Consultation Response

CERTIFICATION OF DISCLOSURE IN COMPANIES' ANNUAL AND INTERIM FILINGS

and

AUDIT COMMITTEES

A consultation on two proposed multilateral instruments by the Ontario Securities Commission

Comments from the Association of Chartered Certified Accountants (ACCA)

September 2003

ACCA is the largest and fastest-growing international accountancy body in the world. Over 300,000 students and members in 160 countries are served by more than 70 staffed offices and other centres.

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Executive Summary

ACCA is pleased to respond to the Ontario Securities Commission (OSC) request for comments on the proposed multilateral instruments 52-109 (certification of disclosure in companies' annual and interim filings) and 52-110 (audit committees) issued on June 27, 2003.

We note the strong influence of the US Sarbanes-Oxley Act and the related Securities and Exchange Commission (SEC) rules. The OSC has adopted a similar approach to Sarbanes-Oxley in responding to the crisis in confidence in capital markets triggered by the failures of Enron and WorldCom. In contrast the UK and many other countries have chosen a different response, which we believe to work well. This response has essentially been to review and improve upon a voluntary system, where capital markets act on information disclosed by companies in accordance with a code. This has helped to ensure good governance practice.

Both proposed OSC rules are brief compared with the very detailed rules of the SEC on these two areas. For example, rule 52-109 on certification of disclosure makes no attempt to define internal control or how to assess it. We assume companies will have to turn to the relevant SEC rules for clarification. We note that proposed rule 52-109 says it is acceptable to follow Sarbanes-Oxley section 302(a) in complying with rule 52-109 in respect of annual and interim report certification. This begs the question as to whether rule 52-109 is actually needed.

Under Canadian company law the whole board is responsible for the financial statements. These proposed rules place responsibility for financial statements on the CEO and CFO and we therefore question whether the proposed rules actually contradict company law.

We have considerable concerns over the proposed rule for certification of disclosure, which we consider to be conceptually flawed. This rule focuses on the financial reporting aspects of internal control, although using the term 'internal control'. This term, however, already has an accepted meaning, which encompasses all aspects of control to assist an organization in achieving its objectives. The proposed rule is likely to increase confusion over the meaning of internal control and discourage companies from adopting proper risk management practices which consider all significant risks, not simply risks to financial reporting.

We believe the proposed rule on audit committees will not necessarily lead to more effective audit committees because the rule focuses too much on composition and authority. We believe audit committees will perform better if they also report to shareholders on how they have discharged their responsibilities.

Certification of Companies' Annual and Interim Filings

GENERAL COMMENTS

The proposed rule gives no guidance on what internal control is or how it should be assessed. It implies the narrow definition of internal control which was recently promulgated by the SEC in accordance with Sarbanes-Oxley Rule 404. This is a retrograde step as previous guidance on internal control has used a much wider definition of internal control. In the absence of clarity in the OSC proposed rule on the meaning of internal control, our comments below are based on the definition given by the SEC.

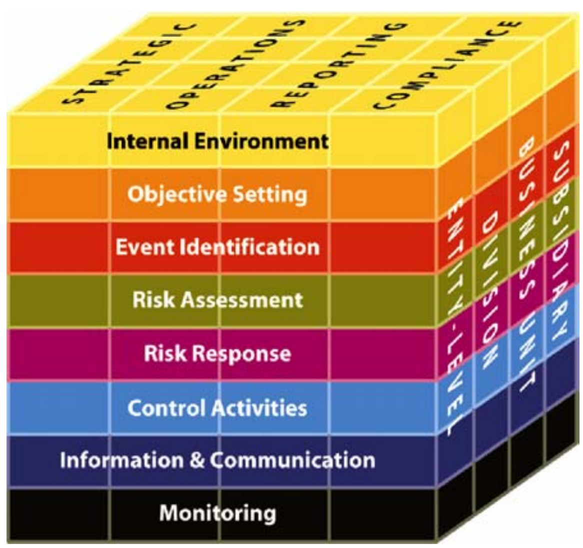
Previous authoritative guidance showed considerable consensus on internal control. Such guidance includes:

- the report of the US Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 'Internal Control – Integrated Framework'
- the guidance on the 'criteria of control', known as CoCo, published in 1995 by the Canadian Institute of Chartered Accountants
- the Turnbull Report in the UK
  and
- the King Code of Corporate Governance in South Africa.

These all adopted a much wider view of internal control, which considers all aspects of an enterprise's objectives and the risks which can affect the achievement of these objectives.

The European Commission (EC) also implied a similar understanding of internal control in its May 2003 communication on corporate governance. The return by the SEC and the OSC to a narrow financial view of internal control will result in a wide variety of approaches, which may mean that disclosures on internal control have little meaning. It may also serve to discourage boards from adopting a proper approach to risk management which covers the whole organization.

We reproduce below the framework for internal control and risk management that was proposed by COSO in their new guidance on enterprise risk management.



The top of the cube shows four categories of objective:

- strategic
- operations
- reporting
  and
- compliance.

Objectives, risk and internal control should be considered as a whole so as to encompass the big picture. The SEC definition of internal control, and the implied OSC understanding, look only at one category of objective — reporting.

Internal control, however, covers the whole of an organization. The board, in approving and authorizing directors to sign the accounts, already confirms that the accounts fairly present the financial position of the company and, of course, the auditor expresses his or her independent opinion. It could, therefore, be argued that disclosures on internal financial control alone are unnecessary as they say no more than that the financial statements are not misleading.

We also question when a board might disclose a material weakness. If, for example, management detect a major fraud, one might consider that there is a material weakness. However, if management nevertheless accounts correctly for any losses incurred, then no ‘material weakness in internal control over external financial reporting’ (to use the SEC terminology) would have occurred, so presumably no disclosure of a material weakness would be needed. Management could then report that internal control is effective, which clearly would be misleading to shareholders. Worse, it could even be (wrongly) argued that the discovery of the fraud was an example of effective rather than ineffective internal control.

It seems likely that boards would only disclose a material weakness when a prior period adjustment is required because of a concealed or undetected long running material weakness. Disclosure would of course only be made if, and after, the weakness is detected.

Taking a wider view of internal control as set out by COSO, CoCo and Turnbull, rather than considering only controls over financial reporting, will benefit and protect the business. An assessment of the wider aspects of internal control could, for example, identify a threat to the business which could cause the business to fail in say 18 months time unless appropriate action were taken. An approach which focuses only on internal control over external financial reporting is unlikely to detect the risk. If the company fails, provided the failure is correctly accounted for, internal (financial) control would be considered effective.

The SEC rule in relation to Sarbanes-Oxley Rule 404 places little emphasis on evaluating the control environment, even though this is a key aspect of internal control. The SEC focuses instead on lower level 'transaction type' controls. This lack of emphasis on the control environment may be because the control environment extends well beyond financial reporting to business operations and legal and regulatory compliance (which are the other aspects of internal control considered by COSO, CoCo, etc). It would be impractical, if not impossible, to consider the control environment only in relation to financial reporting.

We wonder why the OSC has chosen, unlike Sarbanes-Oxley, not to require external auditors to attest the statement.

In summary, we consider that the proposed rule is conceptually flawed and would suggest that the OSC should take this opportunity to build on best practice already developed elsewhere in the world rather than follow the US approach.

Notwithstanding our overall concern we set out below comments on individual aspects of the proposed rule.

RESPONSES TO SPECIFIC QUESTIONS

PART 1 - DEFINITIONS, APPLICATIONS AND TRANSITION

Transition Period

The one year transition is not appropriate as it would mean that the disclosures given in the first year are made without the officers having undertaken the processes to ensure they can properly make their certification. This is because the term 'based on my knowledge' offers sufficient scope for a CEO or CFO to say almost anything. Users of financial statements could therefore gain false comfort from any disclosure. The CEO and CFO will have sufficient knowledge to give a meaningful certification only after they have reviewed internal (financial) control. It would be better to say nothing on this matter during the transition period. As referred to above, we question whether this part of the proposed rule undermines existing Canadian company law, which makes the whole board responsible for the accounts.

Differentiation of Issuers

Large and small issuers should be treated equally.

PART 2 - CERTIFICATION OF ANNUAL FILINGS AND PART 3 - CERTIFICATION OF INTERIM FILINGS

Form of Reporting

The timing gap between the issue of financial statements and the issue of a certification on internal control would be a problem if there is a weakness in internal control. It would be preferable to file these documents at the same time and in the same document — the annual report.

Interim Evaluation

The interim certificate requires disclosure of significant changes in internal control or other factors. It is difficult to see how this could be certified without a proper evaluation of changes in internal control.

PART 4 THE CONCEPT OF FAIR PRESENTATION

Application of The Proposed Instrument to Certain Classes of Reporting Issuers

We note the remarks in the 'Request for Comment' regarding the situation where the results of a GAAP audit do not fairly reflect the overall financial condition of a company. This seems to be saying that GAAP and the external audit process can not be relied upon to ensure accounts fairly present the financial position of the company. This is a severe indictment of both GAAP and the audit process.

We recommend that Canadian GAAP be amended to include an overriding statement to ensure that the accounts do present fairly the financial position. We reproduce below, and commend, the approach adopted by the International Accounting Standards Board.

The International Financial Reporting Standards (2003), in its overall considerations, states that 'Financial statements should present fairly the financial position, financial performance and cash flow of an enterprise'.

It goes on to say that 'in the extremely rare circumstances when management concludes that compliance with a requirement in a standard would be misleading, and therefore that departure from a requirement is necessary to achieve a fair presentation, an enterprise should disclose:

a) that management has concluded that the financial statements fairly present the enterprise's financial position, financial performance and cash flows;

b) that it has complied in all material respects with applicable International Accounting Standards except that it has departed from a standard in order to achieve a fair presentation;

c) the Standard from which the enterprise has departed, the nature of the departure, including the reason why the treatment would have been misleading in the circumstances and the treatment adopted;

and

d) the financial impact of the departure on the enterprise's net profit or loss, assets, liabilities, equity and cash flows for each period presented.

We believe this approach would better serve the public interest than the solution proposed by the OSC because it would eliminate the possibility of a GAAP audit resulting in a clean audit of accounts which do not fairly reflect the overall financial position. The public is entitled to take an audit report at face value and should not need to be aware that the words 'in accordance with generally accepted accounting principles' can actually amount to being an exclusion clause.

Different Ownership Structures

If the public has a beneficial interest in the company the same principle (i.e. full transparency) should apply.

Definition of Internal Control And Disclosure Control

These terms have not been defined but should be. Criteria for evaluation should also be given.

As stated above, we would prefer a wider definition of internal control such as used in COSO, CoCo and Turnbull rather than the SEC narrow view.

It is also necessary to give guidance in the evaluation of effectiveness. The SEC implies that effective means 'free from material weakness.' This may be a simple definition but is hardly satisfactory. It is similar to saying that 'good' = 'not bad'. How would material weakness be assessed? In the UK, the experience has been that it is extremely difficult to define 'effective', which is one reason why boards have to report on their process for assessing effectiveness but do not have to disclose their opinion.

Audit Committees

GENERAL COMMENTS

As a general comment, the rule focuses too much on the composition and authority of audit committees. It does not attempt to address how they operate or how shareholders and other interested parties can assess their effectiveness, nor is it likely to ensure improvement in audit committee performance. In the UK, the Smith Report calls for the annual report to contain a section on the function of the audit committee, similar recommendations having been made for the EC. We recommend that the OSC adopt a softer approach, which would focus on disclosure of audit committee performance rather than just on its structure.

RESPONSES TO SPECIFIC QUESTIONS

PART 3 — COMPOSITION OF AUDIT COMMITTEE

Q. 1
We would prefer an approach which considers the threats to independence, and how these threats are safeguarded, rather than one which adheres to a rigid set of rules. Subsection 1.4(2) which says that 'a material relationship is one that could, in the view of the board, reasonably interfere with exercise of independent judgement' should refer to the board's informed view, after having considered all matters which could affect, or could reasonably be thought by others, to affect its exercise of independent judgement.

Q. 2a
Many other matters in addition to those cited in Subsection 1.4(3) could affect independence. These could include close personal friendships or business relationships between directors and executives of the company or with their major suppliers or customers.

Q. 3
Yes, the exemption in section 3.3 should appropriately address concerns of controlling shareholders.

Q. 4
The meaning of the term 'affiliated entity' is not clear. The exemption for controlled companies should stay.

Q. 5
The definition of financial literacy probably does not allow an issuer to assess a member adequately. It is clumsy and not very helpful.

Q. 6
The transitional exemptions are appropriate. No further exemptions are necessary.

PART 5 — REPORTING OBLIGATIONS

Q. 1
If the company does not disclose that it has a financial expert on the audit committee it either means that it does not have one or no one willing to be described as one. This could be a sensitive area, particularly in view of the liability risk for financial experts. We suggest there is no need to explain the absence of one, although companies could explain if they chose. This is an example of where principles are more effective than rules.

Disclosure and having interested (and active) stakeholders provide the best means of ensuring that audit committee members are effective.

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