications. The design of the certification support process should reflect the size of the issuer's organization and the nature of its business and, at a minimum, it should provide for a disclosure policy, disclosure committee and sub-certifications.

Audit committees and management also should assess whether management should annually assess the design and operating effectiveness of DC&P and ICFR, even though the CEO and CFO are not required to provide these certificates.

Audit committees and boards should ask the certifying officers whether there are any indications that could suggest significant or material ICFR weaknesses (e.g., material and/or numerous year-end adjustments). If serious ICFR weaknesses exist that are not or cannot be remediated, the certifying officers and board should consult with legal counsel as to the appropriate course of action.

Liability Risks for Misrepresentations and Failure to Disclose

Osler, Hoskin & Harcourt LLP[8]

Directors and officers of public issuers face a significant risk of being named as defendants to a securities class action claim for misrepresentations in public statements made by or on behalf of the issuer or for failing to make timely disclosure in such statements. The risk of a securities class action lawsuit is particularly high when an error or omission is detected and the issuer releases a corrective disclosure, but can arise whenever there is a material drop in the issuer's share price.

Even when directors and officers have strong defences, securities class actions can be costly and difficult to resolve. They can also divert attention from the business, depress share values, impede the raising of capital, harm reputations and lead to enforcement proceedings.

Directors and officers need to implement and follow procedures that help prevent the circumstances that can lead to securities class action claims and lay the foundation for a strong defence if a claim is commenced. This chapter offers an overview of the circumstances that commonly lead to such claims, the defences that may be available, and the implications for directors and officers.

8 This chapter was written by Larry Lowenstein, a partner in the Litigation Department of Osler, Hoskin & Harcourt LLP, and Andrea Laing, now a partner at Blakes, Cassels & Graydon LLP. The authors also thank Andrew MacDougall and Sylvain Lussier, who are partners at Osler, and Robert Carson, who is an associate at Osler, for their assistance.

The Broad Scope of Securities Class Actions

Directors and officers face a risk of liability *any* time a public statement is made by or on behalf of the issuer, either in a document or an oral statement, as well as any time that a public statement *ought* to be made. They may be named as defendants along with the issuer and other parties, such as experts, whose statements about the issuer may be at issue. The risk of liability and the resulting need to implement effective disclosure compliance controls, therefore, go far beyond what many directors and officers may consider to be their continuous disclosure obligations.

These risks are not new, but they have become a much more serious threat in recent years. The Securities Act of each province and territory (collectively the "Securities Acts") has been amended to contain a statutory procedure to facilitate class actions alleging misrepresentations and/or failures to disclose in statements made by or on behalf of issuers whose securities trade on secondary markets.

Directors and officers can also be sued under the Securities Acts for misrepresentations in "primary market" documents (such as prospectuses) and under the common law. While all types of claims pose significant risks for directors and officers, this chapter focuses exclusively on statutory claims in respect of statements made to the secondary market.

The Securities Acts impose liability for misrepresentations in "core" documents (including directors' circulars, financial statements, and other defined documents).[9] While this may not be surprising, many directors and officers may not be aware that the Securities Acts also impose liability for misrepresentations in "non-core" documents, such as press releases and company websites,[10] in largely the same way that it can attach to misrepresentations in core documents. Notably, even oral statements can create exposure when they are made by persons with actual, apparent or implied authority to speak for the issuer.

9 The Ontario *Securities Act* defines a wide array of documents as "core documents", including prospectuses, take-over bid circulars, issuer-bid circulars, directors' circulars, rights offering circulars, management's discussion and analysis and annual information forms. For certain defendants, such as officers (and directors who are also officers of the issuer), the Act defines additional documents as "core documents", including annual financial statements, interim financial reports and material change reports. Directors should therefore be aware that the definition of "core document" is broader for directors who are also officers of the issuer.

10 Although the Ontario *Securities Act* does not define the term, "non-core" documents are any documents released by or on behalf of an issuer that do not fall within the definition of "core documents". While this captures documents that are released to the market (like press releases) or filed with a regulator, it may also capture statements on an issuer's website.

Statutory Defences for Directors and Officers

Although directors and officers cannot entirely eliminate the risk of being named as defendants to a securities class action, they can implement and follow procedures to deter plaintiffs from commencing claims and lay the foundation for a strong defence if and when a claim is commenced. There are important statutory defences available to protect directors and officers who have taken appropriate steps to ensure the accuracy of disclosures.

Reasonable Investigation

Perhaps the most significant defence is that of "reasonable investigation." Even if a plaintiff demonstrates that the issuer released public statements that contained material misrepresentations, a defendant will not be liable if he or she proves that, before the release of the document or oral statement containing the misrepresentation, he or she conducted (or caused to be conducted) a "reasonable investigation" and had no reasonable grounds to believe that the document or statement contained a misrepresentation. A similar defence applies to omissions.

To determine whether an investigation is reasonable, the court may consider various factors including: (i) the knowledge, experience and function of the director or officer; and (ii) the director's or officer's role in the preparation and release of the document or oral statement, or in the decision not to disclose a material change. In the case of a director, the court may also consider whether the director served a dual role with the issuer (i.e., as both director and officer).

The court will also consider the existence and nature of the system in place to ensure compliance with the issuer's continuous disclosure obligations—and the reasonableness of reliance on that system. It is, therefore, important that directors and officers ensure that appropriate disclosure controls and procedures are implemented and followed. It is also critical to ensure that the entire process is well documented so there is a clear evidentiary record to substantiate a "reasonable investigation" defence. Not only will this be critical at trial, but it may also demonstrate the strength of the defence in settlement discussions.

We note, in particular, that while a good certification process can be an important aspect of a "reasonable investigation" defence, it will only help protect directors and officers in respect of disclosure documents that are certified. Vigilance also needs to be exercised over disclosures not covered by the certification process, such as press releases and public oral statements. This can be challenging, especially with respect to the detection of material omissions, as it can be difficult to ensure that company personnel disclose all necessary facts "up the ladder" to senior management and directors—especially for bad news. Directors and officers should impose processes to ensure that material bad news comes to their attention in the same timely and accurate way as good news.

Reliance on Experts

In certain cases, directors and officers can defend a lawsuit on the basis that they relied on an expert. A defendant will not be liable with respect to any part of a document or oral statement that includes, summarizes, or quotes from an expert report or opinion if the defendant had no reasonable grounds to believe that a misrepresentation or failure to disclose has occurred. Directors, officers and issuers should be careful to involve their experts in the disclosure process to ensure that statements referencing expert reports accurately represent the expert's opinion.

To rely on this defence, the defendant must also show that the expert consented in writing to the use of the report or opinion and that the defendant fairly represented the expert's report or opinion. This is worth emphasizing, as other than in the case of audited financial statements and mineral reports, it is generally unusual for experts to provide such consent. It may be difficult to obtain consent in light of the expert's own concerns about potential liability.

Forward-Looking Information

The Securities Acts offer a "safe harbour" for forward-looking information where certain requirements are met. Directors or officers will not be liable for a misrepresentation in forward-looking information if they can prove that they had a reasonable basis for the conclusion or projection in the forward-looking information and that the document or statement containing the forward-looking information contains:

- Reasonable cautionary language identifying the forward-looking information as such and identifies the factors that could cause the actual results to differ materially from the forward-looking information.
- A statement of the material factors or assumptions applied in making a conclusion, forecast or projection in the forward-looking information.

What Directors and Officers Can Do to Protect Themselves and Their Companies

Although these defences are important, they are unlikely to protect directors and officers who have not implemented, followed and documented appropriate disclosure controls. Directors and officers can decrease the risks of liability to themselves and their companies by:

- **Ensuring that directors, officers and issuers have appropriate secondary market liability insurance in place.** This is not an area to cut corners. A range of insurance products has been developed in response to the risk of liability and some include features such as coverage for the costs of internal investigations and media relations consultants.
- **Implementing procedures for vetting the accuracy of all public disclosures**. These procedures should include careful documentation of each review that is performed. Diligence is only as good as the diligence that is *actually* performed and documented. A defence is only as good as the diligence that can be *proved* to have been performed.
- **Ensuring that procedures are in place for escalating "bad news" within the organization**. Liability attaches to omissions in much the same way that it attaches to misrepresentations.
- **Retaining experts, including accounting and legal advisors**. They can advise on difficult disclosure decisions and help lay the process for defences that may need to be advanced. They can also assist in developing appropriate controls and procedures.
- **Investigating erroneous statements and omissions as quickly as possible**. The way an issuer identifies and corrects an error or omission can have a significant impact on its potential liability. It is critical to get it right the first time. Professional advisors can help.

Key messages

Directors and officers should think like defendants before they *become* defendants. Although they can never eliminate the risk of a lawsuit, if directors and officers ensure that appropriate controls and procedures are implemented, followed and documented, they will have laid the groundwork for a solid defence.

7 Key Questions for Directors

In-depth monitoring and evaluation of the effectiveness of the issuer's CEO and CFO certification support process should be part of the mandate of audit committees. In reviewing the audit committee's report and overseeing the certification support process more broadly, directors should ensure the audit committee has provided information about:

- The audit committee's review of the certification process so the board understands how the process was conducted.
- The way in which the audit committee carried out its oversight responsibilities.
- Major conclusions arising from the review of the process including remediation plans for material weaknesses and lessons for future quarters.
- How this information supports the audit committee's conclusion to recommend approval of the financial statements and MD&A.

To ensure the certification support process is effective and that the company is deriving the most value from its investment in the process, boards should expect audit committees to address seven key questions:

1. What process is in place to determine whether the scope of the disclosures covered by the support process is appropriate?
2. What process is in place to assess whether the scope of the required certifications is appropriate?
3. How is the design and implementation of the certification support process evaluated?
4. How do the external auditors contribute to the certification support process?
5. How are the design and operational effectiveness of DC&P and ICFR evaluated?
6. What degree of support would the process provide as a defense against civil litigation, if needed?
7. What mechanisms are in place to ensure that the effectiveness of the certification process can be sustained?

In this section, we explore each of these questions in more detail.

1. What process is in place to determine whether the scope of the disclosures covered by the support process is appropriate?

The disclosure universe is expanding. The size and complexity of the financial statements and related notes, MD&A and other disclosures continues to grow, the number of disclosure documents is increasing, and the internet and social media give readers 24-hour access to that information and more opportunity to critique it.

The risks of not disclosing material facts within the prescribed timeframes, not clearly explaining important issues, or making material misstatements are escalating. At the same time, changes in financial reporting, disclosure requirements, voluntary disclosures, and advances in information technologies and social networking create additional risks.

Civil liability exposure for officers and directors for misleading disclosures in the secondary markets is real and significant. And it is imposing financial and other costs for those whose disclosures and reporting are proved or even alleged to be deficient.

Issuers may benefit by expanding the definition of DC&P set out in NI 52-109 to include a wider range of disclosures and related risks that fall within the process that supports the certifications and ensures effective controls exist to mitigate these risks.

2. What process is in place to assess whether the scope of the required certifications is appropriate?

Canadian certification requirements range from "content only" certifications for venture issuers to SOX 404 compliance with auditor attestation for issuers that are SEC registrants. Non-SEC registrants should still consider the potential benefits of broadening their support process beyond the certifications covered by NI 52-109. For example:

- **Non-SEC registrants** should determine whether to adopt more rigorous certification requirements, which would strengthen their ICFR and entity-level controls.
- **Venture issuers** should assess whether the benefits outweigh the costs of voluntarily adopting the requirements to design and evaluate DC&P and ICFR.

- **TSX issuers** that are not SEC registrants should assess whether greater auditor involvement would strengthen the discipline and credibility of their certification process.
- **Privately held companies** should consider implementing the main features of a certification support process, especially if they intend to make a future public offering of their shares.

3. How is the design and implementation of the certification support process evaluated?

A TSX issuer's certification support process should include a disclosure policy, disclosure committee, sub-certification process and an evaluation of the effectiveness of DC&P and ICFR.

The support process should be designed and documented so everyone involved in it understands what is expected of them, including the roles of the internal and external auditors. The design of the process should be reviewed annually and updated as necessary in response to changes in the issuer's strategies, structure and business circumstances.

4. How do the external auditors contribute to the certification support process?

As part of their oversight of the certification support process, audit committees should obtain the auditors' views on the effectiveness of the certification support process. They should also ask the external auditors whether they consider the support process to be an important entity-level control. If they do, then the audit committee should ask how the auditors address this control in their audit plan.

If the auditors do not consider the process to be an entity-level control, the audit committee should ask why and assess whether the auditor's planning decisions raise concerns about the reliability and effectiveness of the support process, which the audit committee then needs to address.

Audit committees should initiate these discussions during the audit planning stage. There would be little to gain by asking the auditors to comment after the audit is concluded about something that was out of scope and not addressed. Depending on the extent to which certification matters are covered in the audit plan or the quarterly review procedures, audit committees may wish to ask the auditors to provide their observations of the support process in their quarterly review reports or to perform additional specified procedures related to that process. For example, with management input, audit committees may decide that the external auditors should be asked to carry out additional tests of controls.

As part of their oversight of the certification process during the year, audit committees may wish to discuss these questions with their external auditors:

- In conducting their audit, how much reliance do the auditors place on the certification support process as an entity-level control?
- Do the auditors have any comments about the issuer's disclosure policy, and the disclosure committee's mandate, composition, independence and operating effectiveness?
- Are there any differences between management's assessment of major financial reporting and disclosure risks applied in evaluating DC&P and ICFR and those identified and assessed by the auditors in planning their audit?
- What comments do the auditors have on management's evaluation of DC&P and ICFR, and management's identification of significant deficiencies and material weaknesses?
- In their audit plan, how have the auditors responded to any significant deficiencies and/or material weaknesses in DC&P and ICFR identified by management?
- Did the auditors' review of "fraud risk" identify any risks or issues that were not addressed in management's evaluation of ICFR?
- What comments do the auditors have on the overall fairness of presentation of the financial information contained in the financial statements and MD&A (without reference to GAAP) as certified by the CEO and CFO?

5. How are the design and operational effectiveness of DC&P and ICFR evaluated?

All organizations need controls to ensure that material facts are made known to the senior officers and that the financial statements and MD&A are complete and properly prepared. Issuers, therefore, need to design DC&P and ICFR appropriate to their size, type of business and organizational structure while audit committees should understand and approve the control process management used in designing DC&P and ICFR.

All organizations should evaluate and test the effectiveness of DC&P and ICFR at least annually, even if they are not required to do so under their certification requirements.

TSX issuers are required to disclose material weaknesses in ICFR in the MD&A. We recommend that venture issuers voluntarily disclose any weaknesses in ICFR in their MD&As.

6. What degree of support would the process provide as a defense against civil litigation, if needed?

Although directors and officers cannot eliminate litigation risk entirely, they can implement and follow procedures to deter plaintiffs from commencing claims and lay the foundation for a strong defence if a claim is commenced.

Three statutory defences can protect directors and officers who have taken appropriate steps to ensure the accuracy of disclosures:

1. Demonstrating that they carried out a **reasonable investigation** that produced no reasonable grounds to believe that the document or statement contained a misrepresentation.
2. Reliance on an **expert report or opinion** that found no reasonable grounds to believe that a misrepresentation or failure to disclose has occurred.
3. "Safe harbour" provisions regarding **forward-looking information**, where directors and officers had a reasonable basis for the conclusion or projection in the forward-looking information.

While important, these defences are unlikely to protect directors and officers who do not have effective, well-documented disclosure controls in place. Directors and officers can decrease the risks of liability to themselves and their companies by:

- Implementing procedures for vetting the accuracy of all public disclosures.
- Ensuring that procedures are in place for escalating "bad news" within the organization.
- Retaining experts, including accounting and legal advisors.
- Investigating erroneous statements and omissions as quickly as possible.

An effectively implemented process to support the NI 52-109 certifications can be the basis for an effective defence against civil litigation. Directors, officers and issuers also should acquire secondary market liability insurance.

7. What mechanisms are in place to ensure that the effectiveness of the certification process can be sustained?

Maintaining an effective process to support the certifications over the longer term requires active leadership and a commitment to continuous improvement. Without either, the support process will likely deteriorate, exposing officers and directors to the risk that a legal defense based on "reliance on certification" and "reasonable investigation" may not be available when it is most needed.

Summary

An effective support process covering all elements of the certifications, including the annual evaluation of the effectiveness of DC&P and ICFR, constitutes an important entity-level control. The certifications demonstrate the certifying officers' public accountability for the filings, and the support process establishes the accountabilities and responsibilities of people within the organization involved in preparing the information to be included in the filings.

As a result, investigating the effectiveness of the process that supports CEO and CFO certification can:

- Help boards and audit committees discharge their disclosure oversight responsibilities, particularly for ensuring the company's financial disclosures contain no material misstatements, omit no material facts necessary to make a statement not misleading, and fairly present in all material respects the issuer's financial condition, results of operations and cash flows, and
- Provide the basis for a solid defence in the event that the directors and officers are sued for alleged disclosure failures.

So what's at stake when it comes to certification and disclosure? To answer the question we pose in our title, the biggest risks ultimately involve the issuer's reputation and brand, which take a lot of time and effort to build and can be destroyed almost instantly. An effective certification support process helps protect the issuer's brand, sustain its reputation and build trust with its investors.

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James L. Goodfellow, FCPA, FCA is a corporate director and a retired partner and vice chairman of Deloitte. He is a graduate of Dalhousie University, and practiced public accountancy with Deloitte and various predecessor firms for 40 years. In 2009, Jim was awarded the Ontario Institute of Chartered Accountants' Award of Outstanding Merit, which is the highest honour that CPA Ontario can bestow upon its members.

He is a past chairman of the CICA Accounting Standards Board as well as a past chairman of the CICA Canadian Performance Reporting Board. He is a frequent speaker on issues related to financial reporting, corporate governance and audit committees.

Jim co-chaired the 2011 and 2012 Audit Quality Symposiums hosted by the Canadian Public Accountability Board that brought together thought leaders and policy makers from Canada and around the world to discuss issues related to audit quality. He was also a member of the Enhancing Audit Quality Audit Committee Working Group that has developed guidance for audit committees in overseeing the work of the external auditor.

He served on the board of directors of Deloitte before his retirement and has served on the audit committee of the Department of Foreign Affairs and International Trade (DFAIT). Jim is currently a member of the board of directors of Discovery Air Inc. (where he chairs the Audit Committee) and the board of directors of Canadian Tire Corporation (where he is a member of the audit committee and chairs the Management Resources and Compensation Committee).

Jim has written extensively on professional issues, including co-authoring the book *Integrity in the Spotlight: Audit Committees in a High Risk World* with Maureen Sabia and co-authoring the two 2006 publications *Internal Control 2006: The Next Wave of Certification—Guidance for Directors* and *Internal Control 2006: The Next Wave of Certification—Guidance for Management* with Alan Willis.

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Alan D. Willis is a Chartered Professional Accountant who, as an independent consultant and author, provides research, writing and advisory services in the areas of performance measurement and business reporting, sustainability, risk and corporate governance.

Regarding risk and corporate governance, he co-authored with Jim Goodfellow the CICA's 2006 publications on guidance for directors and management *Internal Control 2006: The Next Wave of Certification—Guidance for Directors* and *Internal Control 2006: The Next Wave of Certification—Guidance for Management*.

Over the last two decades, his numerous projects for the Canadian Institute of Chartered Accountants and other national and international institutions have addressed the business, investment, accounting and reporting implications of a wide range of sustainability issues facing companies today, as well as associated assurance and verification issues. Related CICA guidance publications which he has authored or co-authored include *Sustainability: Environmental and Social Issues Briefing: Questions for Directors to Ask; Climate Change Briefing: Questions for Directors to Ask; Long-Term Performance Briefing: Questions for Directors to Ask* as well as the Discussion Brief *Environmental, Social and Governance (ESG) Issues in Institutional Investor Decision Making*.

He has worked extensively with major Canadian and international initiatives and standards setters to advance best practices in performance measurement and business reporting, particularly as these relate climate change and corporate sustainability issues, and, through the International Integrated Reporting Council, their integration with financial performance measurement and reporting. He is a member of the International Corporate Governance Network and its committee on Integrated Business Reporting, and an advisor to the Sustainability Accounting Standards Board.

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