

June 30, 2005

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

Re: Multilateral Instrument 52-111 Reporting on Internal Control over Financial Reporting and related matters

Dear Mr. Stevenson:

We appreciate the opportunity to submit the following written remarks in response to the Canadian Securities Administrators' ("CSA") request for comments seeking feedback on the Proposed Internal Control Materials and the Revised Certification Materials. We are providing comments for the following questions:

1. **Suitable control framework** - Are there any other control frameworks that should be identified in the Proposed Internal Control Policy that satisfy the criteria for a suitable control framework?
2. **Evidence** - Is the guidance in the Proposed Internal Control Policy regarding the content of the evidence adequate and appropriate?
3. **Internal control report** - 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?
4. **Effective date and transition** - Is the phased-in implementation of the Proposed Internal Control Instrument appropriate? 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?

#### **Suitable control framework**

We feel that a distinction should be made between the control environments of a larger organization in comparison to that of a smaller organization. As an alternative to the list of suggested control frameworks outlined in Companion Policy 52-111CP, members of the CSA should consider a model for small business currently under development by The Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). This is anticipated for

release this summer. Currently, it is unknown whether this proposed model can be considered as a suitable control framework under the proposed rules, given that it is uncertain whether COSO will provide opportunity for feedback from the public. However, we feel that the CSA should take this model (or other appropriate alternatives for small organizations, if available) into consideration because when a smaller corporation applies a control framework designed to be more suitable for larger corporations, it can lead to additional cost burden. This is due to the smaller corporation's attempt to design an internal control environment with policies and procedures that far exceed the needs of the business in order to meet the required criteria. Based on what we have seen happen with the accelerated Sarbanes-Oxley filers in the U.S., it can be expected that the costs of designing, implementing, testing, and improving internal controls over financial reporting will be significant. A framework that is more suitable for smaller corporations should be included in the proposed documents. The aim is to avoid excessive and unnecessary expenses as a result of inability to apply a suitable control framework for evaluating the effectiveness of an organization's internal controls over financial reporting.

### **Evidence**

Overall, we have concerns about the contents outlined in Part 2 of the Proposed Internal Control Materials. The contents lack focus on risks and do not provide sufficient guidance for management over the assessment process. We believe that this will have significant implications on the level of scoping and extent of work to be performed. Without addressing these issues, it is questionable whether the costs and the extent of work to be performed justifies the incremental benefit of improving the quality and reliability of financial and other continuous disclosure reporting. As such, we would like members of the CSA to consider the following:

- Companion Policy 52-111CP - Part 2.5 outlines the information expected to be included as evidence to support management's assessment of the effectiveness of internal control over financial reporting. The main focus of the policy appears to be on the design and documentation of processes and controls. We feel that this can lead to a broad spectrum of processes and controls to be included in the assessment without appropriate consideration to the specific financial and other disclosure risks within an organization. Companies can spend considerable amounts of effort, time and money on design, documentation, and tests of processes and controls to meet the criteria outlined in the proposed rule. Therefore, we suggest shifting the focus of the assessment to a risk-based approach. In other words, instead of documenting and testing what potentially could be every process and control in an organization, we should first understand and assess key financial reporting risks, and then design, document, and test the key processes and controls that address those risks. In addition, certification experiences to date have revealed too much of a focus on quantitative measures to determine scoping such as significant accounts and coverage. The major audit firms have driven this quantitative focus. We strongly recommend that the CSA consider

issuing additional guidance that allows for a risk-based approach to scoping beyond a pure quantitative approach.

- A clear definition should accompany the following statement from Companion Policy 52-111 CP - “...*all significant accounts and disclosures in the financial statements*”. Without a defined scoping level [based on the word *significant*], it will have a tremendous impact on companies with decentralized operations. This can translate to additional costs as the level of scoping and testing may be more extensive, than otherwise necessary, to support management's assessment and conclusion. We suggest that qualitative and quantitative guidelines be included in the proposed rule that clearly outlines what is considered sufficient level of evidence and work to be performed to substantiate that reasonable support is obtained.
- Management is required to assess the effectiveness of internal control over financial reporting and Part 2 of the Proposed Internal Control Materials outlines various components of that assessment. However, the instrument does not prescribe how management is expected to perform such assessment. Furthermore, the Securities Administrators have not issued specific guidance for management to consider. By default, management is expected to rely on guidance provided by the accounting/auditing profession and the related auditing standards. We believe that this is not appropriate because of the different level of professional standards required of the auditors and would therefore suggest members of the CSA outline specific guidance for management on the assessment process. Alternatively, the proposed rules should outline that management can adopt the standards and guidance followed by the auditing profession. However, we believe that in this case, it would be prudent for members of the CSA to consider the applicability of the auditing standards to meet management's objectives in the assessment process.

### **Internal control report**

We question the appropriateness of the requirements relating to disclosure of 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. The reasons are as follows:

- This can have an impact on companies' strategic initiatives and/or timing of acquisitions or other business arrangements. We believe that it is the company's responsibility to protect shareholders' value. Activities conducted by management should focus on implementing appropriate strategies and managing business risks. As such, the proposed disclosure requirements would erode management's ability to do so.
- Under the current proposed requirements, it would appear that all limitations in management's assessment extending to joint venture, VIE, or acquired business are to be disclosed. This disclosure requirement appears too prescriptive and does not taking

into account the level of significance of the joint venture, VIE, or acquired business in an organization's overall financial picture.

### **Effective date and transition**

We agree that a phased-in implementation should be taken in order to provide adequate time for market registrants to comply with the proposed instruments. However, we do not believe that the proposed implementation dates will be adequate to address the issue with cost and limited availability of appropriate expertise for two reasons. First, companies have started to hire resources to comply with the certification requirements pertaining to design and effectiveness of disclosure controls and procedures (effective starting financial year-ending March 30, 2005), and design of internal control over financial reporting (effective starting financial year-ending June 30, 2006). This has put a strain on an already limited resource available for all public companies, and because of that, companies are paying a premium with this sudden increase in demand. Second, constraints will be imposed on resources down the road as a significant number of relatively small TSX-listed companies are phased in to comply with the Proposed Internal Control Instrument (effective starting financial year-ending June 30, 2006 to 2009 depending on market capitalization as at June 30, 2005). The evidence that a significant portion of the issuers (i.e. approximately 63%) expected to comply for first year-ends June 30, 2008 and 2009 is concerning. The percentage quoted is derived from the summarized table outlined in CSA's document - "Notice Request for Comments". We suggest members of the CSA to consider the following:

- Recent corporate accounting scandals resulted from "tone-at-the-top" issues, outright fraud and poor corporate governance, not the lack of routine process-level controls. Instead of having all companies design internal control over financial reporting starting year-ending June 30, 2006, management should be required to implement policies and procedures to enhance the overall control environment. For example, areas to be addressed are tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company wide programs such as codes of conduct and fraud prevention. This will be specific to deal with the broader control environment/culture issues and help to enhance investors' confidence.
- The implementation phases as outlined in the Proposed Internal Control Instrument should be broken down further. As an example, market capital greater than \$500,000 – June 30, 2006, market capital of \$350K to \$500K – June 30, 2007, market capital of \$200K to \$350K – June 30, 2008, market capital of \$50K to \$200K – June 30, 2009, and market capital under \$50K – June 30, 2010. The aim is to have a more even distribution of issuers (depending on market capital) comply with the requirements each year.



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Thank you for considering our views. We hope these feedbacks prove useful as the CSA makes its determination on whether to adopt the Proposed Internal Control Materials and Revised Certification Materials.

Sincerely,

Ting Yeh  
Manager, Financial Reporting  
Magellan Aerospace Corporation