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Participating CSA Members
c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8

Dear Mr. Stevenson:

RE: Comments on Proposed MI 52-111 and Related Matters

We respectfully submit our comments on the Canadian Securities Administrators' ("CSA") proposed Multilateral Instrument 52-111 and amendments to Multilateral Instrument 52-109 ("the Instruments") as per the request for comment dated February 4, 2005.

We agree with the need for such measures in the Canadian marketplace and believe that significant benefits can be derived. In addition, we agree with the reasoning and rationale for maintaining consistency with U.S. Sarbanes-Oxley requirements and that a phased implementation approach is most appropriate.

Based on our experience as advisor to our clients on internal control over financial reporting (ICFR), both here in Canada as well as in the United States and other countries, we appreciate the significant benefits that companies, and the market in general, can reap from such efforts. However, without proper guidance and implementation of such regulations, the costs quickly begin to erode the potential benefits. It is with this view that we present our comments and recommendations.

Our recommendations focus on the following:

1. Inclusion of more detailed guidance to management, specifically around the following:
    a. Clarify what constitutes "effective internal control" and, more specifically, what constitutes "reasonable assurance",
    b. Focus on a top-down, risk-based approach to the evaluation of internal control over financial reporting;
2. Clarify the distinction between "disclosure controls and procedures" and "internal control over financial reporting";
3. Delay in the implementation timelines; and
4. Elimination of exemptions for venture issuers.

Our comments are detailed below.

1. Inclusion of More Detailed Guidance to Management

Without guidance for management, companies are effectively subject to the available auditing standards and the auditor's interpretation of those standards. Our experience with Sarbanes-Oxley showed that the absence of explicit guidance to management has often led to inconsistencies in interpretation and execution from company to company. For example, we have seen instances where companies were required by their auditors to apply steps that management did not consider necessary to support the assertion in the internal control report. These same steps were not necessarily required by other auditors, even within the same audit firm. While we agree the evaluation of ICFR requires judgment, we believe that the lack of a top-down, risk-based approach results in excessive work on low risk matters, leading to higher compliance costs for companies, thereby reducing the net benefit of the initiative, both from a company and market perspective.

As such, management should be provided with guidance on which to build the foundation for understanding when sufficient documentation and an appropriate body of knowledge exist to support a conclusion regarding the effectiveness of ICFR. This guidance would also help management and auditors delineate the activities each must perform to discharge their respective responsibilities under the Instruments.

We would recommend guidance more specifically on the areas detailed below.

Clarify what constitutes "effective internal control" and, more specifically, what constitutes "reasonable assurance"

As described previously, management needs an understanding of when they have achieved compliance. The concept of reasonable assurance recognizes that a registrant can never expect to eliminate risk and this is built into the definition of ICFR adopted by the CSA in the draft instrument. "Reasonable assurance" is also a long-standing principle rooted in the auditing literature and in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control – Integrated Framework. It is an important concept because management must attain this level of assurance when formulating a conclusion regarding the effectiveness of ICFR in achieving specific objectives or assertions around reliable financial reporting. It is intended to be a practical standard, because regardless of its design, a system of internal controls has inherent limitations. Achieving absolute assurance is a cost-prohibitive, if not an impossible, standard to achieve. That all said, very little has been added to the literature over the years as to what the "reasonable assurance" concept actually means in practice.

The compliance process should not be a bottomless pit into which issuers throw resources and money. There needs to be an articulation of the goal at a sufficiently granular level, so that management, audit committees and auditors can say, "That is enough." Absent expanded guidance, companies have limited options beyond performing their assessment consistent with the standards written for the auditors.

For example, the following are among the activities a company should implement to build a credible case for achieving a reasonable level of assurance:

- Document the critical processes supporting financial reporting and the most important underlying controls embedded within those processes which provide a basis for concluding that relevant financial reporting assertions are met -- This documentation should be sufficient to enable an independent party to review it for purposes of evaluating the design effectiveness of ICFR. New employees should be able to review the documentation for their functional area to learn their roles and understand how they are expected to contribute to the control environment.
- Establish an effective process for risk identification -- Management should periodically assess the financial reporting risks inherent in the company's processes. This process should result in periodic improvements in the company's processes and in the underlying controls embedded within those processes.
- Implement a robust self-assessment process to periodically confirm that key controls remain in place -- This process should facilitate periodic feedback from process owners regarding the continued effectiveness of the most important controls in the critical processes comprising the registrant's ICFR. It should be supported by periodic testing of the most important controls by the process owners responsible for those controls. It should not be confused with the "back-up certifications" commonly used in practice.
- Provide appropriate oversight by implementing an effectively-functioning process for monitoring and testing -- This process should include independent "over testing" of process owner testing and other independent tests of controls by an objective and competent evaluator (such as an effective internal audit function). This documentation should be sufficient to enable an independent party to review it for purposes of evaluating the operating effectiveness of ICFR.
- Implement effective company-level controls that are periodically reviewed with the audit committee as changes occur in the company -- The registrant's entity-level controls, including its anti-fraud program, should be continually strengthened with the objective of improving entity-level monitoring and auditing systems that report and provide feedback with respect to the performance of the financial reporting process. This continuous improvement process should be supported through effective audit committee oversight. Management should (1) consistently enforce the code of conduct and established policies, (2) appropriately follow-up and investigate complaints around the financial reporting process, and (3) appropriately respond to any ethical or policy violations, including modification of compliance standards, policies and procedures.
- Implement a process to identify when changes in critical processes and important controls occur -- This ongoing process should monitor for and escalate change which materially affects, or is reasonably likely to materially affect, ICFR.

- Document "management's assessment process" to conclude as to the effectiveness of ICFR, in a manner sufficient that an independent party can understand what was actually done and the basis for management's conclusions -- The documentation supporting management's assessment process should provide reasonable support for the assessment, as explained in paragraph .040 of the Canadian Institute of Chartered Accountants Auditing and Assurance Standards Board proposed assurance recommendations on "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" ("CICA Standard"). This documentation should address the processes, procedures and due diligence management completed when executing its responsibilities and supporting its conclusions.

If the CSA were to articulate the activities necessary for management to achieve reasonable assurance for purposes of evaluating the effectiveness of ICFR, companies would have a better road map to "institutionalize" the compliance process around ICFR. With that road map as the foundation, companies can move on to improving efficiency and effectiveness.

Focus on a top-down, risk-based approach to the evaluation of internal control over financial reporting

Based on our experience, the extent of control documentation, testing and monitoring is often driven by quantitative coverage objectives, resulting in high risk areas and lower risk areas being accorded the equivalent level of effort. While companies must establish a pervasive system of internal control for all aspects of their organizations, not all controls are equally significant. Nor do all accounts and assertions have the same likelihood of material misstatement. A top-down, risk-based approach helps ensure that the right level of effort and resources is directed to the right areas in proportion to the risk.

The importance of risk identification and assessment processes needs to be emphasized as a tool for ensuring that management, the auditors and public reports in general are focused on the most significant issues, which will yield greater net benefits from this initiative. A risk-based approach also leads to a more efficient and effective compliance process. If it isn't risk-based, an evaluation of ICFR is an endless process. If approached solely with a quantitative view as opposed to a top-down focus, the evaluation can lead to misguided effort and significant waste.

A risk-based approach is the most practical way to evaluate ICFR because it ensures a sharper focus when (1) determining the nature and extent of process documentation, (2) the selection of controls to evaluate and test, and (3) the nature, timing and extent of controls testing. Simply stated, a risk-based approach ensures that the assessment process sufficiently addresses the right things.

In a process as intricate as an evaluation of the effectiveness of ICFR, a continuous improvement mindset can help eliminate non-essential practices and simplify and focus the process. Based on our experience, the following are a few examples of areas that should be

reviewed by management and the auditors with the intent of applying a truly risk-based approach:

- There needs to be an assessment of the level of effort required to test routine transactions. Testing to the same extent every account above a quantitative threshold, without regard to the relative risk, is driving excessive work in practice. A quantitative approach to the scoping process often allocates a significant testing effort to controls over routine transaction processing areas, even though the history of past financial reporting scandals has shown that the real financial reporting risks often lie within such areas as non-routine transaction processing, estimation transaction processing, complex reporting and disclosure requirements, and the potential for management override of established processes and controls. Despite this anomaly, extensive detailed testing is often performed in areas where the risk of material error is low.

- There needs to be an evaluation as to whether the right level of effort and resources is being directed to the right areas. For example, more emphasis should be directed to evaluating the effectiveness of entity-level controls, antifraud controls, the period-end financial reporting process and other areas, including audit committee oversight, in proportion to the relative risk, consistent with a risk-based approach. The effort expended in these areas should be greater in proportion to the total effort. To illustrate:

  – Despite the vital importance to reliable financial reporting, the "softness" of entity level controls and the antifraud program and related controls often led evaluators to place greater weight on performing more testing of the "more tangible" controls over routine processes. While this practice creates an impressive body of work, it drives up the cost of the evaluation process with diminishing returns. For example, the process of documenting, evaluating and testing the controls over prepaid assets and intercompany accounts may not be nearly as important as testing the controls to prevent, deter and detect fraud in sensitive areas.

  – The emphasis given to controls over information technology (IT) affecting financial reporting processes was oftentimes less in relation to manual process controls. For example, increased attention needs to be given to understanding IT-related risks and to integrating the testing of IT application controls and manual controls at the process level, including IT application controls embedded within ERP systems. There also needs to be a sharper focus on IT general controls and how they affect the evaluation of controls over key IT applications. For example, these controls include (1) IT application-level user access controls, including controls over IT application segregation of duties requirements and (2) other IT general controls, including the consideration of change controls. If management is able to conclude on the effectiveness of IT general controls, the scope of tests over IT application controls can be appropriately focused.

- A truly risk-based evaluation should drive the selection of controls to test. Our experience indicates there is significant variability among both companies and auditors when it comes to selecting the controls to test. The filtering process is vital to making the assessment of ICFR more efficient and effective, because it narrows down the population of controls to the ones that really matter, making the linkage of individual controls with the significant accounts and assertions to which they relate, as required by paragraph 84 of the CICA Standard, a more manageable task. Filtering also increases the efficiency of testing, because excessive testing drives significant non-value-added activity around controls that are not that important to the overall assessment of ICFR.

The CSA should affirm that the process of evaluating ICFR must be driven by a top-down, risk-based approach that directs the appropriate level of effort and resources to the right areas in proportion to the risk. If management is able to formulate a conclusion around the key risks, and the auditor is able to concur with that conclusion early in the process, the ICFR assessment is less likely to go astray toward unnecessary work.

2. Clarify the Distinction between "Disclosure Controls and Procedures" and "Internal Control Over Financial Reporting"

Without further clarification of the distinction between "disclosure controls and procedures" and "internal control over financial reporting", we believe that it is unclear as to which controls and procedures an issuer's management must certify for the "modified certificate" under MI 52-109 (Form 52-109FM1) during the transition period before MI 52-111 goes into effect. Therefore, we recommend that the CSA further clarify the distinction between these two categories of controls and procedures and more narrowly define the nature of the disclosure controls and procedures that management must certify during the transition period. In making this amendment, the CSA should reaffirm its view that management has an ongoing and longstanding responsibility with respect to internal control procedures and, along with the auditors, has historically reviewed internal control over financial reporting in conjunction with the annual audit of the issuer's financial statements; therefore, the relief the CSA offers with respect to management's responsibilities during the transition period is restricted to the certification process.

MI 52-109, in its current form, defines "disclosure controls and procedures" as:

> "controls and other procedures of an issuer that are designed to provide reasonable assurance that information required to be disclosed by the issuer in its annual filings, interim filings or other reports filed or submitted by it under provincial and territorial securities legislation is recorded, processed, summarized and reported within the time periods specified in the provincial and territorial securities legislation and include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its annual filings, interim filings or other reports filed or submitted under provincial and territorial securities legislation is accumulated

and communicated to the issuer's management, including its chief executive officers and chief financial officers (or persons who perform similar functions to a chief executive officer or a chief financial officer), as appropriate to allow timely decisions regarding required disclosure;"

As defined in MI 52-109, disclosure controls and procedures apply to financial and non-financial information required to be included in an issuer's filings. This definition is broader than the scope of internal control over financial reporting. To the extent that internal controls impact disclosure, a company's disclosure controls are clearly inclusive of such internal controls because disclosure controls apply to all material information to be included in public reports, both within and outside the financial statements.

Given this broad view of disclosure controls, there are very few internal controls that would not be viewed as a subset of disclosure controls. Therefore, we recommend that the CSA clarify the distinction between disclosure controls and internal controls so that issuers will understand their scope.

It seems clear from the transitional certificates outlined in the proposed amendments to MI 52-109 that the CSA does not intend for issuers to provide conclusions regarding internal controls before MI 52-111 takes effect. Given this intent, we recommend clarification of the nature of the disclosure controls that management is required to certify during the transition period. Otherwise, issuers may become confused as to whether they, in effect, need to satisfy the internal control requirements in order to satisfy the disclosure control requirements.

3. Delay Implementation Timelines

In our experience, first time compliance with Sarbanes-Oxley Section 404 requirements is a significant endeavour requiring twelve (12) to twenty-four (24) months of concentrated effort, particularly by large and diversified companies. Given that the Canadian requirements are similar to the U.S. requirements, Canadian companies can expect similar timelines to achieve compliance.

We strongly support the four-year phased implementation timelines but we suggest that implementation deadlines be revised to allow sufficient time for organizations to efficiently and effectively achieve compliance allowing for the typical 12 to 24 months preparation time for first time compliance.

4. Elimination of Exemptions for Venture Issuers.

The proposed requirements for Multilateral Instrument 52-111 provide exemptions to ventures issuers which include a large number of Canadian public companies.

Similar to the U.S. experience, we believe that all public companies should be subject to the same regulatory requirements. Accordingly, we recommend maintaining the same standard of investor confidence in the entire Canadian marketplace and that all publicly traded companies be required to meet the same regulatory requirements. In keeping with the consistent treatment seen in the U.S., venture issuers should be subject to the same requirements relating to internal control over financial reporting. This would eliminate any tendencies for companies to measure the cost of compliance to the impact of moving off the TSX to the other exchanges. The timing of implementing the requirements for venture issuers can be used to offset some of the cost concerns that will arise.

We recognize the need for additional guidance for smaller issuers and support the development of guidance similar to what is forthcoming from the Committee of Sponsoring Organizations ("COSO") to assist smaller companies achieve compliance in a manner that is tailored to the size and needs of their organization.

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We appreciate the opportunity to submit our comments and feedback. If you have any questions or comments, please contact Carmen Rossiter at (647) 288-4917 or carmen.rossiter@protiviti.com.

Yours very truly,

Carmen Rossiter
Managing Director