

CPR Alert

Canadian Performance Reporting

EVALUATING THE OPERATIONAL EFFECTIVENESS OF ICFR

Non-venture issuers' CEO and CFO certifications must address conclusions from the evaluation of the operational effectiveness of internal control over financial reporting (ICFR), effective December 15, 2008. Accordingly, non-venture issuers with calendar year-ends will have to make their first report about their conclusions from the evaluation in the first 90 days of 2009. This is an activity that needs to be carefully planned, executed and monitored, and takes on special emphasis in the current uncertain and volatile economic environment. The Canadian Securities Administrators (CSA) provide useful guidance in the Companion Policy to National Instrument 52-109.

Background

The securities regulators had always planned that the CEO and CFO certification should extend to the evaluation of the operational effectiveness of an issuer's ICFR¹. This element of the certification program was delayed, however, due to differing views about both the type of entity to be evaluated and whether the evaluation should be subject to independent auditor attestation. In March 2006, the CSA decided that the ICFR evaluation should be limited to management certification. Then, in April 2008, the CSA proposed limiting the disclosure controls and procedures (DC&P) and ICFR elements of the certification to non-venture issuers. The final rule is in line with the April 2008 proposal². For years ending on and after December 15, 2008, the CEO and CFO certification extends to the operating effectiveness of ICFR for non-venturer issuers.

The CSA's Companion Policy to National Instrument 52-109 provides a lot of guidance about the design of ICFR, and the evaluation of its operational effectiveness. This Alert discusses and summarizes the highlights of the Companion Policy as it relates to the evaluation.

Objective of ICFR evaluation

An entity's ICFR should be designed in accordance with a suitable control framework to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. The objective of the evaluation is to determine whether the design of an entity's ICFR is operating as intended at the financial year end.

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- ¹ The CEO and CFO certification has been part of the Canadian regulatory landscape since 2004 when the securities regulators' then Multi-Lateral Instrument (MI) 52-109 was published. At that time, the "bare certificate" addressed the content of an entity's filings. It required the CEO and CFO to certify that the interim and annual filings contained no misrepresentations and that the financial information fairly presented in all material respects the entity's financial condition, results of operations and cash flows. In 2005, the certification was expanded to require the CEO and CFO to address the design and evaluation of DC&P. This was supplemented in 2006 with a requirement to address the design of ICFR.
- ² The final version of NI 52-109 and its Companion Policy can be accessed at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20081024_52-109_cert-of-disclosure.jsp and http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20081024_52-109_companion-policy.jsp, respectively.

An effective ICFR evaluation process will likely be especially important in today's economic environment

should help to ensure that all key risks are identified and properly managed. This will likely be especially important in today's economic environment that can produce new uncertainties and where previously identified risks can take on new significance. As discussed below, the CSA advocate a top-down, risk-based approach to the evaluation.

Reporting conclusions from the evaluation

The CEO and CFO certificates require that conclusions about the evaluation of ICFR be reported in the MD&A³. When a material weakness exists, the entity's ICFR cannot be considered effective. In that event, each material weakness, its impact on financial reporting and ICFR, and any plans or actions taken to remediate the weakness are reported in the MD&A.

Disclosure should provide an accurate and complete picture of any material weakness

the weakness and assess its potential impact on and importance to the financial statements. Disclosure should clearly distinguish any material weakness that has a pervasive impact on ICFR. While mitigating procedures do not eliminate a material weakness, their disclosure may help provide an accurate and complete picture of the weakness.

Disclosure of a material weakness in the annual MD&A needs to continue until the weakness is

Reporting on the operational effectiveness of ICFR is an important activity that needs careful planning, execution, and oversight. While necessary to comply with regulation, a well-designed and executed evaluation process

remediated. Once a weakness has been remediated, information about the change would be disclosed in the next interim or annual MD&A as a change in the entity's ICFR.

Definition of material weakness

The CSA defines a material weakness as a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the reporting issuer's annual or interim financial statements will not be prevented or detected on a timely basis. This definition is now identical to the SEC's definition of a material weakness in ICFR.

The Companion Policy notes that a deficiency related to the operation of ICFR exists when a properly designed component of ICFR does not operate as intended. When a component of ICFR does not operate as intended but where a compensating control exists, there would be no deficiency. Mitigating procedures need to be distinguished from compensating controls. Mitigating procedures do not meet the threshold for being a compensating control because they only partially address the financial reporting risks or because they are not designed by or under the supervision of the entity's certifying officers and thus do not represent an internal control.

When a deficiency or combination of deficiencies is identified, their severity needs to be evaluated. A material weakness occurs when the deficiency results in a reasonable possibility that the entity's ICFR will fail to disclose a misstatement and when the potential misstatement could be material. A misstatement does not need to exist for a material weakness to exist.

The materiality of a potential misstatement must be assessed from both a qualitative and quantitative perspective. Factors to consider include the financial statement amounts or total of transactions relating to the deficiency and the volume of activity relating to the deficiency that has occurred in the current period or that is expected in future periods.

³ An entity may limit the scope of the design of its ICFR in limited circumstances related to a recent acquisition, or when there is insufficient access to design and evaluate the controls of a proportionately consolidated entity or a variable interest entity. When such a limitation exists, this must be disclosed in the MD&A, together with summary information about the entity excluded from the design.

Approach to evaluation

The CSA advocate a top-down risk-based approach to the evaluation of ICFR

The CSA do not specify any particular approach for the evaluation process, although they advocate a top-down, risk-based approach. Under this approach, risks are identified and assessed to determine the scope and complexity of the ICFR. The risks to

be considered are those that would either individually or in combination with others reasonably result in a material misstatement of the financial statements.

Evaluation tools

The Companion Policy discusses examples of evaluation tools that can be used in performing ICFR evaluations:

- certifying officers' daily interaction with the control systems;
- walkthroughs;
- interviews with those involved with the relevant controls;
- observation of procedures and processes;
- reperformance;
- review of documentation evidencing performance of controls, polices or procedures.

A combination of evaluation tools should be used. The nature, timing and extent of evaluation procedures depends on the level of risk the component of ICFR is designed to address. Inquiry and observation alone could be satisfactory when evaluating a control with a lower risk, but will not provide an adequate basis for the evaluation as a whole.

Timing for evaluation

While testing procedures may occur throughout the year, sufficient procedures have to be performed to evaluate the operation of the components at the year end. Components may not be excluded from the evaluation based on prior-year evaluation results.

Documentation

In view of the flexibility in approach to the evaluation, entities should be careful to ensure that their documentation is complete and accurate and supports the adequacy of the evaluation process. Since the eval-

uation is assessing whether the design is working as intended, entities must also ensure that the design is appropriately documented.

Documentation in support of the design of ICFR could include policy manuals, process models, flowcharts, job descriptions, documents, internal memoranda and forms etc.

The documentation should include the key elements of the control environment and descriptions of all the significant controls, the ongoing risk assessment process, the flow of transactions, and how significant transactions and classes of transactions are initiated, authorized, recorded, and processed.

Documentation evidencing the evaluation of the effectiveness of ICFR would normally include:

- description of the process the certifying officers followed;
- how the extent of testing was determined;
- description of and results of applying the various evaluation tools;
- conclusion about the operating effectiveness of ICFR and whether a material weakness existed at the period end.

Role of the board

An entity's ICFR is a critical element of its risk management processes. As well, conclusions about the effectiveness of ICFR are reported in MD&A that is approved by the board. The Companion

Policy notes that an entity's board of directors may wish to clarify its role by adopting a written mandate to explicitly acknowledge responsibility for the entity's stewardship, including responsibility for internal control and management information systems. In considering an entity's disclosure about its evaluation of ICFR in the MD&A, the board should understand the basis for concluding that any particular deficiency or combination of deficiencies did not constitute a material weakness.

Both the design and evaluation of ICFR should be documented

The board may wish to explicitly acknowledge responsibility for stewardship, including ICFR

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Venture issuers

Although exempt from the DC&P and ICFR elements of the CEO and CFO certification, venture issuers still have a responsibility to provide accurate and complete financial reports. Accordingly, venture issuer CEOs and CFOs must continue to certify that interim and annual filings contain no misrepresentations and that the financial information in the filings is fairly presented. As well, their interim and annual certifications must continue to include a “Note to Reader”, unless they choose to comply with all the DC&P and ICFR elements of the certification process for non-venturer issuers. The “Note to Reader” highlights the fact that the certifying officers are not making representations about the establishment or maintenance of controls and procedures related to the entity’s filings or a process regarding the reliability of financial reporting.

An effective system of ICFR is critical to the preparation of timely, accurate and complete financial reports in today’s complex financial reporting environment. Periodic evaluation is an essential element of an effective system of ICFR. The importance of the evaluation of the effectiveness of ICFR to the CEO and CFO certification process is evidenced by securities regulators’ statements that they will pay careful attention to the first year’s reporting of the effectiveness of ICFR. As well, when a misstatement in previously filed financial statements is discovered, they may investigate how this relates to previously reported conclusions about ICFR operational effectiveness. It seems likely that securities regulators’ future continuous disclosure reviews will include consideration of the entity’s ICFR evaluation process.

Venture issuers have a responsibility to provide accurate and complete financial reports

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