navigating the new world*

multilateral instrument 52-109–practical guidance for management

volume one: risk assessment and scoping

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overview

On March 10, 2006 the Canadian Securities Administrators (CSA) issued CSA Notice 52-313, announcing proposed rules that would require management to certify and report on the effectiveness of internal control over financial reporting (ICFR) for years ending on or after December 31, 2007*. Previous requirements under Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings* concerning evaluation of the design of ICFR were not affected by this latest announcement. Effectively this means that the internal control requirements of the Multilateral Instrument will be implemented over a two-year period – management will make an assessment of the *design* of internal control over financial reporting for years ending on or after June 30, 2006, with an annual evaluation of the *operating effectiveness* of internal control over financial reporting commencing for years ending on or after December 31, 2007*. As a result, companies will need to carefully consider how to most efficiently and effectively implement the new requirements, to avoid duplication of effort and maximize use of available resources. As the deadline for certification is fast approaching for calendar year end companies, issuers should be well underway on their projects to meet these requirements.

PricewaterhouseCoopers has developed the "Risk and Extent" approach to internal control over financial reporting. This is a pragmatic approach that is cost-effective for all organizations, since it is risk-based, tailored to a company's particular circumstances, and phased in over a two-year period.

This publication is the latest in a series of monographs that PricewaterhouseCoopers has published in relation to Bill 198 and Multilateral Instrument 52-109. The first volume in a new series, Multilateral Instrument 52-109 – Practical Guidance for Management, this publication describes the key activities integral to a successful risk assessment and scoping process. It reflects the insights and perspectives we have gained by working closely with our clients over the past several years, and the direct experience of PricewaterhouseCoopers Partners and Staff worldwide in the implementation of internal controls over financial reporting.

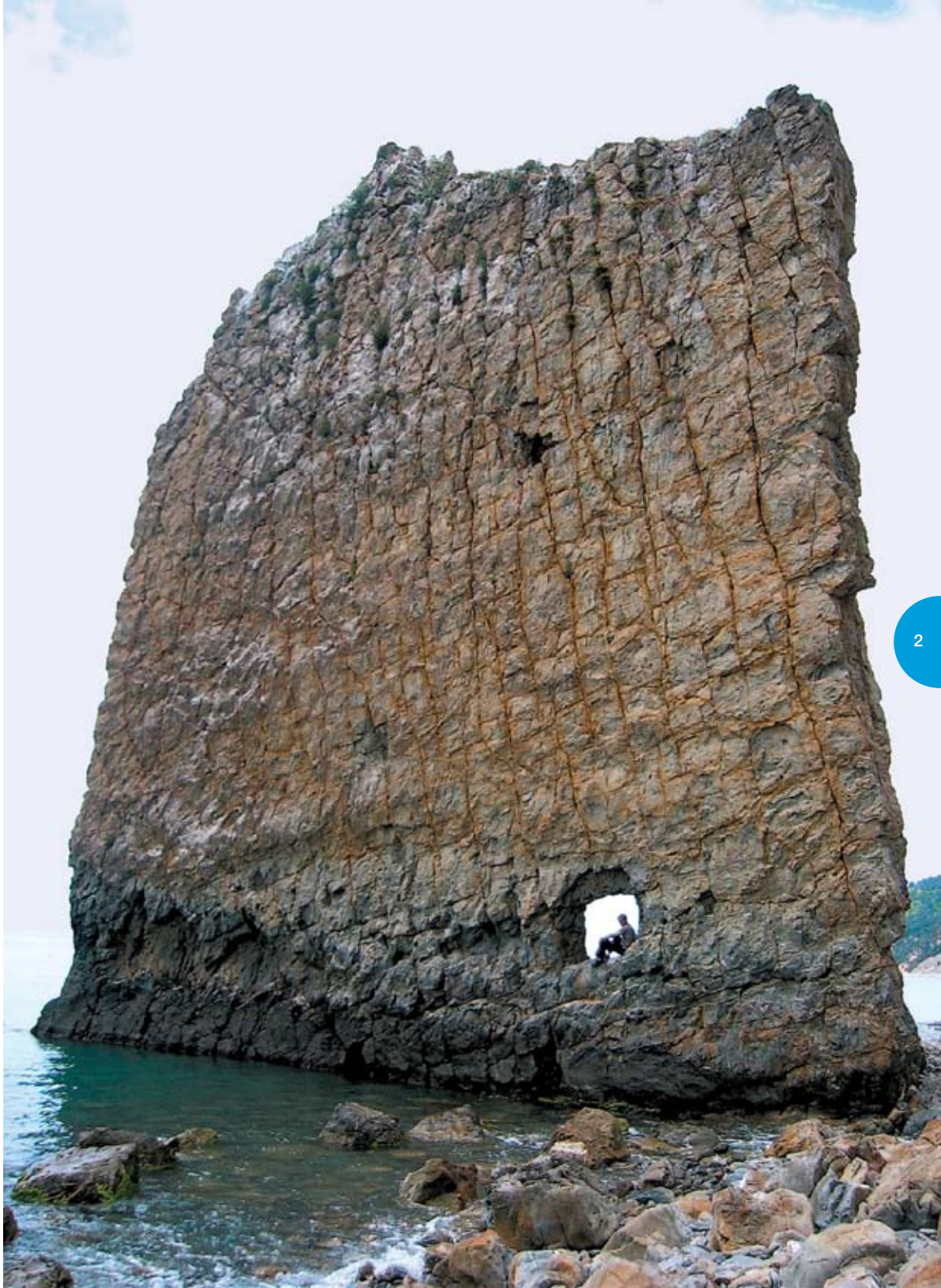
Additional information and assistance may be obtained from your local PricewaterhouseCoopers representative.

* At the earliest, and subject to the final regulations.

background

Risk assessment and scoping is a critical phase in implementing and sustaining an effective certification process to meet the current and proposed requirements of Multilateral Instrument 52-109. Investing the appropriate level of effort and resources in this phase and applying a “top-down” risk-based approach will aid in achieving an effective and efficient overall project. PwC’s Risk and Extent approach to internal control over financial reporting requires an assessment of the likelihood and potential impact of controls and processes breaking down. This approach allows management to focus on controls that have the most significant impact on mitigating important risks, while spending less time and effort on areas where risk is low.

PwC’s risk assessment methodology encompasses an identification of potential risks that may impact financial reporting and then assessing and prioritizing the impact of these risks. A sound and well thought-out risk assessment up front will enable the Company to prioritize key controls, identify potential weaknesses and enhance the Company’s overall internal controls project by making it more efficient and cost effective.



selecting an internal control framework

Management may find it useful to evaluate internal control over financial reporting in the context of an existing framework. A suitable internal control framework provides an organized basis for making an evaluation, and provides useful implementation guidance. The framework currently being used by the majority of companies around the world is COSO.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) was charged in the mid-1980's with the responsibility of defining an effective framework for systems of internal control. Since its publication in 1992, the COSO framework has become widely accepted as the benchmark for establishing and assessing a structure for internal controls. The COSO framework is the most commonly applied model for Sarbanes-Oxley Section 404 reporting in the United States, and we recommend its use for application to internal control projects in Canada as well.

Under the COSO framework, "internal control" is defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

For purposes of the certifications under Multilateral Instrument 52-109, management will focus only on the achievement of objectives relating to reliability of financial reporting.

COSO identifies five components of control (Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring) that need to be in place and integrated to ensure the achievement of control objectives. In preparing for the internal control certification process, management will need to consider controls which address all five of these components.

In 2006, COSO issued *Internal Control over Financial Reporting - Guidance for Smaller Public Companies.* This guidance supplements, but does not replace or modify, COSO's 1992 Internal Control – Integrated Framework. The Guidance is aimed at smaller public companies, but should be useful to companies of all sizes, and is intended to help management in establishing and maintaining effective internal control over financial reporting. While not designed explicitly for this purpose, the guidance may also be helpful in more efficiently assessing internal control over financial reporting effectiveness.

The guidance clarifies the principles underlying the five control components (Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring). It discusses the attributes that most commonly exist and provides specific small-business examples of how these principles and attributes are used. The guidance can be particularly helpful where it has been difficult for management of smaller public companies to demonstrate the effectiveness of internal control given the informal nature and lack of segregation of duties common among the systems and processes at these companies.

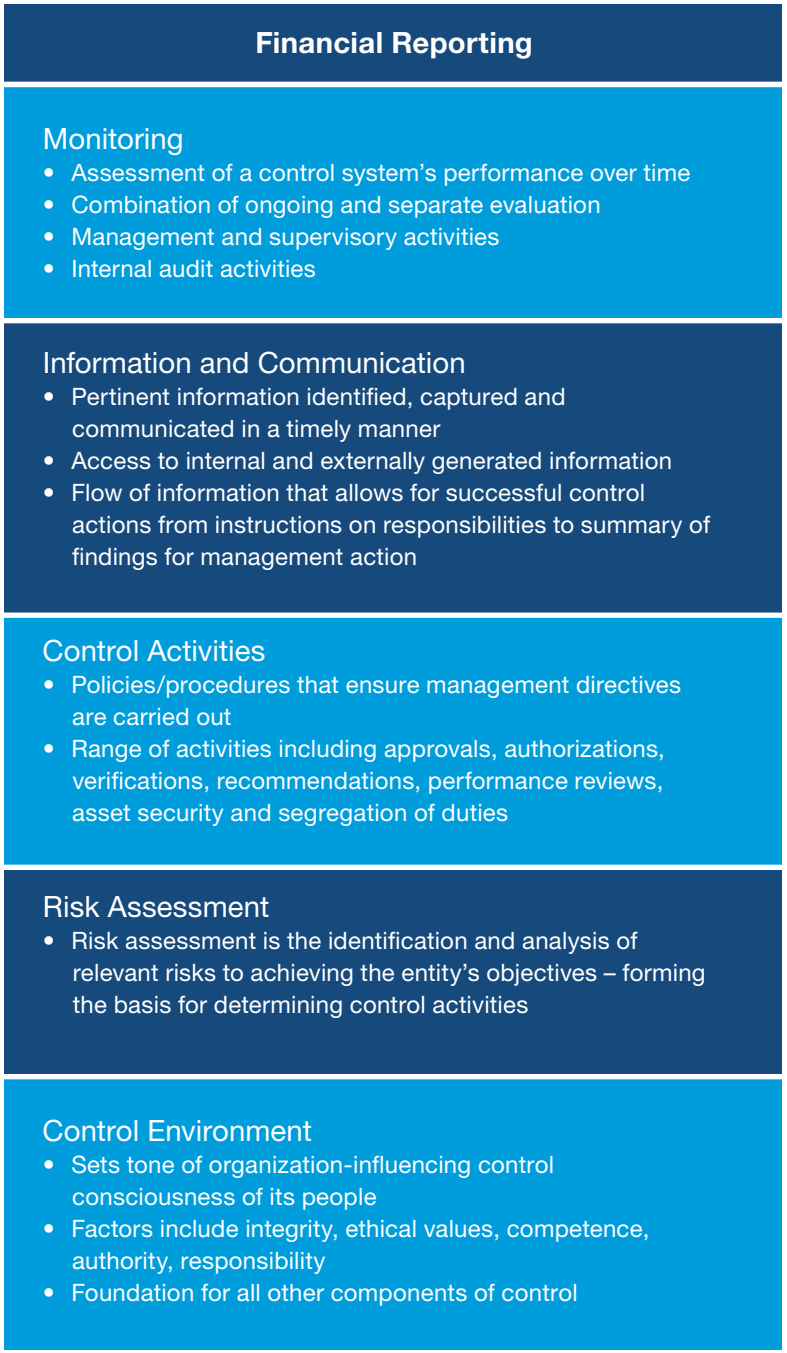


Figure 1 – The COSO Framework

risk assessment and scoping phase

Management should begin its approach to certification by developing a scoping methodology which will allow the Company to effectively and efficiently evaluate the design and operating effectiveness of internal control over financial reporting across the organization. We believe that this methodology should be top-down and risk-based, to ensure that management focuses its project on important areas of financial reporting and disclosure. Given their strong interrelationship, risk assessment is an important aspect of the scoping phase — the assessment of risk will determine the accounts and locations which will be included in scope, and will drive the extent of documentation and testing that is performed.

The following is a summary of the overall approach that PwC recommends in performing the scoping phase of the Company's internal control project. We believe that following such an approach will enable the Company to focus its efforts and energies on the processes and controls that have been assessed as having greater risk:

Step 1
Determine Materiality

Step 2
Perform Risk Assessment Analysis

Step 3
Map Significant Accounts to Business Processes and IT Infrastructure

Step 4
Consider Significant Company-Level Controls

Once the scoping process is complete, management can determine what documentation is necessary for each control and the nature, timing, and extent of testing to be performed for each significant account, disclosure, and business process at each of the Company's locations.

step 1: determine materiality

It is important to recognize that a key purpose of the internal control certification process is to identify control weaknesses that individually or in the aggregate could cause or result in a material misstatement – not to identify all deficiencies in controls that may exist. Management will likely uncover a number of relatively minor deficiencies in controls during the course of its work; however, that is a by product of the process and not the main intent or focus of the scope of the project.

In order to determine which accounts and disclosures are significant and should be included in scope, management must apply and consider the concept of materiality. The same definition of materiality that applies to the preparation of a set of financial statements also applies to reporting on the effectiveness of internal control over financial reporting. Materiality is more than just a quantitative concept; judgments about materiality are highly subjective and may change throughout the process.

Management should consider the following criteria for determining the scope of its internal control project:

Overall materiality: Overall materiality involves the risk of material misstatement of the consolidated financial statements. Management should consider the guidance included in SEC Staff Accounting Bulletin No. 10, Materiality, when assessing materiality. Applying a materiality threshold (i.e., 5 percent) against certain key metrics, such as pre-tax income, is often useful for making a preliminary assumption about whether an item is likely to be material.

Overall materiality is also used to assess whether aggregated misstatements are material to the consolidated financial statements.

Planning materiality: Planning materiality should typically be based on an income statement measure, such as pre-tax income or loss, and should be used to consider the financial significance of individual accounts or components of accounts. To provide an allowance for the aggregation of misstatements across individual accounts, planning materiality should be less than overall materiality. Planning materiality should generally range between 50 and 75 percent of overall materiality. In determining this amount, management will consider the overall level of risk for the organization, and other qualitative factors, such as known weaknesses in internal controls, frequency of audit adjustments in the past, relevant industry risks, extent of management turnover, market pressures, liquidity considerations, and results of prior-year internal control assessments or internal audit reviews.

Based on an assessment of these and other existing factors, a higher risk entity would generally have a lower planning materiality (and perform relatively more work), and a lower risk entity would have a higher planning materiality and consequently perform less work overall.

For example, for a company with approximately $20 million of pre-tax income, overall materiality might be determined to be $1 million of pre-tax income, with planning materiality for a higher risk entity being approximately $500,000 (i.e., 50 percent of $1 million), and planning materiality for a lower risk entity perhaps being approximately $750,000 (i.e., 75 percent of $1 million).

Overall materiality and planning materiality levels should be documented by management, along with (1) the rationale behind the quantitative materiality levels and (2) any changes in the determination of materiality that arise during the remainder of management's assessment.

step 2: perform risk assessment analysis

In terms of reliable financial reporting, risk assessment involves the identification and analysis of those factors or circumstances that could result in a material misstatement in the financial statements. This requires a detailed understanding of the organization and its business, processes, and controls. Risk assessment involves identifying, assessing and prioritizing the potential breakdown of the business processes in financial reporting systems. This allows businesses to focus on control activities that have the most impact on mitigating important risks while spending less time and effort on areas where risk is low.

PwC's risk assessment methodology encompasses the following steps:

- **Identification of potential risks –** These are the risks potentially impacting the achievement of financial reporting objectives. This includes an analysis of the business processes that impact the financial statement accounts and information technology infrastructure and the processes that support the reporting. Included in the identification of potential risk is a consideration of internal factors such as account complexity, business process characteristics, and employee capabilities. External influences and factors include economics, competition, industry conditions, regulatory and political environment, and changes in technology, supply sources, customer demands, and creditor requirements.

- **Assessment and prioritization –** This involves analyzing the identified risks through a process that includes estimating the potential impact of the risk on the financial statements and an assessment of the likelihood of the risk occurring. Management establishes the criteria to assess and prioritize the impact of risks.

When we mention risk, we are generally referring to inherent risk. Inherent risk is defined as the susceptibility of the financial statements to material error or fraud, without recognizing the effectiveness of the underlying control systems in place. The level of inherent risk will vary for different accounts, and even for various elements of a single account. For example, areas involving complex calculations such as inventory costing are more likely to be misstated than those accounts or processes involving simple calculations, such as prepaid expenses. Cash may be more susceptible to loss or manipulation in a company whose business involves the handling of large amounts of cash on a daily basis. Areas involving greater levels of subjective management judgement, such as inventory obsolescence, income taxes, or the allowance for doubtful accounts typically have higher levels of inherent risk.

A wide variety of techniques can be used by companies to assess risk. There is no one single approach. Many companies will conduct interviews with business process owners and financial reporting personnel. In other organizations, self-assessments of risk by business process owners, or facilitated sessions with the appropriate levels of senior management, may be useful in performing the risk assessment for the organization.

Risk assessment should be performed at two levels, first at the overall company level and secondly, at the business process level.

assessment of overall entity-wide risks

At a macro level, risk assessment examines the entity level risks facing the Company and their impact on the business. This risk analysis focuses on the Company's business, how it is organized, how the main business units function and how transactions are controlled and recorded. Obtaining this type of knowledge about the business enables the project plan to be more focused and ensures that key risks impacting the Company as a whole are tailored into the plan.

The following is a summary of some of the potential macro risks that should be considered at this early stage of the risk assessment (this list is an example only and is not designed to be all-inclusive).

- Impact of current economic, competitive and industry conditions on the Company
- Impact of regulatory and political environment
- Changes in technology and the impact on operations
- Customer demands/supplier demands on operations
- Financial and credit obligations of the Company
- Quality and quantity of personnel in key positions
- Changes in key personnel throughout the organization
- Structure and organization of the Company
- Reliability of information systems and potential changes and upgrades
- Overall quality of financial reporting and demands by investment community (i.e., analyst coverage)

When performing the macro risk assessment, management should assess the impact of such entity-level risks on the financial statement accounts, disclosures and the Company's business processes.

account/business process risk assessment

(i) Start with the Consolidated Financial Statements

The secondary risk assessment is performed at the account or business process level. This assessment should be performed by an individual who is familiar with the business, the types of transactions that may occur, and their impact on the financial statements.

The starting point will generally be the consolidated financial statements for the Company. In practice, many companies have used the most recent fiscal year-end financial information to complete the risk assessment exercise. However, the particular financial information used in this analysis may vary based on what level of detail is available at the Company (for example, annual vs. quarterly vs. monthly results), the reliability of the data, and what is considered most representative of the Company's upcoming year-end. The key is to select financial information that will be the most indicative of the company's current year – historical financial information, forecasted data, or a combination of both.

If management believes that the financial results for the year have been or will be substantially impacted by unusual events or significant transactions, then management should consider adjusting the results for the purpose of scoping to make them more indicative of the Company's expected year-end. Examples of such transactions that might require consideration include:

- Significant unusual or non-recurring transactions (debt refinancing, restructurings, impairments, etc.) occurring only in the previous year, or are expected to occur in the current year
- Significant acquisitions – consider the "full year" results of significant acquisitions in the prior year or current year
- Significant dispositions/discontinued operations
- Related party transactions that may distort earnings (i.e., transactions that are not at arm's length)

One question that has often been raised is whether management should include in the scope of its internal controls project an assessment of controls located at entities that have only been acquired in the current year, but for which the operations have not yet been integrated. To date, the CSA have not issued detailed interpretive guidance in this area for Canadian companies. In the United States under the SOX 404 regulations, companies are permitted to exclude acquired entities from their internal controls assessment in the year of acquisition. We understand that several registrants have contacted the OSC directly to discuss their individual circumstances. Accordingly, for any Canadian registrant that plans to exclude controls located at a significant acquired entity in the current year, we would recommend that management discuss this matter with the company's legal counsel, to determine the appropriate course of action.

(ii) Assess the Level of Risk of Material Misstatement (Categorize as High, Medium, Low or Insignificant)

Once the relevant financial statements or financial information has been selected, it is time to determine the level of risk for each significant account or area. In performing this risk assessment, management must determine whether components of the business process are considered insignificant, low, medium or high risk in relation to the consolidated financial statements. A risk rating will be assigned to each relevant account or area by management. The risk rating will ultimately determine the extent of work that is necessary (i.e., documentation and testing) for each area, as higher risk areas will generally require greater attention than lower risk components.

When identifying and rating the risk for each account or area, management may find it useful to disaggregate

the account into separate sub-accounts or processes, to evaluate each separately. For example, the "other assets" line item on the consolidated balance sheet may include multiple accounts or components that are subject to different risks and controls, and therefore should be considered separately. Similarly, different processes or sub-processes for an account may be subject to different risks and controls. For example, certain aspects of accounts receivable for a particular company might be lower or moderate risk, but the allowance for doubtful accounts might be higher risk due to the significant judgement that management needs to apply to this process. In this situation, it would make sense to look at the risk rating for the allowance for doubtful accounts sub-process separately. For relatively straightforward accounts, such as prepaid expenses or goodwill, disaggregation may not be required, and a single risk rating for the entire account may be appropriate. The key point here is to disaggregate only to the level that makes sense for the organization.

In determining the appropriate risk rating for a particular area, we recommend the following guidance:

High

These accounts or processes are critical to the financial statements and are complex in nature, subject to significant judgement, and generally have a higher probability of containing a material error. As a result they require greater attention, and we recommend that detailed process documentation be developed for these areas, outlining the process and identifying the key controls. In addition, greater testing of operating effectiveness will generally be performed by management in these areas.

Medium

These accounts and processes are of moderate risk of misstatement, and should also have some process documentation and identification of key risks in place; however, the documentation for these areas will likely be at a higher level. Management may elect to perform some detailed testing for these areas.

Low

These processes require less process documentation and, in general, testing for such areas will be relatively limited. Management may focus its attention on a limited number of key controls, such as higher-level monitoring controls or important business performance reviews.

Insignificant

These accounts and processes are unlikely to lead to a material error. Management will likely exclude these areas from consideration in determining the extent of documentation and testing to be performed.

In determining whether an account is significant, and for assessing the appropriate risk rating for a particular account or area, management should consider the risk that the account or disclosure could contain misstatements that, individually or when aggregated, could have a material effect on the financial statements. The use of a percentage of overall materiality (such as planning materiality) as a minimum threshold may provide a reasonable starting point for evaluating the financial significance of a particular account or process; however, judgement, including a review of relevant qualitative factors, must be exercised to determine whether accounts and processes above or below that threshold should be evaluated. Management should consider both quantitative and qualitative factors.

Examples of qualitative factors to be considered include items such as the following

- Size and composition of the account
- Susceptibility to loss due to errors or fraud
- Volume of activity, complexity, extent of judgement applied to the area, and homogeneity of the individual transactions processed through the account
- Nature of the account (for example, suspense accounts will generally warrant greater attention)
- Accounting and reporting complexities associated with the account
- Exposure to losses represented by the account (for example, loss accruals related to a consolidated construction-contracting subsidiary)
- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the account
- Existence of related-party transactions in the account
- Changes in account characteristics since the previous period (i.e., new complexities, subjectivity, or types of transactions)
- Prior-year internal control deficiencies

Although an account should not be considered significant solely because it is quantitatively large, we believe that it would be unusual for an account that significantly exceeds materiality to be excluded entirely from the scope of management's assessment. For example, high-dollar, lower risk accounts, such as bank deposits, payroll, and fixed assets will generally be considered to be significant accounts. If these material accounts are determined to have lower risk, however, the level of documentation, and the nature, timing, and extent of testing will be modified in accordance with this assessment.

In addition, certain quantitatively immaterial accounts may be included as significant accounts on a qualitative basis (i.e., the process for calculating income taxes might be included, even though the current balance might be less than materiality) or because they represent an important performance measure to investors. Judgement, including a careful review of relevant qualitative factors, must be exercised in determining whether amounts above or below quantitative thresholds (such as planning materiality and overall materiality) must be evaluated.

As part of the Risk and Extent Approach, PwC has developed a detailed diagnostic tool to assist clients in assessing risk for relevant processes and accounts. Your local PwC representative can assist you in determining the appropriate risk ratings for your organization.

revenue and receivables cycle

Potential Risk Factors	Yes	No	Comments
1 Business unit has a significant number of new customers			
2 Significant contracts exist which require judgment or have complex arrangements with customers			
3 Products sold are subject to significant price changes			
4 Complex revenue recognition exists such as percentage of completion method			
5 Customers have significant rights of return or adverse sales commitments			
6 Business unit has a deteriorating aging of receivables			
7 Customers are in industries experiencing unfavorable business conditions			
8 Business unit has significant related party transactions			
9 Gross margins in business unit are declining			
10 Returns as a % of sales are increasing			
11 Significant sales occur in foreign currencies or countries			
12 Significant amount of revenue is accrued at period end			
13 Company has rebate / co-op discount programs that require accrual			
14 Business unit engages in consignment sales			

Figure 2 – Excerpt of PwC's Diagnostic Tool for Assessing Risk

(iii) Summarize the Risk Assessment

Once Company management has performed its risk assessment, an analysis of the accounts impacted by the assessment can be prepared. This analysis provides the Company with a preliminary sense of where the overall risks are present, and potentially where work will need to be focused.

Figure 3 is an example of Company XYZ Ltd. where certain accounts and processes had various risks assigned to them. The risk ratings were assessed based on completing PwC's Diagnostic Tool.

The relevant financial reporting assertions have also been addressed by management as part of the following example. Financial statement assertions are representations by management that are embodied in the financial statements. Relevant assertions are those that have a meaningful bearing on whether the account is fairly stated. In determining whether a particular assertion is relevant, management should consider:

- The nature of the assertion
- The volume of transactions or data related to the assertion
- The nature and complexity of systems, including the use of information systems and technology by which the Company processes and controls information supporting the assertion

For example, with respect to bank and cash balances, valuation may not be relevant unless currency translation is involved or there are doubts about the bank or other depository where the balance is being held. However, existence and completeness are almost always relevant. For accounts receivable, valuation will be relevant to the allowance for bad debts, rather than for the gross amount of the receivables balance. The assessment and consideration of relevant assertions by management is important in order to ensure that coverage of risk and financial statement implications have been fully addressed.

XYZ Company Ltd.										
		Overall Account Risk Rating				Relevant Financial Statement Assertions				
Financial Statement line item	% of Total	High	Medium	Low	Insignificant	Existence	Comp	Valuation	Rights & Obligations	Presentation & Disclosure
Cash	1%			✔		■	■		■	
Accounts Receivable	5%		✔			■	■	■		
Inventory	15%									
- Raw Materials				✔		■	■			■
- Work in process					✔					
- Finished goods			✔			■	■	■		■
Prepaid expenses	1%			✔		■	■			
Income tax recoverable	5%	✔				■	■	■		■
Deferred income taxes	5%	✔				■	■	■		■
Property, plant and equipment	25%									
- Plant additions and disposals				✔		■	■	■		■
- Capitalized software project		✔				■	■	■		
- Amortization of PP&E				✔			■	■		
Accounts payable	10%		✔			■	■	■		■

Figure 3 – High-level Risk Assessment Summary

step 3: map significant accounts to business processes and IT infrastructure

In order to determine the areas or sub-processes of the Company that require more attention, we recommend that management next map the accounts and their relative risk ratings identified in Step 2 to the various business processes within the Company. To the extent that accounts were disaggregated in assigning the risk ratings in Step 2, some of the individual processes and sub-processes may already have been defined. The mapping of accounts to processes enables management to determine the areas that will need to be documented and potentially tested in more detail. The following chart provides an example of risks mapped to key processes. Note that some accounts, such as prepaid expenses in the example below, may only consist of one process.

Appendix 1 indicates some typical processes/cycles and sub-processes that companies may wish to consider as part of this analysis.

Once account risks are mapped to relevant processes and sub-processes, an understanding of the information technology systems that support the accumulation of data in these cycles should be performed. This step is important at this early stage as it enables management to evaluate the complexity of the business processes and the impact of IT on the control environment. In addition, this will assist management in determining potential automated controls that may be tested and may reduce the number of manual controls subject to management's testing.

		Risk Rating			
Account	**Sub-Process**	**High**	**Medium**	**Low**	**Insignificant**
Cash	Treasury			✔	
	Investments				✔
Accounts Receivable	Billing			✔	
	Credit and Collections		✔		
	Revenue Recognition	✔			
Inventory	Purchasing			✔	
	Inventory Costing	✔			
	Shipping and Receiving		✔		
Prepaid expenses				✔	
Taxes	Income tax provision	✔			
	Compliance and Planning	✔			
Property and Equipment	Purchasing			✔	
	Capitalization projects		✔		
Financial Statements	Consolidation	✔			
	Note disclosure	✔			

Figure 4 – Example of Accounts Mapped to Processes and Sub-processes

The following is an example of mapping key processes to the various applications:

Business Process	Risk Rating	Application Name	Operating System	Critical Spreadsheets
Treasury	L	Treasury management system/Foreign exchange software	Windows	N/A
Investments	L	Excel Spreadsheet	Windows	Investment Summary
Billing	L	PICS system	UNIX	N/A
Credit Collections	M	PICS system	UNIX	N/A
Revenue Recognition	H	Excel Spreadsheet	Windows	Month end accrual analysis
Purchasing	L	SAP	SAP	N/A
Inventory costing	H	Excel Spreadsheet	Windows	Inventory costing
Consolidation	H	Excel Spreadsheet	Windows	2006 Consolidation

Figure 5 – Example of Processes Mapped to IT Applications

step 4: consider significant company-level controls

Once Steps 1-3 have been completed, the Company will have determined the areas deemed to be higher risk for the organization (and therefore requiring greater attention). Prior to commencing any documentation or testing of these accounts and processes, we believe that management should identify relevant company-level controls that are in place, since the nature and effectiveness of these controls will have an impact on the extent of testing that will be required for key controls at the transaction level, and will permit management to focus its documentation and testing on those areas that possess greater risk and could have a material impact on the financial statements.

Company-level controls function within all five COSO internal control components and often have a pervasive effect on controls at the process, transaction, or application level. Company-level controls occur throughout an organization, not just at the corporate office. Management should consider where in the organization company-level controls operate (i.e., corporate level, segment level, business unit level, or at a lower level). Although the corporate office may be responsible for compiling and issuing accounting policies and procedures, management will likely want to consider following up on such controls at significant individual locations to ensure that the policies are being appropriately implemented and applied.

Effective company-level controls can often reduce the nature, timing and extent of testing performed, particularly in lower risk accounts and processes. Management may be able to obtain assurance through evidence such as self-assessments, internal audit reviews, and other monitoring controls—particularly detailed business performance reviews or direct monitoring of controls that help to achieve one or more financial statement assertions. When company-level controls operate at an appropriate level of precision that would prevent or detect errors, management's evaluation of company-level controls can often result in a decrease in testing that management would otherwise have to perform on controls at the more detailed level (i.e., at the process, transaction, or application levels).

The following table illustrates some typical company-level controls that should be considered in setting the scope for the project. These areas should be documented and evaluated early in the project.

Examples of Company-Level Controls

Components of Internal Control and Anti- Fraud Programs	Human Resources Policies and Procedures	Risk Assessment Process	Audit Committee	Internal Audit	Whistleblower Program	Code of Conduct and Compliance	Information Technology Environment & Organization	Self-Assessment	Administration of Shared Services	Disclosure Committee	Oversight by the Board	Policies and Procedures Manual	Period-End Reporting	Business Performance Reviews
Anti-Fraud Program	●	●	●	●	●	●					●		●	
Control Environment	●		●		●	●	●				●	●		
Risk Assessment	●	●	●	●	●			●		●	●			
Information & Communication	●	●	●	●	●	●	●		●	●	●	●	●	
Monitoring			●	●	●			●		●	●	●		
Control Activities							●		●			●	●	●

Figure 6 – Examples of Company-Level Controls

multi-location considerations

For some organizations, the business processes and sub-processes for each account may take place at multiple locations or business units (i.e., corporate offices, manufacturing plants, or distribution centres). Management will need to determine the extent of documentation and testing to be performed at each location to support its internal controls certification process.

In determining which locations or business units will be included in the scope of the project, management will evaluate such factors as:

- Relative significance of the location or business unit to financial position and operations
- The risk of material misstatement at that location or business unit
- The extent to which business processes/cycles and underlying controls for a given location or business unit are part of a central-processing or a shared-services environment

When determining the locations or business units that are subject to assessment, management should first identify all locations in its organization. Although this may seem like a relatively straightforward task, it may prove challenging for many multinational corporations, because of the complexity of their overall organizational structure. Business units may be defined in a number of different ways, such as by legal entity (i.e., subsidiary), division, or operational facility (i.e., a plant or sales office), and may be organized by geography, legal structure, or management reporting structure. Management will need to apply judgement in defining its locations or business units for the purpose of scoping and testing of internal controls.

In most cases, the nature, timing and extent of documentation and testing at each individual location will vary. As noted earlier, there should be a direct relationship between the degree of risk that a material error could exist in a particular area and the amount of attention management should devote to that area. As the risk associated with the area being tested changes, the level (i.e., nature, timing and extent) of testing will change correspondingly. Accordingly, in preparing its risk ratings for different accounts and processes, management may want to consider and evaluate each location's relative financial significance and the risk of material misstatement associated with that location. Often the risk associated with a particular account or process will be different for individual business units within an organization. For example, inventory valuation might be particularly complex at one division of an organization and therefore rated as higher risk, but might be relatively straightforward and rated as moderate or lower risk for another division of the same organization. As a result, for complex organizations with multiple business units, management may wish to consider allocating individual risk ratings at a business unit level, similar to the example below.

	Relevant Risk Ratings					
Financial Statement line item	**Division A**	**Division B**	**Division C**	**Division D**	**Investment in E**	**Corporate Office**
Cash	Low	Low	Low	Med	Low	Med
Accounts Receivable	Low	Low	Low	High	Low	Med
Inventory						
- Raw Materials	Low	N/A	Low	Low	Low	N/A
- Work in process	N/A	N/A	Low	N/A	N/A	N/A
- Finished goods	Low	Med	Low	High	Low	N/A
Prepaid expenses	Low	Low	Low	Low	Low	Low
Income tax recoverable	N/A	N/A	N/A	N/A	N/A	High
Deferred income taxes	N/A	N/A	N/A	N/A	N/A	High
Property, plant and equipment						
- Plant additions and disposals	Low	Low	Low	Low	Low	Low
- Capitalized software project	High	Med	Med	Med	Med	High
- Amortization of PP&E	Low	Low	Low	Low	Med	Low
Accounts payable	Low	Low	Med	Low	Low	High

Figure 7 – Example of Modified Risk Rating Chart for Multiple Locations

investments and joint ventures

To date, the CSA have not provided any specific implementation guidance with respect to investments and joint ventures. For Sarbanes-Oxley Section 404 projects in the United States, the SEC provided guidance in this area, as follows.

Equity Method Investments

The SEC has indicated that controls over the recording of transactions into the investee's accounts are not part of the registrant's internal control structure. However, the evaluation of a Company's internal control over financial reporting would include the Company's own controls for reporting the equity method investment (including the investee's earnings/losses) and making the related disclosures in the investor's financial statements, in accordance with generally accepted accounting principles.

Variable Interest Entities and Proportionately Consolidated Entities

The SEC staff has indicated that management may exclude an entity from its assessment in situations where:

- the entity was in existence prior to December 15, 2003 and is consolidated by virtue of FASB Interpretation No 46, *Consolidation of Variable Interest Entities;* and
- the registrant does not have the right or authority to assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment.

Similarly, in situations where management has been unable to assess the effectiveness of internal control due to the inability to dictate or modify the controls and the inability, in practice, to assess those controls, management may exclude from its assessment, entities accounted for via proportionate consolidation in accordance with EITF 00-1, *Investor Balance Sheet and Income Statement Display Under the Equity Method for Investments in Certain Partnerships and Other Ventures.* For new or modified arrangements, management should ensure it obtains a right of authority to access internal controls of the consolidated entity.

It is not clear at this point in time whether the CSA will adopt similar guidance for Canadian companies implementing Multilateral Instrument 52-109. Accordingly, we would recommend that management discuss its anticipated approach with the company's legal counsel, to determine the appropriate course of action.

coming soon

Volume 2 of our new series, *Extent of Work - Documentation and the Evaluation of Design*, will provide guidance and our recommendations regarding management's documentation and evaluation of the design of internal controls over financial reporting.

appendix 1

typical business processes/cycles and sub-processes/sub-cycles

Inventory and Production
Inventory master file maintenance
Inventory quantity control
Obsolete and slow-moving inventory control
Shipping activities
Production activities
Receiving activities
Inventory costing

Purchasing
Vendor master file maintenance
Requisitions
Purchase orders
Receiving
Invoice processing
Cash disbursements

Revenues
Customer master file maintenance
Pricing and order processing
Invoicing
Credit and collections
Returns
Cash application and receipts processing
Revenue recognition
Incentive programs

Payroll and Employee Benefits
Payroll and employee master file maintenance
Time and attendance
Processing payroll
Pension and post retirement benefits
Management incentive and stock option programs

Capital Spending and Maintenance
Capital master file maintenance
Capital acquisition requests
Depreciation
Disposals
Leases (operating, capital)

Financial Reporting (including period-end reporting)
Planning, budgeting, and management reporting
General ledger maintenance
Consolidation and adjusting, eliminating and consolidating entries
Accounting policies and procedures
Footnote support
Account analysis and reconciliations
Currency translation
Inter-company accounts
Adoption of new accounting pronouncements

Treasury and Risk Management
Debt and related interest
Cash
Investments and related interest
Equity
Hedging and derivatives
Workers' compensation and other self-insurance programs
Legal exposures
Environmental exposures
Guarantees and other commitments

Taxes
Income taxes (local, state and federal)
- effective tax rate
- valuation allowances
- tax contingency considerations

Sales taxes
Property taxes

Information Systems
Information Systems
Control environment
Program development
Program changes
Access to programs and data (security access)
Computer operations

Other/Miscellaneous
Restructurings and impairments
Prepaids and other miscellaneous assets
Other miscellaneous liabilities and accruals
Equity method investments
Miscellaneous other income and expense
Purchase accounting
Discontinued operations

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