An Early Look at Internal Controls in Canadian Public Companies: SOX 404 Reports

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ABSTRACT

At present there is little evidence available about the state of internal controls in Canadian public companies. The first opportunity we have to examine these controls is with a small set of 31 Canadian public companies cross listed (or listed only) on US exchanges that were required to file under Sarbanes Oxley Act of 2002, Section 404 in 2004 and 2005. We find that compared to similar-sized U.S. companies, Canadian firms report higher rates of internal control problems at a similar stage of SOX implementation. In the first full year of SOX reporting in the United States, 13 per cent of companies disclosed weaknesses in internal controls according to the US SEC. In comparison, 19 per cent of cross-listed (or listed only) Canadian firms report material weaknesses at roughly the same stage of implementation. While comparisons about Canadian public companies being 'worse' than US public companies should be made carefully due to the small sample size, there is no evidence that supports regulatory conjectures that we do not need audits of internal controls in Canada. Furthermore, in four out of six cases where material weaknesses are found, company Chief Executive Officers and Chief Financial Officers had certified the internal controls over financial reporting as being effective as late as the previous quarter to the one where they disclosed the material weaknesses. This reinforces US evidence that certification by itself does not lead to either finding or disclosing material control weaknesses by corporate management.

An Early Look at Internal Controls in Canadian Public Companies: SOX 404 Reports

The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of public companies in effort to protect the interests of investors. As required by the Sarbanes-Oxley Act of 2002 Section 101, the PCAOB has the duty to adopt standards regarding the audits of public companies. One of the Act's most controversial requirements is Section 404 which requires management to assess and auditors to attest to the effectiveness of internal controls over financial reporting. Hence, the PCAOB passed Auditing Standard No.2 *An Audit of Internal Controls Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (PCAOB AS2 2004). This standard requires the auditor to opine on the financial statements and also give: (1) an audit opinion on management's assessment of the effectiveness of internal controls, and (2) an audit opinion on the design and operations of the internal controls as at the fiscal year end (PCAOB AS2 2004, par.5). In order to provide support for their opinions, auditors must assess the organizations' internal controls and, where appropriate, classify the design and operational effectiveness of these controls into the following categories: (1) deficiency, (2) significant deficiency, or (3) material weakness (PCAOB AS2 2004, par.7-10). The rigour of the audit process is what many have viewed as the most effective (Knechel, Salterio and Ballou 2007) and the most costly (Hermanson 2005) part of the SOX legislation.

In Canada, firms traded exclusively on Canadian exchanges are not subject to the same level of reporting because of the March 2006 decision by the Canadian Securities Administrators not to proceed with a Canadian equivalent of SOX (CSA Notice 52-313 2006). This decision is in response to complaints from Canadian CEOs and CFOs about the costs associated with documenting and testing their internal controls, not to mention the cost of having the internal control systems audited by their external auditor. A major insurance company CFO stated in a public letter to the Ontario Securities Commission, "*We are going to spend between $20 and $30 million this year and every year in the future to comply with SOX [internal control testing and auditing].*"

To provide some early evidence on this issue, this study investigates SOX 404 reports from 31 firms that are cross-listed in Canada and the U.S. (or are Canadian and listed only in the US) and are required to file SOX 404 reports with the US SEC for the first time in 2004 or 2005. We find that compared to similar-sized U.S. companies, Canadian firms report higher rates of internal control problems at a similar stage of SOX implementation. These weaknesses included major financial statement accounts such as accounts receivable, revenue recognition and miscalculation of expenses.

Furthermore, the data also shows that more than two-thirds of Canadian companies did not disclose major internal control weaknesses the quarter before their final preparations for being audited were in progress. While better than the U.S. rate of 87 per cent (Glass Lewis & Co 2005), this finding reflects the potential weak state of internal controls in corporate Canada – unbeknownst to management – even though CEOs and CFOs are required by SOX 302 to certify they have effective control systems in place.

These preliminary findings have important implications for Canadian regulators and standard setters who are currently discounting the importance of internal control audits in corporate governance within the Canadian financial markets (CSA Notice 52-313 2006). Canadian firms that are cross listed, or listed only, on both Canadian and American stock exchanges must comply with the American legislation and audit standards with the consequent penalties associated therewith. Given the proposed weaker certification by management requirement in Canada, how should we expect that the true state of internal controls at Canadian public companies will be known? Board members of Canadian companies will need to proceed with caution in approving the management discussion and analysis section of annual reports in 2006 in light of the report of management on controls without any requirement for audit.

The remainder of this report describes briefly the research agenda that lead to the creation of this report, background on the internal control audit debate and the details of our preliminary study.

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.

Third, 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. The current project is situated in this strand of our research program.

Background: Internal controls and the SOX 404 debate

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, the 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 lead 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 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 SOX at $1.4 trillion (Zhang 2005), a cost determined by measuring the stock market decline over the two weeks 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 1997-2002 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.

Given that the Canadian Securities Administrators decided not to proceed with a SOX 404 audit requirement (CSA Notice 52-313 2006) or any more principled alternative (see Appendix C for one suggested alternative approach), the CSA decided to have management report on the effectiveness of its internal control systems, similar to the SOX 302 management certifications in the US. However, the evidence from the US (Glass, Lewis & Co. 2005) 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). Since internal control problems do not appear overnight, there are only two possible reasons for this: either management did not know or management lied in its certification.

Our preliminary study

We employed a list of Canadian based companies registered with the US Securities and Exchange Commission as of July 2006 as a base for our sample (www.sec.gov). This list provides 497 possible firms of whom 365 issued stock in the US. We then eliminate the 77 mirco-cap (less than $5 million) companies and the 74 very small cap (less than $25 million) companies that are not yet required in the US to file under SOX 404 even if they are US based companies. We hand checked all filings (8K, 10K, 10Q etc) in the period 2003 to 2005 for each of the remaining 214 companies with the SEC via the EDGAR (the online reporting system that is mandatory for all US SEC registrants to employ). In total, we find 31 Canadian based companies that have filed a SOX 404 audit report by June 30th 2006 for fiscal years ending in 2005 and 2004 (see Table 1 for 2005 companies).[1] Large cap cross listed Canadian companies, approximately 183 of them, that file in the US under what is known as "20-F" will be required to report under SOX 404 for fiscal years ending in 2006. This larger group of companies is the eventual target of our study.

Table 1 provides a description of our 2005 sample including exchanges traded on, size of company (in total assets and market capitalization at fiscal year-end) and name of audit firm. For each company we then read the various SEC filings in detail as well as searching the financial press for stories about these companies. Table 2 summarizes our findings about management's assessment of effectiveness of internal controls, the auditors two reports thereon (on management's report and on the effectiveness of internal controls operations) and the auditor's report on the financial statement. Under PCAOB AS#2 management can report that its internal controls are ineffective and the auditor can agree with that assessment. This requirement leads to the auditor's opinion over management assessment of ineffective controls as being "unqualified." Normally, an

[1] Interesting two companies included in our 31 reported in 2004 but not in 2005. In both cases they reported effective controls. These companies are Suncor and Stressgen Biotech.

"unqualified" auditor's report, also known as a 'clean opinion,' would in financial statement context be considered good news as it would mean the financial statements are fairly presented in accordance with generally accepted accounting principles. But in this case all that an "unqualified" report means is that the auditor agrees with management that it has ineffective controls and that the auditor has found no additional ineffective controls, beyond what management has identified in its assessment, during its audit (see Chapters 8 and 15, Knechel, Salterio and Ballou 2007 for more details). See Table 2 for the six firms that reported material weaknesses in 2005.

Using the market capitalization numbers in Table 1 we then calculate the rates of material weaknesses disclosure by size in Table 3 Panel A. It is important to note the overall rate of 19% but the fact that it is constant across the three larger size categories. Panel B of Table 3 provides a similar sample at the same stage of implementation of SOX 404 in the USA based on SEC data (SEC Advisory Committee on Smaller Public Companies 2006, Table 11). While the Canadian rates are somewhat higher in each size category, given this is a small sample, all we can conclude is that there is no evidence that Canadian public companies internal controls are any better than US public companies and they may be worse.[2]

To assess the seriousness of the issues involved, we summarize in Table 4 the material weaknesses documented in three of our six companies. Note, that given the degree of press coverage of the woes at Nortel, we do not use it to generate any of our examples. We provide further details about each of these three companies problems in mini-case studies (see Appendix A and B).[3] For one company, Lions Gate Entertainment, we provide details about the extent of the remedial control work it took management to fix the material weaknesses, again showing these weaknesses were no small matters (see Appendix A).

Finally, we examine the Section 302 certifications filed by management (the CEO and the CFO) for the four quarters preceding the quarter the material weaknesses are revealed. As can be seen in Table 5, in four of the six cases, management certified right up to the quarter prior to the quarter revealing the material weakness that they had assessed their controls over financial reporting as "effective." As internal controls do not generally deteriorate in one quarter (Knechel, Salterio and Ballou 2007), it is likely there were problems with controls that were either not discovered or disclosed prior to the quarter in question.

Conclusions

This study investigates SOX reports from 31 firms that are cross-listed in Canada and the U.S. (or listed only in the US) and are required to file under SOX 404 for the first time in 2004 or 2005. We find that compared to similar-sized U.S. companies, Canadian firms report higher rates of internal control problems at a similar stage. Furthermore, these are

[2] A Chi-square test reveals no significant difference in the two distributions ($\chi^2(1)= 1.38$, $p>0.10$).
[3] We have developed extensive teaching cases on three of these companies for classroom use. Please contact first author about using these materials.

not technical weaknesses about obscure accounting details but weaknesses in major items like accounts receivable, revenue recognition and miscalculation of expenses. In the first year of SOX reporting in the United States, 13 per cent of companies disclosed weaknesses in internal controls. In comparison, 19 per cent of cross-listed Canadian firms report material weaknesses at roughly the same stage of implementation.

The data also shows that more than two-thirds of Canadian companies did not disclose major internal control weaknesses the quarter before their final preparations for being audited were in progress. While better than the U.S. rate of 87 per cent, this finding reflects the potential weak state of internal controls in corporate Canada – unbeknownst to management – even though CEOs and CFOs are required by SOX to certify whether they have effective control systems in place. Although the sample size is small, we feel these initial reports could be indicative of widespread poor internal controls in Canada. Since the CSA's decision not to adopt internal control audit requirements was made when concrete data was not available, the results of this study provides important information for regulators and investors.

Boards and audit committees should be concerned that either management does not know about – or worse, does not disclose – material weaknesses in their internal controls before an audit of internal controls is eminent. This finding occurs despite the fact that management is required by a law, a law with significant penalties, to do so. Ultimately, this is a huge red flag for Canadian boards because the CSA requires such disclosures in management's discussion and analysis for the first time in 2006 with a much more modest penalty regime.

We would recommend, based on the data to date, larger Canadian companies boards and audit committees should voluntarily contract with their audit firms to conduct an internal control audit that mirrors SOX principles. We also suggest to regulators that this research is further evidence that internal control audits should be a requirement for all large Canadian companies and that Canadian investors not have two levels of protection, a higher one for cross listed firms and a lower one for Canadian only domestic registrants.

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Table 1

All Canadian Companies Reporting Under SOX 404
For year ended in 2005 (in ,000)

Company name	2005 Year end date	1st Listing	Other Listing	Total Assets	Market capitalization	Auditor
Alcan Inc.	12/31	TSX	NYSE	$16,944,000	$26,638,000	PWC
Altair Nanotechnologies Inc.	12/31	NASDAQ		$4,828	$33,464	Deloitte
Angiotech Pharmaceuticals Inc.	12/31	TSX	NASDAQ	$32,014	$494,694	Ernst & Young
Cognos Inc.	February 28	TSX	NASDAQ	$408,146	$1,063,967	Ernst & Young
Cott Corp.	12/31	TSX	NYSE	$689,500	$1,171,400	PWC
Fairfax Financial Holdings Ltd.	12/31	TSX	NYSE	$21,691,200	$27,565,700	PWC
Golden Star Resources Ltd.	12/31	TSX		$172,363	$564,603	PWC
GSI Lumonics Inc.	12/31	NASDAQ		$66,888	$373,444	Ernst & Young
Hub International	12/31	TSX	NYSE	$581,427	$1,001,353	PWC
Imax Corp.	12/31	NASDAQ	TSX	$266,454	$243,411	PWC
Imperial Oil Corp.	12/31	AMEX	TSX	$8,949,000	$15,582,000	PWC
Inco Ltd.	12/31	NYSE	TSX	$6,066,000	$12,010,000	PWC
Ipsco Inc.	12/31	NYSE	TSX	$898,386	$2,639,019	Ernst & Young
Ivanhoe Energy Inc.	12/31	TSX	NASDAQ	$36,110	$240,877	Deloitte
Lions Gate Entertainment Corp.	March 31	TSX	NYSE	$737,490	$854,629	Ernst & Young
LML Payment Systems Inc	March 31	NASDAQ		$1,228	$9,070	Grant Thornton
MDC Partners Inc.	12/31	TSX	NASDAQ	$310,683	$507,315	KPMG
Nexen Inc.	12/31	TSX	NYSE	$10,582,000	$14,590,000	Deloitte
NGAS Resources	12/31	NASDAQ		$74,546	$146,773	Other
Nortel Networks Corp.	12/31	TSX	NYSE	$16,546,000	$18,112,000	Deloitte
Nova Chemicals Corp.	12/31	TSX	NYSE	$3,998,000	$5,217,000	Ernst & Young
Open Text Co.	12/31	NASDAQ	TSX	$220,750	$640,936	KPMG
Oppenheimer Holdings Inc.	12/31	NYSE		$1,876,344	$2,184,467	PWC
Optimal Group Inc.	12/31	NASDAQ		$181,393	$384,683	KPMG
Potash Corp of Saskatchewan	12/31	NYSE	TSX	$3,225,400	$5,357,900	Deloitte
QLT Inc.	12/31	NASDAQ	TSX	$250,383	$776,494	Deloitte
SunOpta Inc.	12/31	TSX	NASDAQ	$132,282	$301,482	PWC

Company name	2005 Year end date	1st Listing	Other Listing	Total Assets	Market capitalization	Auditor
TLC Vision Corp.	12/31	TSX	NASDAQ	$56,844	$301,043	Ernst & Young
Ultra Petroleum Corp.	12/31	TSX	AMEX	$276,064	$847,266	KPMG
Vitran Co Ltd.	12/31	TSX	NASDAQ	$61,926	$201,728	KPMG
Workstream Inc.	May 31	NASDAQ		$12,718	$75,657	PWC
Average Total Assets*				**$4,520,335**	**USD**	
Average Total Assets Adverse Opinion*				**$3,482,481**	**USD**	
Average Market Capitalization*					**$5,106,017**	**USD**
Average Market Capitalization Adverse Opinion*					**$4,388,951**	**USD**

* No significant different between two groups.

Table 2

Management Assessments and Auditor Reports
Over Effectiveness of Internal Controls over Financial Reporting
For year ended in 2005

Company	Management's Assessment of Internal Control Effectiveness	Auditor's Report on Management's Assessment	Auditor's Report on Internal Control Effectiveness	Auditor's Report on Financial Statements
Alcan Inc.	Effective	Unqualified	Unqualified	Unqualified
Altair Nanotechnologies Inc.	Effective	Unqualified	Unqualified	Unqualified
Angiotech Pharmaceuticals Inc.	Effective	Unqualified	Unqualified	Unqualified
Cognos Inc.	Effective	Unqualified	Unqualified	Unqualified
Cott Corp.	Effective	Unqualified	Unqualified	Unqualified
Fairfax Financial Holdings Ltd.	Effective	Unqualified	Unqualified	Unqualified
Golden Star Resources Ltd.	Ineffective	Unqualified	Adverse	Unqualified
GSI Lumonics Inc.	Effective	Unqualified	Unqualified	Unqualified
Hub International	Effective	Unqualified	Unqualified	Unqualified
Imax Corp.	Effective	Unqualified	Unqualified	Unqualified
Imperial Oil Corp.	Effective	Unqualified	Unqualified	Unqualified
Inco Ltd.	Effective	Unqualified	Unqualified	Unqualified
Ipsco Inc.	Effective	Unqualified	Unqualified	Unqualified
Ivanhoe Energy Inc.	Effective	Unqualified	Unqualified	Unqualified
Lions Gate Entertainment Corp.	Ineffective	Unqualified	Adverse	Unqualified
LML Payment Systems Inc	Ineffective	Unqualified	Adverse	Unqualified
MDC Partners Inc.	Ineffective	Unqualified	Adverse	Unqualified
Nexen Inc.	Effective	Unqualified	Unqualified	Unqualified
NGAS Resources	Effective	Unqualified	Unqualified	Unqualified
Nortel Networks Corp.	Ineffective	Unqualified	Adverse	Unqualified
Nova Chemicals Corp.	Effective	Unqualified	Unqualified	Unqualified
Open Text Co.	Effective	Unqualified	Unqualified	Unqualified
Oppenheimer Holdings Inc.	Effective	Unqualified	Unqualified	Unqualified
Optimal Group Inc.	Effective	Unqualified	Unqualified	Unqualified
Potash Corp of Saskatchewan	Effective	Unqualified	Unqualified	Unqualified
QLT Inc.	Effective	Unqualified	Unqualified	Unqualified
SunOpta Inc.	Effective	Unqualified	Unqualified	Unqualified
TLC Vision Corp.	Effective	Unqualified	Unqualified	Unqualified
Ultra Petroleum Corp.	Ineffective	Unqualified	Adverse	Unqualified
Vitran Co Ltd.	Effective	Unqualified	Unqualified	Unqualified
Workstream Inc.	Effective	Unqualified	Unqualified	Unqualified

Table 3
Rate of Material Weakness Reporting

Panel A: Canadian Companies Reporting Material Weaknesses

		Canadian Cross Listed Companies		
Market Capitalization		**Total # of Companies Reporting**	**2005 Material Weaknesses**	**2005 Rate of MW**
Less than $100M		3	0	0%
$100M to $500M		9	2	22%
$500M to $1B		5	1	20%
$1B to $10B		10	2	20%
Greater than $10B		4	1	25%
TOTAL		**31**	**6**	**19%**

Panel B: US Companies Reporting Material Weaknesses

Market Capitalization	**Total # of Companies Reporting**	**2004 Material Weaknesses**	**2004 Rate of MW**
Less than $100M	305	56	18%
$100M to $500M	988	159	16%
$500M to $1B	455	63	14%
$1B to $10B	936	80	9%
Greater than $10B	223	9	4%
TOTAL	**2907**	**367**	**13%**

Source: US SEC Study.

All material weaknesses reported by June 30th of the year after the first year of SOX 404 reporting requirement.

No significant differences between the Canadian and US distributions of companies reporting material weaknesses.

Table 4
Selected SOX-404 Management Disclosures of Internal Control Weaknesses from Cross-listed Companies

Company	Quotes from Item 9A Controls and Procedures
MDC Partners Inc.	Revenue Recognition: "Specifically, controls were not designed and in place to ensure that customer contracts were analyzed to select the appropriate method of revenue recognition. In addition, controls were not designed and in place to ensure that revenue transactions were analyzed for appropriate presentation and disclosure of billable client pass-through expenses or for revenue recognition on a gross or net basis" (Dec.31, 2005 10-K, p.136).
Lions Gate Entertainment	Revenue Recognition: "The process of determining our participations expense and related liabilities for financial reporting purposes involves detailed calculations and analysis, a portion of which is subject to an estimation process. We perform detailed analysis to estimate these charges on a quarterly basis; however, certain amounts were miscalculated. These miscalculations were detected, either by management or our independent auditors, and adjusted for, during our financial statement close process" (Mar.31, 2005 10-K, p.35). Amortization: "We have a detailed methodology for determining film amortization; however, we have made mistakes in the use of source data used in the calculations and in the calculations themselves that management or our independent auditors have discovered during the financial statement close process" (Mar.31, 2005 10-K, p.35).
Ultra Petroleum	Accounts Receivable, Asset capitalization & Amortization: "The Company did not have adequate policies and procedures regarding supervisory review of account reconciliations and account and transaction analyses. This deficiency resulted in the following material errors in the Company's preliminary 2005 consolidated financial statements: • misclassification of costs between proved and unproved oil and gas properties and understatement of depletion expense; • improper reporting of value added taxes; • understatement of asset retirement obligations; • overstatement in tubular inventory; • understatement of capitalized well cost accrued liabilities; and • overstatement of accounts receivable" (Dec.31, 2005 10-K, p.71-71).

Table 5
Management's Certifications of Effectiveness of Internal Control
Under SOX Section 302 By Quarters
Before the Year-end Disclosure of Material Weakness

	Q(t-1) B4 S.404	Q(t-2) B4 S.404	Q(t-3) B4 S.404	Q(t-4) B4 S.404
Golden Star Resources Ltd.	Effective	Effective	Effective	Effective
Lions Gate Entertainment Corp.	Effective	Effective	Effective	Effective
LML Payment Systems Inc	Effective	Effective	Effective	Effective
MDC Partners Inc.	Not Effective	Not Effective	Not Effective	Not Effective
Nortel Networks Corp.	Not Effective	Not Effective	Not Effective	Not Effective
Ultra Petroleum Corp.	Effective	Effective	Effective	Effective

Q(t-n), n = 1 to 4 is the quarter before (B4) the Section 404 report (S.404) with material weakness(es).

Appendix A

LIONS GATE ENTERTAINMENT CORP.

Case Demonstrating Extensive Nature of Changes Needed to Bring into Compliance with Good Internal Control Practices.

About LGE
An independent producer and distributor of motion pictures, television programs, home entertainment, family entertainment and video-on-demand products

404 Material Weaknesses in 2005 with remedies in 2006
Material weaknesses resulting from the following four control deficiencies found for FYE 2005 (March 31):

WEAKNESS: Calculating participations expense and related liabilities for financial reporting purposes
-amounts owed to particular parties involved with a film based on financial performance of that film
-estimates of these charges made on quarterly basis
-some estimates were miscalculated

Changes made to fix weakness 4th quarter 2006:
-we redesigned the methodology used for calculating the liability to allow for more direct comparisons to the participation statements;
-we assigned an employee and hired an additional accountant within the participations accounting group to focus on these calculations and allow for additional review of the analysis;
-we developed a detailed control checklist to check that the calculations use appropriate assumptions, are based on correct data and are functioning appropriately;
-we are providing further training to the recently allocated personnel;
-we continue to refine the procedures and controls, and are developing additional detective controls and designing controls over the accuracy of the source data used in the calculations.

WEAKNESS: Calculating amortization of investment in film and television programs
-detailed methodology used
-made mistakes in use of source data used in calculations and in calculations themselves

Changes made to fix weakness 4th quarter 2006:
-we hired an additional accountant in our film accounting group;
-we implemented additional review procedures;
-we are developing additional controls to further ensure the accuracy of source data used in our calculations; and
-we are evaluating the design of the application performing the calculations and will make improvements or replace the application as appropriate.

WEAKNESS: Monitoring certain charges billed to us by our outsourced home entertainment distribution service provider
-lacked rigorous monitoring process over certain distribution and marketing charges billed from one of outsourced providers
-have recorded amts billed without significant validation to ensure information in complete and accurate
-represented less than 5% of total distribution and marketing expense in I/S for 2005

Changes made to fix weakness 4th quarter 2006:
-we hired an additional accountant within our home entertainment operations group;
-we established procedures and controls for analyzing information and determining the amounts to record; and
-we are developing additional validation controls.

WEAKNESS: Financial statement close process
-occurs when closing and analyzing books at end of quarters and years
-much manual, non-routine or estimate work occurs
-due to limited personnel, account balances have not been analyzed on a timely basis, resulting in later account adjustments

Changes made to fix weakness 4th quarter 2006:
-we have continued to enhance our closing checklist and timeline which assigns specific accounts and procedures to individuals and requires others to review such account analysis as part of the close;
-we have hired an additional accounting manager to prepare and review account analyses and we plan to hire additional qualified resources;
-we continue to evaluate and improve our processes for analyzing accounts and are designing controls over specific closing steps via implementation of specific control checklists;
-we created an internal audit function; and
-we are improving our controls and processes associated with our computer applications and data files.

NOTE: Lions Gate Entertainment reports on a March 31 year end basis. Hence, on March 31, 2006 (one year after the reports we cite) Lions Gate reported it had remedied its deficiencies by March 31 and had effective controls in place. It disclosed the above details about how they went about dealing with the problems discovered in 2005.

Appendix B

Detailed Examples of Internal Control Problems

MDC PARTNERS

Company Description

MDC Partners is a provider of marketing communications services, and secure transaction products and services. The Marketing Communications group provides advertising, specialized communication and consulting services to clients.

2005 – Excerpts from Management's Report on Internal Control

As of December 31, 2005, we did not maintain effective internal control over financial reporting due to the following material weaknesses:

1. Accounting for Complex and Non-Routine Transactions
    - Insufficient finance personnel with technical accounting knowledge
    - No appropriate process to address and review complex and non-routine accounting matters which involved material adjustments for complex and non-routine transactions in the following areas that were detected and corrected prior to the release of our interim financial statements:
        - Accounting for dilution gains and losses related to equity transactions of subsidiaries.
        - Accounting for a one-time "bill and hold" transaction as revenue when it did not meet all of the accounting requirements for revenue recognition.
        - Accounting for a stock arrangement related to shares provided to employees of a subsidiary by a principal shareholder.
    - The material adjustments impacted the following accounts: product revenue, cost of products sold, office and general expenses, other income (expense) and settlement of long-term debt, inventory, other assets, minority interest, and additional paid in capital.

2. Revenue Recognition and Accounting for Related Costs
    - Deficiencies in the controls over the application of accounting and the recording of revenue and costs. Controls were not designed and in place to ensure that customer contracts were analyzed to select the appropriate method of revenue recognition.
    - Errors were identified and corrected prior to issuance of the 2005 consolidated financial statements in the following accounts: accounts receivable, sales to be billed, accrued liabilities, services revenue, and cost of services sold.

3. Segregation of Duties

- Certain duties within the accounting and finance department were not properly segregated and there were instances whereby personnel had the ability to initiate transactions or accounting entries within certain financial reporting applications that were not compatible with their other roles and responsibilities.
- None of the segregation of duty or access control deficiencies resulted in a misstatement to the financial statements but there was a more-than remote likelihood that a material misstatement of our annual or interim financial statements would not be prevented or detected.

2005 – Excerpts from Auditor's Report on Internal Control

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects. Also, in our opinion, because of the effect of the material weaknesses described above on the achievement of the control criteria, MDC Partners Inc. has not maintained effective internal control over financial reporting as of December 31, 2005.

2004 – Excerpts from SOX 302 Report on Internal Controls and Procedures

The Company identified deficiencies in its disclosure controls and procedures, including material weaknesses in its internal control over financial reporting, and concluded that, as of September 30, 2004, our disclosure controls and procedures were not effective.

We subsequently:

- Expanded supervisory activities and monitoring procedures of our financial reporting processes and personnel involved in such processes**;**
- Adopted a formal set of Disclosure Controls & Procedures;
- Formed a management Disclosure Committee; and
- Implemented other corrective actions described below under "Changes in Internal Control Over Financial Reporting".

The weaknesses adversely affect the Company's ability to record, process, summarize and report financial data and, by themselves or in combination, result in a more-than-remote likelihood that a material misstatement in our financial statements or other financial reporting will not be prevented or detected by our employees in the normal course of performing their assigned functions.

- The amount of Company resources and level of technical accounting expertise within the accounting function are insufficient to properly evaluate and account for non-routine or complex transactions which contributed to the delay in filing financial statements timely. Consequently, management believes that the Company has inadequate procedures and oversight for

appropriately assessing and applying accounting principles for non-routine or complex transactions.

- The Company did not maintain effective controls over the timing of revenue recognition and the classification of related balance sheet accounts.
- The Company did not maintain effective controls over the selection, application and monitoring of its accounting policies related to leasing transactions. Specifically, the Company's controls over its selection, application and monitoring of its accounting policies relating to the effect of lessee involvement in asset construction, lease incentives, rent holidays and leasehold amortization periods were ineffective to ensure that such transactions were accounted for in conformity with GAAP; and
- The Company did not maintain effective controls over documentation to evidence the authorization of certain previously approved transactions.

Changes in Internal Control over Financial Reporting

We currently are designing and implementing improved controls to address the material weaknesses described above in our control environment.

- The Company has hired a Chief Accounting Officer with US GAAP expertise and additional personnel, and are actively pursuing appropriate additional personnel with US GAAP expertise in its accounting and finance functions, at both the Company's operating subsidiaries and corporate head office,;
- We have developed, distributed and begun to communicate and implement comprehensive accounting policies in a number of areas.
- We have developed and are continuing to refine procedures for ensuring appropriate documentation of significant transactions and application of accounting standards to ensure compliance with US GAAP; and
- We are improving procedures for reviewing underlying business agreements and documenting the support for accounting entries and transactions.

Relevant Press Releases

April 3, 2006 – MDC Partners Inc. announced today that it has appointed BDO Seidman, LLP, as its new independent registered accounting firm, effective immediately. At the Company's request, KPMG LLP resigned as the Company's principal independent accounting firm on March 31, 2006.

July 29, 2005 – MDC Partners Inc. completed and filed its Sarbanes-Oxley Section 404 report on internal controls over financial reporting, as part of a Form 10-K/A filed with the Securities and Exchange Commission on July 26, 2005. The Company is now in compliance with all filing requirements with the Securities and Exchange Commission and all NASDAQ listing requirements. Therefore, NASDAQ will remove the fifth character "E" from the Company's NASDAQ trading symbol, effective Monday, August 1, 2005, and the Company is no longer subject to delisting from The Nasdaq Stock Market.

ULTRA PETROLEUM

Company Description

Ultra Petroleum Corp. is a publicly traded (AMEX - UPL), rapidly growing independent exploration and production company focused on its core properties in Green River Basin of Wyoming and the shallow waters of Bohai Bay, China.

2005 – Excerpts from Management's Report on Internal Control

The disclosure controls and procedures were not effective as of December 31, 2005, because of the material weaknesses described below.

- The Company did not maintain effective company level controls. Certain accounting personnel in key roles did not possess an appropriate level of technical expertise and the monitoring of the internal audit function was not sufficient to provide management a basis to assess the quality of the Company's internal control performance over time.
- The Company did not have adequate policies and procedures regarding supervisory review of account reconciliations and account and transaction analyses which resulted in the following material errors:
    - misclassification of costs between proved and unproved oil and gas properties and understatement of depletion expense;
    - improper reporting of value added taxes;
    - understatement of asset retirement obligations;
    - overstatement in tubular inventory;
    - understatement of capitalized well cost accrued liabilities; and
    - overstatement of accounts receivable

These errors have been corrected by management prior to the issuance of the Company's 2005 consolidated financial statements.

- The Company did not have adequate policies and procedures to ensure that accurate and reliable interim and annual consolidated financial statements were prepared and reviewed on a timely basis. Specifically, the Company did not have: sufficient personnel with the skills and experience in the application of U.S. generally accepted accounting principles; and policies and procedures regarding the preparation and management review of footnote disclosures accompanying the Company's financial statements.

As a result of these deficiencies, material errors were identified in the footnotes to the Company's preliminary 2005 consolidated financial statements. These errors have been corrected by management prior to the issuance of the Company's 2005 consolidated financial statements.

The Company's management has identified what it believes are the steps necessary to address the material weakness described above, as follows:

(1) Increasing training for the Company's current accounting personnel, hiring additional accounting personnel and engaging outside consultants with technical accounting expertise, as needed, and reorganizing the accounting department to ensure that accounting personnel have adequate experience, skills and knowledge relating to the accounting and internal audit functions assigned to them.
(2) Establishing additional and refining current policies and procedures to more effectively reconcile its accounting entries along with better documentation procedures to meet the standards established by COSO.

2005 – Excerpts from Auditor's Report on Internal Control

In our opinion, management's assessment that Ultra Petroleum Corp. and subsidiaries did not maintain effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects. Also, in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, Ultra Petroleum Corp. and subsidiaries have not maintained effective internal control over financial reporting as of December 31, 2005.

Relevant Press Releases

March 16, 2006 – Ultra Petroleum Corp. (AMEX: UPL) today announced that it will file a 15-day automatic extension notification with the Securities and Exchange Commission relating to its Annual Report on Form 10-K for the fiscal year ended December 31, 2005. Ultra Petroleum will file for the automatic extension to allow additional time to complete the preparation of its consolidated financial statements and the work required to complete management's assessment of internal controls over financial reporting in accordance with Section 404 of Sarbanes-Oxley and the rules of the Public Company Accounting Oversight Board. While the company has not yet completed its assessment of its internal control over financial reporting, management has identified certain deficiencies in its internal controls. To the extent that any of these deficiencies meet the definition of material weaknesses in Auditing Standard No. 2 of the Public Company Accounting Oversight Board, the company will disclose those weaknesses and related remediation activities in its Form 10-K. At this time, Ultra Petroleum expects to report year-end results that are consistent with the preliminary estimates outlined in its February 7, 2006 news release and anticipates that it will be able to file its complete Annual Report on Form 10-K on or before March 31, 2006.

LML PAYMENT SYSTEMS INC.

Company Description

LML Payment Systems is a financial payment processor specializing in providing end-to-end check processing solutions including conversion, verification, and conversion. The company also does real-time monitoring of debit, credit and EBT transactions for authorization and settlement. LML Payment Systems Corp. is the result of a corporate reorganization effective April 1, 2001 in which the payment processing subsidiaries acquired by LML over the previous three years were merged into a single operating company.

2005 – Excerpts from Report of Management on Internal Controls

- Management determined that our access controls over our financial application system did not operate to segregate incompatible duties and this lack of segregation was not compensated effectively with other compensating, detective controls.
- This deficiency represented a more than remote likelihood that a misstatement that is more than inconsequential, but less than material, could occur to the financial statement accounts
- We implemented changes to our access controls over our financial application system to appropriately segregate incompatible duties: the removal of certain rights in our financial application system to certain senior level personnel within the finance and accounting department.

2005 – Excerpts from Auditor's Report on Internal Control

LML Payment Systems Inc. did not maintain effective internal control over financial reporting as of March 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as a result of the ineffective segregation of duties enforced by access controls over the Corporation's financial application system.

Appendix C

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 "mircocaps", 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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