



# Internal Control Certifications – SOX, CEO/CFO Certification & Public Sector Responses

**Deloitte Point of View –  
Presentation to CMA Conference  
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# Discussion Items

- Introductions
- Sarbanes Oxley
- CEO/CFO Certification
- Public Sector Responses

## Appendices

- Sarbanes Oxley
- Relevant Multilateral and National Policy Instruments
- Control Rationalization Approach

# Sarbanes Oxley

# Sarbanes-Oxley Act of 2002

## Overview

- July 25, 2002 – U.S. Congress passed the Sarbanes-Oxley Act of 2002
- July 30, 2002 - President Bush signed act into law
- Most comprehensive reform since securities acts of the 1930's. Provides clarity and certainty on a number of highly debated issues by:
  - Establishing an independent, full-time oversight board (the Public Company Accounting Oversight Board) for capital-market participants; the SEC has oversight of the board
  - Establishing new responsibilities for audit committees and corporate officers
  - Establishing several new public-company reporting requirements
  - Defining “non-audit” services that public accounting firms can provide to audit clients
  - Strengthening penalties for corporate fraud
  - Requiring rules to address analyst conflict of interest
  - Significantly increasing the responsibilities and budget of the SEC

# Obligations and Opportunities

## Objectives of the Control Requirements in Sarbanes-Oxley

- Restore **public trust and confidence** in the public securities market
- Improve **corporate governance** and promote ethical business practices
- Enhance **transparency and completeness** of financial statements and disclosures
- Ensure that company executives are aware of material information emanating from a well-controlled environment
- Hold company management **accountable** for material information that is filed with the SEC and released to investors
- Achieve new levels of **corporate excellence**

# Understanding the Requirements

## Section 302

### Summary of the Requirements

#### **Requires the CEO and CFO to certify quarterly and annually that they:**

- Are responsible for disclosure controls and procedures
- Have designed controls to ensure that material information is known to them
- Have evaluated the effectiveness of disclosure controls
- Have presented their conclusions in the filing
- Have disclosed to the audit committee and auditors significant control deficiencies and acts of fraud
- Have indicated in the filing significant changes to internal control

#### **Introduces the concept of disclosure controls and procedures (“disclosure controls”)**

- Broadens the current emphasis of integrity and completeness of controls relating to financial reporting
- Examples of non-financial disclosures include the signing of a significant contract, termination of a strategic relationship, and legal proceedings

# Understanding the Requirements

## Section 404

### Summary of the Requirements

#### Requires management to annually:

- State their responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting
- Conduct an assessment of the effectiveness of the company's internal controls and procedures for financial reporting

#### Requires the independent auditor to:

- Attest to management's assertion (requires a framework such as COSO)

# CEO/CFO Certification

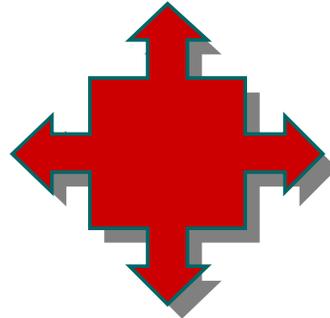
# Capital Reform: Four Major Areas of Impact

## Impact on Audit Committees

- Responsibilities, Independence, Financial Literacy, AC Financial Expert

## Impact on Auditors

- Regulation of Audit Firms
- New Independence Standards



## Impact on Management

- Continuous Disclosure Obligations
- CEO/CFO Certification
- Internal Control Reporting

## Penalties

- Larger fines and jail terms
- Disgorgement
- More commitment to enforcement
- Civil liability for disclosures in secondary markets

# CSA Notice 52-313

- On March 10, 2006, the Canadian Securities Administrators released notice 52-313 indicating an intent not to proceed with Multilateral Instrument 52-111 and to amend and restate MI 52-109
- The proposed changes to the requirements are as follows:
  - CEOs and CFOs of reporting issuers will be required to evaluate the effectiveness of ICFR, but will not have to issue a separate management report on internal control
  - Annual CEO/CFO certificates will be expanded to state that they have evaluated the 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**
  - The earliest that the proposals will come into effect is in respect of financial years ending on or after December 31, 2007

# CSA Notice 52-313 - Canadian Certification Rules

Based on the proposed changes, the following table reflects the requirements and their effective dates:

CEO/CFO Certificate			
① Effective Date: March 30, 2004	② Effective Date: March 30, 2005	③ Effective Date: June 30, 2006	④ Effective Date: December 31, 2007*
Key assertions: <ul style="list-style-type: none"> <li>• Fair representation of annual and interim filings</li> <li>• Completion and accuracy of material facts</li> </ul>	Assertions from ① plus: <ul style="list-style-type: none"> <li>• Design of disclosure controls and procedures</li> <li>• Operating effectiveness of disclosure controls and procedures</li> </ul>	Assertions from ② plus: <ul style="list-style-type: none"> <li>• Expressed responsibility for establishing and maintaining internal control over financial reporting (ICFR)</li> <li>• Design of ICFR</li> <li>• Disclosure in MD&amp;A of material changes in ICFR</li> </ul>	Assertions from ③ plus: <ul style="list-style-type: none"> <li>• Evaluation of effectiveness of ICFR</li> <li>• Disclosure of ICFR effectiveness conclusions in MD&amp;A</li> </ul>

\* CSA Notice 52-313 indicated that "the earliest that these requirements will apply is in respect of financial years ending on or after December 31, 2007". It is expected that the revised and expanded MI 52-109 will be issued in approximately September 2006 and will be subject to a 30 or 60-day public comment period

# Key Questions and Concerns for Issuers

- How does the CSA Notice change the responsibilities of internal stakeholders (e.g. management, Audit Committee, etc.)?
- What should be done to address the certification requirements?
- How do you know that you have done enough, especially in an environment with no standards for management?
- Does management or the Audit Committee need independent assurance given that auditor attestation has been removed?

# Enhanced Responsibilities – Management

- CEO and CFO
  - Increased onus on management to detect and report material weaknesses without auditor attestation
  - Self reporting: The U.S. Experience\*
    - Only 1 in 12 companies with ineffective Section 404 controls self reported ineffective 302 controls in the prior year
    - Only 1 in 8 companies with ineffective Section 404 controls self reported ineffective 302 controls in the prior quarter
    - A full 9 out of every 10 companies with ineffective Section 404 controls self reported ineffective 302 controls in the same period end that an adverse Section 404 was reported

**The CSA has stated that they will monitor implementation of the proposed rules and may enquire into the procedures that companies are employing to address the requirements.**

\* Source: The Lord & Benoit Report, *Bridging the Sarbanes-Oxley Disclosure Control Gap*, 2006

# Enhanced Responsibilities – Management (cont'd)

- Impact of secondary market civil liability
  - Burden of proof shifts for Core Documents\*
  - CEO and CFO certificates
  - Conclusions of DC&P and ICFR are in the MD&A (a Core Document)

\* Includes: a prospectus, a take-over bid circular, an issuer bid circular, a directors' circular, a rights offering circular, management's discussion and analysis, an annual information form, an information circular, annual financial statements and interim financial statements

# Enhanced Responsibilities – Board of Directors and Audit Committees –

- MI 52-110, *Audit Committees*
  - Responsibility to review MD&A and F/S
  - Responsibility to establish “whistle-blowing” procedures
- NP 58-201, *Effective Corporate Governance*
  - Satisfying itself that the CEO creates a culture of integrity
  - Code of business conduct
  - Identification of the principal risks of the issuer's business, and ensuring the implementation of appropriate systems to manage these risks
  - Responsibility for internal control and management information systems
- Civil liability exposure – management’s DC&P and ICFR conclusions are contained within the MD&A (MI 52-110 requires Audit Committee review of MD&A)
  - Elimination of independent auditor attestation removes a key element of Board and Audit Committee assurance with respect to management’s compliance process and ICFR

**Audit Committees should consider using internal audit, external audit or their readiness service provider (or a combination thereof) to conduct independent assessment procedures with respect to management’s compliance process and ICFR.**

# Responding to CSA Notice 52-313 – Management’s Compliance Process

- CSA Notice 52-313 does not diminish the responsibilities of issuers with respect to CEO and CFO Certification. In fact, we believe that the elimination of auditor attestation increases the importance of management designing and implementing a robust compliance process to address the requirements
- Given that the CEO and CFO have an obligation to identify (and will likely have to report) “Material Weaknesses” in their disclosure controls and ICFR, the process implemented by management must be designed to provide confidence to the market that all “Material Weaknesses” have been detected and disclosed

**The responsibility for validating the sufficiency of management’s certification activities has shifted from the auditor to the audit committee.**

# Important Decisions and Actions Issuers Should Take

Issuers that are well underway with their compliance initiative **should not stop or slow their activities** given the relatively tight timelines presented by the 2006 and 2007 requirements. Those that have not started should not wait for the final rule and guidance from the CSA. In our view, there are a few important decisions and actions that all reporting issuers need to take now, despite the fact that the specific rule proposals related to ICFR will not be known until the CSA publishes an amended and restated MI 52-109 for comment later this year. The next few pages of this document review our perspectives with respect to the **important decisions and actions issuers must take**.

**Get educated** with respect to the complex maze of instruments and requirements.  
**Engage your Audit Committee and Board in discussion** as soon as possible to review your response

# Important Decisions and Actions Issuers Should Take (cont'd)

- Control Framework and Entity Level Controls
  - Reporting issuers must decide on, and implement, a suitable control regime that appropriately integrates the CSA's prescribed responsibilities of the board of directors, the audit committee, management and the CEO/CFO certification requirements
  - The choice of a control framework and the overall design of a suitable control regime is a critical decision that should be approved by the board of directors
  - Issuers should take a "top down" approach that starts with the identification of business, disclosure and financial reporting risks
  - Particular attention should be placed on the areas of board responsibility set out in Section 3.4 of National Policy 58-201, *Effective Corporate Governance*

# Important Decisions and Actions Issuers Should Take (cont'd)

- Identification of Principal Business Risks
  - National Policy 58-201, *Effective Corporate Governance*, recommends that the identification of principal business risks be a specific responsibility of the board, and issuers should ensure that they have implemented an effective process to identify all of them
  - These principal business risks should include disclosure and financial reporting risks to make it possible to ensure a proper alignment between these risks and the systems put in place to manage and control them
  - CEOs and CFOs need a reliable risk identification process to be able to assess whether their design of DC&P and ICFR adequately addresses all principal disclosure and financial reporting risks
  - Such a risk identification process also provides a basis for ensuring that the various risk disclosures provided in the financial statements, MD&A, the Annual Information Form (AIF) and the disclosure of corporate governance practices are complete, fairly presented and informative to investors

# Important Decisions and Actions Issuers Should Take (cont'd)

- Effectiveness of the CEO/CFO Certification Process

- DC&P and ICFR, and management's evaluation and testing of these controls, should be aligned with the principal business, financial reporting and disclosure risks, which requires an effective process to identify these risks
- Issuers should examine their process for evaluating the design and effectiveness of DC&P (required for the first time in 2005), and determine how to expand and change it to support their assessment of ICFR in 2006
- In our view, many issuers do not fully appreciate the interrelationship between DC&P and ICFR, and that their financial statements are included in the documents over which disclosure controls are to be exercised
- Audit Committees should also review how they discharge their oversight responsibilities with respect to the DC&P disclosures in the MD&A and identify what improvements, if any, should be made
- A control rationalization approach should be used to build an efficient and effective compliance process (see appendix)
- IT strategies and direction, system architecture(s), and enterprise application(s) controls which support the issuers disclosure compliance system, DC&P, and ICFR, need to be addressed and evaluated in the assessment of principal risks and in the CEO and CFO certification process
- Build a process that is sustainable in the long-term by focusing on the key elements of people, process and technology

**Assess current and contemplated compliance activities against the recommended elements of a robust certification compliance process to identify any gaps. Significant gaps should be addressed as soon as possible**

# Important Decisions and Actions Issuers Should Take (cont'd)

- Preliminary Identification of Potential Weaknesses in Control
  - CEOs and CFOs should identify all potential control weaknesses that could indicate possible design weaknesses in ICFR
  - If these design weaknesses are not remediated now, then, if they are material, they will likely need to be publicly disclosed in the MD&A when the CEO and CFO complete their annual certification in 2006

# Important Decisions and Actions Issuers Should Take (cont'd)

- Board and Audit Committee Responsibilities
  - Audit committees should review their risk and control related responsibilities, and the information and assurance they require in discharging their responsibilities
  - The audit committee must consider both DC&P and ICFR, since the CEO and CFO must disclose their conclusions in the MD&A, a “core document” that must be reviewed by the audit committee and approved by the board of directors
  - The charters of the board of directors and the audit committee must clearly articulate the division of responsibilities between the board and the audit committee
  - In addition to assessing their responsibilities for the oversight of internal control vis-à-vis those of the board, audit committees should also ensure they are complying with all of the CSA’s other requirements for audit committees
  - CSA Staff Notice 52-312 indicated that approximately one-third of the companies reviewed by the CSA were not in compliance with the CSA’s audit committee requirements

# Public Sector Responses

# Certification Background

## CONTROL FOCUS AT CANADIAN FEDERAL GOVERNMENT LEVEL

- Origins of the issue:
  - Private sector business failures and regulatory response;
  - Government scandals and increased visibility of Auditor General comments; and,
  - “Restoring Trust and Accountability” theme.
- Converging ‘control-based’ requirements as a result of:
  - TBS Crown corporation governance review (exploring a certification regime) – February 2005;
  - New Internal Audit Policy (renewed focus on risk and controls), effective April 2006;
  - Departmental F/S audit requirement (requirement for control reliance);
  - MAF assessments (expected practices and controls); and,
  - Upcoming Policy on Financial Management (enhanced CFO role and focus on controls), published by April 2006, in force by April 2007, full compliance by April 2009;

# Certification Background

## CONTROL FOCUS AT CANADIAN FEDERAL GOVERNMENT LEVEL

- New Financial Management Policy Framework:
  - Supports the Government's direction to strengthen financial management across the public service
  - Supports the re-establishment of the Office of the Comptroller General
  - Translates the CFO Model in policy terms
- 5 Core Financial Management Policies
  - Policy on Financial Management Roles and Responsibilities
  - Policy on Resource Management
  - ***Policy on Internal Control***
  - Policy on Financial Information and Reporting
  - Policy on Financial Systems and Infrastructure
- Policy on Internal Control (Proposed)
  - Deputy Head responsible for "extended" risk management and the system of control
  - CFO responsible for "core" risk responsibilities related to financial systems, records, reporting and financial controls, including all financial controls in programs
  - Program Managers responsible for "core" risk responsibilities related to program systems, records, reporting, and for the implementation and operation of financial controls

# Certification Background

## CONTROL FOCUS AT CANADIAN FED GOVT LEVEL – STATEMENT ON INTERNAL CONTROLS (SIC)

- Deputy Head will provide an annual Statement on Internal Control
- *Statement on Internal Control:*
  - A high-level summary of the ways in which departmental personnel are trained to mitigate risk
  - Confirmation that the effectiveness of the system of internal control has been reviewed, including controls over financial reporting;
  - Confirmation that the results of the effectiveness review have been discussed by the Deputy Head with the Audit Committee
  - Necessary actions have been or are being taken to remedy significant failings or weaknesses with respect to internal control
- Deputy Head will obtain assurances and evidence to support SIC via:
  - **Audit Committee** – Review of risk management and management control framework matters
  - **Chief Audit Executive** – Various internal audits and Annual Opinion on effectiveness and adequacy of risk management, control, and governance
  - **Chief Financial Officer** – *CFO Statement of Internal Control* for financial controls and internal controls over financial reporting
  - **Managers** – Stewardship Representations (SIC-like) for all controls within their Purview (proposed)
- Comptroller General will provide Treasury Board with a Government-wide Statement on Internal Controls.

# U.S. Federal Government Internal Controls Certification

- In light of the new internal control requirements for publicly-traded companies, in December 2004, the Office of Management and Budget of the United States Federal Government issued revised requirements to its 15 largest federal government agencies related to management's responsibility for internal control.
- The stated purpose of the revised requirements was to improve the accountability and effectiveness of federal programs and operations by establishing, assessing, correcting and reporting on internal control.
- The revised requirements, effective in fiscal year 2006, defined management's responsibility related to internal control, the process for assessing internal control effectiveness, internal control standards, and new specific requirements for conducting management's assessment of the effectiveness of internal control over financial reporting.
- **The U.S. federal government requirements are extremely similar to private sector certification requirements** (except that an independent audit on management's certification is not required).

# WHY SOME CROWN CORPORATIONS ARE EXPLORING CERTIFICATION

- Some Federal Crowns have initiated scoping project to explore certification for a variety of reasons, including:
  - Certification could assist in **maintaining leadership in the areas of corporate governance and financial reporting**;
  - Certification can provide **additional comfort and allow for greater confidence for both senior management and the Board** that the Crown's financial reporting adheres to the highest standard;
  - Internal controls over financial reporting will be identified, documented, and tested, resulting in **improved financial processes and improved controls**;
  - **Treasury Board is currently studying** whether a Crown corporation certification program should be put in place;
  - Certification may **identify unknown risk areas** or areas where controls need improvement, or may **identify overlap of controls and potential savings** from the elimination of redundant controls;
  - A strong internal control environment should **lead to better decision making and a smoother annual audit**.

***“The governance system for Crown corporations must be as robust as its private sector counterparts, therefore the government supports the use of certification.”***

**Treasury Board**

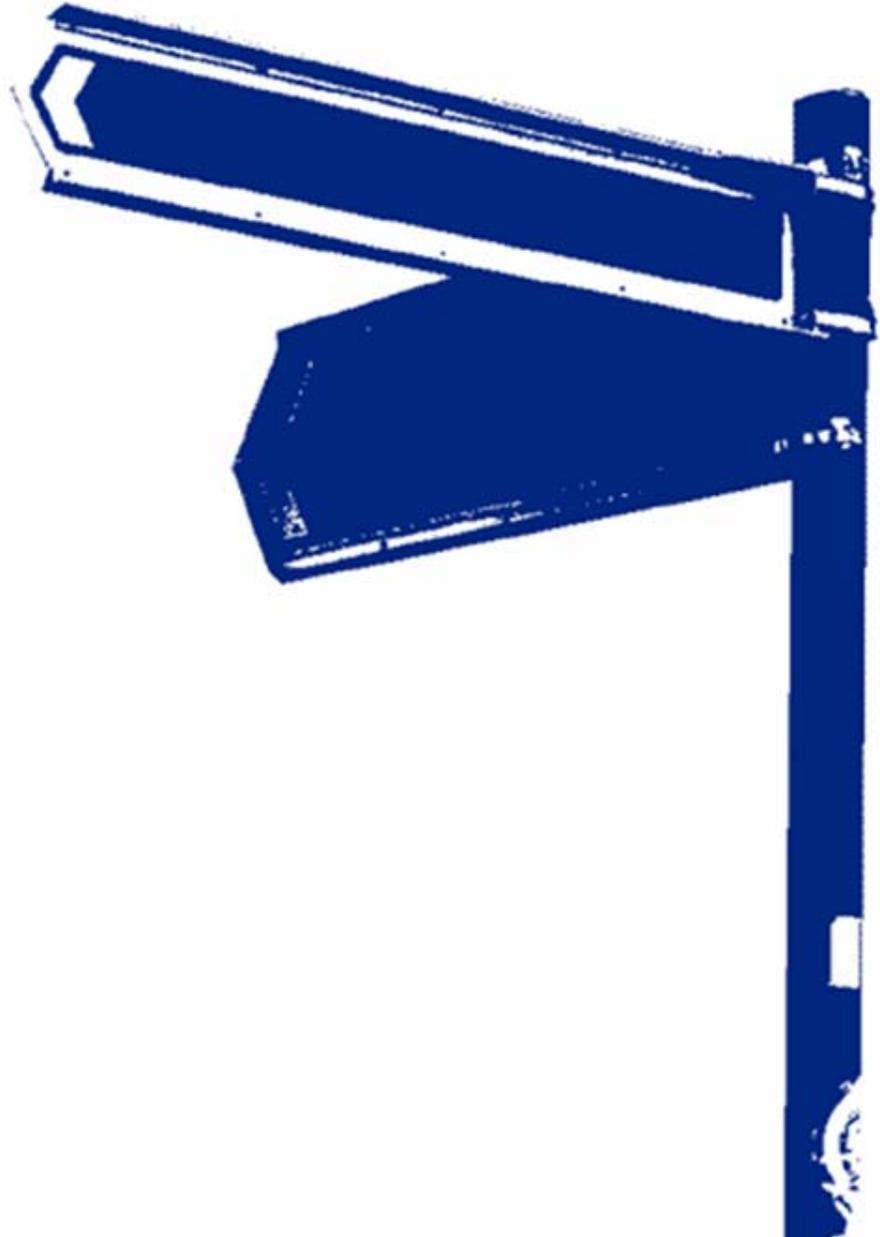
*(Review of the Governance Framework for Canada's Crown Corporations, February 2005)*

***“...a range of private sector practices could usefully be emulated in Crown corporations ...[including] improving the quality of reporting and disclosure.”***

**Auditor General**

*(Chapter 7 – Governance of Crown Corporations, February 2005)*

# Appendix



# Appendix – Relevant Multilateral and National Policy Instruments

## Multilateral Instrument 52-109, *Certification of Disclosures in Issuers' Annual and Interim Filings*

Effective March 30, 2004, this national instrument came into force in all CSA jurisdictions, except British Columbia and Quebec, on March 30, 2004. This instrument came into force in Quebec on June 30, 2005 and in British Columbia on September 19, 2005. This instrument requires CEOs and CFOs to certify on the fair representation of annual and interim filings and the completion and accuracy of material facts. It also requires certifications with respect to the design and operating effectiveness of disclosure controls and procedures and, starting in 2006, will require certifications with respect to the design or ICFR. CSA Notice 52-313, discussed earlier in this document and issued on March 10, 2006, proposes to expand this instrument to include certifications with respect to the operating effectiveness of ICFR and to disclose conclusions in the issuers' annual MD&A.

## Multilateral Instrument 52-111, *Reporting on Internal Control over Financial Reporting*

Published for comment on February 4, 2005 in every Canadian jurisdiction except British Columbia, this instrument was substantially similar to the requirements of Sarbanes-Oxley Section 404 and would have required management of an issuer to evaluate the effectiveness of the issuer's ICFR against a suitable control framework. In addition, the issuer would have been required to file, with the securities regulatory authorities, a report of management on its assessment of the effectiveness of ICFR and a report of the issuer's auditor prepared in accordance with the CICA's auditing standard for internal control audit engagements. CSA Notice 52-313, discussed earlier in this document and issued on March 10, 2006, communicated that the CSA has determined that they will not proceed with the proposed Multilateral Instrument 52-111 and have therefore withdrawn the instrument.

# Appendix – Relevant Multilateral and National Policy Instruments

## Multilateral Instrument 52-110, Audit Committees

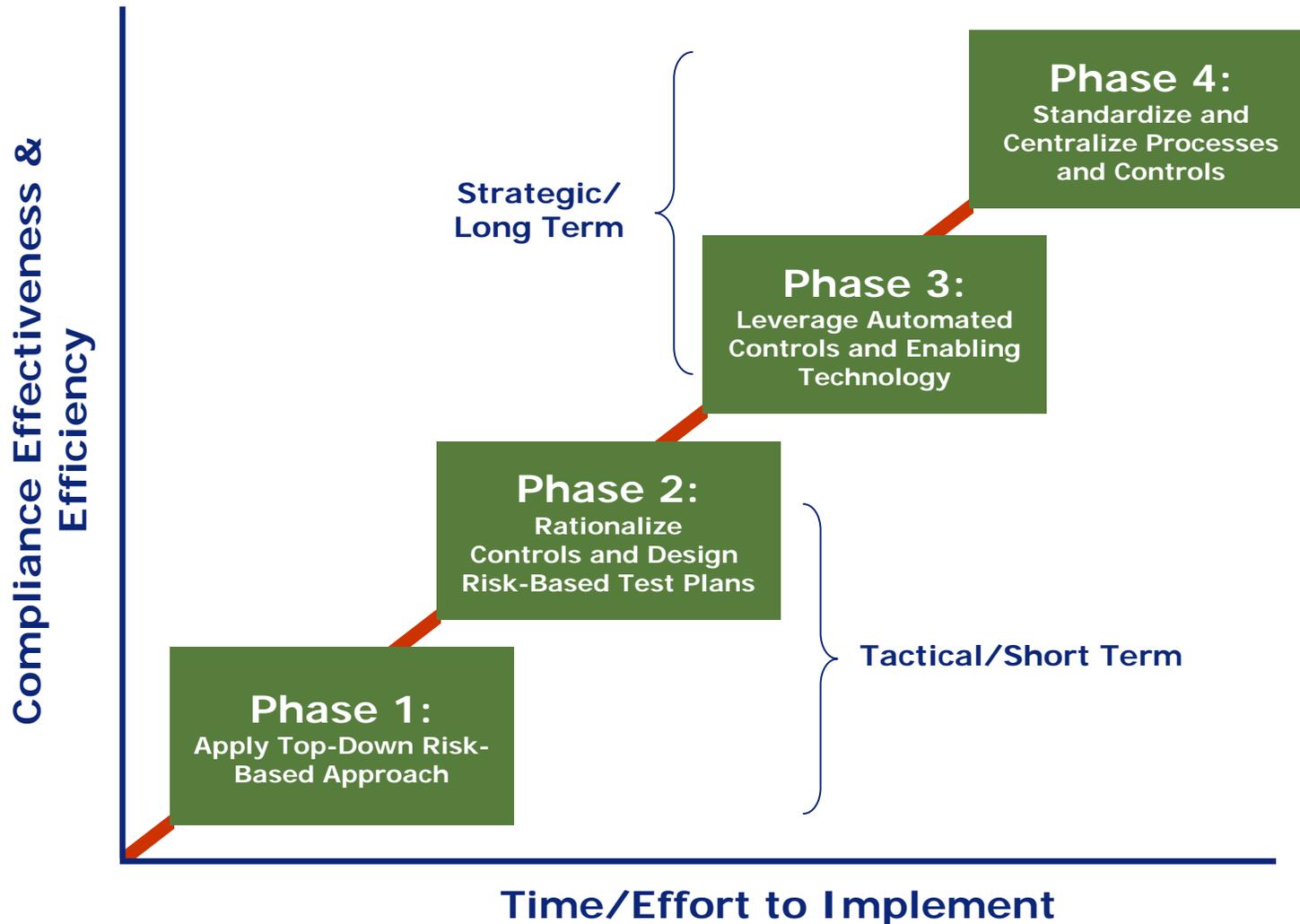
Issued on January 14, 2004, this national instrument applies to essentially all reporting issuers (with certain noted exceptions such as investment funds and SEC foreign issuers) and sets out new responsibilities for Audit Committees, including the requirement that Audit Committees must review the issuer's financial statements, MD&A and annual and interim earnings press releases before the issuer publicly discloses the information. Among other things, this instrument also contains requirements for Audit Committee composition.

## Multilateral Policy 58-201, Effective Corporate Governance

Published for comment on January 16, 2004, the purpose of this policy is to confirm as best practice certain governance standards and guidelines that had evolved through the confluence of legislative and regulatory reforms and the initiative of other capital market reform participants. Among other things, this policy sets out one of the responsibilities of the Board as being the identification of the principal risks of the issuer's business, and ensuring the implementation of appropriate systems to manage these risks

# Appendix - Control Rationalization Approach

## Four-Phased Risk-Based Approach



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