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Previous issues of *Risk Alert* are available on the AASB’s website (www.aasb.ca). Suggestions for and comments on *Risk Alert* are always appreciated and may be directed to:

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risk

ALERT

FOR CHARTERED ACCOUNTANTS PERFORMING AUDIT AND REVIEW ENGAGEMENTS

Auditor Involvement with Management’s Internal Control Certifications

CEOs and CFOs of most Canadian public companies and other reporting issuers (issuers) must certify their annual securities filings for years ending after June 29, 2006. The certificates that are filed with Canadian securities regulators include matters pertaining to the design of their entity’s internal control over financial reporting and the effectiveness of their disclosure controls and procedures. Management is not allowed to modify the

wording of these certificates — set out on a form provided by the CSA — even when internal control weaknesses have been identified. Instead, management will have to disclose in the annual MD&A the nature of any weaknesses identified in the design of internal control over financial reporting, the risks associated with those weaknesses and the plan, if any, to remediate the weaknesses.¹

¹ These are the Certification of Annual Filings (the Certificate) required by Multilateral Instrument 52-109 (MI 52-109). Required MD&A disclosures are also discussed in CSA Staff Notice 52-316, “Certification of Design of Internal Control over Financial Reporting.” Excerpts of these documents are included on pages 5 and 6 of this Risk Alert.



The auditor is not required to provide an opinion on these certifications and disclosures; however the certifications and disclosures will also have an impact on auditors:

- Auditors will be associated with management's MD&A disclosures about any weaknesses in internal control.
- There is also a risk that some people, including the entity's directors, may not understand the auditor's role and responsibilities regarding internal control over financial reporting.

This *Risk Alert* discusses these issues and suggests actions auditors may take to deal with them. Future publications will expand the discussions of these and other concerns relating to the auditor's association with certifications and work on internal control as part of a financial statement audit.

Auditor association with management's MD&A assertions

Auditors are associated with information in a designated public document (such as MD&A). Consequently, they read and consider the information in such documents to assess whether it is inconsistent with the financial statements also contained in that document. Auditors consider that information based on the knowledge acquired during the financial statement audit, with particular attention to matters related to the financial statements. They are not responsible for assessing whether the document complies with securities legislation or regulation, as they generally will not have the legal expertise for that. Nevertheless, if auditors believe that a designated public document appears to contain a material misstatement of fact,²

or a misrepresentation,³ they would follow the recommendation and guidance in *Auditor Association with Annual Reports, Interim Reports, and Other Public Documents*, paragraphs 7500.31-.35.

Significant issues may arise from an entity's MD&A disclosures on internal control. For example, during a financial statement audit, the auditors may have identified improperly designed controls that appeared to indicate a material weakness in internal control. When management prepared its MD&A, however, it may not have identified that weakness, or it may have omitted other weaknesses from its MD&A disclosure. Whether the improperly designed controls identified by the auditors should be disclosed in the MD&A in accordance with CSA Staff Notice 52-316 is a compliance issue that would generally be beyond auditor expertise. Auditors may, however, believe that, based on their knowledge, the omission appears to be a misrepresentation in the MD&A. Paragraphs 7500.31-.35 discuss what auditors might do in such circumstances. For example, they might attempt to resolve the matter with management. If the matter remains unresolved, they should inform the audit committee and the board of directors of the issue. In some situations, they might even consider notifying the board that they cannot consent to the use of the auditor's report and, ultimately, might have to resign from the engagement.

Auditors might consider the following when they try to resolve what appears to be a misstatement of fact, or a misrepresentation regarding internal control, in management's MD&A:

- Depending on the strategy and approach the auditors have taken in auditing the financial statements, they would

² A material misstatement of fact is an untrue statement.

³ A misrepresentation is an untrue statement of a material fact, or an omission of a material fact that must be stated or that is necessary to ensure that a statement is not misleading in light of the circumstances in which it is made.

not necessarily have obtained much information about the possible internal control weakness identified during the audit but not reported in the MD&A.

Matters that could come to light when they discuss this matter with management include:

- the auditor may have misunderstood and incorrectly evaluated the design of the control;
- the control may not be a primary control in the financial reporting process;
- there may be other controls that compensate for the apparent weakness in the control that management is aware of but the auditor is not.
- A possible misstatement of fact or misrepresentation in the MD&A could have legal implications for compliance with securities regulations. As assessing such compliance would generally be beyond auditor expertise, auditors might suggest that management consult its securities counsel or other appropriate experts on the matter.
- The auditors would document all significant aspects of how they have dealt with this matter, including:
 - communications with management, the audit committee and board of directors;
 - the reasons provided by management, the audit committee or the board of directors as to why the apparent weakness was not disclosed in the MD&A;
 - their consideration of those reasons and their conclusion as to whether those reasons dispel their belief that there has been a failure to identify a weakness in internal control in the MD&A.

- Should the matter not be readily resolved, the auditors may wish to consult with their own legal counsel.

Potential for misunderstanding the auditor's role and responsibilities

Auditors consider an entity's internal control as part of the financial statement audit. Discussions with management, and those charged with governance, about control matters (including MD&A disclosures) are an important aspect of the audit. Anecdotal evidence suggests, however, that there is still relatively widespread misunderstanding of what a financial statement audit entails, particularly with respect to the auditor's role and responsibilities regarding internal control. Various people, including directors, often think that the auditors have a more extensive role in internal control than is actually the case. They may have an unrealistic expectation, for example, that the auditors will always identify any and all material weaknesses in internal control while performing a financial statement audit.

To help prevent such misunderstanding, and consistent with Section 5751, *Communications with Those Having Oversight Responsibility for the Financial Reporting Process*, auditors may wish to clarify their internal control role and responsibilities to those charged with governance. Some key points to consider including in such communications are set out below.

- *Auditors obtain an understanding of internal control relevant to the audit, but not all controls are relevant to every audit.*

Auditors must always obtain an understanding of an entity's controls relevant to the audit of the financial statements. Controls relevant to the audit are those likely to prevent, or detect and correct, material misstatements in the financial statements. But not all controls relating to financial reporting are relevant to every audit. Auditors use significant professional judgment in determining what controls are relevant in the circumstances of a particular financial statement audit.

Auditors take many factors into account in making this judgment, including:

- what would be considered a material misstatement of the financial statements;
- the significance of the related risk of misstatement that a control is meant to address;
- the size of the entity;
- the nature of the entity's business, including its organization and ownership characteristics;
- the diversity and complexity of the entity's operations;
- applicable legal and regulatory requirements;
- the circumstances and the applicable component of internal control; and
- the nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.

As a result, the controls considered relevant to a particular audit can vary widely between various audit engagements.

- *Auditors evaluate the design of controls relevant to the audit and determine whether they have been implemented. Auditors are not, however, required to determine whether relevant controls are operating effectively.*

Following generally accepted auditing standards (GAAS), auditors:

- Evaluate whether an entity's management has appropriately designed controls relevant to the audit. This involves considering, for example, whether the right control has been assigned to the right person within the entity.
- Determine whether an entity's management has implemented the controls relevant to the audit. Auditors obtain evidence as to whether management has gone beyond just designing controls and has actually made them operational.

Auditors consider management's design and implementation of controls relevant to the specific circumstances of the audit when assessing the risks of material misstatement of the financial statements and determining the nature,

timing and extent of their substantive procedures (i.e., procedures to detect material misstatements).

Although it is not required by GAAS, auditors may decide that, for a particular engagement, it makes sense to rely on the effective operation of some controls in determining the substantive procedures they will perform. In this case, the auditors would go beyond evaluating the design of relevant controls, and determining whether they have been implemented, to also test whether the controls on which they intend to rely are operating effectively.

As a result of these issues, auditor depth of understanding of internal control resulting from the financial statement audit can vary widely. The auditors' knowledge of internal control will normally be greatest when they decided that the audit strategy to be followed for a particular engagement should include performing tests of the operating effectiveness of controls. This approach is viable, of course, only if management has put controls in place that are operating effectively.

In any event, managers with ongoing hands-on involvement in implementing effective internal control are likely to have a broader and more in-depth understanding of an entity's controls than the financial statement auditor would.

- *Although an issuer's auditors must provide the audit committee with any material information about weaknesses in internal control that have come to their attention, they may not be aware of all the material weaknesses in internal control that do, in fact, exist.*

As noted above, the strategy and approach to audits can vary significantly. For example, for audits where the auditors do not test the operating effectiveness of relevant controls, their knowledge of internal control weaknesses may be limited. Also, any communication they may issue to the audit committee on internal control may be relevant to that committee's review and approval of the MD&A disclosures about a weakness in internal control over financial reporting. That communication would not, however, provide a sufficient basis for the audit committee to determine whether such disclosures comply with CSA staff Notice 52-316.



FORM 52-109F1 — CERTIFICATION OF ANNUAL FILINGS⁴

I, **<identify the certifying officer, the issuer, and his or her position at the issuer>**, certify that:

1. I have reviewed the annual filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of **<identify issuer>** (the issuer) for the period ending **<state the relevant date>**;
2. Based on my knowledge, the annual filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the annual filings;
3. Based on my knowledge, the annual financial statements together with the other financial information included in the annual filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the annual filings;
4. The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have:
 - (a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the annual filings are being prepared;
 - (b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and
 - (c) evaluated the effectiveness of the issuer's disclosure controls and procedures as of the end of the period covered by the annual filings and have caused the issuer to disclose in the annual MD&A our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by the annual filings based on such evaluation; and
5. I have caused the issuer to disclose in the annual MD&A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

⁴ Form 52-109F1 – Certification of Annual Filings which CEOs and CFOs are required to sign and submit to relevant securities commissions for financial years ending after June 29, 2006.

CSA STAFF NOTICE 52-316 CERTIFICATION OF DESIGN OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Purpose of notice

This notice communicates staff's views regarding the ability of the certifying officers of a reporting issuer to certify the design of the issuer's internal control over financial reporting (ICFR) as required by Multilateral Instrument 52-109 — *Certification of Disclosure in Issuers' Annual and Interim Filings* (the Certification Instrument) if the certifying officers are aware of a weakness in the design of the issuer's ICFR.

Background

The Certification Instrument came into force in all CSA jurisdictions, except British Columbia and Quebec, on March 30, 2004. The Certification Instrument came into force in Quebec on June 30, 2005 and in British Columbia on September 19, 2005.

With limited exceptions, the Certification Instrument applies to all reporting issuers other than investment funds.

The Certification Instrument requires a reporting issuer to file an annual certificate for each financial year ending after June 29, 2006 in Form 52-109F1 (the full annual certificate) without modification. The full annual certificate requires the certifying officers to certify, among other things, that they have *"designed ... internal control over financial reporting, or caused it to be designed under [their] supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP."*

Issuers have asked us whether certifying officers can certify the design of ICFR if the certifying officers are aware of a weakness in the design that has not been remediated. We will address this issue in more detail in a proposed amended and restated version of the Certification Instrument that we intend to publish later this year, but in the interim this notice responds to these inquiries.

Staff's views

We acknowledge that there are circumstances in which the certifying officers of a reporting issuer can conclude that they are able to certify that they have designed the issuer's ICFR as required by the full annual certificate even though the certifying officers have identified a weakness in the design. In our view, the certifying officers can certify the design of the issuer's ICFR if the issuer's disclosure about the identified weakness presents an accurate and complete picture of the condition of the design of the issuer's ICFR.

The Certification Instrument does not explicitly require the certifying officers to cause the issuer to disclose a weakness in the design of the issuer's ICFR but it does require the certifying officers to cause the issuer to disclose in the annual MD&A the certifying officers' conclusions about the effectiveness of the disclosure controls and procedures (DC&P). In our view, the conclusions about the effectiveness of the DC&P should include disclosure of identified weaknesses in the DC&P.



Given the substantial overlap between the definitions of DC&P and ICFR, it is our view that the certifying officers therefore should cause the issuer to disclose in the annual MD&A the nature of any weakness in the design of the issuer's ICFR, the risks associated with the weakness and the issuer's plan, if any, to remediate the weakness. If no such plan exists, the issuer should consider disclosing its reasons for not planning to remediate the weakness.