Enterprise Risk

Same end game, different approach.

A practical, streamlined approach to certification compliance for smaller companies

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The road well travelled

The business world is slowly coming to terms with the certification requirement – a road paved by large organizations with cautionary tales of the past three years. Now, with accumulated common knowledge and improved tools, the certification journey is sign-posted for smaller Canadian public companies. Yet the question remains, **should** these companies take the road well travelled?

For smaller Canadian issuers, the CEO and CFO certification deadline for certifying on design of internal control over financial reporting (ICFR) has arrived and the expected deadline for assessing operational effectiveness is rapidly approaching.

Many are looking to larger U.S. Securities and Exchange Commission (SEC) registrants that have complied with the certification requirements to glean best practices and lessons learned. But with limited practical guidance from the regulators as to how to develop and implement a compliance process, the challenge for smaller companies is significant.

Regardless of size, one thing is certain — complying with certification requirements is complex and requires significant time and effort. Without exception, it's wise to implement a long-term sustainable strategy to establish and evaluate ICFR. An early start helps to ensure control weaknesses are identified and fixed in time to avoid potential material weakness disclosures in the Management Discussion and Analysis (MD&A).

The certification regulations aim to enhance the transparency and accountability for the quality and reliability of financial reporting by the CEO and CFO. Certifying on the design of ICFR is the third phase in the Canadian Securities Administrators' (CSA) overall certification agenda. The fourth phase is expected to include a new dimension in that all reporting issuers – big and small – will be required to certify on the operational effectiveness of ICFR.

Although this fourth 'effectiveness' phase, expected for year ends on or after December 31, 2007, has not yet been finalized by the CSA, the supposition is that it will require a significant amount of effort for organizations to develop, execute and sustain the annual assessment of operating effectiveness. If the lessons coming from the SEC filers are leveraged, this additional amount of effort can be streamlined and addressed in a sustainable manner.

On March 10, 2006, the Canadian Securities Administrators released Notice 52-313 proposing 52-109, the original internal control instrument guiding issuers, be amended as follows, effective, at the earliest, for financial years ending on or after December 31, 2007:

- CEOs and CFOs of reporting issuers will be required to evaluate the operating effectiveness of ICFR, but will not have to issue a separate management report.
- Annual CEO/CFO certificates will be expanded in the future to state they have evaluated the operating effectiveness of the issuer's ICFR.
- Issuers will be required to include in their MD&A a description of their process for evaluating the effectiveness of the issuer's ICFR and their conclusions about the effectiveness of ICFR as of the end of the financial year.
- Issuers will not be required to obtain their external auditors' opinion of management's assessment of the effectiveness of internal control or the auditors' own assessment of the effectiveness of internal control.
- The requirements will apply to all reporting issuers, including all public companies listed on the TSX and TSX-V, in all Canadian jurisdictions.

Certification: A one-way ticket to growth?

Successful organizations view certification as an opportunity to reap business benefits – whether small process changes or infrastructure enhancements – from their compliance investment.

The compliance payback isn't a myth; nor is it exclusive to larger organizations where improvements are destined to be discovered in the most remote process control. For smaller organizations, the internal control assessment activities also provide opportunities to achieve benefits beyond compliance.

Public companies embracing effective corporate governance will ultimately be rewarded by the market. Complying with the requirements doesn't only affect a company's share price. It opens doors to capital because improved disclosures give investors greater assurance about the accuracy, completeness and timeliness of financial reports. Furthermore, it may better position smaller organizations for growth by standardizing organizational processes, policies and controls, and weeding out inefficiencies and streamlining systems before they become untenable. A focus on identifying where fraud could occur and assessing existing anti-fraud programs and controls is a useful preventive measure.

Still, the cost of developing a certification program is a real business issue for smaller organizations. Good internal control should not be seen as a one-time expense; rather, because it fundamentally changes the cost of doing business, it should be factored into an organization's business model. Controls certification is here to stay but it need not be a sunk cost – a practical, streamlined approach to the certification process can help companies reduce their costs of compliance in year one and beyond.

The smaller company advantage

Smaller organizations have two things going for them. They can leverage the experience and existing methodology of the larger registrants without having to recreate the wheel. And – perhaps more important – they can use their unique attributes as leaner, simpler organizations to their advantage in designing and implementing a practical approach to compliance.

A cautionary tale

How does a smaller enterprise avoid the pitfalls and costly experiences of the SEC filers who have already complied with Section 404 of the Sarbanes-Oxley Act? Many of these organizations ended up producing too much documentation and testing an excessive number of internal controls with a sweeping bottom-up approach. The result? The average cost of compliance for SEC registrants soared into the millions of dollars and the exercise became overly complicated and burdensome. In some cases, major risks did not receive appropriate attention and excessive time was spent in low risk areas.

The lesson for smaller organizations is clear – embed a top-down, risk-based approach from the start and focus, focus, focus.

Essentially, the emphasis should be on identifying and increasing compliance activities around the most important internal controls and areas of greatest risk. This will allow companies to design the most effective and efficient control framework necessary to address financial reporting risks. It can also drive down the cost of testing operational effectiveness required for 2007.

Chances are smaller companies have weak internal controls over financial reporting

More than half of first year accelerated SEC filers reporting ineffective controls over financial reporting had revenues under $250 million, according to the Lord & Benoit Report *Bridging the Sarbanes-Oxley Disclosure Control Gap, 2006.*

Silver lining

While the profile of a smaller company may appear as an obstacle to compliance, it may be an opportunity in disguise. Consider the differences between the larger and smaller market segments. It's generally more difficult for smaller companies to implement frameworks and demonstrate compliance as typically, the rigour that's required to do so is not as culturally or systematically integrated as it is in larger organizations. As well, the shortage of appropriately-skilled resources in smaller organizations makes it difficult to execute new initiatives like compliance. The segregation of duties among senior executives – a fundamental control premise – is hierarchically maintained in larger organizations while in smaller entities, roles and interests often overlap and conflict. Furthermore, there is an increased opportunity for management and controlling shareholders to override internal controls due to the limited number of personnel and the active, hands-on involvement of senior executives and controlling shareholders in these companies.

These and other challenges are inherent in smaller organizations and at first glance appear to work against the compliance effort. However, with a senior management team that is likely more hands-on, leaner operations, less complex business processes, and a more informal control environment, the compliance effort can be manageable for smaller companies – even streamlined - with the right approach. In fact, smaller companies may be *better* suited to meeting their certification requirements efficiently.

How does a smaller organization best execute a compliance approach?

Don't approach certification in a manner similar to a large, complex multi-location organization.

A simplified approach toward certification – same destination

While there are no prescriptive rules for smaller companies to follow, a successful approach is governed by the overriding principle of simplicity. Two factors substantially differentiate the exercise from that of large organizations:

- placing a heavier reliance on documenting and testing entity-level, disclosure, financial close and reporting controls, rather than deeper process and transaction-level controls
- enabling a leaner certification team with an outsourced technology solution to address specific compliance activities, such as documentation and testing, rather than deploying multiple users to manage the compliance program

The compliance journey

Phase 1: Apply a top-down, risk-based scoping approach

For all organizations, big or small, the compliance journey should begin with a comprehensive enterprise risk assessment and scoping activities. Risk assessment and the related scoping are really the foundation of the CEO/CFO certification compliance program because it focuses where companies need to consider, and the resources needed to address identified key control requirements.

Essentially, a top-down risk assessment and related scoping activities help identify the key internal controls and related business processes that are critical to the organization and need to be documented and assessed. For example, by pinpointing general ledger line items and relevant assertions, such as inventory valuation or revenue validity that need special attention, business processes that are the source of these accounts can be focused on given the risks needing further consideration and the scoping can then be addressed so as to ensure the risks are adequately addressed. Ultimately, scoping should inform whether the risk is material based on both quantitative and qualitative considerations.

Keep it simple

By focusing primarily on the critical control areas, smaller organizations can manage the extent of documentation required, adequately demonstrate there are controls in place, and better facilitate the testing of those controls for the expected 2007 requirements concerning operational effectiveness.

Phase 2: Focus the documentation effort in areas of greatest risk

When it comes to preparing for the certification of a company's ICFR, design documentation plays a foundational role. It enables management to appropriately certify on the design of internal controls, and it provides a foundation for the development of test plans for assessing operational effectiveness.

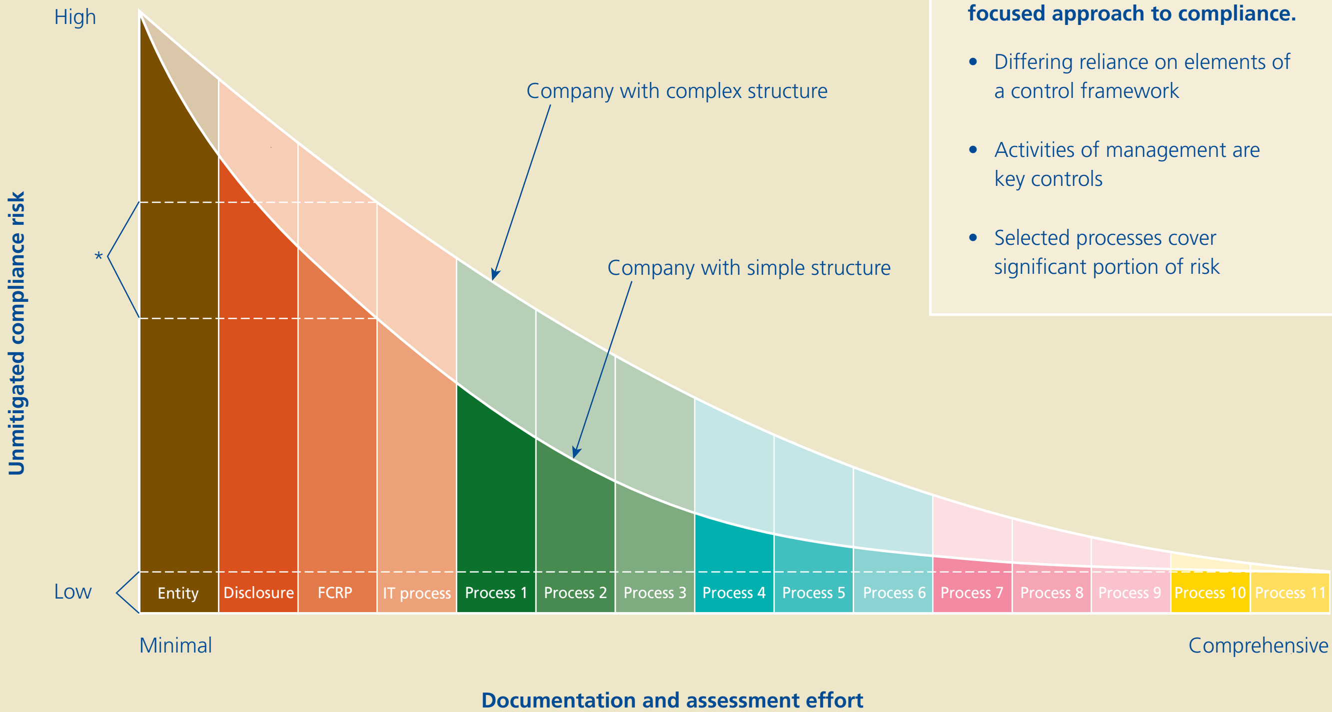
For large organizations, documenting and testing internal controls must occur at both the entity *and* process transaction levels in order to appropriately cover the risks. The very nature of most larger organizations adds to the complexity. Distributed operations in multiple jurisdictions creates a reliance on individuals across various business units to consistently document and report on a wide range of controls typically using a sophisticated enterprise-wide application.

However for most smaller Canadian organizations, with inherently fewer significant business processes requiring controls, the most risk generally appears in a few critical control areas, typically: entity-level, disclosure, financial closing and reporting and information technology processes. The critical control areas have a significant influence on financial reporting accuracy because of their pervasive impact on controls at the process, transaction, or application level. In other words, smaller companies with a simple structure often have the opportunity to take a more focused approach.

The underlying message – and one formed from experience – is that it's not possible to create a control system that prevents every error with absolute assurance. Large or small, the goal of any compliance effort should be to create a sustainable system where the key internal controls documented and tested are those that prevent and detect errors with a high degree of assurance.

Documentation benefits

- Gives companies a better understanding of their internal controls, which tends to improve operational effectiveness and reduce the potential for reporting errors
- Helps companies identify and eliminate redundant controls and improve the design of controls through more efficient practices
- Supports training of new personnel
- Helps contribute to a "due diligence defence" to risks arising from the provisions of civil liability for continuous disclosure



Smaller companies often have the opportunity to take a more focused approach to compliance.

- Differing reliance on elements of a control framework
- Activities of management are key controls
- Selected processes cover significant portion of risk

* Potential savings in effort to be recognized by aligning approach to company structure.

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Phase 3: Design gap remediation

Issuers need to have designed controls that are responsive to all control risks identified to be significant to ICFR. When control design deficiencies are identified, it is important to act as soon as possible. A control designed and placed in operation to remediate a design weakness should be operating effectively for a reasonable period of time. Disclosure should otherwise be made if the design weakness was determined to be a material weakness.

Making a judgment call

In 2007, with the expected release of the revised Multilateral Instrument 52-109, CEOs and CFOs will be required to certify on the operating effectiveness of ICFR, not only to ensure controls perform the way they should but to answer the ultimate question "Is our internal control over financial reporting operating effectively?"

Phase 4: Testing and evaluation of internal control effectiveness

Here's where the smaller company faces a challenge as a result of its size and composition. Contemplating the adequacy of documentation and assessing the materiality of control deficiencies that are identified with respect to the implementation and operation of internal controls – the underpinning of the effectiveness assertion – requires significant experience and a skill set that may not be found in-house.

Similar to larger issuers, smaller companies need to develop an assessment strategy for their key internal controls to appropriately evaluate their operational effectiveness. The testing strategy generally includes a consideration of the nature, extent and timing of control tests based on the amount of relative risk.

Determining an organization's internal control effectiveness demands unbiased and specialized expertise – a healthy dose of skepticism is warranted. Consider this test scenario: a bank account reconciliation is tested to ensure it is completely reconciled and ties to supporting source information. The test also includes determining whether the appropriate individuals prepared and reviewed the reconciliation. Should this test fail, the results are further analyzed to determine whether the deficiency in the cash management process is material to the organization. On its own, a deficiency may be immaterial, but combined with others ("aggregated"), it may well be significant or material.

It's critical then that smaller organizations obtain access to the requisite experience and competencies to assess whether the principal financial reporting risks are being controlled effectively and material internal control weaknesses are being identified.

Taking the technology short cut

Technology needs for the certification process are different for smaller companies

The need for an information management system in any organization's compliance program is a given. The high volume of data, limited people resources, need for tight security of the documentation, the requirement to update documentation quarterly or annually for ongoing certification and reporting obligations, clearly benefit from automation.

For smaller organizations, it's the extent of automation that's in question. Leveraging computer-assisted auditing techniques in only some compliance activities can help decrease the cost of testing and improve effectiveness. While the documentation and testing phases benefit from a highly automated environment, scoping and planning can be managed efficiently with manual processes.

Additionally, outsourcing technology can be a prudent, cost-effective alternative for smaller companies and should be considered. Typically, the information technology infrastructure to support an in-house certification database application does not exist. Web-enabled systems offered through an Application Service Provider (ASP) are available. An ASP model refers to a situation where the software vendor hosts the software on behalf of their client, and is responsible for managing and maintaining the software to an agreed upon level of availability, so that the client does not have to worry about installing, administering or maintaining the application. Vendors are designing certification systems pre-populated with generic risk and controls knowledge that can be customized. For the smaller company with its lean, centralized certification project team, using technology becomes an affordable, manageable and transferable task, going a long way toward creating a long-term sustainable certification process.

Stay lean and focused

Smaller companies can avoid the endless costs and complexities of certification.

1. **Set clear objectives – begin with the end in mind**
   Determine your compliance vision early. Are your objectives purely compliance-focused or do you expect a return on investment earned through other business benefits? Objectives should be discussed by senior executives and with the company's audit committee and communicated to relevant stakeholders.

2. **Set the tone throughout your organization – get all leaders on board**
   Ensure there is strong support for certification efforts throughout your organization. Active and direct involvement of senior leaders, through both actions and words, is vital to success. Without it, the certification process can lose focus or signal a weak disclosure culture.

3. **Embed good governance**
   As part of effective governance and oversight, audit committees should request, review and monitor the CEO's and CFO's multi-year plan for compliance, and certification updates should become a standing agenda item for audit committee meetings.

4. **Make sustainability job one**
   A small certification project team should be assigned to the initiative, executing on a detailed project plan with the proper sequencing of activities, timelines and assigned accountabilities. Complement the team with external advisors to gain access to risk and control knowledge bases, leading tools, techniques and practices – the resulting knowledge transfer will build sustainability into your initiative.

5. **Involve external advisors early in the process**
   Identifying, documenting and assessing ICFR requires specialized skills. Do not simply assign available resources to the project without first determining whether they possess the requisite competencies. Experienced external consultants can help navigate common roadblocks, complete the evaluation process efficiently, and help minimize certification risks. If internal resources are not available, consider a sustained compliance program where external advisors are involved with annual testing which includes operational effectiveness for the fourth phase of the certification requirements.

Time is of the essence – Hit the ground running

Documentation of ICFR is an important element to support the ICFR design certification effective for years ending on or after June 30, 2006, followed soon after by requirements to certify on the operating effectiveness of these controls. Look for solutions that provide you with a running start with control documentation that can be tailored to your organization.