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June 30, 2005

Dear Mr. Stevenson/Ms. Beaudoin:

**Response to Proposed Multilateral Instrument 52-111 and Companion Policy 52-111CP  
Reporting on Internal Control Over Financial Reporting**

We appreciate the opportunity to comment on the Proposed Multilateral Instrument 52-111 and Companion Policy 52-111CP *Reporting on Internal Control Over Financial Reporting* (the Instrument) and are pleased to provide our comments and suggestions herein.

The stated objective of the instrument is "...to improve the quality and reliability of financial and other continuous disclosure reporting by reporting issuers...this in turn will help to maintain and enhance investor confidence in the integrity of our capital markets.". We concur with this objective and believe that, on the whole, the proposals made by the Canadian Securities Administrators (CSA) and the Ontario Securities Commission (OSC) are a positive step toward that end and will drive improvements in the ability of issuers to prepare reliable financial statements..

We also wish to commend the CSA and OSC for the manner in which they have drafted the Instrument. Although there are substantial similarities in content between the instrument and the materials promulgated by the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB), we found the instrument to be clearer and more logically presented than that of your US counterparts.

When discussing the importance of the Instrument, it should also be noted that many of the important elements of internal control over financial reporting (ICOFR) will help to prevent or detect fraud. Codes of conduct, whistleblower protection, controls around management override and HR policies

and practices all contribute to creating a culture in North American companies where financial reporting related fraud is less likely to manifest itself. While not an absolute deterrent, having companies focus on these areas of ICOFR can only improve their performance in reducing the instances of fraudulent financial reporting.

We have categorized our detailed comments regarding the Instrument into the following sections:

- Significant Observations (provided in the body of this letter below)
- Minor Observations (provided in Appendix A)
- Responses to questions specifically posed by the CSA and OSC (provided in Appendix B)

### **Significant Observations**

#### ***Harmonization with the SEC and PCAOB***

As previously noted, the Instrument is substantially similar in content and purpose to the rules and standards established by the SEC and PCAOB. We concur with this approach and believe it is important to continue the development of parallel rules and standards going forward. Harmonization with the US approach to ICOFR helps preserve the multi-jurisdictional system that exists between our two countries.

The SEC and PCAOB have issued additional implementation guidance concerning ICOFR in the form of policy statements and frequently asked questions. If we maintain rules and standards in Canada that are consistent with those in the US, reporting issuers in Canada will be able to leverage this guidance in their ICOFR assessments. In particular, we believe that the recent information from the SEC and PCAOB goes to the core of the issues that increased costs and frustration last year in the US. Toward this end, we believe it is critical to the successful implementation of the Instrument that the CSA and OSC establish a group whose responsibility is to review US implementation guidance and (as appropriate) endorse the views therein for use by Canadian reporting issuers. We also recommend that the Canadian Institute of Chartered Accountants be encouraged to establish a similar group to assess guidance issued by the PCAOB specific to auditors. If the recent guidance can be embraced by all parties involved in achieving the objectives of the instrument, we may well avoid in Canada what we agree were excessive costs to US issuers.

There has been some discussion concerning whether guidance developed by the US should be incorporated explicitly into the Instrument in Canada. The profile of this option has been raised recently by the issuance of additional guidance by the SEC and PCAOB as a result of their round-

table discussions held on April 13 of this year. We wish to point out that the issues raised during the round-table discussions dealt with the interpretation of the rules and the practicalities of their implementation. As such, both the SEC and PCAOB concluded that the rules and standards as written are sound and do not require change or modification. Instead, they will continue to issue guidance on implementation that should be read as a supplement to the rules and standards.

We concur with this approach and believe that the Instrument as written is consistent with this view. By separating the implementation guidance from the rules and standards, regulators and standard setters will be better able to respond with guidance on a timely basis to address evolving practices and interpretations of the rules and standards as they are developed by management and auditors “in the field”.

#### ***Smaller Public Companies***

The SEC has established an Advisory Committee on Smaller Public Companies in order to examine the concerns expressed by smaller reporting issuers in complying with the ICOFR rules. Concurrent with this, the Committee of Sponsoring Organizations (COSO) has been re-commissioned in order to study the application of control frameworks within a smaller company environment.

We acknowledge and applaud the CSA and OSC’s awareness of the importance of this issue in Canada as demonstrated by the phased implementation approach proposed in the instrument. We strongly suggest that the CSA and OSC use the time provided by this phased approach to actively investigate the smaller public company issue. Specifically, we strongly encourage the CSA and OSC to be actively involved in the work being done in the US. We also recommend that a committee be established in Canada to address the concerns of smaller public companies that are unique to the Canadian business environment.

#### ***Disclosure Controls and Procedures***

We are concerned about the overlap between the evaluation of design of ICOFR in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers’ Annual and Interim Filings* and the assessment of ICOFR that is required under 52-111. Specifically, in instances where the reporting issuer is required to provide a full annual certification under 52-109 but is NOT yet required to comply with 52-111, form 52-109FVT1 requires management to certify that,

*The issuer’s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have... designed such **internal control over financial reporting** [emphasis added], or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of*

*financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP...*

With the current level of guidance, it is unclear to companies what they have to do (if anything) to support their CEO/CFO certification as to design of ICOFR for 52-109. This confusion is exacerbated by the lack of guidance relative to any evidentiary requirement under 52-109. Although we appreciate that the nature and extent of work supporting the certification has been left to management's judgment, some guidance in that regard would be useful considering that in some instances a company will be certifying as to the design of ICOFR in 2006 and yet not have to perform an evaluation of ICOFR until as late as 2009.

We also wish to point out that there is currently no objective standard in place that measures the effectiveness of disclosure controls and procedures. It seems that the only test of these controls would be when a failure occurs and, in our mind, that is too late. We recommend that the CSA and OSC launch, or encourage the SEC to launch, a study on disclosure controls and procedures for the purpose of developing guidance around what is considered a desirable control structure. Concurrent with this study, a similar investigation of disclosure controls and procedures in small public companies should also be undertaken.

### ***Market Capitalization***

The Instrument provides for the phased implementation based upon the market capitalization of the reporting issuer. We are encountering a number of questions from reporting issuers regarding the composition of "market capitalization". Given the importance of this calculation to the timing of reporting issuer compliance, we recommend that the Instrument be expanded to provide a more detailed discussion of the calculation of market capitalization.

### ***Role of the Audit Committee***

We wish to point out that there is specific guidance around the role of Audit Committees in the review of audited financial statements, recommending financial statements for approval by the Board of Directors and in the oversight of the work of external auditors. However, there is no similar guidance around the role of Audit Committees as it pertains to an audit of internal control over financial reporting. We recommend that the CSA and OSC undertake to provide guidance in this area.

\* \* \* \* \*

We would be pleased to discuss any questions or comments you may have with respect to this letter. To do so, please contact Axel Thesberg (416-777-3882), Mark Davies (416-777-3805) or Jim Newton (416-777-8319).

Yours very truly

A handwritten signature in black ink that reads "KPMG LLP". The letters are in a cursive, slightly slanted font. Below the signature is a long, horizontal, slightly wavy line that extends to the right.

KPMG LLP  
Chartered Accountants

cc Mark Davies  
Bill MacKinnon  
Michael Meagher  
Jim Newton  
Axel Thesberg  
Paul Weiss

## **Appendix A: Minor Observations**

- Nowhere in the Instrument is it stated that, should the reporting issuer have a material weakness in their internal control over financial reporting, they would conclude that internal control is ineffective. Although the proposed CICA standard indicates that this is the case, we believe that reporting issuers should not have to refer to the auditing standard on this matter. There should be an explicit reference to this conclusion in the Instrument.
- Section 1.1 defines an “internal control audit report” to include a report that “states that an opinion cannot be expressed”. Consideration should be given to whether issuers should be allowed to file a denial of opinion. This may mean that management has not completed its evaluation and that they are, in effect, not complying with the Instrument.
- Section 1.1 should specifically define the terms “material weakness” and “significant deficiency” rather than making reference to the auditing standard. These concepts are fundamental to management’s assessment of internal control over financial reporting. Note that the definition of material weakness could also be used to address the first bullet point noted above.
- Section 2.5(3) indicates that the internal control report from management can be dated prior to the audit report. What then would be the implications of a subsequent event identified by the auditors but not by management be upon the auditor’s report?
- Section 2.1 of the Companion Policy (CP) is described as “No formal requirement for interim evaluation”. We believe that the word “formal” should be deleted as it implies that an informal evaluation may be contemplated. Our understanding is that there is no requirement whatsoever for interim evaluations.
- Section 2.4(4) indicates that the Instrument does not encompass elements of control frameworks that relate to operational or compliance concerns “with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements...” If this comment is to remain in the Instrument, there should also be a comment acknowledging that in many instances internal controls over financial reporting may achieve multiple control objectives.

## **Appendix B: Responses to questions specifically posed by the CSA and OSC**

### **Scope of Application**

1. Do you agree that the Proposed Internal Control Instrument should apply to all reporting issuers other than investment funds and venture issuers? If not, which issuers do you believe should be subject to the Proposed Internal Control Instrument?

*The table set out below under “5. Summary of Proposed Internal Control Materials – Effective date and transition” provides a breakdown of issuers by market capitalization, which may be helpful in preparing your response to this question.*

**Yes. In particular, we agree that a separate class of issuers within the senior exchange is not appropriate.**

2. Do you believe that venture issuers should be subject to different requirements relating to internal control over financial reporting beyond what is required by the Revised Certification Materials? If so, what should be the nature of any different requirements?

**No.**

### **Management’s Assessment of Internal Control over Financial Reporting - Management**

3. Should the term “management” be formally defined? If so, what would be an appropriate definition?

**We do not see this as a significant issue.**

4. If “management” is not defined, is the guidance in the Proposed Internal Control Policy adequate and appropriate?

**Yes.**

### **Management’s Assessment of Internal Control over Financial Reporting – Scope of Evaluation**

5. Is the guidance set out in the Proposed Internal Control Policy with respect to the scope of the evaluation of internal control over financial reporting in relation to each of the circumstances set out above adequate and appropriate?

**The guidance set out in Section 2.3 of the Companion Policy is complete. However, recent guidance suggests that controls that have a pervasive impact, such as the control environment, should be considered first. As such, we recommend that the ordering of Section 2.3(2) CP be reconsidered. Although this may sound like a minor point, the emphasis is important and fundamental to the “top-down” approach recommended by both the SEC and PCAOB.**

**Management’s Assessment of Internal Control over Financial Reporting – Suitable Control Framework**

6. Are there any other control frameworks that should be identified in the Proposed Internal Control Policy as satisfying the criteria for a suitable control framework?

**No.**

7. Are there any specific aspects of the identified control frameworks on which additional guidance is required to assist in their application by issuers that have limited formal structures for internal control over financial reporting?

**See our comments regarding “Smaller Public Companies” in the body of our response letter.**

**Management’s Assessment of Internal Control over Financial Reporting - Evidence**

8. Is the guidance in the Proposed Internal Control Policy regarding the content of the evidence adequate and appropriate?

**Yes. However, we do have a few specific comments:**

- **2.5 (1) CP: The term “testing processes” is confusing, particularly the use of the term “testing” as it refers to management. It may be more appropriate to refer to management’s evaluation of design and operating effectiveness (i.e.: management evaluates, auditors test). Such a change would be consistent with recent SEC guidance indicating that management has many more options available to assess controls than do auditors (e.g.: various forms of self-assessment or use of monitoring controls to provide evidence of effective operation).**
- **2.5(1)(a) “Financial disclosure” should read “Financial statements”.**



- **2.5(2)(a) It is not clear what is meant by, “the evidence should include ... the design of controls over relevant assertions ...”. In the CICA standard, this section refers to documentation. Perhaps heading up bullet (a) with “documentation of” would be clearer.**
- **2.5(3) The phrase “written or non-written form” is confusing. Is this making reference to the fact that management can use a flowchart or a narrative or other form as long as the evidence is documented? Perhaps this should be clarified with an example.**

9. Are the requirements in the Proposed Internal Control Instrument regarding the manner in which the evidence must be maintained adequate and appropriate? Is the guidance in the Proposed Internal Control Policy regarding the manner in which the evidence may be maintained adequate and appropriate?

**Yes**

10. Is the requirement in the Proposed Internal Control Instrument on the period of time during which the evidence must be maintained adequate and appropriate?

**Yes.**

### **Internal Control Report**

11. Is it appropriate to require disclosure of any limitations in management’s assessment of the effectiveness of an issuer’s internal control over financial reporting extending into a joint venture, VIE or acquired business? If not, are there alternative ways of providing transparency with respect to any limitations in management’s assessment?

**Yes. However, we do have some specific comments:**

- **2.6(3) The instrument acknowledges that management may not always have access to the underlying entity in order to assess internal control over financial reporting. Perhaps some clarification should be provided as to how management can conclude that they have joint control (and therefore proportionately consolidate) but do not have access to the underlying entity. One might conclude that this scenario is not consistent with the notion of joint control. Some clarity on this would be very useful as it is not an issue in the US (given differences in accounting standards) and, as such, they have not provided any guidance.**

- **2.6(3) Regarding portfolio and equity investments, we believe the statement that “management will often not have access to the underlying entity” is very true. Given this fact, we recommend that management be fully exempted from assessing the controls over these investments.**
- **2.6(4)(b) Please check the references in this section. We believe they should refer to 5.6(5)(d)(ii) only.**
- **2.6(5) The last sentence in this section is confusing. Specifically, what are the implications if management has the ability to evaluate internal control over financial reporting but not the ability to design? One might conclude that, in such a case, management is not in a position to remediate an identified deficiency. If this is so, what are the ramifications? Additional explanation of this concept would be useful.**

12. Are there any other circumstances under which management may reasonably limit its assessment? Should disclosure of these circumstances be required?

**No.**

### **Exemptions**

13. Are the exemptions from the Proposed Internal Control Instrument appropriate?

**Yes.**

14. Are there any other classes of issuers that should be exempt from the Proposed Internal Control Instrument?

**No.**

### **Effective Date and Transition**

15. Is the phased-in implementation of the Proposed Internal Control Instrument appropriate?

**Yes.**

16. Does the phased-in implementation adequately address the concerns regarding the cost and limited availability of appropriate expertise within reporting issuers and among external advisors and auditors? If not, how can these concerns be addressed?

**As acknowledged by many, the phased-in implementation helps address the concerns regarding the cost and limited availability of appropriate expertise. Also as discussed above, we believe that the recent SEC and PCAOB guidance goes right to the core of many of the implementation issues and as such can also contribute to the cost issues raised.**

### **Anticipated Costs and Benefits**

17. Are there any costs or benefits associated with the Proposed Internal Control Materials that have not been identified in the Internal Control CBA? If so, what are they?

**While attempts at costs and benefits are necessary, any quantitative analysis is wholly incomplete because of the significant assumptions that must be made and the much greater degree of difficulty associated with quantifying the benefits. We wish to point out that what cannot be easily quantified is the cost of internal control failures (whether intentional or unintentional), the related impact on cost of capital and the benefits to investors of addressing these concerns. Further, it is much easier to quantify the more direct costs to companies although we absolutely agree that these costs need to be brought down relative to the recent experience in the US. However, another benefit that cannot be measured is the increased ability of issuers to produce reliable financial statements without significant audit adjustments given that management has now assessed and remediated their internal control over financial reporting.**

18. Do you believe that the benefits (both quantifiable and unquantifiable) justify the costs of compliance (both quantifiable and unquantifiable) for:
- (a) issuers with a market capitalization of less than \$75 million?
  - (b) issuers with a market capitalization of \$75 million or more but less than \$250 million?
  - (c) issuers with a market capitalization of \$250 million or more but less than \$500 million?
  - (d) issuers with a market capitalization of greater than \$500 million?
  - (e) all issuers?

**As discussed above, we support attempts at measuring costs and benefits but believe that any conclusion will have to be largely a judgmental determination made by the securities commissions in light of the objectives proposed. As noted above, we are supportive of the objectives of the instrument and the likelihood that it will lead to an improvement in many public companies ability to prepare reliable financial statements.**

### **Alternatives Considered**

19. Do you agree with our assessment of the identified alternatives?

**Yes. We believe that the US rules and standards coupled with the recent guidance from the SEC and PCAOB creates an effective model if embraced by the regulators, the standard setters, public companies and independent auditors. It is also important to note that, should Canada adopt a materially different approach, the overall cost of implementation would be increased on a relative basis as all parties involved would not be able to as effectively leverage US guidance and experience.**

20. What other alternatives, if any, would achieve the objectives identified above?

**As discussed above, we support harmonization with the US rules and standards including the most recent guidance from the SEC and PCAOB.**

#### **Significant changes to Current Certification Instrument and Current Certification Forms**

21. Is it necessary or appropriate to require a venture issuer to refile its annual certificates for a financial year when it voluntarily files an AIF for that financial year after it has filed its annual financial statements, annual MD&A and annual certificates for that financial year?

**We do not have a view on this issue.**

22. Since the AIF may be voluntarily filed several months after the issuer's annual financial statements and annual MD&A, there may be a significant gap between the time that the annual financial statements and annual MD&A are filed and the time that the annual certificates are refilled. Is this timing gap problematic?

**We do not have a view on this issue.**

#### **Significant Changes to Current Certification Policy**

23. Is the guidance regarding the treatment of underlying entities set out in the Revised Certification Policy adequate and appropriate?

**We do not have a view on this issue.**