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Canadian Securities Administrators

Alberta Securities Commission
Manitoba Securities Commission
Autorité des Securities Commission
New Brunswick Securities Commission
Office of the Attorney General, Prince Edward Island
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut
Saskatchewan Securities Commission
Ontario Securities Commission
Nova Scotia Securities Commission
C/o John Stevenson, Secretary
Ontario Securities Commission
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Suite 1900, Box 55
Toronto, Ontario M5H 3S8
Fax :(416) 593-2318
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Dear Sir/Madam, **Re: Reporting on Internal Control over Financial Reporting**

The purpose of this letter is to set out the thoughts that I expressed, at sessions held in Calgary and Toronto, on the proposed new legislation regarding auditing of internal controls. In addition, I am making some suggestions from the excellent advice that came out of the sessions.

We now have the benefit of the U.S. experience using legislation, which is virtually identical to the Canadian proposed legislation. The implementation in the U.S. has resulted in costs that are much higher than expected and at best the implementation has been overdone by its attention to detail and not using a risk based top down approach. The SEC, following a roundtable discussion with participants, commented as follows:

> **"Top-Down / Risk-Based Assessments**
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> The feedback indicated that one reason why too many controls and processes were identified, documented and tested was that in many cases neither a top-down nor a risk-based approach was effectively used. Rather, the assessment became a mechanistic, check-the-box exercise. This was not the goal of the Section 404 rules, and a better way to view the exercise emphasizes the particular risks of individual companies. Indeed, an assessment of internal control that is too formulaic and/or so detailed as to not allow for a focus on risk may not fulfill the underlying purpose of the requirements. The desired approach should devote resources to the areas of greatest risk and avoid giving

all significant accounts and related controls equal attention without regard to risk."

It is hard to believe that misreading the legislation could have caused such an unintended result. We also heard it is unlikely that the U.S. legislation will change because of political consideration but will be changed by a process of guidance and interpretation of the legislation. In Canada we have no similar problem and the Canadian legislation needs to be significantly redrafted so that the intent can be clearly set out.

The U.S. will continue its multi billion dollar learning experience, which will influence the same auditors as in Canada. At least we should let this settle out by ensuring that the earliest we implement is at least a year later than that afforded Canadian foreign private issuers. The same staggered process should be continued based on size.

The challenge that emerged from our discussions in Toronto was to move the Canadian system, not to where the U.S. is, but rather to where it should be going. Like Wayne Gretzky, the great skill was not going to the puck but going to where it would be. Likewise we have that same opportunity.

We heard much about the U.S. flawed implementation and its failure to focus on the main issue - fraudulent manipulation by senior executives. It is interesting to ask; " now that have the answer in the U.S. what was the question? The answer in the U.S. was a highly detailed and documented internal control exercise. It did not directly address the main issue - fraud by senior executives, and we heard much about the misplaced emphasis on detail and documentation. Costs were multiples of expectations and the greatest burden was on the smaller entities. Materiality and risk seemed to have been largely ignored. The roundtables and subsequent advice said it needed a top down risk based approach. It is hard to believe so many misinterpreted the requirements of the law. Equally, institutional practice will likely prevent this from becoming a reality without a change in law. How will the auditors with reputations at stake, do less and that with less documentation, especially as they are audited by their peers.

The implications for Canada are profound. All of the larger Canadian companies are interlisted and will be caught up by the requirement. The remainder in Canada are much smaller and unless we reform our approach will be caught by the misplaced requirement on detail and documentation while still not addressing the core issue of fraudulent manipulation at the top.

The original intent in the U.S. was to deal with the problems where controls were avoided at the CEO / CFO level. It is recognized that laws will not prevent deliberate intent to deceive. Just as laws against murder do not prevent the crime. Our emphasis should be on prevention and to continue to focus on the entity controls that are in the best position to flag and prevent intentional manipulation of information.

In Canada we have gone far in reforming of corporate governance practices. Many would say we are more advanced than the U.S. Rather than blindly following the U.S. and its wasteful diversion let us focus. on where the abuse can exist and be detected.

Accordingly focus. on entity controls provides a real opportunity for Canada to get it right. It would deal with a top down risk based approach by definition. Equally, it would recognize the nature of the population of companies that are not now caught by the U.S. rules. It would put the emphasis where it belongs. It could save a mandatory diversion of effort to focus on essential corporate controls. It would leave any need to comply with the evolving U.S. standards until after the broken bones are mended and markets can assess where the benefits truly lie. In the meantime, the focus should prevent the intentional abuse, which is what the issue was in the first place.

If we focused on a top down risk based approach for internal controls with emphasis on entity controls, we might get to where the U.S. will get to, but without the detours and with a sounder legislated framework.
Because of the importance of this issue I would encourage the regulators, in response to the input they have received, to develop a new proposal for further public discussion. I suggest it would have the following principles

-Top down risk based approach
-Greater emphasis on entity controls
-Further staging delay to permit U.S. experiences to be solidified and to recognize the current U.S. timetables for foreign private issuers
-Staging for smaller entities to accommodate additional work being done on control framework for smaller entities

Maybe in Canada we can get to where the puck will be and truly answer the core question without the wasteful expenditure of scarce resources.

Yours sincerely

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