

THE FINAL RULES – CEO CFO CERTIFICATION

Introduction

Over the past three years, there has been considerable focus on restoring investor confidence in publicly listed companies. In early 2004, the Canadian Securities Administrators (CSA) issued new requirements that had significant impact on Audit Committees (multilateral **52-110**); on external auditors (**52-108**); and on CEOs and CFOs (multilateral **52-109**, **52-111**, and most recently **52-113**). Rules have been issued and amended various times over the course of the past two years. Additionally, an extensive national instrument (NI) was issued in 2004 on Continuous Disclosure Obligations (NI **51-102**).

Needless to say, it takes considerable effort to keep up with the new requirements and the ongoing changes.

Instrument 52-110 on Audit Committees required many companies to revise their audit committee composition and expand the committee's mandate. Auditor oversight took on new meaning under instrument 52-108. A new body was established to oversee the firms that perform audits of publicly listed companies. Companies saw changes in the practices of their external audit firms and Audit Committees have been enquiring about the firm's standing with the Canadian Public Accountability Board (CPAB). The weighty continuous disclosure instrument 51-102 (over 100 pages) contained an extensive array of requirements including nationally harmonized continuous disclosure, changes to filing deadlines, additional requirements relating to the MD&A, business acquisition reports and material change reports.

The rule on CEO CFO Certifications dealing with disclosure controls and internal controls over financial reporting has undergone various iterations – we saw versions in June 2003, January 2004, November 2004, February 2005 and again with 52-313 in March 2006. There are two related instruments: 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings and 52-111 Reporting on Internal Controls Over Financial Reporting; which have now been amended by the new 52-313.

The Certification Rule

Under the amended rules (52-109, 52-111, 52-313) the CEO and CFO are required to personally certify on an interim basis and an annual basis as to certain actions and information.

On an interim basis, the CEO and CFO must certify that:

1. they have reviewed the interim filings
2. the filings do not contain any untrue statement of material fact or omit any material fact
3. the financial statements, together with other financial information provided, fairly presents in all material respects, financial condition, results of operations, and cash flows
4. they are responsible for establishing and maintaining disclosure controls and internal control over financial reporting and have
 - a. designed disclosure controls and procedures to provide reasonable assurance that material information is made known to the CEO and CFO

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- b. designed internal controls over financial reporting to provide reasonable assurance regarding reliability of financial reporting and preparation of financial statements
5. they have disclosed in the MD&A any changes in the internal controls that occurred in the interim period.

In addition to the above, on an annual basis, the CEO and CFO must certify that they:

- have evaluated disclosure controls and procedures as at the year-end and disclosed their conclusions about the effectiveness of disclosure controls and procedures in the MD&A (this commenced with December **2005** year ends¹).
- have designed and established a system of internal control over financial reporting (this commences with December **2006** year-ends)
- have evaluated the effectiveness of internal controls over financial reporting as at the year-end and disclosed their conclusions about the effectiveness of the internal controls in the MD&A (this commences with the December **2007** year end).

The disclosure in the MD&A regarding effectiveness must provide a description of the process for evaluating the disclosure controls and internal controls.

It is important to note that the representation regarding fairness of financial information is not qualified by the phrase “in accordance with generally accepted accounting principles”. The certification is intended to provide assurance that the financial information as disclosed and viewed in its entirety meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under GAAP. In the view of the CSA, fair presentation includes but is not necessarily limited to:

- selection of appropriate accounting policies,
- proper application of appropriate accounting policies,
- disclosure of financial information that is informative and reflects underlying transactions, and
- includes additional disclosure necessary to provide investors with a materially accurate and complete picture of financial condition, results of operations and cash flows.

Also while financial condition is not defined, the CSA suggests considering items such as liquidity, solvency, capital resources, overall financial health of the company, current and future considerations, events, and risks or uncertainties that might impact the company’s financial health.

Many CEOs and CFOs issued certificates for the quarter ended March 31, 2004 certifying that they:

- ✓ reviewed the filings
- ✓ there were no untrue statements
- ✓ financial statements fairly present.

Filings have continued for quarters in 2004 and 2005, and at the year ended December 31, 2005 the CEOs and CFOs certified two additional elements:

- ✓ responsibility for the design of disclosure controls and procedures
- ✓ responsibility for evaluating effectiveness of disclosure controls and procedures and disclosing that conclusion in the MD&A.

¹ If your company does not have a December year end, refer to the instruments for the effective date.

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Commencing with the certificate for December 31, 2006, a certificate on responsibility for the design of system of internal controls over financial reporting must be provided. Then commencing with the certificate for December 31 2007 an evaluation of the effectiveness of internal controls is to be provided.

Disclosure Controls and Internal Controls

There are two types of controls that have been identified in the certificate requirements. The definitions provided by the CSA are:

Disclosure controls and procedures are controls and other procedures to provide reasonable assurance that information required to be disclosed by the issuer in its filings or other reports submitted as required by securities legislation is recorded, processed, summarized and reported within the time periods specified in the securities legislation and includes controls and procedures designed to ensure that information required to be disclosed is accumulated and communicated to the issuer's management, including its CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

Internal control over financial reporting is a process designed by the CEO and CFO and effected by the issuer's Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes policies and procedures that:

- a) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer,
- b) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the issuer's GAAP, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer, and
- c) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the annual financial statements or interim financial statements.

In order to have an organized framework against which a company can evaluate the completeness and integrity of its control framework, companies are generally utilizing the control model expounded by the Committee of Sponsoring Organizations (COSO).

There are five levels of controls in the COSO model:

- 1) Control Environment
- 2) Risk Assessment
- 3) Control Activities
- 4) Information and Communication
- 5) Monitoring.

The governance level has a strong role in the control environment as well as in the monitoring level, with some role in the other layers. Management will have a strong role in the control environment, risk assessment, information and communication, and monitoring. Control activities are those that are generally carried out by personnel within processes.

Critical Processes and Key Internal Control Identification

Methodology

Business processes drive account balances and account activity. Each process can be classified as routine, non-routine or estimation. The classification is necessary in understanding the types of risks and controls needed to mitigate the risks of errors in reporting. For each business unit, management needs to determine the significant accounts using materiality considerations (see below). To select the significant processes, management must perform the following:

- Map the processes to the significant accounts, and identify the critical processes involved in processing major classes of transactions affecting significant accounts (e.g. sales);
- Identify additional processes that impact the account balance (e.g. Consolidation);
- Identify processes for identifying disclosures required in notes to financial statements and other disclosure documents (AIF, MD&A, and others).

Materiality

The rules anticipate the concept of materiality. The phrase “reasonable assurance” is used in the definition of disclosure controls and internal controls and the certificates refer to ‘material fact’ and ‘filings fairly present’. A level of materiality needs to be stated as the amount that a misstatement would impact decisions.

In deciding which accounts and processes are selected for evaluation, quantitative and qualitative factors need to be considered. Accounts that are immaterial in amount but could adversely affect the Company’s reputation would be considered. Also, accounts with balances less than materiality should be reviewed to determine whether such accounts are significant by considering:

1. Susceptibility to errors or to fraud;
2. Volume of activity (if it is relatively high);
3. The extent of estimation involved in determining the account balance;
4. Accounts where there has been a history of errors;
5. Accounts which are complex or not subject to standard processing (e.g. intangibles, taxation);
6. Accounts that would have a significant impact on covenants; and
7. Accounts that are sensitive (e.g. related parties).

As a final measure, the aggregate of accounts not selected needs to be reviewed to ensure that a significant error could not be hidden in those accounts in aggregate.

Accounts and Processes to be Documented for Internal Controls

With the guidance of materiality, the accounts that are over the threshold can be identified. From there each account needs to be analyzed and underlying accounts from different business units identified to determine which processes impact the balance and therefore need to be documented.

Many companies have numerous business units reporting financial results which in turn are consolidated to arrive at the published financial statements. In order to determine what needs to be documented, the consolidated financial statements and accounts need to be disaggregated into the individual units. Where significant accounts are identified, the reporting process must be documented at the relevant business unit.

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The following will generally be the significant processes to be documented where the process results in an entry to a financial account:

1. Revenue, accounts receivable, cash receipts
2. Purchase, payables, payment
3. Inventory
4. Payroll and benefits
5. Information technology
6. Capital asset acquisition
7. General ledger and financial statement preparation
8. Management control environment
9. Treasury (foreign exchange, banking)
10. Income taxes
11. Consolidation

Design and Effectiveness of Internal Controls

The process for concluding on the design and effectiveness of internal controls consists of.

1. Document - Prepare documentation of the following:
 - Process flowcharts identifying the key controls
 - Narrative description of the process providing specific information around the purpose of the process, key inputs and outputs, risks and controls;
 - Identify internal controls to prevent and/or detect potential errors in financial reporting;
 - Walk-through of each process from end-to-end to test integrity of the information documented and the existence of controls.

For each accounting process and for each potential accounting risk/error, the documentation must identify controls to mitigate the risk/error. An absence of controls and gaps in controls over risks/errors must be identified for remediation steps.

2. Conclude on design (2006)

Based on the results of the walk-throughs, the identification of controls in response to potential risks/errors and the degree of gaps and absence of controls, documenters will need to conclude on the effectiveness of the design of controls.

3. Test and conclude on effectiveness (2007)

The evaluation of the effectiveness of the operation of the controls and conclusions will be derived from the results of sufficient testing of the controls. The testing must cover a period that is sufficient to know if the controls were in place (or would continue to be in place) throughout the reporting cycle and testing will be designed to cover a sufficient sample to know if the control operated effectively. The conclusion on effectiveness will consider the test results. Testing can consider the impact of compensating controls.

Documentation and testing of each process is a time consuming exercise. Correcting gaps and deficiencies also takes considerable time. Even though the conclusion on the effectiveness of the internal controls is not needed until the year ended December 2007, it can take **12 to 18 months** to reach the point where the documentation has been completed, remediation retested, and final conclusions reached.

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External Auditors

The most recent rules do not require an audit of management's assertion on the adequacy of design or effectiveness of the disclosure and internal controls. However the information gathered during the documentation exercise can be provided to the external auditors as this could be a cost savings under the new generally accepted auditing standards that now require the external auditors to understand the company's internal controls relevant to the audit of the financial statements. This will reduce the time that the external auditors would otherwise spend creating their own documentation of the same information.

Project Plan

An example project plan is provided for reference. Given the amount of work involved in this exercise, it is important to put together a project plan, a working committee and a steering committee to keep the project on track.

Concluding Comments – Don't Wait

It is difficult to adequately express how much work is involved to gather the necessary information to permit the CEO and CFO to provide the certification under the final rules. This is a very detailed process and it is imperative that companies get the process underway.

We hope this advisory has been informative but please **note** that this is a simplified outline of the current rules. There are many defined terms, particular situations, certain exemptions and other critical information in the details of the instruments. It is important that you read the full text of the applicable instruments and consult your professional advisors to assess the full impact on you and your company. For the full text, go to http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/rm_part5_index.

Booker & Associates would be pleased to meet with you to discuss this further.

Booker & Associates will not assume liability for any reliance placed on this newsletter.

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Example Work Plan

Step	Description	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb
1.0	Overall project planning											
1.1	Develop project plan, determine materiality, disaggregate F/S into processes and units											
1.2	Prepare list of business units and identify the timing for each unit											
2.0	Enterprise Wide Control Environment											
2.1	Prepare documentation of governance and management control environment – conclude											
2.2	Prepare documentation on Audit Committee in relation to 52-110 - conclude											
2.3	Document IT control environment – conclude											
2.4	Prepare documentation on disclosure committee and controls - conclude											
3.0	Move to business unit focus											
3.1	At each business unit, create process maps, identify controls, conduct walkthroughs – conclude on design, identify remediation											
3.2	Conduct testing at business units and processes – conclude on effectiveness											
4.0	Corporate Level											
4.1	For corporate processes - update process maps, identify controls, conduct walkthroughs – conclude on design, identify remediation											
4.2	Conduct tests of process-level controls – conclude on effectiveness											
5.0	Retest where remediation put in place											
6.0	Summarizing and Enterprise Conclusions											
6.1	Prepare Internal Control Report											
6.2	Decide on disclosure re deficiencies											
7.0	Status reports to Steering Committee											
8.0	Status reports to Audit Committee						X			X		X

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