



## **CA-Queen's Centre for Governance Technical Report**

### **Management's Evaluation of Design Effectiveness of Internal Controls over Financial Reporting: Weak Regulation and Inconsistent Compliance**

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**DRAFT: Comments are appreciated as this is a work in progress.**

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**EXECUTIVE SUMMARY**

Canada does not have a national securities regulator per se. Rather Canada has ten provincial securities regulators plus three territorial regulators of which four have significant or the potential to have significant capital markets regulatory capacity and potential impact: Alberta, British Columbia, Ontario and Quebec. Collectively these provincial and territorial securities regulators call themselves the Canadian Securities Administrators (CSA). While always somewhat problematic, the weaknesses of such a system of security regulation became even more apparent as the regulators attempted to implement the Canadian version of the package of reforms associated with the Sarbanes Oxley Act of 2002 (SOX) that were within their statutory power. The Sarbanes-Oxley Act of 2002 is a large and complex piece of legislation that involves corporate governance changes, executive compensation changes, criminal penalties for various activities changes, regulation of the audit of public companies in addition to the internal control audit provisions that have captured much of the media attention. This technical report focuses on the CSA attempts to deal with one of the most prominent parts of that package, the internal control requirements (SOX 302 and SOX 404).

In the spirit of SOX 302 Part a, management’s disclosure controls effectiveness assessment, the Canadian Securities Administrators proposed in June 2003 Multilateral Instrument 52-109 *Certification of Disclosure in Issuers’ Annual and Interim Filings* to require that management make disclosure control effectiveness evaluations and report on those evaluations in the company’s Management Discussion and Analysis (MD&A). Disclosure controls ‘are designed to provide reasonable assurance that information required to be disclosed by the issuer’ in its various regulatory filing is made available within the company to those who have to make disclosure decisions. Further, the CSA proposed that management assess the effectiveness of internal controls over financial reporting, similar management’s SOX 302 Part b certification. However, the CSA could not obtain unanimous agreement even for the SOX 302 based proposals as the British Columbia Securities Commission dissented. Hence, the debate in Canada over how much the investor had a right to know about the state of a company’s internal controls did not start with the question of audited disclosures, but rather whether anything needed to be revealed about internal controls at all. Over the next 18 months even this modest proposal was diluted after a round of issuer (i.e. mainly management) comments. Another round of amendments and a longer phase in period was required to finally bring British Columbia Securities Commission on-side in September 2005. The lack of a national securities regulator and the drive to lowest common denominator securities regulation weakened the initial proposed regulation and began the debate well back from where it started in the United States.

Given where the debate started, it is not surprising that the CSA was unable to achieve consensus on proposing that the disclosures in 52-109 be audited. Hence, when they issued for comment Multilateral Instrument 52-111 *Reporting on Internal Control over Financial Reporting* over the objections of the British Columbia Securities Commission many considered the proposal ‘dead on arrival’. Based on the comments received (again mainly from the

management of firms who are never likely to volunteer for an audit), the Canadian Securities Administrators decided not to proceed with the audit requirement (CSA Notice 52-313 2006), however, the CSA announced they would revisit and strengthen their previous requirement for management to certify that internal controls were designed and implemented effectively (52-109). The so-called new proposal, while unanimously endorsed by all members of the CSA this time, was merely an elaborate version of the original 2003 proposal. The proposal is clear that the question of audit is still not even being considered. The comment period ended in June but no rule has yet emerged and from a quick glance at the comment letters, the comments were far from unanimous from supporting this still relatively weak level of investor protection.

Overall, in this preliminary research we seek to answer the question: are Canadian regulators fooling themselves in expecting that voluntary management compliance with internal control effectiveness evaluations will provide investors with the benefits of a rigorous review of internal controls without the associated costs that have been attributed to the audit regime in the USA? The initial evidence provided by the CSA itself was not encouraging. In the spring and summer of 2006 the CSA undertook a review (CSA Staff Notice 52-315 *Certification Compliance Review* released September 22, 2006) of the most recent certification for 229 TSX issuers and 52 Venture issuers focusing on the disclosure controls evaluation in the MD&A that was attested to as being present in the MD&A in the certification signed by the Chief Executive Officer and the Chief Financial Officer. While 98% of the TSX registrants certified they had made the disclosure only 80% had actually made the disclosure that they had certified they made in their MD&A. On the Venture Exchange things were substantially worse. 87% certified they had disclosed the evaluation but only 38% actually made the disclosure that they had certified they made in their MD&A. As the CSA report concludes “This widespread non-compliance with such a clear and basic requirement shows that many issuers are not paying adequate attention to their disclosure obligations.” Further, this report did not even look at the substance of the disclosures, only the fact they were made.

We examine our research question as 2006 is the first year that a large number of Canadian public companies had to formally evaluate their internal control systems. For Canadian only listed companies, both on the TSX and those on the Venture Exchange, it was the first year that they were required to evaluate the effectiveness of the design of their internal controls (but not the effectiveness of their implementation) under Multilateral Instrument 52-109 *Certification of Disclosure in Issuers’ Annual and Interim Filing*. For 159 Canadian companies cross listed on a US exchange, and hence registrants with the US Securities and Exchange Commission (SEC), it was the year to comply with Sarbanes Oxley Act of 2002 (SOX) Section 404 (or in the case of 53 of the companies, claim an exemption but to provide management’s assessment of effectiveness of internal controls). In most cases (except for 27 of the Canadian registrants in the US) it was also the first time such disclosures were made.

Key specific findings in our study include evidence about the following questions

- Comparing the unaudited TSX internal control disclosures with Canadian cross listed companies subject to SOX 404 audit and other US based benchmarks, is there evidence that Canadian TSX companies who report on their internal controls are understating their control

weaknesses? This question speaks to the weakened regulation that occurs due to the current CSA political process, given the lack of a national securities regulator.

- We found that unlike the mandatory compliance in the USA due to the statute based SOX regime, 9% of TSX firms did not disclose anything about internal control design effectiveness evaluations in their MD&A. Further of the 91% that did acknowledge some responsibility for internal controls only 54% provided an opinion about the management's assessment effectiveness of control design. Hence, barely half of larger Canadian companies are providing management's assessment about the effectiveness of their internal controls.
  - We find that Canadian TSX companies voluntarily reporting either control design weaknesses or negative effectiveness of control design opinions have: (i) higher rates of control problems than did Canadian cross listed companies subject to 404 audit, (ii) the same rate of control problems as Canadian cross listed companies who provided an management evaluation of internal control effectiveness but were 404 exempt, (iii) a higher rate of control problems than the combined sample of the Canadian cross listed companies, and (iv) a higher rate of control problems than the sample of US based SOX 404 companies excluding the 350 largest US companies.
  - Our conclusion is that despite regulatory requirements to carry out evaluations of internal control design effectiveness, only a minority of Canadian only listed companies (combining TSX and Venture) are disclosing the results of these evaluations in contrast to the US where it is mandatory for management to disclose its evaluation. Further is interesting to speculate, how are the securities regulators going to monitor the implementation of their regulation given this lack of disclosure but without a clear regulatory requirement to disclose?
- Is compliance with the internal control design evaluation requirement equal across the TSX and the Venture Exchanges? What differences, if any, are observed in the state of internal controls between companies listed on the TSX versus those on the Venture Exchange? These questions speak to the issue of whether firms perceive that different securities regulators will enforce the same regulations once enacted. It was the same regulations for all Canadian only listed companies that were supposed to be the key benefit from weakening the proposed internal control regulations in order to obtain unanimous provincial agreement. However, if the same regulations are enforced differentially, what benefit was achieved?
    - We find that for Canadian only listed firms on the TSX and Venture exchanges that 91% and 62% respectively acknowledge some responsibility for evaluating the design effectiveness of internal controls. We also find that 22% of the TSX firms and 54% of the Venture Firms report weakness in their design effectiveness of internal controls. Furthermore, despite management being required to make an evaluation, only 54% of the TSX companies and 29% of the Venture companies disclose management's opinion on the design effectiveness of internal controls.
    - We conclude that the evidence is consistent with our conjecture that firms perceive that compliance with the spirit and the letter of the regulation is more likely to be either demanded by investors or enforced by regulators on the TSX rather than on the Venture exchange. This suggests, in the case of regulators that there may be a perception of differential commitment to enforcement of the same regulations.

- Does corporate governance play a role in determining whether a company discloses it has evaluated its internal control system design and whether a company discloses that it has an effectively designed internal control system? This question speaks to what motivates companies to respond differently to the same regulations.
  - We find strong associations between more independent audit committees and managements' decision as to whether to disclose information about their responsibility for internal control assessments. We also find strong associations between more independent boards and whether the company's management disclosed an opinion that it had an effectively designed control system.
  - These findings suggest that the board plays a critical role in establishing the internal control system quality whereas the audit committee is only able to ensure management discloses the testing of the system but by itself cannot set quality.
- Have Management Discussion and Analysis disclosures about effectiveness of disclosure controls improved since the first year of implementation? This question speaks to whether the potential differences in compliance and hence enforcement 'threat' has become more equal across the country in the second year of this required disclosure.
  - We find there is evidence to suggest that disclosure controls and procedures effectiveness opinion disclosure has improved from the Canadian Securities Administrators investigation in 2006. In both the TSX and Venture exchanges compliance with disclosure has increased (TSX 80% to 93% and Venture 38% to 81%). In addition, for companies making disclosures 9% of TSX and 17.5% of Venture companies limited their opinion to the annual filings rather than to the entire set of filings as required by regulation. This increases the differential between the two exchanges in substantive compliance from 12% to 20%.
  - Hence, these findings support our conjecture that firms do not act as if the regulations will be enforced the same across the two exchanges which reflect that different regulators may not have the same commitment to enforcement of the same regulation.

We think that the evidence is clear that the current voluntary disclosure of management only assessments of internal controls regime is not working. In Canada the current regulatory regime has transformed what was intended to be a corporate malfeasance deterrence mechanism into a 'good citizenship contest' where the 'good citizens' comply with the letter and the spirit of the regulations and all the others get say 'I am complying with the law'. The 'good citizen' companies are unlikely to be among those who need enhanced deterrence of corporate malfeasance. So much for the aim of strengthening internal controls in companies to make investing in them safer for investors, which was the goal of the SOX inspired package of reforms.

Overall, based on our analyses of the internal control design effectiveness assessment and the reports of control weaknesses among the firms that have self selected to disclose and in comparison with various SOX samples from the same time period, we can only conclude that Canadian firms are, at best, having as many control problems as US firms and the cross listed Canadian firms and more likely are having significantly more control problems. Furthermore,

the rate of such problems increases rapidly as the size of the company decreases as is shown with our Venture exchange results.

In our previous report (Salterio and Schmidt 2006) we referred to the phrase “deferred maintenance” that was coined in the mist of the SOX 404 implementation period to explain why corporations existing controls were found to contain so many problems. In other words, in the world of corporate re-engineering in the 1990’s control functions were considered not to be value added and were the first to be let go in times of belt tightening. While the control functions were allegedly reassigned, generally when sales, marketing, or production conflicted with carrying out a control duty, the control got put to the side so that soon the control activities were being carried out sporadically at best.

From our analysis it appears that corporate Canada has a widespread deferred maintenance problem that needs to be addressed in the near future. While the words ‘internal control’ has negative connotations in the minds of many business people, the Canadian Institute of Chartered Accountants Risk Management and Governance Board defines “Control is effective to the extent that it provides reasonable assurance that the organization will achieve its objectives reliably.” The internal controls are part of achieving that control objective and managers who use this time as an opportunity to reinvigorate their control systems have been suggested in anecdotal evidence (e.g., Schwartz 2006) and in academic studies (Rikhardsson, Best, Green and Rosemann 2006) to improve corporate performance whereas those who view this as strictly a compliance task to be done as quickly as possible have seen few benefits from the exercise.

## **Management’s Evaluation of Design Effectiveness of Internal Controls over Financial Reporting: Weak Regulation and Inconsistent Compliance**

The purpose of our study is to provide evidence about the following research questions:

- Comparing the unaudited TSX internal control disclosures with Canadian cross listed companies subject to SOX 404 audit and other US based benchmarks, is there evidence that Canadian TSX companies who report on their internal controls are understating their control weaknesses?
  - This question speaks to the weakening of regulations that occurs due to a regulatory process involving a set of ten provincial and three territorial securities regulators attempting to agree on a regulation versus one national regulator.
- Is compliance with the internal control design evaluation requirement equal across the TSX and the Venture Exchanges? What differences, if any, are observed in the state of internal controls between companies listed on the TSX versus those on the Venture Exchange?
  - These questions speak to the issue of whether firms perceive that different securities regulators (Alberta and BC for the Venture mainly versus Ontario mainly for the TSX) will enforce the same regulations once enacted. It was the argument that there should be the same regulations for all Canadian only listed companies that were supposed to be the key benefit from weakening the proposed internal control regulations in order to get unanimous provincial agreement. But if the same regulations are enforced differentially on different exchanges, what is the benefit weakening them?
- Does corporate governance play a role in determining whether a company discloses it has evaluated its internal control system design and whether a company discloses that it has an effectively designed internal control system?
  - This question speaks to what motivates companies to respond differently to the same regulations.
- Have Management Discussion and Analysis disclosures about effectiveness of disclosure controls improved since 2005, the first year of implementation?
  - This question speaks to whether the potential differences in compliance and hence enforcement ‘threat’ has become more equal across the country in the second year of this required disclosure.

Overall, we seek to answer the question: are Canadian regulators fooling themselves in expecting that voluntary management compliance with internal control effectiveness evaluations will provide investors with the benefits of a rigorous review of internal controls without the associated costs that have been attributed to the audit regime in the USA?

We can examine our research question as 2006 is the first year that a large number of Canadian public companies had to formally evaluate their internal control systems. For Canadian only listed companies, both on the TSX and those on the Venture Exchange, it was the first year that they were required to evaluate the effectiveness of the design of their internal controls (but not

the effectiveness of its implementation) under Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filing*. For 159 Canadian companies cross listed on a US exchange, and hence registrants with the US Securities and Exchange Commission (SEC), it was the year to comply with Sarbanes Oxley Act of 2002 (SOX) Section 404 (or in the case of 53 of the companies, claim an exemption but provide management's assessment of effectiveness of internal controls). In most cases (except for 27 of the Canadian registrants in the US) it was also the first time such disclosures were made.

This technical report proceeds as follows. First, a background section provides the context for the research program this particular data is embedded in. Second, a background section on SOX as it relates to internal control assessments and related audits. Third, a background section on the evolution of Canadian regulatory action as it relates to internal controls followed by a section about our sample. Then we present four sections detailing our findings: first, a section comparing the internal control design effectiveness of TSX companies with various samples subject to SOX requirements primarily; second, a section on compliance rates and the state of internal controls for companies listed on the TSX and the Venture Exchange; third, a section on whether stronger corporate governance seems associated with more disclosure and more effectively designed internal controls; and fourth, a brief update on the state of disclosure controls in Canadian companies.

In summary we find that unlike the mandatory compliance in the USA due to the statute based SOX regime, 9% of TSX firms did not disclose anything about internal control design effectiveness evaluations in their MD&A. Further of the 91% that did acknowledge some responsibility for internal controls only 54% provided an opinion about the management's assessment effectiveness of control design. Of these 54%, 46% reported that management's opinion was that internal controls were designed effectively. The equivalent rate on the Venture Exchange is a significantly lower 29% of the sample provided an opinion and there was no offsetting good news as only 13% reported a favourable assessment.

Relatedly we examined key board and audit committee characteristics to see if they were associated with more disclosure and with better design controls. We find strong associations between more independent audit committees and managements decision as to whether to disclose information about their responsibility for internal control assessments. We also find strong associations between more independent boards and whether the company's management disclosed an opinion that it had an effectively designed control system. These findings suggest that the board plays a critical role in establishing the internal control system quality whereas the audit committee is able to ensure management discloses the testing of the system.

We also find that Canadian TSX companies voluntarily reporting either control design weaknesses or effectiveness of control design opinions have: (i) higher rates of control problems than did Canadian cross listed companies subject to 404 audit, (ii) the same rate of control problems as Canadian cross listed companies who provided an management evaluation of internal control effectiveness but were 404 exempt, (iii) a higher rate of control problems than the combined sample of the Canadian cross listed companies, and (iv) a higher rate of control problems than the sample of US based SOX 404 companies excluding the 350 largest US companies.

Finally, with regard to disclosure controls and procedures, we find there is evidence to suggest that disclosure controls and procedures effectiveness opinion disclosure has improved from the previous Canadian Securities Administrators review in 2006. In both the TSX and Venture exchanges compliance with disclosure has increased (TSX 80% to 93% and Venture 38% to 81%). However, there is still a significant difference in compliance between exchanges. In addition, for companies making disclosures 9% of TSX and 17.5% of Venture companies limited their opinion to the annual filings rather than to the entire set of filings as required by regulation. This increases the differential between the two exchanges in substantive compliance from 12% to 20%. Furthermore, due to the weakness of the current regulation that does not require that internal control opinions and weaknesses be disclosed, which resulted in CSA staff attempting regulation by Staff Notice, it appears that we are seeing a large number of reports with internal control weaknesses that are accompanied by unqualified assessment of strong and effective disclosure controls.

## **Background: The research program**

In the aftermath of Enron, WorldCom and the various other accounting or audit scandals of the early 2000's, the call went forth for more "transparency" in accounting, auditing and corporate governance (Arya, Glover and Sunder 2003). One measure of the intensity of the call is the increased media use of the term "transparency" in connection with financial statements and corporate earnings announcements. However, review of the literature in the areas of accounting, auditing and governance reveals that there is no generally accepted consensus regarding what is "transparent." Indeed, that literature, while generally endorsing more "transparency" also debates whether or not there is a limit to transparency, at least from a shareholder perspective (Arya et al 2003).

### *Objectives of research program*

The overriding objective of our proposed research program is to contribute to the existing debate on whether and how accounting, auditing and corporate governance can be made more "transparent." We begin, however, from the premise that the meaning of "transparency" is, at the very least, ambiguous. For this reason, we propose to begin by systematically documenting the popular meanings attributed to transparency in the financial media. In so doing, we expect to be able to specify a comprehensive typology of popular expectations of transparency in financial reporting and governance. Second, we capitalize on the evident explosion of enthusiasm for "transparency" across *all* of the social sciences by employing content analysis to identify the core features of the various conceptualizations of "transparency" that inform the academic research of, not only accountants, auditors and other corporate governance actors, but psychologists (e.g., Gilovich, Savitsky and Medvec 1998), public policy scholars (e.g. Mayes and Razzak 1998; Vishwanath and Kaufmann 2001), sociologists (e.g. Bankowski 1999; Nenquin 1993), systems design experts (e.g. Vicente 1988), education specialists (e.g. Meira 1998), and legal scholars (e.g. Aziz 2004). By moving beyond the domain of accounting and auditing to the broader social sciences, we expect to be able to map the commonalities and divergences between the popular meanings found in the financial media and the various characterizations of transparency in the social sciences at large. This mapping across the broader social domain will advance our understanding of transparency in auditing, financial reporting and governance by identifying features of transparency that have been overlooked in extant accounting research and by situating calls for financial transparency in their social context.

Based on our analyses of the academic and popular usages of "transparency," we propose to examine how preparers of financial reports, Board of Director's audit committee members and auditors believe they have responded to the call for increased transparency. Finally, we propose to examine whether even well intentioned preparers and audit committee members communicate less than they think they are communicating to readers of financial reports due to the "illusion of transparency" and whether auditors can act as an independent check on this lack of transparency. Thus, overall we aim to enhance the ability of accounting researchers, regulators, standard setters and practitioners to understand the diverse uses of the term "transparency", assist in making judgments about whether a given action or proposal will lead to more or less perceived transparency, and to determine how consensus about what is transparent is achieved.

One area of focus is on transparency of the effectiveness of internal control systems disclosures that are the focus of much of the recent literature on corporate governance reform. While other governance reforms were enacted as well, most of the controversy focused the high cost of compliance with the audit requirement of management's assessment of effectiveness of internal controls over financial reporting, the so-called SOX 404 internal control audit requirement.

We decided to study the Canadian internal control design effectiveness assessments which are required of every public company in Canada starting in fiscal 2006. These assessments are not audited, so "truth-telling" cannot be assumed for such assessment given the lack of a credible threat either via regulatory action or via audit. Indeed as we will discuss it is unclear whether these assessments are required to be made public, hence they fall under the heading of voluntary disclosures. In our academic research will attempt to calibrate the overall degree of reliability of such disclosures using a proprietary measure that we are developing. The results should be of interest to regulators in both Canada and the USA. This technical report's data (described more fully later in the report) is derived from the pilot sample that was collected in summer 2007. Full results from the research program are at least a year away.

## **Background: SOX required management assessment and external audit of controls**

The Sarbanes-Oxley Act of 2002 is a large and complex piece of legislation that involves corporate governance changes, executive compensation changes, criminal penalties for various activities changes, regulation of the audit of public companies in addition to the internal control audit provisions that have captured much of the media attention. Hence, when one speaks of the effects of SOX, one cannot just focus on internal controls as the internal control component of SOX was embedded in a broader package of reforms.

Two provisions of SOX relate to controls. SOX 302 part b requires management to evaluate its internal controls over financial reporting and this reporting then provides the basis for the auditor's report under SOX 404, the audit of internal controls over financial reporting. Most observers have not focused the first paragraph in SOX 302 (part a) that requires management to certify that it has effective controls over its disclosures that it makes to the public markets. This latter requirement has been in effect for all US SEC registrants since 2004.

It has always been good business practice to have effective and efficient internal controls, which means they have to be documented and tested. Entire courses in MBA programs are devoted to Management Controls (e.g., Simons 2000). Furthermore, corporate law requires adequate books and records be maintained as a requirement of incorporation. Many observers in the US point to the Foreign Corrupt Practices Act that dates back to the 1970's requiring companies to have effective internal controls. However, the evidence about SOX implementation in the USA has led to a new phrase being developed: "deferred maintenance." In other words, the control systems were not being kept up to date in the 1990's.

According to US Data (*Compliance Week*), at least 582 companies warned investors about internal control problems in the fiscal year 2004, the first year of widespread SOX auditing in the US. Of those, 314 warned of a material weakness - the most significant category of problem. In addition, 171 companies had an adverse audit opinion on their internal controls without any prior revelation of material weaknesses by company management.

In the US, the generally accepted estimates of total SOX 404 compliance costs in 2004 for *all* companies combined was \$24 billion; with some suggesting \$5.8 billion as a more realistic number. Compliance costs of between \$4 and \$6 million per billion dollars in sales have been documented by the US Financial Executives Institute (see Hermanson 2005). However, one more extreme study put the costs of complying with all provision of SOX at \$1.4 trillion (Zhang 2005), a cost determined by measuring the stock market decline over the two week period when SOX was passed into law in 2002.

In contrast, Glass, Lewis & Co (2005) provides an alternative investor oriented perspective. They compute the market value losses attributed to financial statement fraud in the 20 largest US public company fraud cases from 1997 to 2002 as US \$306 billion. By company, this lost market value ranged from \$335.5 million to \$80 billion with a median of \$5 billion per company.

Despite being in its third full year of US company operation, SOX 404 audits and associated management internal control evaluations continue to report ineffective internal controls at rates approaching 10% once one eliminates the huge US based companies (e.g. General Electric) from the sample. Using the Audit Analytics ([www.auditanalytics.com](http://www.auditanalytics.com)) data base, and after eliminating the largest 350 US based corporations from the data, we found a rate of 9.8% of adverse and qualified internal control opinions in the remaining 3,563 US companies. This sample of US based companies is closer in size to the companies that we consider in our study, Canadian TSX registrants that are not cross listed on a US stock exchange (see Table 1). We also find that of the 106 Canadian companies that are cross listed in the US and have to report under SOX 404 that 6.6% (7 companies) have adverse or qualified opinions. Finally, a further 53 Canadian cross listed companies provided a management assessment of internal control over financial reporting (SOX 302 b) but claimed an exemption from the SOX 404 audit. This exemption allows Canadian cross listed companies with market capitalization between \$75 million and \$750 million to postpone the SOX 404 auditor's attestation requirement until 2007, and small Canadian cross listed companies to postpone until 2008 (Tonello and Brancato 2007). Of the companies claiming exemption, 18.8% (10 companies) reported internal control weaknesses as documented by management. See Table 2.

**Table 1****Samples Descriptive Statistics – 2006****Panel A. Means**

<b>Sample</b>	<b>Number</b>	<b>Revenue (\$)</b>	<b>Net income (\$)</b>	<b>Assets (\$)</b>
<b>Canadian only listed companies</b>				
TSX	100	1,628,762,520	85,988,250	3,917,282,020
Venture	99	4,497,515	-1,228,707	14,606,787
<b>SOX 404 Companies</b>				
Cross listed Canadian*	106	3,589,666,724	455,751,593	22,775,863,188
Cross listed Canadian exempt*	53	137,710,405	-4,904,349	253,916,750
US Companies with 350 largest excluded	3563	1,224,094,029	68,764,127	1,610,947,088

**Panel B. Medians**

<b>Sample</b>	<b>Number</b>	<b>Revenue (\$)</b>	<b>Net income (\$)</b>	<b>Assets (\$)</b>
<b>Canadian only listed companies</b>				
TSX	100	171,900,500	8,358,500	226,151,000
Venture	99	0	(41,000)	3,770,000
<b>SOX 404 Companies</b>				
Cross listed Canadian*	106	\$570,963,500	\$31,688,524	\$1,096,374,500
Cross listed Canadian exempt*	53	0	-2,955,381	50,411,234
US Companies with 350 largest excluded	3563	330,615,008	15,387,000	685,225,000

\* Could contain a few Canadian incorporated companies that are only listed in the US.

**Table 2**  
**SOX 404 - 2006**  
**Ineffective Controls Reported Rate**

**Panel A: Canadian Cross Listed Companies\* Reporting Under SOX 404**

	<b>SOX 404</b>		<b>Number Weaknesses Identified</b>	<b>Number of Companies</b>
SOX 404 internal control qualifications			9	7
2006 Cross listed Canadian Companies				106
	Per company control weakness		1.29	
	% problems			6.60%

**Panel B: Canadian Cross Listed Companies\* Reporting Under SOX 404 But Claiming Exemption.**

	<b>SOX 404 eligible BUT claimed exemption</b>		<b>Number Weaknesses Identified</b>	<b>Number of Companies</b>
Management internal control weaknesses			25	10
2006 Cross listed Canadian companies				53
	Per company control weakness		2.5	
	% problems			18.87%

**Panel C: US Based Companies (excluding largest 350) Reporting under SOX 404**

	<b>SOX 404</b>		<b>Number Weaknesses Identified</b>	<b>Number of Companies</b>
SOX 404 IC qualifications			791	348
2006 US based (less 350 largest) Companies				3563
	Per company control weakness		2.27	
	% problems			9.77%

\* Could also be US registrant only with no Canadian listing in a small number of cases.

## **Background: The Process of Developing Canadian Regulations on Controls**

Canada does not have a national securities regulator per se. Rather Canada has ten provincial securities regulators plus three territorial regulators of which four have significant or the potential to have significant capital markets regulatory capacity and potential impact: Alberta, British Columbia, Ontario and Quebec. Collectively these provincial and territorial securities regulators call themselves the Canadian Securities Administrators. All securities regulations must be negotiated among them or they apply only in the province in question. A National Instrument means that all regulators have agreed to a certain regulation whereas a Multilateral Instrument means that one or more regulators have not agreed to implement the regulation.

Within the areas that they had statutory power over, the Canadian Securities Administrators (CSA), a self-proclaimed “forum” for the provincial and territorial regulators, attempted to implement various parts of the SOX package of reforms in Canada where they had jurisdiction. In almost all cases the reforms were a weaker version of the SOX requirements, for example the audit firms are inspected by the Canadian Public Accountability Board (CPAB) which has no legal jurisdiction and who issues no public reports on individual audit firms unlike the equivalent Board set up under SOX (i.e. the Public Company Accounting Oversight Board (PCAOB)).

In the spirit of SOX 302 Part a, management’s disclosure controls effectiveness assessment, the Canadian Securities Administrators proposed in June 2003 Multilateral Instrument 52-109 *Certification of Disclosure in Issuers’ Annual and Interim Filings* to require that management make disclosure control effectiveness evaluations and report on those evaluations in the company’s MD&A. Disclosure controls

means 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 ..... 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;

MLI 52-109 Part I, 1.1

Further, the CSA proposed that management assess the effectiveness of internal controls over financial reporting, similar management’s SOX 302 Part b certification. However, the CSA could not obtain unanimous agreement even for the very modest SOX 302 based proposals as the British Columbia Securities Commission dissented. Hence, the debate in Canada over how much the investor had a right to know about the state of a company’s internal controls did not start with the question of audit, but rather whether anything needed to be revealed about internal controls. The lack of a national securities regulator and the drive to lowest common denominator securities regulation started the debate well back from where it started in the United States.

Over the next 18 months even this modest proposal was diluted after a round of issuer (mainly management) comments and proclaimed everywhere but BC in 2004. Another round of amendments and a longer phase in period was required to finally bring British Columbia

Securities Commission on-side in September 2005. Hence it was 2005 before management (except those who reported to the BC Securities Commission who commenced the phase in process in 2005) was required to evaluate and disclose in the MD&A their evaluations of the effectiveness of their disclosure controls. As securities regulations require that all MD&A disclosures must be reviewed by the Audit Committee and approved by the Board, securities regulators argue this approval provides some oversight to the evaluation and disclosure process.

As part of the compromises made, for the years 2006 and 2007 management must evaluate the effectiveness of its internal controls system design but not whether the controls are working effectively. Effectiveness assessment by management of implementation of controls is not required before 2008, some five years after it became in force in the US. Furthermore, while management must disclose their disclosure control effectiveness evaluations in MD&A there are no requirements for management's assessments of effectiveness of internal controls to be disclosed. However, if there are problems with a company's internal controls, even in 2006 and 2007 when management evaluates internal control design effectiveness that is another matter. Using somewhat convoluted logic, the CSA staff issued the following clarification about what must be disclosed if a company has an internal control design weakness:

The Certification Instrument does not explicitly require the certifying officers to cause the issuer to disclose a weakness in the design of the issuer's ICFR but it does require the certifying officers to cause the issuer to disclose in the annual MD&A the certifying officers' conclusions about the effectiveness of the disclosure controls and procedures (DC&P). In our view, the conclusions about the effectiveness of the DC&P should include disclosure of identified weaknesses in the DC&P.

Given the substantial overlap between the definitions of DC&P and ICFR, it is our view that the certifying officers therefore should cause the issuer to disclose in the annual MD&A the nature of any weakness in the design of the issuer's ICFR, the risks associated with the weakness and the issuer's plan, if any, to remediate the weakness. If no such plan exists, the issuer should consider disclosing its reasons for not planning to remediate the weakness.

CSA Staff Notice 52-316 (September 29, 2006)

*Certification of design of internal control over financial reporting*

So making no statement about internal controls in a company MD&A in 2006 and 2007 may mean the firm:

- has evaluated and found the internal controls to be designed effectively but decided to make no disclosure; or
- have found weaknesses but are not reporting them as the firm does not feel that a Staff Notice is sufficient authority to require such a disclosure; or
- have found weaknesses but are not reporting them as the firm does not believe they affect disclosure controls which are the only public reporting requirements irrespective of the Staff Notice (very similar reasoning to the second); or
- has ignored the requirement and did not carry out an evaluation.

In the USA, the informativeness of management's evaluations of effectiveness of internal controls, without an audit looming, has been questioned. The evidence from the US (Glass, Lewis & Co. 2005) in the first year of SOX 404 implementation shows that 87% of the 584 companies that provided disclosures about internal control problems in one quarter had not reported any problems in the quarter *immediately preceding* (Chart 2 of Glass, Lewis & Co 2005) yet all of a sudden they were found by management (or the auditor at times it is unclear) just as the audit of controls is looming. Since internal control problems (especially lack of documentation, lack of expertise, lack of segregation duties) generally do not appear overnight, there are only two possible reasons for this: either management did not know or management lied in its certification.

In Canada, given the debate started at the level of investor right to know anything about the state of internal controls, it is not surprising that the CSA was unable to achieve consensus on proposing that the disclosures in 52-109 be audited. Hence, they issued for comment Multilateral Instrument 52-111 *Reporting on Internal Control over Financial Reporting* over the objections of the British Columbia Securities Commission. The proposed instrument was heavily based on the very detailed and prescriptive approach taken in the USA to implement SOX 404, which subsequent events has shown not to be the only means of implementing such a requirement (i.e. the revision of both the SEC management standard and the PCAOB audit standard towards to a more top down risk based approach in 2007 is a clear indication of that).<sup>1</sup> Based on the comments received, the Canadian Securities Administrators decided not to proceed with the audit requirement (CSA Notice 52-313 2006) or any more principled alternative (see Appendix A). However, the CSA announced they would revisit and strengthen their previous requirement for management to certify that internal controls were designed and implemented effectively. As the Table 3 Panel A shows, this new proposal is a 'back to the future' document where the original proposal from 2003 are being fleshed out rather than anything really new being brought to the table. The only interesting point about this is that it is a proposed national policy with all jurisdictions on side. So five years later, we have agreement about something that was totally uncontroversial in the US, that investors had the right to know about management evaluations of the state of internal controls in their companies. The comment period ended in June but no rule has yet emerged and from a quick glance at the comment letters, the comments were far from unanimous from supporting this still relatively weak level of investor protection.

As for compliance with the first level of MLI 52-109, the CSA did a review (CSA Staff Notice 52-315 *Certification Compliance Review* released September 22, 2006) in the spring and summer of 2006 of the most recent certification for 229 TSX issuers and 52 Venture issuers and their associated MD&A. The review focused on the disclosure controls evaluation and certification of the effectiveness of such controls (basically analogous to SOX 302 Part a) as these were, except for companies in Quebec and British Columbia, suppose to be totally in effect by 2005. The review only looked for two basic things:

- whether issuers filed the certificate required by 52-109;

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<sup>1</sup> Note that Knechel, Salterio and Ballou (2007) audit textbook that went to press before the PCAOB announced the exposure draft of AS #5 fully articulated the concept of a top down risk based approach to implementing an internal control audit. Hence, this was not a new idea.

- whether issuers disclosed the results of their evaluation of disclosure controls in the MD&A as required by the certificate that they had filed.

The review did not report results about whether the issuers had reported weaknesses in their disclosure controls, whether they had limited the disclosure control evaluation in any way etc, This review was a pure compliance with the letter of the standard review.

Even with these limitations, the findings were insightful about Canadian manager's voluntary compliance. While 98% of the TSX registrants had filed the certificate only 80% had actually made the disclosure that they had certified they made in their MD&A. On the Venture Exchange things were substantially worse. 87% filed the certificate but only 38% actually made the disclosure that they had certified they made in their MD&A. As the CSA report concludes "This widespread non-compliance with such a clear and basic requirement shows that many issuers are not paying adequate attention to their disclosure obligations." The CSA review was released without an accompanying press release on a Friday afternoon late in September 2006. As such, it garnered little or no media attention as best we can tell.

**Table 3**  
**Comparison of Original, Current and Proposed Versions of Instrument 52-109**

**Panel A: Original proposals in 2003 resurrected in 2007**

<p align="center"><b>2003 Original Proposal</b> <b>MLI 52-109</b> <b>June 27, 2003</b></p>	<p align="center"><b>Current – 2006 and 2007</b> <b>MLI 52-109</b> <b>Including amendments to June 3,</b> <b>2005</b></p>	<p align="center"><b>Proposed NI 52-109</b> <b>To be effective after June 29, 2008</b></p>
<p>The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal controls for the issuer, and we have: ..... (c) <i>evaluated</i> the effectiveness of the issuer's disclosure controls and procedures <b>and internal controls</b> as of the end of the period covered by the annual filings; and (d) <i>disclosed in the annual MD&amp;A</i> our conclusions about the effectiveness of the disclosure controls and procedures <b>and internal controls</b>, in each case based on our evaluation as of the end of the period covered by the annual filings;</p>	<p>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: ..... (c) evaluated the effectiveness of the issuer's disclosure controls and procedures as of the end of the period covered by the annual filings and have caused the issuer to disclose in the annual MD&amp;A our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by the annual filings based on such evaluation; and</p>	<p>The issuer's other certifying officer(s) and I have: (a) evaluated, or caused to be evaluated under our supervision, the effectiveness of the issuer's DC&amp;P at the financial year end and the issuer has disclosed in its annual MD&amp;A our conclusions about the effectiveness of DC&amp;P at the financial year end based on such evaluation; and (b) <i>evaluated</i>, or caused to be evaluated under our supervision, the effectiveness of <b>the issuer's ICFR</b> at the financial year end and the issuer has <i>disclosed in its annual MD&amp;A</i>: (i) our conclusions about the effectiveness of <b>ICFR</b> at the financial year end based on such evaluation; (ii) a description of the process we used to evaluate the effectiveness of <b>ICFR</b>; .....</p>
<p>I have disclosed, based on my most recent evaluation, to the issuer's auditors and the audit committee of the issuer's board of directors or persons performing the equivalent function: ..... (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's <b>internal controls</b>; and</p>		<p>The issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of <b>ICFR</b>, to the issuer's auditors, the board of directors and the audit committee of the board of directors any fraud that involves management or other employees who have a significant role in the issuer's <b>ICFR</b>.</p>

**Panel B: Proposals consistent across time**

<p><b>2003 Original Proposal MLI 52-109 June 27, 2003</b></p>	<p><b>Current – 2006 and 2007 MLI 52-109 Including amendments to June 3, 2005</b></p>	<p><b>Proposed NI 52-109 To be effective after June 29, 2008</b></p>
<p>Based on my knowledge, the annual filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the annual filings;</p>	<p>Based on my knowledge, the annual filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the annual filings</p>	<p>Based on my knowledge, having exercised reasonable diligence, the annual filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, for the period covered by the annual filings.</p>
<p>Based on my knowledge, the annual financial statements together with the other financial information included in the annual filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of the date and for the periods presented in the annual filings</p>	<p>Based on my knowledge, the annual financial statements together with the other financial information included in the annual filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the annual filings;</p>	<p>Based on my knowledge, having exercised reasonable diligence, the annual financial statements together with the other financial information included in the annual filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date of and for the periods presented in the annual filings.</p>
<p>The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal controls for the issuer, and we have: (a) designed those disclosure controls and procedures, or caused them to be designed under our supervision, and implemented those disclosure controls and procedures, to provide reasonable assurances that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the annual filings are being prepared, and that such material information is disclosed within the time periods specified under applicable provincial and territorial</p>	<p>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: (a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the annual filings are being prepared; (b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable</p>	<p>The issuer's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (DC&amp;P) and internal control over financial reporting (ICFR) for the issuer.  The issuer's other certifying officer(s) and I have, as at the financial year end: (a) designed DC&amp;P, or caused it to be designed under our supervision, to provide reasonable assurance that: (i) material information relating to the issuer is made known to us by others, particularly during the period in which the annual filings are being prepared; and (ii) information required to be disclosed by the issuer in its annual</p>

Draft for discussion only

<p>securities legislation;                  (b) designed those internal controls, or caused them to be designed under our supervision, and implemented those internal controls, to provide reasonable assurances that the issuer's financial statements are fairly presented in accordance with generally accepted accounting principles;</p>	<p>assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and</p>	<p>filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time periods specified in securities legislation; and                  (b) designed ICFR, 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.</p>
<p>I have disclosed in the annual MD&amp;A whether there were significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls, made during the period covered by the annual filings, including any actions taken to correct significant deficiencies and material weaknesses in the issuer's internal controls.</p>	<p>I have caused the issuer to disclose in the annual MD&amp;A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.</p>	<p>The issuer has disclosed in its annual MD&amp;A any change in the issuer's ICFR that occurred during the period beginning on <i>&lt;insert the date &gt;</i> and ended on <i>&lt;insert the last day of the financial year&gt;</i> that has materially affected, or is reasonably likely to materially affect, the issuer's ICFR.</p>

## **Our Sample**

To carry out our study we took two random samples from Canadian only listed companies on the TSX Exchange and on the TSX Venture Exchange. The TSX Exchange sample was a random sample of all companies listed on the Exchange that had financial data on Canadian Compustat in 2005 (over 1800 companies) and verified they continued to be on Canadian Compustat when the new list was released in August 2006. These represent the largest and most actively traded companies on the Exchange. For the Venture Exchange we took a random sample of the companies listed on the S&P /TSX Venture Composite Index as of May 14, 2007 based on our belief that the set of factors required for inclusion in the Index (see [www.tsx.com/en/listings/venture\\_issuer\\_resources/index\\_eligibility.html](http://www.tsx.com/en/listings/venture_issuer_resources/index_eligibility.html)) would result in companies that had an active market following and were most likely to be of interest to investors.

In summer 2007 we targeted a sample of 100 companies from each exchange as part of a larger ongoing exercise to collect data for all Canadian listed only companies on the TSX (approximately 1200) and a larger sample of Venture issuers (300 companies). We gathered data about company size, corporate governance, disclosure control reports and internal control reports. Table 1 provides means and medians for the TSX and the Venture sample for sales, total assets and net income. We searched the annual report, the proxy (aka information circular) and the annual information form from the first year end on or after June 30, 2006 to ensure MLI 52-109 fully applied for the relevant information. On a test basis, the coding was checked by a second coder to ensure that material was not being missed and was being coded consistently. This checking resulted in 100% of the disclosure control reports and the internal control reports being cross checked by at least two coders at least one of whom was a CA. The remaining data had an approximate cross-check rate of 25%.

Table 4 shows, by exchange, the incidence of disclosure of the requirement to evaluate design effectiveness of internal control, any weaknesses in control design disclosed, steps taken to deal with that weakness (if any), an opinion on control design effectiveness (if any), whether the scope of the evaluation was described and the number of design weaknesses identified as well as a breakdown as to the two major types of weaknesses disclosed (i.e., segregation of duties and expertise). We report only 99 companies for the Venture exchange as we could not find the necessary corporate governance data to include the last company in our sample.

**Table 4**

**Panel A. TSX Disclosures About Management Evaluation of Internal Control Design Effectiveness**

	<b>Internal Control Design Evaluation Mentioned</b>	<b>No change in controls over last period report</b>	<b>Weaknesses Reported</b>	<b>Mitigating Controls</b>	<b>Plans to address weaknesses</b>	<b>Scope of evaluation by management reported</b>	<b>Effectively Designed Internal Controls Opinion</b>	<b>More than minimal disclosure</b>	<b>No. Internal Control Weaknesses Identified</b>
<b>Total</b>	91	67	20	17	18	12	46	56	37
<b>% of 100</b>	<b>91.00%</b>	<b>67.00%</b>	<b>20.00%</b>	<b>17.00%</b>	<b>18.00%</b>	<b>12.00%</b>	<b>46.00%</b>	<b>56.00%</b>	
<b># of companies</b>	100	100	91	20	20	91	91	91	20
<b>% of # of companies</b>	<b>91.00%</b>	<b>67.00%</b>	<b>21.98%</b>	<b>85.00%</b>	<b>90.00%</b>	<b>13.19%</b>	<b>50.55%</b>	<b>61.54%</b>	<b>1.85</b>
	<b>Types of control weakness</b>				<b># companies with opinion</b>		54		
	<b>Segregation of Duties</b>		10		<b>Effectively designed if opinion given</b>		85.19%		
	<b>Expertise (specialized accounting or tax)</b>		9						

**Panel B. Venture Disclosures About Management Evaluation of Internal Control Design Effectiveness**

	Internal Control Design Evaluation Mentioned	No change in controls over last period	Weaknesses Reported	Mitigating Controls	Plans to address weaknesses	Scope of evaluation by management reported	Effectively Designed Internal Controls Opinion	More than minimal disclosure	No. Internal Control Weaknesses Identified
<b>Total</b>	61	38	33	25	11	3	13	42	54
<b>% of 99</b>	<b>61.62%</b>	<b>38.38%</b>	<b>33.33%</b>	<b>25.25%</b>	<b>11.11%</b>	<b>3.03%</b>	<b>13.13%</b>	<b>42.42%</b>	
<b># of companies</b>	99	99	61	33	33	61	61	61	33
<b>% of # of companies</b>	<b>61.62%</b>	<b>38.38%</b>	<b>54.10%</b>	<b>75.76%</b>	<b>33.33%</b>	<b>4.92%</b>	<b>21.31%</b>	<b>68.85%</b>	<b>1.64</b>
	<b>Types of control weakness</b>				<b># companies with opinion</b>		29		
	Segregation of Duties		20		Effectively designed if opinion given		44.83%		
	Expertise (specialized accounting or tax)		8						

## What We Found – Effects of Weaker Canadian Internal Control Regulations

Research question:

*Comparing the unaudited TSX internal control disclosures with Canadian cross listed companies subject to SOX 404 audit and other US based benchmarks, is there evidence that Canadian TSX companies who report on their internal controls are understating their control weaknesses?*

One of the key differences between the Canadian context and the SOX regime is strength of regulation and the regulator. SOX, be it 302 or 404, is a statute law, enforced by a vigilant well funded regulator (SEC) with a history of strong enforcement actions both administratively and criminally. Furthermore, compliance is mandatory for all public firms 302 and 404 subject to certain exemptions (mainly size related for Section 404 audits, all other parts are mandatory). In Canada, on the other hand, we have a “forum” of 13 provincial and territorial regulators, some virtually one person operations, with limited enforcement powers and a poor history of criminal prosecution. For example, despite the CSA’s conclusion of “widespread non-compliance” in their disclosure controls effectiveness review report (CSA Staff Notice 52-315), the CSA noted that they “will take action where we decide it is appropriate.” We are unable to find any public instances of any action being taken and indeed the names of the non-compliant companies were not made public by the CSA, hence there was not even potential for public embarrassment as a penalty for certifying something that managers did not do. Hence, we first examine voluntary disclosure about internal control evaluations taking a liberal definition of disclosure.

As can be seen in Table 4 Panel A, for TSX firms, we found that 91% did make some mention of responsibility for internal control assessment. However, we also noted that:

- 9% of TSX firms did not disclose anything about internal control design effectiveness evaluations including large firms like Loblaw Companies (see mini-case in Appendix B), Power Corp, Power Financial and The Score Media.
- of the 91% that did acknowledge some responsibility for internal controls only 60% provided an opinion about the management’s assessment effectiveness of control design.
- hence only 54% of our TSX sample provided an opinion on design effectiveness of internal controls over financial reporting. But of these 54%, 46% (or 85% of the 54%) reported that management’s opinion was that internal controls were designed effectively.
- further, the equivalent rate on the Venture Exchange (Table 4 Panel B) is a significantly lower 29% of the sample provided an opinion and there was no offsetting good news as only 13% (or 45% of the 29%) reported that management’s opinion was that internal controls were designed effectively.

Hence, our conclusion is simple, despite regulatory requirements to carry out evaluations of internal control design effectiveness, an overall minority of Canadian only listed companies are disclosing the results of these evaluations in contrast to the US where it is mandatory for management to disclose its evaluation. Further is interesting to speculate, how are the securities regulators going to monitor the implementation of their regulation? Remember that in 2006 the

CSA followed up on CEOs and CFOs certification that they had disclosed their disclosure control evaluations in the MD&A and found widespread noncompliance with disclosure, never mind doing the evaluation in the first place. Finally, academics argue that firms that make disclosures in such a voluntary marketplace are more likely to be ‘higher quality’ and hence have better controls than the firms that do not report.

Nonetheless, we compare the TSX management assessments of internal control design effectiveness to US internal control assessments (both audited (404) and unaudited (302)) to see whether the TSX sample has fewer internal control design weaknesses than the overall rate of ineffective controls under SOX as would be expected by those arguing that an audit is necessary to reveal all problems. This expectation is based on the contention made in the United States (Glass Lewis & Co 2005) and by some Canadian commentators (see Appendix A for comments by one of this study’s authors) that management’s assessment of internal control effectiveness without the discipline of an audit is unlikely to be effective at finding weaknesses in many cases, especially those that investors care most about where management is engaging in corporate malfeasance. Given the data we have available we propose three tests:

1. TSX Canadian only listed companies compared to Canadian cross listed companies subject to SOX 404 audit in 2006. Focusing on TSX allows for comparable size to cross listed companies rather than including Venture sample (see Table 1).
2. TSX Canadian only listed companies compared to Canadian cross listed companies that provided a management report on internal control in 2006. Expands the comparison group of cross listed companies to include those that have only management assessments of control effectiveness. We examine both the combined sample and the sample of cross listed companies without audit by themselves (see Table 1).
3. TSX Canadian only listed companies compared to US based companies subject to SOX 404 audits in 2006 excluding the largest 350 US companies. This comparison increases the rate of US noncompliance by removing the huge US firms that have the largest resources and the most incentives to achieve a ‘clean’ SOX 404 opinion. It also results in a US sample that is roughly similar in size to that of the TSX Canadian only listed companies (see Table 1).

As we have two Canadian TSX measures, number of companies disclosing design weaknesses as well as number of companies reporting ineffective internal control design opinions, we compare both of those to the US SOX 404 (or management opinion only) data. See the Table 5 for a summary of the various rates of internal control problems reported in the samples.

We find that for Canadian TSX companies that voluntarily reported either control design weaknesses or negative effectiveness of control design opinions have:

- higher rates of control problems than did Canadian cross listed companies subject to 404 audit,
- the same rate of control problems as Canadian cross listed companies who claimed an exemption from the 404 audit but who provided an management evaluation of internal control effectiveness,
- a higher rate of control problems than the combined sample of the Canadian cross listed companies (both those audited and those with management opinions only), and

- a higher rate of control problems than the sample of US based SOX 404 companies excluding the 350 largest companies US based companies.

## **CONCLUSIONS:**

The result of the regulatory process has lead Canada to having a very weak internal control evaluation and disclosure standard as can be seen in our data. Instead of internal control evaluations acting as a deterrent to management for committing corporate malfeasance, because of the voluntary nature of disclosure (and implicitly compliance) the regulation has become a way of exhibiting 'good corporate citizenship'. Only 54% of TSX companies disclosed an internal control design effectiveness opinion and 29% of the Venture exchange companies did likewise compared to the entire population of firms (above a certain size) being required to do so in the US. In this subset of "good corporate citizens" who complied with both the spirit and letter of the regulation, we are not surprised to find rates of internal control problems greater than or equal to equivalent populations of firms listed in the US that are subject to the stricter regulatory regime of SOX, be it 302 or 404. However, it is unlikely that the real targets of SOX inspired regulation will be found in this set of firms that voluntarily complies with the spirit and intent of regulation as those are the firms with management that is least likely to commit malfeasance in the first place. It is firms like Enron and their like who fought every regulatory intervention that SOX is designed to deal with, however imperfectly at times.

**Table 5**  
**Summary of Rates of Internal Control Problems Reported in Various Samples**

	<b>TSX Reporting Weaknesses</b>	<b>TSX internal controls effectively designed (if opinion given)</b>	<b>Canadian Cross Listed SOX 404 with Audit</b>	<b>Canadian Cross Listed SOX 404 Audit Exempt</b>	<b>Canadian Cross Listed Combined</b>	<b>US based 2006 SOX 404 Audit Companies (excluding largest 350 companies)</b>
	<b>(Table 4, Panel A)</b>	<b>(Table 4, Panel A)</b>	<b>(Table 2, Panel A)</b>	<b>(Table 2 Panel B)</b>		<b>(Table 2 Panel C)</b>
Companies with control problems	20	8	7	10	17	348
Total Companies	91	54	106	53	159	3563
<b>% with problems</b>	<b>21.98%</b>	<b>14.81%</b>	<b>6.60%</b>	<b>18.87%</b>	<b>10.69%</b>	<b>9.77%</b>

## What We Found - Exchange Compliance Differences

Research question:

*Is compliance with the internal control design evaluation requirement equal across the TSX and the Venture Exchanges? What differences, if any, are observed in the state of internal controls between companies listed on the TSX versus those on the Venture Exchange?*

Defining compliance with management's assessment of internal control design effectiveness requirement is a problem for any researcher. As we noted previously, making no statement about internal controls in a company's MD&A in 2006 and 2007 may mean the firm:

- has evaluated and found the internal controls to be designed effectively but decided to make no disclosure; or
- have found weaknesses but are not reporting them as the firm does not feel that a Staff Notice is sufficient authority to require such a disclosure; or
- have found weaknesses but are not reporting them as the firm does not believe they affect disclosure controls which are the only public reporting requirements irrespective of the Staff Notice (very similar reasoning to the second); or
- has ignored the requirement and did not carry out an evaluation.

The latter possibility is particularly cogent in light of the CSA experience with the much simpler requirement to disclose management's assessment of disclosure control effectiveness where, in the CSA's study released in 2006, they found widespread non-disclosure in the MD&A despite the filing of correct certification in 98% of the TSX companies and 87% of the Venture companies that such disclosure had been made. Of course, the CSA does not know whether the certificates were signed without the evaluation being carried out or whether the companies did not disclose an evaluation that had been carried out.

Hence, to test our research question we examined the MD&A broadly for any indication that management evaluated the design effectiveness of its internal control over financial reporting. We accepted the sentence "There has been no change in the company's internal control over financial reporting that occurred in the most recent period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting." as the absolute minimum statement of management responsibility for evaluation of internal control design. We based this conclusion on the wording of the certificate that both the CEO and the CFO must sign:

5. I have caused the issuer to disclose in the annual MD&A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

MLI 52-109, Form 52-109F1

We are aware that some have interpreted this paragraph as meaning, "no change, no need to report" but the overall emphasis on providing information to shareholders in 52-109 combined with this explicit certification is highly suggestive that this is the minimal disclosure keeping

with the spirit of the regulation. Lawyers can fight about the legal technicalities, as accountants we are interested in substantive disclosure to the markets of decision relevant information. We more narrowly search the entire annual report, proxy (management information circular) and annual information form for any indication of management's opinion about the design effectiveness of internal controls over financial reporting. This broader search did not give credit for an almost standard line in most statements of management responsibility that 'management is responsible for designing an effective system of internal control' as those statements well pre-date the new regulation and were not thought to be strong enough by regulators.

We find that 91% of the TSX companies' management provide some indication that they are responsible for evaluating the design effectiveness of internal control over financial reporting compared to 62% of the Venture Exchange companies. However, the 9% of the TSX sample not making any mention at all of internal controls in their MD&A includes several high profile companies such as Loblaw Companies, Power Corporation, Power Financial and Score Media. In Appendix B we highlight Loblaw Companies Ltd, which has taken charges on its financial statements for restructuring, for inventory overvaluation and inventory shrinkage in the past two years as well as disclosing recently that the CFO and controller departed subsequent to fiscal 2006 yearend and announced massive layoffs at head office. Yet, despite all these changes, there has been no mention in the MD&A any changes in internal control over financial reporting in the past two years, or any indication that the controls over financial reporting were assessed. Which of the four meanings should be attributed to Loblaw's Board and management's silence?

When management does report the results of a control effectiveness evaluations, over 54% of the Venture companies report design weaknesses in their controls compared to 22% of the TSX companies (see Table 4), a significantly lower rate for TSX firms. In the set of companies that mentions anything about internal controls, there is only a marginal difference in the rate that an opinion is provided (48% versus 59%) but because the rate of mentioning controls is so much lower on the Venture exchange the raw rates are highly different (29% overall for the Venture versus 54% overall for the TSX). Further, the rate of reported design effectiveness is much lower on the Venture exchange, as less than half report controls are designed effectively versus over 85% on the TSX, a highly significant difference. See Figure 1.

Companies on both exchanges report the existence of mitigating controls (85% and 76%) and 90% of TSX companies have plans in place to remedy at least some of the control weaknesses. Venture issuers, normally due to segregation of duties issues or the inability to hire specialized expertise that would not be fully utilized due to their size of operations, are significantly less likely to have such plans in place (33% have such plans).

There is very limited disclosure about how the evaluations were carried out (i.e. the scope of the evaluation) by either the TSX (13%) or the Venture (5%) companies. Indeed, more than the fact that management did an evaluation was mentioned only 60% to 70% of the time and normally that was in the context of a definition of what internal control was and what its limitation were.

Appendix C includes examples of good disclosures made by companies in their MD&A. Common across these disclosures is management's effort to inform investors rather than simply comply with MLI 52-109. That is, these companies have taken additional steps to ensure that the investor understands what management is doing, and what the certification means. In addition, these companies are informing the investor on how they design and undertake their evaluation, clearly communicating the requirements and conclusions.

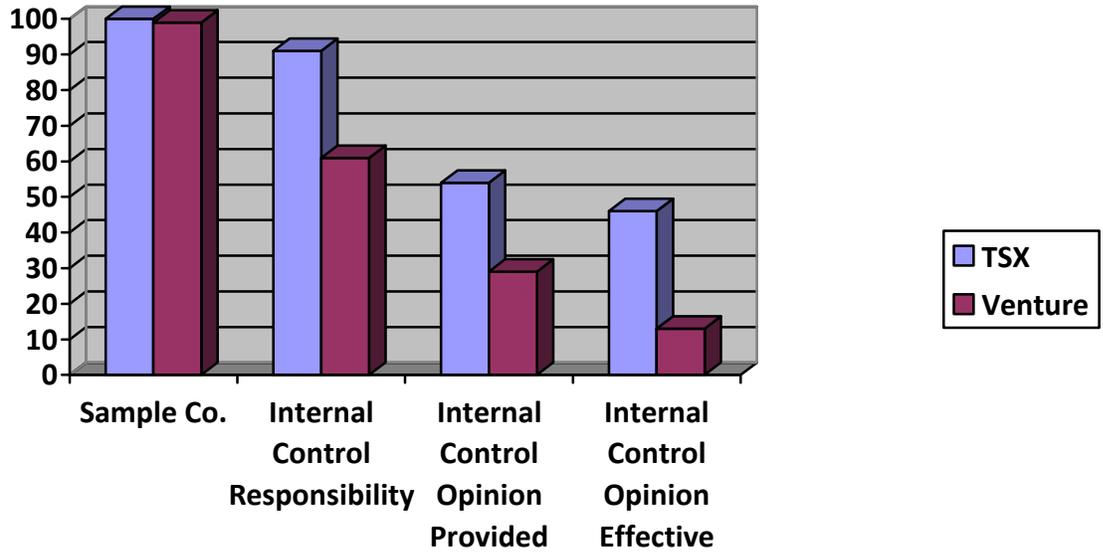
## **CONCLUSIONS:**

1. Most TSX registrants are disclosing, at least minimally, that they have some responsibility for internal controls in their MD&A although there are several high profile holdouts. When TSX registrants do accept responsibility for internal controls, management almost 60% of the time provide their opinion about design effectiveness based on the assessment. However, management rarely tells readers how they arrived at that opinion. TSX companies generally have plans to deal with any weaknesses they reported finding in addition to having mitigating controls currently.
2. Venture registrants are much less likely to disclose, however minimally, that they are responsible for internal controls in their MD&A. They provide the results of assessing controls at only a slightly lower rate than TSX companies in the set of companies that makes some acknowledgment of its responsibility for controls in the MD&A but given so few of those are found in the Venture exchange the absolute differences are large (29% versus 54%). Furthermore, Venture companies exhibit significantly greater rates of weaknesses and rates of management assessments of ineffective control design. While Venture firms are likely to have mitigating controls in place they are less likely to plan to deal with the weaknesses due to size constraints and inability to hire expertise that would not be fully utilized.

Hence, even though we biased our Venture sample towards the more active and stable Venture companies (i.e. members of the Composite Index), we find significantly less compliance with 52-109 compared to the TSX companies. This we believe may be reflected by management's views about differential enforcement. The Venture exchange is based in Calgary and the primary regulators are the Alberta and British Columbia Securities Commission. The TSX exchange is based in Toronto and the primary regulator is the Ontario Securities Commission. Given that it has been British Columbia that has consistently lead the charge for weaker regulation one might expect that registrants in the exchange that BC has significant regulatory authority over might be lead to believe that enforcement of such a regulation would not be a priority. The data certainly supports the lack of uniformity in compliance across the two exchanges which generally indicate a belief that there will be minimal consequences for non-compliance.

**Figure 1**  
**Internal Control Design Effectiveness Results**

**TSX & Venture Companies Sample**



## What We Found – Good Corporate Governance Enhances Compliance

Research question:

*Does corporate governance play a role in determining: whether a company discloses it has evaluated its internal control system design, and whether a company discloses that it has an effectively designed internal control system?*

While at this early stage of our research we do not have refined analyses of the link between corporate governance quality and the decision to disclose the management assessment as well as the effectiveness opinion result, we did carry out an initial analysis of traditional key governance indicators and their association with whether the internal control design evaluation by management was mentioned in the MD&A and whether the opinion, for those who provided one, was that there was effective internal control design.

We employed two sets of variables, those related to the corporate board:

- # of independent board members
- % of independent board members of total directors
- # of fully independent board members (eliminating ‘grey’ directors)
- % of fully independent board members of total directors
- % of manager board members of total directors

and those related to audit committee of the board:

- # of independent directors on audit committee
- % of independent directors on audit committee
- manager on audit committee (mainly for Venture firms)
- # times audit committee meets each year.

Each of these features has been used extensively in corporate governance research (see Beasley and Salterio 2001 for example). None of them is perfect and they only provide weak indications of the effects of corporate governance on such matters as internal control system effectiveness at preventing fraud and error and providing high quality financial reporting.

We found the following:

1. Governance factors associated with the decision to disclose management’s assessment of internal control design effectiveness:
  - a. Factors increasing the likelihood of effective design assessment:
    - i. # of independent directors on audit committee
    - ii. # times audit committee meets each year.
  - b. Factor decreasing the likelihood of effective design assessment:
    - i. manager on audit committee (mainly for Venture firms)
2. Governance factors associated with management’s opinion that they have effectively designed internal controls over financial reporting:
  - a. Factors increasing likelihood of disclosure:
    - i. # of independent board members

- ii. % of independent board members of total directors
- iii. # of fully independent board members (eliminating 'grey' directors)
- iv. % of fully independent board members of total directors
- v. # of independent directors on audit committee
- vi. % of independent directors on audit committee
- b. Factors decreasing the likelihood of disclosure:
  - i. % of manager board members of total directors
  - ii. manager on audit committee (for Venture firms only)

## **CONCLUSIONS:**

Somewhat surprising to us was the conclusion that the audit committee seemed to drive the decision whether to disclose that management was undertaking the internal control assessment. Stronger and more active audit committees tended to see that such disclosures were more likely to be made.

Also somewhat surprising to us was that stronger boards were associated with whether the company had an effectively designed internal control system according to management's assessment. While the associations showed that the audit committee played a role the overall board measures were consistently equal to or stronger than in their association with the effective design opinion than were the audit committee measures.

Despite the above significant results, several limitations of the analysis must be discussed. First, the correlation statistics are tendencies only, and therefore there is no guarantee that a company that exhibits strong governance factors makes the voluntary disclosures. Loblaw Companies provide an excellent counter-example of a very strong and independent audit committee (a subcommittee of the Board of Directors) yet we cannot find any disclosures about internal control evaluations in the MD&A. Secondly, for the purpose of the correlation analysis, the TSX and Venture samples were combined in order to derive conclusions based on the overall sample. Nonetheless, by combining the TSX and Venture samples, broader generalizations regarding the governance factors are possible.

## **What We Found – Disclosure controls compliance: a year later**

Research question:

*Have Management Discussion and Analysis disclosures about effectiveness of disclosure controls improved since 2005, the first year of implementation?*

Overall, MD&A disclosures regarding the effectiveness of disclosure controls in 2006 within our TSX and Venture sample were 93% and 81% a significant improvement for both over the reported CSA results in 2005 (see Table 6 Panels A and B). Furthermore, there is still a significant difference in rate of compliance between the two exchanges (12%). In addition, unlike the CSA we also examined the quality of the disclosures and we found is that 9% of the TSX companies and 17% Venture companies restricted their effectiveness assessment to year end disclosures only, and indeed some to only the disclosures in the annual report. This difference in proper certification widens the compliance difference from 12% to 20% after adjusting for quality. Recall the 52-109 certification is that the company has a system in place that allows management to ensure it receives on a timely basis throughout the year the information necessary to meet its continuous disclosure obligations.

From a broader perspective, there appears to be some key problems with how the securities administrators have conveyed what they mean about disclosure controls and internal controls over financial reporting. When one compares the disclosure control weakness rate identified in Table 6 Panel A and B versus the weaknesses in internal control identified in Table 4 Panel A and B, it is readily apparent that the rate of internal control weaknesses are greater for both the TSX and Venture (22% and 54% respectively) as compared to the rate of weaknesses in disclosure control (3% and 4% respectively). In Staff Notice 52-316, the CSA indicates that there is “substantial overlap” between disclosure control and procedures and internal control over financial reporting. If internal controls have a “substantial overlap” with disclosure controls as the Staff Notice contends, how are there so many cases of ineffective internal controls combined with a MD&A certification of effective disclosure controls. This inconsistency highlights problems associated with carrying out regulation by staff interpretations of weak regulations instead of passing the regulation requiring disclosures of internal control design effectiveness evaluations in the first place.

### **CONCLUSION:**

While we find improvement in basic compliance over the CSA initial study of disclosure control certifications, we still find major issues associated with a task so basic that it does not even draw comment in the US. In addition, we find inconsistent rates of compliance between the two exchanges indicating the likelihood of differential regulatory scrutiny across the country given different provincial regulators. Further we find problems associated with attempting to implement regulation via staff notices when the regulation itself is weak leading to conceptual confusion and inconsistencies in certifications.

**Table 6**

**Panel A. TSX Disclosures about Management Evaluation of Disclosure Control Effectiveness**

	<b>Effective Disclosure Controls</b>	<b>Limited reporting to Annual Filings Only</b>	<b>Weakness Disclosed</b>	<b>Other Deficiencies/ Disclosures</b>	<b>Other disclosure control weaknesses</b>
<b>Total</b>	93	8	3	1	4
<b>% of 100</b>	93.00%	8.00%	3.00%	1.00%	4.00%
<b># of companies</b>	100	93	93	93	93
<b>% of # of companies</b>	<b>93.00%</b>	<b>8.60%</b>	<b>3.23%</b>	<b>1.08%</b>	<b>4.30%</b>
<b>Per CSA report (52-315) for 2005 filings</b>					
<b>Total</b>	183				
<b># of companies</b>	229				
<b>% of # of companies</b>	<b>79.91%</b>				

**Panel B: Venture Disclosures about Management Assessment of Disclosure Control Effectiveness**

	<b>Effective Disclosure Controls</b>	<b>Limited reporting to Annual Filings Only</b>	<b>Weakness Disclosed</b>	<b>Other Deficiencies/ Disclosures</b>	<b>Other disclosure control weaknesses</b>
<b>Total</b>	80	14	3	5	6
<b>% of 99</b>	80.81%	14.14%	3.03%	5.05%	6.06%
<b># of companies</b>	99	80	80	80	80
<b>% of # of companies</b>	80.81%	17.50%	3.75%	6.25%	7.50%
<b>Per CSA report (52-315) for 2005 filings</b>					
<b>Total</b>	20				
<b># of companies</b>	52				
<b>% of # of companies</b>	38.46%				

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## Appendix A

### **If not SOX 404 then what? A More Informative Auditor's Report**

Throughout North America public companies are complaining about the costs associated with the requirements of Sarbanes Oxley Act Section 404! Section 404 requires that management document and test its internal controls over financial reporting and that the auditor audits that report and the effectiveness of the internal controls. Why was SOX 404 mandated by the US Congress? Because research shows that lack of internal control at the highest levels of public companies is strongly associated with fraud.

To date over 3000 firms registered with the US Securities and Exchange Commission (SEC) have reported under Section 404. More than 13% have reported ineffective controls over financial reporting. Over 6000 smaller SEC registered public companies have not yet been required to report under SOX 404. In Canada, only the 180 largest cross-listed companies have been required to report due to their US stock exchange listing. For the last six months the Ontario Securities Commission has been considering whether to require some or all companies that are traded on Canadian stock exchanges to report under Canadianized version of SOX 404.

Back in the USA, smaller public companies who want to avoid SOX 404 appear to have found some friends on the SEC's Advisory Committee on Smaller Public Companies. The Committee is recommending that the SEC not require any reporting on internal control for what they call "microcaps", companies with less than \$125 million US in market capitalization (total market value of shares issued) and in previous year's gross revenue. The Committee is also recommending that companies with less than \$750 million US in market capitalization and last year gross revenues of less than \$250 million US not be required to have an audit of their management's report over the effectiveness of internal control. The combined effects of these two exemptions would remove the audit requirement for over 90% of the public companies that have not yet had internal control audits and it would result in almost 85% of them not providing a management report on controls. If similar size limits were applied in Canada at least 75% of the TSX companies and nearly 100% of the TSX Venture companies would qualify for one or both the exemptions.

Does the audit requirement matter? Some Canadian chief financial officers, such as the Senior VP and Chief Financial Officer of Keyera Facilities Income Fund, a TSE \$1 billion Canadian market cap believe "most investors are unconvinced that the external auditor's report would provide any degree of incremental comfort" over a management report on internal control effectiveness. However, the US experience to date for larger public companies is that 87% of companies who disclosed internal control problems had filed CEO and CFO certifications that their company had effective controls over financial reporting in the immediately preceding quarter according to Glass, Lewis & Co.. So based on the evidence to date, the proposal for a management report over internal control effectiveness without an audit is likely to be less than effective.

Other Canadian chief financial officers appear to labour under another delusion, such as the VP Finance and Chief Financial Officer of Bow Valley Energy Ltd who asserted in a comment

letter to the OSC “the current audit opinion inherently provides assurance that the company in question has effective controls in place, assuming a clean audit opinion is issued.” I am certain that their auditors at Pricewaterhousecoopers are happy with that comment! Unfortunately, as any auditor worth his or her salt will tell you, this is not necessarily so! There is no requirement that the auditor evaluates and tests the effectiveness of internal controls if there are alternative lower cost means of assuring that the financial statements are prepared in accordance with generally accepted accounting principles. While there is no doubt that the auditor needs to understand how the accounting system works in order to audit the financial statements, the auditor is only required to obtain an “*understanding of internal control relevant to the audit.*” Furthermore, the auditor’s rule book, the CICA Assurance Handbook, explicitly states that “an understanding of an entity’s controls is not sufficient to serve as testing the operating effectiveness of controls.” Mind you, the Handbook has encouraged auditors to test effectiveness of internal controls for almost a generation; but internal control reliance, as it is called, went out of style for all but the largest companies in the audit cost cutting days of the 1990’s.

So if SOX 404 is too expensive for smaller public companies and mircocaps; and management reporting over internal control effectiveness is unreliable without an audit; and the audit of financial statements does not necessarily provide any assurance over internal control effectiveness, then what is a regulator or standard setter to do? The answer might be simple: require the auditor disclose whether he has relied on internal controls in carrying out his or her audit. Add a fourth paragraph to the auditor’s standard unqualified (or “clean opinion”) report (technically known as an *emphasis of matters* paragraph) that states:

Due to the size of XYZ Ltd., there is no regulatory requirement [that management report on the effectiveness of internal controls and] that we audit that report and form an opinion on the effectiveness of internal controls over financial reporting. Due to the *reason inserted here*, we have not relied to any material extent on testing the operating effectiveness of internal controls over financial reporting in reaching our opinion on these financial statements.

The reason stated could be as simple as more cost effective audit evidence is available for the majority of elements on the financial statements to the reason that the company’s internal control system as it is changing quickly as the company is growing rapidly. If the auditor places some level of reliance on internal controls over financial reporting in reaching his or her audit opinion about the financial statements, a different fourth paragraph could be written, stating that:

Due to the size of XYZ Ltd., there is no regulatory requirement [that management report on the effectiveness of internal controls and] that we audit that report and form an opinion on the effectiveness of internal controls over financial reporting. We have placed *limited/moderate/substantial (choose the one that reflects the extent of reliance)* reliance on the effectiveness of the internal control over financial reporting during our audit of the financial statements. During the control effectiveness testing done to support our *limited/moderate/substantial* reliance, nothing came to our attention that suggests there is a material weakness in the internal controls over financial reporting. Our opinion might

have changed if we had carried out an audit of the effectiveness of internal controls over financial reporting; hence this opinion is not a substitute for an integrated audit of the financial statements and the effectiveness of internal controls over financial reporting.

While not perfect, it is certainly consistent with the goal of investor protection. By providing clarity as to what reliance the auditor has placed on internal controls and not leaving it as a guessing game, investors can appropriately evaluate the risk involved in investing in smaller public companies. Most sophisticated investors realize that the operational risks of smaller public companies and mircocaps are greater than their larger cousins. These investors should also realize that the auditor's report over the financial statements does not assure the investor that the company has an effective system of internal control over financial reporting and price that into their investment decision. Simple, straightforward, cost effective and informative! What more could a regulator or standard setter look for?

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**NOTE:** Final version published as S. Salterio. SOX for Canada. *National Post*. Don Mills, ON. (March 21, 2006) FP 19 as an op-ed.

## Appendix B

### Loblaw Companies Ltd.

Loblaw Companies Ltd.'s MD&A in the 2006 annual report did not disclose any information regarding internal control over financial reporting including any mention as to the design effectiveness or change in internal controls over financial reporting. In the past two years Loblaw Companies Ltd. has experienced substantial internal changes, any or all of which might have affected internal controls over financial reporting as the "comment" after each point speculates:

- In early to mid 2005, after evaluating the supply chain network, the company approved plans to restructure the supply chain which entailed closure of distribution centers and relocation of business activities to other centers. Estimation of total restructuring costs was estimated to be \$90 million with 1,400 positions affected. (Comment: Large scale layoffs often are associated with changes to internal controls.)
- Also in 2005, the company underwent restructuring of the administrative and operating offices with associated reorganization of the operations, procurement, and merchandising groups. These restructuring activities neared completion at the end of fiscal 2005. (Comment: Changes in these groups could affect internal controls over financial reporting as these groups and their associated control activities monitor key inputs into cost of goods sold.)
- In fiscal 2006, overstocked inventory was liquidated resulting in a charge of \$68 million (Comment: Weak internal controls are often associated with inventory overstocking).
- In fiscal 2006, unexpected inventory shrinkage of \$35 million. (Comment: Unexpected shrinkage is often associated with weak controls).
- Subsequent to 2006 fiscal year end, the company announced the departure of the Executive Vice President and CFO, Richard Mavrincac, and the Executive Vice President and Financial Controller, Steve Smith. Furthermore, the company announced that another 800-1000 job losses in National Head Office and other areas of the company. (Comment: Potential change in top financial leadership makes reassurance about strength of controls even more important. Repeat of comment associated with first bullet point.)

To give Loblaw's management full credit, in management's statement of responsibility separate from the MD&A the following line does appear "To provide reasonable assurance that assets are safeguarded and that relevant and reliable financial information is produced, management is required to design a system of internal controls and certify as to the design effectiveness of internal controls over financial reporting." However, this statement does not require explicit Audit Committee and Board approval under securities regulations as does the MD&A, although they will normally review it as part of their due diligence.

**Appendix C**  
**Illustrative Examples of Good Internal Control Disclosures**

**Panel A: TSX Disclosures about Management Evaluation of Internal Control Design Effectiveness**

**Company 1: Norwall Group Inc.**

**Internal Controls over Financial Reporting**

Management is also responsible for the design of internal controls over financial reporting (“ICFR”) within the Company in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles (“GAAP”). Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, the design of any system of control is based upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all future events, no matter how remote, or that the degree of compliance with the policies or procedures may not deteriorate. Accordingly, even effective ICFR can only provide reasonable, not absolute, assurance of achieving the control objectives for financial reporting.

The design of the Company’s ICFR was evaluated by management, including the Chief Executive Officer and Chief Financial Officer, in accordance with criteria established in the Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and Multilateral Instrument 52-109 as at December 29, 2006.

Based on their review of the documentation of ICFR and process walkthroughs conducted under their supervision, the CEO and the CFO have concluded that the design of ICFR , except for the limitations noted above, would provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP as of December 29, 2006.

## Company 2: AltaGas Income Trust

### INTERNAL CONTROLS OVER FINANCIAL REPORTING

Management of the Trust is responsible for establishing and maintaining adequate internal controls over financial reporting. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be designed effectively can provide only reasonable assurance with respect to financial statement preparation and presentation. The Trust has used the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework to evaluate the design of internal controls over financial reporting.

At December 31, 2006 management assessed the design of the Trust's internal control over financial reporting and concluded that internal control over financial reporting is suitably designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The assessment also concluded that there were no material weaknesses in the design of AltaGas' internal control over financial reporting that have been identified by management.

There have been no changes in the design of internal control over financial reporting during the year ended December 31, 2006 that have materially affected or are reasonably likely to materially affect the Trust's internal control over financial reporting.

**Panel B: Venture Disclosures about Management Evaluation of Internal Control Design Effectiveness**

**Alternative Fuel Systems – Recognizing that internal controls and disclosure controls are related and discussing problems associated with remedying them.**

**Internal Control over Financial Reporting**

AFS management has concluded that as at December 31, 2006, the following weaknesses existed in the design of internal control over financial reporting. These weaknesses should also be considered as weaknesses in the Company's disclosure controls and procedures.

The Company does not have an adequate segregation of duties within the Finance function due to a small staff complement. As a result there is no independent review of more complex areas of accounting and certain accounting estimates prepared by the CFO.

Management concluded and the Board of Directors agreed that, taking into account the best interests of the company and its shareholders, the Company does not have sufficient size and scale to warrant the hiring of additional staff to correct the weaknesses in the segregation of duties at this time.

Notwithstanding these weaknesses, based on the Company's mitigating procedures, the CEO and CFO have satisfied themselves that these weaknesses have not resulted in material errors in the financial statements.

Subsequent to the December 31, 2006 year-end, management has implemented a procedure for another officer of the company to review and sign off on the listing of net payroll deposits and disbursements.

There have been no changes in the Company's internal control over financial reporting that occurred during the most recent interim period ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.