June 2, 2005

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West, Suite 1900
Box 55, Toronto, ON
M5H 3S8

Mr. Stevenson:

The Institute of Chartered Accountants of Ontario and the Ontario Chamber of Commerce would like to commend the Canadian Securities Administrators (CSA) and the Ontario Securities Commission (OSC) for providing an opportunity for stakeholders to provide input on Multilateral Instruments 52-109 and 52-111. Our organizations feel it is our duty to help with this exercise by acting together as a conduit to put forward the views of Ontario's business community in advance of the finalization of these instruments.

With this submission, our organizations are bringing to your attention valuable recommendations based on the views of business leaders representing a wide array of industry sectors. While total consensus among a diverse group on such a complex subject is not possible, the recommendations contained in this submission capture the most prevalent views arising from the discussion.

By way of introduction, here is some pertinent background on our respective organizations:

- The Institute of Chartered Accountants of Ontario is the qualifying and regulatory body of Ontario's 31,000 CAs. Since 1879, the Institute has protected the public interest through the CA profession's high standards of qualification and the enforcement of its rules of professional conduct.

- The Ontario Chamber of Commerce represents over 57,000 businesses through 160 local Chambers of Commerce and Boards of Trade, and has been Ontario's business advocate since 1911. Its advocacy and policy initiatives focus on six areas key to the economic well being of the province: health; education; energy; finance and taxation; transportation and infrastructure; and border issues.

The submission we are filing is the result of a roundtable consultation held in Toronto on May 12, 2005 at the Institute of Chartered Accountants of Ontario. The Institute and the Chamber worked in unison to bring together a prominent group representing Ontario business leaders to evaluate and make recommendations regarding the regulations being proposed by the CSA. A complete list of participating organizations is attached to this document (see Appendix A).

The roundtable participants were very interested in the changes that the CSA is recommending, which would bring Canadian regulations closer to alignment with the U.S. rules set out by the *Sarbanes-Oxley Act* (SOX) Section 404. As you know, many Chartered Accountants are deeply involved in business activities already affected by SOX or that will be affected by these proposed changes, whether they are involved in public practice or working in senior finance positions in industry. The Institute is also very concerned with ensuring that the supply of CA professionals needed to handle this workload is available in both public practice and industry.

As for the Ontario Chamber's membership, many of the people and companies represented by the Chamber are either going to be affected by this regulatory change or have already been affected by the changes SOX Section 404 have driven in the United States.

Overview

It is important to state from the outset that all the participants at the May 12 consultation fully support the objectives of the proposed internal control rule, including:

- Improving the quality and reliability of financial reporting
- Bringing discipline to the financial reporting process
- Promoting a culture that emphasizes strong internal control
- Maintaining and enhancing the reputation of Canadian markets
- Appropriately balancing costs and benefits

Few could argue with the "spirit" of the suggested changes proposed by the CSA, or with that of the U.S. SOX legislation that preceded it. However, as has been seen in the U.S. implementation, getting the implementation right the first time is crucial to the success of the project.

As was made clear at the U.S. Securities and Exchange Commission (SEC) April 13 meeting with American business leaders, the introduction of a new regulatory environment is a challenging exercise that, if not handled correctly, can have negative repercussions for investors and businesses alike. In the U.S., the regulators, investors and business communities are now engaged in a process to fine-tune and improve SOX Section 404. This is a positive step, but one that comes after a year of turmoil and confusion since the rules came into effect. As you know, on May 16, the SEC responded to the views aired at the April meeting by issuing clarifications on the original intent of the regulations and promising further consultations aimed at improving them.

As the CSA based its new regulations on the original SOX Act's Section 404 and the approach to applying Section 404 may now be changing, it is important that any Canadian regulations or guidance be adjusted to both the "moving target" in the United States and the unique business environment of Canada.

That is why our organizations are pleased to have this opportunity to provide the insights and advice of business leaders in advance of these regulations being finalized. We believe this can be a very valuable exchange of ideas that will help protect investors while also helping the business community to continue to create shareholder value.

Consultation process

The purpose of the roundtable was to bring together a group of senior financial professionals (Chief Financial Officers, VPs Finance, etc.) from organizations that would be affected by changes to the regulatory environment. A complete list of the participating organizations is attached as Appendix A. Its membership included representatives with an interest in financial reporting and governance from the following sectors:

- Automotive
- Banking and financial services
- Electrical utilities
- Food processing
- High-tech manufacturing
- Insurance
- Pension funds

- Publishing
- Real estate holdings and development
- Retail
- Wireless communications

While the majority of participating organizations had more than 1,000 employees, several had fewer than 100. Nine participants came from companies traded on the TSX and in the U.S., but three were traded on the TSX only and seven were not publicly traded. The latter group attended with a focus on developing best practices for their organizations.

The meeting was facilitated by Progress Consulting's Scott Ferguson, B.Comm, CA, CMC. He was ably assisted by subject-matter experts recruited from national public accounting firms. The accounting firm representatives were involved solely to provide technical guidance to the industry participants, whose views are captured here. We thank them for their assistance.

During the course of the day, Mr. Ferguson facilitated a dialogue designed to allow participants to exchange views and propose recommendations on the tabled Multilateral Instruments 52-109 and 52-111, drawing from experts with experience on the effects of their U.S. counterpart *Sarbanes-Oxley Act* Section 404.

Participants were surveyed as individuals and in group situations to gather their opinions and recommendations for the CSA and OSC. Those opinions and recommendations have been captured to the greatest extent possible in this report. For a more detailed description of the consultations process, see Appendix B.

Observations

It is important to point out from the start that there was widespread agreement among participants that "something had to be done" in the wake of large-scale corporate failures such as Enron and WorldCom. Every participant either "agreed" or "strongly agreed" with that statement. Three out of every four also agreed that an appropriate response was to "improve disclosure of internal controls." Agreement that the Canadian and U.S. rules needed to be compatible was more than five to one in favour.

However, in a survey conducted at the start of the roundtable, all of our participants also agreed that the proposed Canadian Securities Administrators rules (52-111) and related auditing standards had either "swung the pendulum too far toward rigid controls" or was moving "toward rigid controls." For a number of participants, the certification of disclosure of 52-109 was seen as providing greater protection for the reputation of Canadian markets and substantial assurance for investors, with 52-111 also providing assurance, but at a greater cost in terms of time, expense and resources compared to 52-109.

It was generally agreed that the costs of implementing 52-111 in a manner similar to the way SOX Section 404 was implemented would outweigh benefits, which are also harder to measure than costs. The highest levels of concern were around the costs of documenting, assessing and testing controls; the risk of distracting attention from strategy and core business; and the overall the costs of audits and professional advice.

Significantly, many participants also worried that the regulations would give investors a false sense of security that these controls would prevent fraud.

Another concern was whether the supply of financial professionals, such as CAs, is adequate to meet the ever-increasing workload these new regulations might produce. Demand for top financial professionals in industry and at accounting firms is already straining the supply. Concern was expressed that workload would be a major problem and that companies seeking to comply with new regulations might not have the trained people available who could handle the demands of the work.

Our May 12 roundtable was held several days before the SEC and Public Company Accounting Oversight Board (PCAOB) made a number of clarifications regarding how SOX Section 404 should be interpreted and implemented (May 16). Much of the language used in their public communications echoed the comments of the roundtable, where participants called for “clarity,” “judgment,” “top down, entity-level focus,” “reasonableness,” “risk-based approach” and avoiding audits that are “check the box” exercises.

Recommendations

1. Extend the June 6 deadline for commenting on Multilateral Instruments 52-109 and 52-111, until June 30, 2005

Reasoning:

The changes to the Canadian regulations were proposed for a number of reasons but the primary ones were to keep our markets compatible and competitive with those in the U.S. and elsewhere. The SEC and PCAOB are indicating that they want companies and auditors to change the way they have been applying SOX Section 404 and have also indicated that their approach to applying Section 404 to foreign issuers and small companies may change.

We need to ensure Canadian rules are developed in a context in which we can compare them to the finalized U.S. rules to ensure they remain compatible. For this reason, anticipating that the SEC discussions will extend beyond the CSA’s comment period and at least through June, we recommend that the comment period be extended to June 30, 2005.

Benefits:

Even with the proposed extension of the comment period, the new regulations should still be ready for phased-in implementation by June 2006. Finalizing Multilateral Instruments 52-109 and 52-111 after the equivalent U.S. regulations are amended will ensure that the two markets have regulatory systems that are compatible. It also provides another chance for Canada to learn from and build upon the U.S. experience so we can improve financial reporting within a context that recognizes the unique conditions of the Canadian market.

2. The CSA and OSC should publicly commit to the same standards of compliance and enforcement that the SEC and PCAOB committed to on May 16, 2005

Reasoning:

The SEC and PCAOB are positioning the initial problems in the U.S. in implementing Section 404 of SOX as having been partially caused by a conservative approach by auditors and their clients. At the roundtable on May 12, a recurring concern was that the CSA and OSC were taking the same steps as the U.S. regulators and, therefore, that the new regulations might cause the same challenges of balancing costs and benefits for business in the Canadian context.

If this is a misperception on the part of the business community, the CSA and OSC should make this clear as soon as possible. This approach to implementing 52-111, coupled with the certification requirements of 52-109, will provide a substantial level of assurance to investors and the business community.

Benefits:
The SEC and PCAOB have taken the position that many of the perceived problems associated with SOX 404 could have been avoided if the financial community better understood the regulation and what was and was not required of them. One year into the process, they have undertaken communication and consultation initiatives to clarify the appropriate application of the regulations.

The CSA now has the opportunity to avert any similar problems here in Canada and make expectations clear before the implementation process begins. This will help better focus the efforts of management and auditors on the aspects of financial reporting that are most important, resulting in improvements to the quality and reliability of the reporting while more appropriately balancing costs and benefits. This proactive communication will certainly help maintain and enhance the reputation of Canada's capital markets.

3. The CSA and OSC should specifically commit to high-level principles that will help define the assessment process proposed under 52-111 for all concerned
Reasoning:
At the May 12 roundtable, participants agreed on a number of principles that, if adopted by the CSA and OSC, will help prevent the types of implementation problems experienced in the U.S. with SOX Section 404. These principles are reflected in the *Staff Statement on Management's Report on Internal Control over Financial Reporting* released by the SEC on May 16, 2005 (some of their language has been replicated here) and include:

- Management is responsible for determining the form and level of controls for each organization and the scope of their assessment and testing appropriately. One size doesn't fit all and control effectiveness is affected by many factors requiring distinct approaches by each organization.
- Management is to use a risk-based approach to control reviews and should ensure that the policies, Board oversight and auditing processes are designed to ensure proper "tone from the top," as this is where the highest level of risk resides.
- A central purpose of assessment of internal control over financial reporting is to identify material weaknesses that have more than a remote likelihood of leading to a material misstatement in the financial statements. Each company should use informed judgment in documenting and testing to obtain a reasonable level of evidence.
- "Reasonable" is defined as a high level of assurance but it doesn't mean absolute assurance, nor does it imply coming to a single conclusion or using a single methodology.
- Management and auditors should take a top-down and risk-based approach and avoid "check-the-box" exercises. Resources should be devoted to those areas of greatest risk to focus efforts and avoid wasted effort. Entity-level controls are of prime importance for external auditors, with process-level controls that do not directly impact financial reporting in a meaningful way best handled by internal audit and/or management.
- Independent auditors should use professional judgment when evaluating management's assessments and testing. The traditional Canadian "principles-based" approach to accounting and audit should be encouraged.
- Control deficiencies should be evaluated by: their nature; cause; the relevant financial statement assertion they were designed to support; effect on the broader control environment; and whether other compensating controls are effective. All material errors in reporting are not the result of material weaknesses and shouldn't be treated that way.
- Dialogue between auditors and management must continue as before and should not be affected by the proposed regulations.

Benefits:
As was the case with recommendation 2, it is crucial that the financial community understand how to best interpret these Multilateral Instruments.

The CSA has the opportunity to make expectations clear before the implementation process begins. This will also help better focus the efforts of management and auditors on the parts of financial reporting that are most important, resulting in improvements to the quality and reliability of the reporting while more appropriately balancing costs and benefits. Coupled with management certification and the criminal and civil consequences of non-compliance, this approach will maintain and enhance the reputation of Canada's capital markets.

4. Establish a Canadian equivalent to the Securities and Exchange Commission Advisory Committee on Smaller Public Companies
Reasoning:
As Canada has proportionally more small issuers than the U.S. market, it is important that the Canadian regulations are designed to help up-and-coming companies survive and thrive, while protecting shareholder interests. The SEC has recognized that the costs and burdens of complying with the assessment and reporting requirements are harder to sustain for small issuers and will be studying the issue.

A made-in-Canada approach, developed after and in light of the findings of U.S. consultations, is best, and will result in compatible approaches on both sides of the border. Canadian consultations to explore our unique marketplace should occur before the CSA rules for small public issuers are finalized. As these companies are not to be subject to coverage during the first year of implementation (2006), there is time to get the correct level of controls into place.

Benefits:
Smaller Canadian companies need to improve financial reporting as much as larger companies, but they have greater constraints based on their more limited financial and personnel resources. Recognizing those differences and acting appropriately would help them find the right balance of costs and benefits, while protecting investors. As Canada's markets have a higher percentage of small issuers than U.S. markets, protecting the best interests of these issuers should be a priority.

5. Reassure audit firms that the use of reasonable judgment will be recognized and respected by regulators
Reasoning:
Audit companies in the U.S. have been criticized for taking a conservative approach to implementing Section 404 that resulted in the expensive and time-consuming testing of process controls and retesting of controls already tested by management and internal auditors. One of the reasons the firms took this approach was the risk of being second-guessed by regulators if their approach was judged inappropriate. That could leave the auditors open to regulatory punishments and liable for damages. The SEC has since said that taking a top-down, risk-based approach employing reasonable judgment is appropriate.

In Ontario, where audit firms do not have protection of full-shield limited liability partnerships or proportionate liability legislation enjoyed by most competing jurisdictions, auditors are forced to balance the needs of their clients with the need to also protect their firms. Assurances of the regulators accepting good faith, professional judgment by auditors would help auditors understand and perform their job with more confidence and less risk.

Benefits:
All agree that the top-down, risk-based assessment approach, using sound professional judgment, will result in improved financial reporting and the best balance of costs and benefits for investors and the market. Assurances of fair treatment at the beginning of this process will help increase the comfort level of Ontario-based auditors in the absence of protective legislation found in other jurisdictions.

Summary
The CSA is making important changes to protect the reputations of Canada's capital markets. Canada's business community stands to benefit from the cautious and prudent manner that the CSA has taken in proposing these changes, as we are in a good position to learn from the U.S. experience and get our regulations, and the accompanying guidance for compliance, right the first time.

We still have time to analyze and adjust to changes occurring in the U.S., while modifying our rules to suit the unique conditions of the Canadian market. Implementing these recommendations will help the CSA and the OSC accomplish their primary objectives for initiating these changes in a timely manner that meets the needs of Ontario and Canadian business and investors.

On behalf of leading members of Ontario's business community, we thank you for the opportunity to submit recommendations on this important issue. If you require more information or clarification, as the facilitators of the roundtable consultation, we would be delighted to discuss any of these observations in greater detail with the staff of the CSA and/or OSC. Please feel free to contact us at your convenience.

Sincerely,

Brian Hunt, FCA
President and CEO
The Institute of Chartered Accountants of Ontario

Len Crispino
President and CEO
Ontario Chamber of Commerce

APPENDIX A

Participants in the May 12, 2005 roundtable consultation at The Institute of Chartered Accountants of Ontario

Sponsors

- The Institute of Chartered Accountants of Ontario - Brian Hunt, FCA, President and CEO
- Ontario Chamber of Commerce - Len Crispino, President and CEO

Roundtable Discussion Facilitator

- Scott Ferguson, B.Comm, CA, CMC – Progress Consulting

Participants included senior financial officials with direct compliance responsibilities from the following companies:

- AGF Management Ltd.
- Canada Bread Company, Ltd.
- Canadian Tire Corporation Limited
- Cygnal Technologies Corporation
- Danier Leather Inc.
- Hampton Equity Management Inc.
- J.J. Barnicke Limited
- Manulife Financial
- Maple Leaf Foods Inc.
- Mercedes-Benz Canada Inc.
- Ontario Municipal Employees Retirement System (OMERS)
- Oshawa Power & Utilities Corporation
- RBC Financial Group
- RioCan Real Estate Investment Trust
- Risk Diagnostics Inc.
- Research In Motion Limited
- ScotiaBank Group
- St. Joseph Communications
- TD Bank Financial Group
- Virgin Mobile Canada
- Xerox Canada Ltd.

Subject-matter experts were supplied by:

- BDO Dunwoody LLP
- Deloitte & Touche LLP
- Ernst & Young LLP
- KPMG LLP
- PricewaterhouseCoopers LLP

APPENDIX B

Progress Consulting™

Chartered Accountants of Ontario

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Getting It Right

Report of Comments on CSA Proposal

Multilateral Instruments on Reporting on Internal Control Over Financial Reporting

Ontario Business Roundtable Consultation – Toronto, May 12, 2005

Facilitator: D. Scott Ferguson, **B Com, CA, CMC**

Date: June 2, 2005

Progress Consulting™

Getting It Right

Report of Comments on CSA Proposals

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Getting It Right

Report of Comments on CSA Proposal

INTRODUCTION

Context

In February, 2005, the members of the Canadian Securities Administrators (CSA), other than British Columbia, published a Request For Comments for a 120 day comment period regarding:

- proposed Multilateral Instrument 52-111 ("rules") on reporting on internal control over financial reporting
- companion policy 52-111CP, also on reporting on internal control over financial reporting, and
- revisions to Multilateral Instrument 52-109 (to align it with the proposed 52-111) regarding certification of disclosure in issuers' annual and interim findings.

CSA issued these proposed instruments as the Canadian response to the corresponding Sarbanes-Oxley (SOx) rules in the United States.

The proposed Multilateral Instrument 52-111 is similar to, and in fact based on, SOx Rule 404.

The proposed Multilateral Instrument 52-109 is similar to, and in fact based on, SOx Rule 302.

Earlier in the year, the Canadian Institute of Chartered Accountants (CICA) published auditing standard regarding an issuer's Report on Internal Control Over Financial Reporting (ICOFR). This auditing standard is final, but not yet issued. It has been posted to assist commenters.

The Canadian audit standard ("standard") is similar to, and in fact based on, the U.S. Auditing Standard No. 2.

A Consultation of Senior Ontario Business Leaders

Two leading Ontario business organizations, the Institute of Chartered Accountants of Ontario and the Ontario Chamber of Commerce:

- recognized the importance of Ontario business leaders participating in the 120 day consultation, and
- believed that they had an important role to play to facilitate business leaders' involvement.

Accordingly, they:

- organized the roundtable consultation of prominent Ontario business leaders who have direct certification and compliance responsibilities regarding reporting on internal control over financial reporting
- recruited five volunteer practitioner experts to provide technical support
- provided an independent facilitator to design and lead the discussions, and
- supplied report-writing services to prepare a submission CSA on the participants' behalf.

This consultation comprised representatives from:

- Automotive
- Banking and financial services
- Electrical utilities
- Food processing
- High-tech manufacturing
- Insurance
- Pension funds
- Publishing
- Real estate holdings and development
- Retail
- Wireless communications

These companies vary in size. Most have more than 1,000 employees, although several have fewer than 100. Nine represented companies traded on the TSX and in the U.S., three are traded on the TSX only and seven others are not publicly traded. Those not publicly traded participated with a focus on developing best practices for their organizations.

Participants' stated reasons for taking part in the consultation were to:

- learn how many of their peers agree with the proposed Canadian rules
- understand how others are dealing with the reporting requirements
- exchange views while there is an opportunity to have an impact
- provide constructive feedback to CSA
- express and address their concerns about the disproportionate burden on small companies
- prepare for any differences between Canadian and U.S. approaches, and overall
- assist the CSA in *Getting It Right* in developing the Canadian rules.

Sponsors did not participate in the consultation itself. Their role was to facilitate the involvement of the issuers and potential issuers.

Intention of the Consultation

The intention of this consultation was to enable those who will be affected to provide input on the CSA proposals in the spirit of *Getting It Right*, particularly in light of U.S. experience in implementing SOx 404, which began with certain U.S. registrants' post-November 2004 year-ends.

It is the sponsors' hope that this consultation contributes beneficial input to the CSA and its development of appropriate Canadian rules regarding this new and important aspect of reporting.

Purposes of this Report

As mentioned, this document has been prepared in addition to the consultation's official submission to the CSA .

This report has been prepared by the facilitator as:

- a report to participants on the consultation itself
- a resource for participants in their role as issuers and potential issuers
- a resource for issuers in submitting their own comments directly to CSA as part of this consultation, and
- a record for the Institute of Chartered Accountants of Ontario and the Ontario Chamber of Commerce of the consultation that they sponsored.

Format

The format of this report follows the overarching goals of Canadian rules regarding ICOFR.

Throughout the document, footnotes contain issues and questions for issuers to consider as they develop their own comments to the CSA.

THREE OVERARCHING OBJECTIVES

This consultation was predicated on the basis that there are three overarching objectives of Canadian rules regarding reporting on ICOFR:

1. Protecting the Capital Markets
2. Achieving Comparability with U.S. Capital Markets
3. Balancing Costs with Benefits

CANADIAN CONSIDERATIONS

Canadian capital markets have many similar qualities as those of the United States. Similarly, many Canadian auditing firms that audit public companies have become highly integrated with the auditing approach and processes of their US operations.

Nonetheless, there are some characteristics of the Canadian markets that differ.

For example, the Canadian capital market is characterized by relatively more and smaller public companies. One reason for this is the existence of many small cap resource-based Canadian companies who do not have access to significant capital except through the equity markets. This difference is reflected in one remarkable statistic – that Canada represents:

- Less than 1% of the world's market capitalization, and yet
- Approximately 10% of the world's public companies.

The proposed rules do not mention or expressly address differences between the US and Canadian capital markets.

COMMENTS ON CSA PROPOSAL

Objective #1: *Protecting the Capital Markets*

Endorsement of Goals

Participants endorsed the overarching goals:

1. Protecting the Capital Markets
2. Achieving Comparability with U.S. Capital Markets
3. Balancing Costs with Benefits

The remainder of this report represents participants' views and recommendations as to how best to achieve these goals.

"Something Had To Be Done"

Participants were unanimous that:

- Enron, WorldCom and similar financial reporting failures shook public confidence in the capital markets, and
- "something had to be done" in order to regain public confidence.

Participants either "agreed" or "strongly agreed" that "something had to be done".

Focus on Reporting on ICOFR

The reforms regarding ICOFR affect two levels of control:

- entity-level controls, and
- process-level controls.

Three out of four participants agreed that an appropriate response to "the Enrons" was to focus on improving disclosure of internal controls.

Those who agreed believe that:

- disclosure regarding the quality of such controls provides the capital markets with a stronger sense of the reliability of an issuer's financial reporting,
- which is important information for the markets to assess the value of an issuer and its desirability as a recipient of capital.

Those who disagreed endorsed the importance of internal controls over financial reporting, however:

- are unsure whether the investor community can fairly, consistently and adequately absorb and evaluate such complex disclosure, and
- perceive that the "appropriate response" to large-scale financial reporting failures is already substantially achieved through previous reforms such as the certification requirements under SOx 302 and Multilateral Instrument 52-109.

Improving Financial Reporting In Canada

Participants were asked whether an enhanced focus on reporting on ICOFR will significantly improve financial reporting in Canada. Participants were of two views. Those who agreed believe that ICOFR is important information that should be provided to the capital markets. Those who disagreed believe that the quality of financial reporting is substantially derived from:

- reporting and audit requirements that existed prior to the reforms, and
- the impact of the previous reforms such as the certification requirements, as mentioned above.

Boosting Investor Confidence

Similarly, and for the same reasons, participants were divided as to whether these reforms will significantly boost investor confidence. Those who disagreed point to the market's reaction to issuers who have disclosed material weaknesses in ICOFR under SOx 404. In many cases, the issuer's stock price was affected temporarily or insignificantly, suggesting that the additional disclosure, even when adverse, does not necessarily have a significant impact on the market's assessment of an enterprise.

Preventing Future "Enrons"

Participants were asked whether an enhanced focus on reporting on ICOFR will significantly protect against future financial reporting failures such as Enron.

As they did with the previous questions, participants formed their response by focusing on the marginal (i.e., "additional") benefits of reporting on ICOFR over and above previously existing and recently added financial reporting safeguards.

Based on this logic, some believe that the reforms will indeed significantly protect against a repetition of the kinds of financial reporting failures that created the demand for SOx 404 and 52-111 in the first place.

However, many participants were either unsure or disagreed.

The debate focused on the rules' extent of detail, particularly the requirement that management's evaluation include *all significant accounts, disclosures and related assertions.* About this, there are two schools of thought.

One view is that this extent of detail is required because:

- the "rot runs deep" in companies that perpetrate the extent of fraud that was characteristic of companies such as Enron, and/or
- "fraud" is not the only cause of significant financial reporting failures and that a detailed focus on process-level controls is also necessary to guard against material misstatements caused by "errors".

The opposing school of thought argues that:

- the fraud that is characterized by Enron and similar financial reporting failures "took place at the top" and did not originate in detailed financial reporting processes
- Enron-calibre fraud, and in fact any fraud, is by its nature, designed to be undetected and unprevented by internal controls
- these factors suggest that there is a distinct possibility that there will be financial reporting failures in the future, including some by companies who issue a "clean report" on ICOFR
- such a reporting failure in the future, of an issuer with "a clean report", will suggest to some that the reporting requirements on ICOFR do not, in themselves, adequately protect against major financial reporting failures, and therefore

- these reforms do not provide a significant marginal benefit, at least relative to the costs, in meeting Objective #1: *Protecting the Capital Markets*.

The Pendulum Has Swung too Far

All participants believe that SOx 404 and Multilateral Instrument 52-111 and the related audit standards have swung the pendulum "toward" excessively rigid requirements, particularly relative to their marginal contribution to protecting the capital markets.

Evaluation of Alternatives

Participants reviewed CSA's assessment of the six alternatives it considered in proposing Multilateral Instrument 52-111:

1. Status quo
2. No internal control audit report
3. Less prescriptive auditing standards
4. More limited application
5. Evaluation of entity-level controls only, and
6. Voluntary compliance.

Rejection of Alternatives #1 and #6

Most participants agree with CSA's assessment of (and therefore rejected) alternatives:

1. Status quo, and
6. Voluntary compliance.

Many participants believe there are merits within the other alternatives for protecting the capital markets that should be reconsidered.

Alternative #2: Internal Control Audit Reporting

CSA rejected the "no internal control audit report" alternative because investors would find it difficult to assess and compare the quality and results of issuers' evaluation of ICOFR and accordingly may have less confidence in the issuers who follow the Canadian rules and in the Canadian capital markets.

However, some participants believe that the auditors' report on financial statements itself indicates sufficient reliability of the internal controls over the preparation of those financial statements, and that a separate ICOFR audit opinion is not necessary.

Another option is to have the auditors report on ICOFR in a different format. At present, there is a two-part auditors' opinion:

- an opinion on management's process to evaluate ICOFR, and
- an opinion on the controls themselves.

Some believe that the capital markets would be adequately protected by a combination of:

- management's report and evaluation on ICOFR, and
- an external opinion strictly on management's process to arrive at its self-assessment.

Given the inherent limitations of the reforms to protect against financial reporting failures (outlined above), this alternative may provide sufficient marginal protection at a significantly lower cost.

The issue of costs and benefits is addressed in more detail later in this report.

Alternative #3: Less Prescriptive Auditing Standards

As mentioned, CICA has substantially adopted the terms of U.S. Auditing Standard No. 2.

Participants believe that there is merit in reconsidering the proposed Canadian auditing standard from two perspectives:

- scope, and
- application.

Regarding the scope of the standard, one alternative would be to focus the external audit on higher risk areas such as entity-level controls[1]. Management would still be responsible for designing and evaluating adequate entity-level and process-level controls. However, the cost of the audit requirement would be substantially reduced while nonetheless providing the capital markets with an auditors' opinion on those types of controls that many believe have the greatest likelihood of "preventing another Enron".

Regarding the application of the standard, feedback on the U.S. experience is generating a widely held perception that the standard itself is characterized by:

- "rules-based" auditing
- "tick the box" exercises, and
- coverage-based auditing rather than a risk-based approach.

Deeper analysis reveals that the U.S. and proposed Canadian auditing standards are not, per se, quite as prescriptive as many believe. However, the provisions for the inspection of auditors seem to give rise to the rigid approach that many U.S. issuers are experiencing. For example, the PCAOB in the United States will be inspecting auditors based on, in part, consistent application of the auditing standard:

- among firms, and
- among audits conducted by the same firm.

This puts significant pressure on auditing firms to demonstrate consistency.

Consistency is most difficult to achieve when an auditing standard is fairly new. Accordingly, there is an inherent pressure for auditing firms to emphasize consistency, at least in their initial experience with this very new form of auditing.

As a result, many issuers complain that:

- they initially adopted a risk-based approach to their evaluation, only to discover that their auditors would only find a coverage-based approach to be satisfactory
- the audit of ICOFR was not sufficiently integrated with the audit of the financial statements themselves, and/or

[1] During this consultation, a point was raised that entity-level controls, while likely more effective (at protecting the capital markets) than process-level controls, may not as easily lend themselves to the gathering of objective evidence, and that the evidence requirements of the rules and standard may unreasonably limit the extent to which reliance can be appropriately placed on entity-level controls. Although this point was raised, it was not fully explored. In developing their own submissions to the CSA, participating companies may want to consider this issue.

- the limitation on the auditors' use of the work of management, and particularly the internal auditors, is unreasonably restrictive, at least in the manner in which is being applied[2].

All of these concerns are expressed within the context of taking only necessary and the most effective steps to protect the capital markets.

Many auditors understand, and largely agree with, managements' concerns. During this consultation, auditors told participants that their initial experience with SOx 404 revealed many areas for improvement and that they are keen to rapidly climb "the learning curve" in this new and complex form of auditing. Furthermore, at the April 13th Roundtable in Washington regarding SOx 404, auditors officially assured management that they will endeavour to take more of a risk-based approach that is more fully integrated with the financial statement audit.

Given these considerations, many participants believe that there are opportunities to improve the scope and application of the audit requirements, while still protecting the capital markets, and that these opportunities should be considered.

One recommendation is that there should be "less guidance for issuers and more guidance for auditors", particularly assurance by the inspecting organizations that auditors are permitted, and in fact encouraged, to apply professional judgement in their audits. In this regard, professional judgement means that two reasonable auditors can look at the same circumstance (e.g., whether a finding represents a "significant deficiency" or "material weakness") and possibly draw two different conclusions, neither of which would necessarily be considered to be "wrong". The inspecting agencies can contribute to a less prescriptive application of the auditing standard by encouraging, or at least providing guidance regarding, the application of such judgement.

Such guidance might significantly open the opportunity for the Canadian auditing standard (and indeed the proposed CSA rules) to adopt more of a principles-based approach. (Compared to the U.S., Canadian GAAP and GAAS adopt a relatively more principles-based approach.) Many Canadian commenters, both in this consultation and in others, question why a principles-based approach would be appropriate for Canadian GAAP and GAAS but not for reporting on ICOFR. Furthermore, many proponents of principles-based reporting and auditing believe that it produces better quality and therefore would provide better protection of the capital markets.

Alternative #4: More Limited (or Different) Application

CSA rejected this alternative primarily due to the practical and transparency concerns that arise from developing different standards for different sized companies who are competing in the same capital markets.

Participants understand these concerns however, many point to the substantial feedback that the costs of compliance are disproportionately higher for smaller companies. In fact, the rules themselves are simply not practical for some smaller companies that do not have sufficient resources to build in, for example, the extent of segregation of duties that the rules require.

Furthermore, the rules do not recognize that some entity-level controls and auditing procedures are particularly effective at determining the reliability of financial reporting in smaller enterprises.

Given these factors, the capital markets would not be well served if these rules discouraged worthy companies from raising equity capital, a risk that would be more acutely felt in the Canadian capital market with its relatively greater number of small cap public companies compared to the market in the United States.

[2] During this consultation, the appropriate extent to which auditors should be able to rely on the work of others, particularly the work of internal auditors, was not fully explored. In developing their own submissions to the CSA, participating companies may want to address this issue.

Accordingly, limited application of the rules should be reconsidered.

At least one participant raised another concern. The rules capture small issuers of equity but do not necessarily recognize large issuers of debt. For example, there are issuers of many billions of dollars of debt who, because of a relatively small market capitalization as of June 2005, that do not become subject to the rules until 2010. This is an aberration to be reconsidered.

Alternative #5: Evaluation of Entity-Level Controls Only

Participants considered CSA's concern that restricting the scope of the evaluation to entity-level controls may create difficulty for investors to compare the resulting ICOFR report with those from companies that adhere to SOx 404. However, in pursuing the protection of capital markets, many participants believe that entity-level controls should, at the very least, be *emphasized*.

Canadian commenters in this and other consultations consistently express the view that the greatest protection of the capital markets, or alternatively the greatest risk, emanate from entity-level controls such as the "tone from the top" (intolerance for unethical behaviour), whistle-blowing protection and similar pervasive controls.

Entity-level controls can be emphasized in at least two ways:

- by placing more emphasis on entity-level controls (and less emphasis on process-level controls) in management's evaluation, and therefore in the auditors' scope, and/or
- by restricting the scope of the audit to management's evaluation of only the entity-level controls, as mentioned in Alternative #3 above.

Participants are pleased to see that CSA considered the issue of "practicality" in assessing various alternatives. However, some believe that there is a very practical issue that the proposed rules may not adequately address. Within many issuers, there is:

- a commonly held view that entity-level controls are most significant in protecting the capital markets, and
- cynicism that so much of the effort required to fulfill the rules becomes focused on the relatively less significant process-level controls.

At a micro-level, such cynicism within an issuer undermines the corporate tone that is most conducive to the protection of the capital markets.

At the macro-level, a disproportionate investment of effort that focuses on the less significant class of controls creates the risk of a false sense of security within the capital markets, which, at the extreme, would be a misconception that these rules are so rigorous and extensive as to prevent all significant fraud. As mentioned elsewhere in this report, fraud, by its nature, is designed to elude internal controls.

Four Additional Alternatives

Some participants recommend alternatives to:

- the singling out of IT controls (i.e., IT controls should be addressed cyclically or amongst higher risk business units)
- 100% annual re-evaluation (i.e., cyclical testing may provide adequate protection of the capital markets)
- interim materiality considerations (i.e., that materiality should be based on annual reporting), and
- the restrictiveness of the auditors' use of the work of management and others, particularly the work of internal auditors (i.e., that auditors can apply more reliance without a significant reduction in the effectiveness of the audit).

Application of Judgement

Participants acknowledge that there are opportunities within the rules and the auditing standard for both management and the auditors to apply judgement.

For example, management can apply judgement over the:

- scope of evaluation framework
- scope of management's evaluation (as long as the seven specified categories of controls are addressed)
- evaluation, design and methodology, based on a requirement that the design and methodology merely be "sufficient"
- extent of integration of management's evaluation with the company's existing risk management approach, and
- the content of evidence (as long as it meets the prescribed "minimum" standard) and how the evidence is stored (as long as the evidence is "accessible").

External auditors have opportunities to apply judgement regarding:

- sufficient, appropriate planning, scope and evidence
- the sufficiency of management's documentation, nature and extent of testing
- the extent of auditors' use of the work of "others"
- the evaluation of deficiencies and determination of material weaknesses
- extent and timing of substantive auditing procedures, and
- the extent of auditors' communication with management on ICOFR and accounting matters.

However, participants expressed concern that, for many of these areas of judgement, "the bar" has been set so high as to preclude the extent of judgement that is sufficient and appropriate to protect the capital markets. Further comments regarding guidance for auditors on the use of professional judgement are mentioned above.

Exemptions[3]

Participants noted that there are exemptions to these rules for:

- issuers for whom the transition timetable does not yet apply
- members of the TSX Venture Exchange
- those entities that meet U.S. requirements, and
- other specified exemptions.

[3] This consultation did not include a detailed discussion of exemptions. In developing their own submissions to the CSA, participating companies may want to address this issue, particularly the appropriateness of exempting members of the TSX Venture Exchange.

COMMENTS ON CSA PROPOSAL

Objective #2: *Achieving Comparability with U.S. Capital Markets*

The Need For Comparability

For the most part, participants believe that the rules and auditing standards that apply to the Canadian capital markets need to provide a comparable level of assurance to investors. In fact, participants expressed this opinion in the ratio of more than four to one "in favour".

However, most participants do not believe that this level of comparability should necessarily be achieved by a "lock step" approach to adopting the U.S. rules and standards in Canada, particularly in light of:

- Concerns, expressed in the previous section, over the rules' and standards' effectiveness in providing significant marginal increased protection of the capital markets
- Differences between the characteristics of US and Canadian capital markets ("Canadian considerations"), and
- The indication from the SEC and PCAOB that there will be revisions to the U.S. rules and standards, or at least to their application, in response to feedback on issuers' and auditors' initial experience with SOx 404.

Three Options

Participants considered three approaches regarding comparability with U.S. capital markets:

1. Canadian rules and standards that are substantially the same as those in the U.S., being the approach proposed in 52-111 and the CICA auditing standard
2. Canadian rules that are same in standard, but not necessarily the same in form, such as the adoption of principles-based Canadian rules and auditing standard, as mentioned above, and
3. Canadian rules and auditing standard that focus on those aspects of control and reporting that are most effective at providing protection of the capital markets – rules and a standard that may not be as highly valued by investors as SOx 404, but yet would provide issuers with the opportunity to "step up" to the U.S. standard while, in the meantime, providing Canadian issuers with the most effective sources of assurance and a better balance of benefits and costs.

The second alternative provides opportunities to create a made-in-Canada approach that addresses the limitations expressed in the previous section regarding the protection of the capital markets.

The third alternative provides even more opportunities to address those limitations.

COMMENTS ON CSA PROPOSAL

Objective #3: *Balancing Costs with Benefits*

Various Costs and Benefits

Participants considered various types of costs and benefits:

- Macro: market-level costs and benefits
- Micro: issuer-level costs and benefits, both direct and indirect.

Macro-Level Benefits

Participants recognize that the hoped-for benefits for the capital markets include:

- enhanced focus on internal control over financial reporting
- improved quality and reliability of financial reporting
- enhanced confidence in the capital markets
- alignment with the U.S. regulatory system, and
- leveraging off U.S. lessons and guidance (so long as the rules and standards in Canada are similar).

Macro-Level Risks

Participants also recognize that these rules and standards carry certain macro-level risks such as:

- markets' false sense of security such as a misconception that these rules and standards necessarily prevent all significant fraud, and
- companies de-listing, listing elsewhere or not entering the capital markets in order to avoid the costs.

Micro-Level Benefits

Participants recognize that there are several potential benefits to issuers, such as:

- being competitive in terms of access to capital markets
- being competitive in terms of cost of capital
- reduced risk of loss due to fraud or failure
- improved information for decision-making
- more effective, efficient reliable financial reporting
- stronger boards and audit committees
- better protection of assets
- finding opportunities to improve and consolidate business processes, and
- the ability to be ready and able at any time to describe the state of control.

Micro-Level Costs

Participants recognize that:

- there are both initial and ongoing costs
- initial costs will exceed ongoing costs
- initial costs, at least in the U.S. experience with SOx 404, were higher than expected, and
- costs are disproportionately higher for smaller issuers, complex businesses or highly decentralized operations.

Issuers' direct costs include:

- the initial cost of selecting and applying an appropriate Control Framework
- the initial and ongoing costs regarding controls such as documenting (or updating documentation), assessing (the design), testing (the effectiveness) and documenting (the testing and the evidence)
- professional advice and assistance, especially initially
- premiums paid to experts, both internal and external who are in high demand, particularly initially, and
- additional audit costs, especially initially.

Participants also recognize issuers' significant potential indirect costs, such as:

- distraction from strategy and core business
- diversion of talent and other resources, and
- reduced or slowed nimbleness such as the need to revise the design and documentation of controls as business processes are improved and revised.

An Imbalance of Costs and Benefits

Participants were virtually unanimous that the costs of implementing the new rules and auditing standards would outweigh the benefits.

For the most part, participants perceive that the potential benefits are "moderate" at best. Several participants believe that several of the intended benefits will turn out to be "insignificant".

The benefits that have the greatest likelihood of being "significant" appear to be:

- alignment with the US regulatory system
- the ability to leverage off US lessons and guidance
- more effective and efficient reliable financial reporting, and
- stronger boards and audit committees.

They are particularly concerned about the costs of:

- documenting, assessing and testing controls, particularly process-level controls
- distracting attention from strategy and core business, and
- the overall additional costs of audits and professional advice.