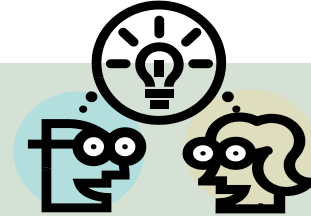


A Top-Down Approach to CEO/CFO Certification

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Editor's Note: We welcome contributions to the newsletter from ICD members. Here is an article submitted by Bruce McCuaig, graduate of the Directors Education Program (Toronto DEP6).



After initially setting out to replicate the Sarbanes-Oxley (SOX) regime here, Canada's securities regulators and standard setters have paused to assess the reaction south of the border, as the backlash there grows more vociferous.

In the clearest indication yet of how the Securities and Exchange Commission in the U.S. would like to see the SOX legislation and related audit standards applied, the U.S. Public Company Accounting Oversight Board (PCAOB) issued a report on November 30, 2005 on the initial implementation of Auditing Standard No.2 (AS2), the real driver of the exorbitant costs and criticism of the legislation.

The report makes a number of technical observations on the performance of U.S. auditors in complying with AS2, but, more importantly, it clearly signals the regulatory direction U.S. filers can expect to see. If the Canadian Securities Administrators and the public accounting profession in Canada are looking

for guidance before proceeding, PCAOB Release 2005-023 provides it.

The PCAOB is calling for a risk-based, top-down approach to assessing and documenting internal controls for CEO/CFO certification. For Canadian companies and boards who want confidence they are on

track for compliance with Canada's version of SOX, here are some questions to consider that reflect the PCAOB's approach:

1 Where are the principle disclosure risks?

A top-down, risk-based approach suggests the best place to start is by looking at the most complex processes, line items, notes and other disclosures where significant reliance is placed on judgments, technical expertise and estimates. Boards should identify what line items are the riskiest in terms of disclosure and understand how those risks are managed. A recent study by the Financial Executives Research Foundation (FERF)¹, *Control Deficiency Reporting: A Review and Analysis of Findings* found that most reportable deficiencies occurred during 2004 in revenues, operating costs and various corporate level accruals and reserves. Most of these deficiencies occurred during the financial close process, not in the work of some remote field office. Much of the cost of SOX in the U.S. was spent on documentation and testing of transactions and processes with little or no inherent risk of material disclosure error. Most of these other risky areas should have been obvious from the outset.

2 What do we know about the disclosure risks we are accepting today?

What internal control weaknesses do we have today? What has been reported by our internal auditor and by our external auditor over the last few years? What is management's assessment of the residual risk associated with major line items and processes? Few companies have formal policies that define a reportable disclosure deficiency and even experts have

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¹ Paisley Consulting is a research sponsor of FERF.

difficulty interpreting the complex definitions of deficiencies provided under the current rules. An inventory of all real or potential deficiencies should exist and it should reflect the views of the auditors as well as internal accounting and operating managers.

3 How good are we at finding and reporting disclosure risks?

According to the FERF study, most reported deficiencies were found by external auditors, not management. Internal auditors have not been rigorous in assessing disclosure controls, probably relying instead on external auditors. Prior to SOX, external auditors had little requirement or incentive to do so. Few companies have formally assessed the skills, tools and approaches required to ensure reportable deficiencies will be detected. U.S. experience suggests that management and internal auditors have done a poor job in this area. Boards should assess management's capabilities and strategies for assessing internal control over financial reporting.



4 Are we sure that identified deficiencies are assessed and remediated?

The legislation as well as good business practice requires monitoring of remediation measures. In the U.S., SOX requires that both individual deficiencies be assessed for remediation and deficiencies be aggregated and assessed for systemic errors as well. Are we identifying and solving root causes or are we remediating symptoms? The FERF study suggested the largest single cause of deficiencies was the "Control Environment" encompassing competence of financial staff, ethical and integrity issues and adequacy of financial staff resources. Deficiencies tended not to be caused by faulty computer systems or clerical error in the accounting

process. Boards are in a good position to objectively assess the significance of deficiencies and their aggregate impact and come to sound conclusions about root causes. Reported deficiencies should provide valuable signals to the board in this regard.

5 Is our certification process sustainable and cost-effective?

The certification requirements under SOX and those proposed in Canada do make sense. In my view, they were needed. What does not make sense are the arbitrary, complex and costly audit standards developed by the PCAOB in the U.S. and echoed in Canada. The recent pronouncement by the PCAOB goes a long way toward clarifying what the auditors are required to do. Canada would do well to incorporate the PCAOB conclusions in its audit standards. But they are still audit and not management standards. Companies need to develop their own management frameworks to improve the reliability of financial reporting, to make the process sustainable and to drive the cost down. Boards need to understand that framework.

Many of the most infamous recent corporate reporting failures have come as a complete surprise to the public and apparently to the board. One well-known Canadian director recently observed, "the problem is that you don't have signals". That may be true, but it is avoidable. There are limits to what a board can reasonably be expected to know. But the signals are almost always there and they can be seen if the right framework is in place.

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