



Auditor attestation of internal controls: a Canadian perspective

Introduction

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading companies headquartered in Canada. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the current audit environment.

The first meeting of the network was held in Toronto on August 1, 2006. Portions of the meeting focused on the withdrawal of Multilateral Instrument 52-111 and the expansion of Multilateral Instrument 52-109. This document reflects a synthesis of the key issues that arose from that discussion.

The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues. Anyone who receives this publication may share it with those in their own network. The more broadly we can disseminate this information to board directors, management executives, and advisers who will become systematically engaged in this dialogue, the greater the value created for all.

Between them, the members of the network who participated in the meeting sit on the boards of over 30 large-, mid-, and small-cap public companies. The attendees were:

- John Caldwell, Audit Committee Chair, Cognos
- Gary Colter, Audit Committee Chair, CIBC
- Denis Desautels, Audit Committee Chair, Alcan
- Don Fullerton, Audit Committee Chair, Husky Energy
- Kerry Hawkins, Audit Committee Chair, Nova Chemicals
- Bob Luba, Audit Committee Chair, MDS
- Eileen Mercier, Audit Committee Chair, CGI Group
- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer, Ernst & Young Canada
- Ted Reevey, Audit Committee Chair, Aliant
- Maureen Sabia, Audit Committee Chair, Canadian Tire
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services, Ernst & Young Canada

VantagePoint reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations.



Overview of MI 52-109

In March 2006, the Canadian Securities Administrators (CSA) announced that “after extensive review and consultation and in view of the delays and the debate underway in the US over the rules implementing section 404 of the *Sarbanes-Oxley Act of 2002* (the Sox 404 Rules), we have determined not to proceed with proposed Multilateral Instrument 52-111 *Reporting on Internal Control over Financial Reporting* (Proposed MI 52-111).”¹ In lieu of implementing MI 52-111, the CSA has proposed expanding MI 52-109 (Certification of Disclosure in Issuers’ Annual and Interim Filings) to stipulate that “the CEO and CFO of a reporting issuer, or persons performing similar functions, will be required to certify in their annual certificates that they have evaluated the effectiveness of the issuer’s internal control over financial reporting as of the end of the financial year. They will also be required to certify that, based on their evaluation, they have caused the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting.”²

Distinguishing between 2006 and 2007 requirements

It is important to distinguish between certification requirements for 2006 and 2007. For companies whose fiscal year ends on or after June 30, 2006, the requirement states that executives must certify that they have designed and implemented internal controls over financial reporting to produce reliable financial statements. However, companies are not required to test and report on the effectiveness of these controls until 2007.

This decision does not change the obligation of Canadian companies registered with the Securities and Exchange Commission (SEC) to comply with Section 404, including the requirement that an independent auditor express an opinion on management’s assessment of the effectiveness of the company’s internal control over financial reporting. However, the CSA’s decision means that companies listed only in Canada will not be required to provide this third-party attestation.

The view of the group

Members acknowledged that Section 404 compliance in the United States has been expensive and time consuming, and few members advocated a full Section 404-style auditor attestation. However, if members are skeptical about the value of a complete Section 404 attestation, they are equally concerned about the wisdom of not engaging auditors at all. Not only do network members seek to safeguard the company, they also recognize that “*our head is on the block. We’re taking the risk.*” Members expressed a desire to create a process around certification and attestation of internal controls that will “*withstand the test of time.*”

¹ Canadian Securities Administrators Notice 52-313, March 10 2006, 1. Complete pdf file available at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/csa_20060310_52-313_status-52-111.pdf.

² Ibid., 2.



In that spirit, members agreed on four main points:

- Auditor attestation is valuable to management and the board
- Auditors can contribute “good tension” to the system
- Companies and their boards would benefit from objective standards
- Management should support independent auditor attestation

Auditor attestation of internal controls is valuable to management and the board

Members identified a number of reasons why they felt external auditors should be involved in the attestation of the effectiveness of internal controls over financial reporting.

From the directors’ perspective, attestation helps reduce the risk of litigation. One member remarked, *“Without external auditor attestation [of internal controls], there is nothing between you and disaster.”* Another member agreed: *“Without attestation, the good news is it’s not much money. The bad news is there’s no standard.”*

Members who had gone through the Sarbanes-Oxley certifications, or who had already had an external auditor attest to their internal controls, supported independent attestation. One member remarked, *“The attestation process exceeded expectations. [It was expensive] – at least [equal to] the [financial statement] audit fee, or more. But, [given a fixed budget,] I’d rather spend money on [internal control attestation] than on quarterly reviews.”* Another member concurred, pointing out that *“if it’s viewed as an investment, companies would be better managed in the end.”*

Members who agreed that *“you have to rely on the experiences of the external auditor”* also felt strongly that the cost of the process was more than earned back by the end result. One member said, *“If you understand the [auditors’] process, you either have comfort in the company, or you don’t.”*

Auditors can contribute “good tension” to the process

While regulations don’t require external auditor involvement, several members believe *“the external auditor brings extra tension to the process ... good tension.”* As a result, the external auditor helps to ensure that the bar for a company’s internal controls remains high, leaving the company *“better off in terms of a control environment.”*

The tension can get to be too great, however. One member cautioned, *“If the relationship between management and the external auditor is testy, you’ve got other issues.”*

Companies and their boards would benefit from objective standards

Members expressed frustration over the lack of clear, objective standards. One audit chair said, *“Audit firms are in a tough spot. They’re the monkey in the middle until there’s more guidance.”* Regulatory guidance does not appear to be forthcoming any time soon. In its absence, committee chairs can turn to a number of



sources, including audit firms, law firms, the Canadian Institute of Chartered Accountants (CICA), and regulators.

Although Sarbanes-Oxley has had an overwhelming impact on corporate governance, standards should not be created that simply mimic U.S. laws. Many U.S. companies and directors believe that a number of the steps those laws require are unnecessary; ideally, Canadian standards should incorporate only those elements of Section 404 compliance practices that are useful and effective.

Management should support independent attestation

One member asked, *“If management requests attestation, do you think the board would ever turn it down?”* The answer from other members was a resounding no. Members noted that management should value and appreciate the attestation because *“if you document processes, you can run the business better.”* Another member asked, *“Other than [because of the] cost, why wouldn’t management want [attestation]?”*

If management should ever do away with auditor attestation of internal controls, board members feel they would have the right to overrule. One member remarked bluntly, *“Management works for the board [on behalf of shareholders].”*

Conclusion

Because independent attestation of the effectiveness of internal controls can provide increased insight into a company, the perception of reduced personal liability, and the addition of a productive source of tension, members of the Canadian Audit Committee Network recommended it on a voluntary basis for Canadian companies that are not subject to mandatory attestation. The process *“[takes the] very necessary step of reducing risk,”* a goal that the audit committee actively pursues.

The views expressed in this document represent those of the Canadian Audit Committee Network, a group of audit committee chairs from Canada’s leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.

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