COMPANION POLICY 52-111CP – TO MULTILATERAL INSTRUMENT 52-111 REPORTING ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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PART 1 – GENERAL

1.1 **Introduction and purpose -**

(1) Multilateral Instrument 52-111 *Reporting on Internal Control over Financial Reporting* (the Instrument) sets out additional disclosure requirements for all reporting issuers, other than investment funds and venture issuers.

(2) The purpose of this Companion Policy (the Policy) is to help you understand how the provincial and territorial securities regulatory authorities interpret or apply certain provisions of the Instrument.

1.2 **Application to non-corporate entities -** The Instrument applies to both corporate and non-corporate entities. Where the Instrument or the Policy refers to a particular corporate characteristic, such as a board of directors, the reference should be read to include any equivalent characteristic of a non-corporate entity.

PART 2 –MANAGEMENT'S ASSESSMENT OF EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

2.1 **No formal requirement for interim evaluation -** The Instrument does not require interim evaluations of internal control over financial reporting. We recognize that some controls operate continuously while others operate only at certain times, such as the end of a financial year. The management of an issuer should perform evaluations of the design and operation of the issuer's internal control over financial reporting over a period of time that is adequate for it to determine whether, as of the end of the issuer's financial year, the design and operation of the issuer's internal control over financial reporting are effective.[1]

2.2 **Management -**

(1) Section 2.1 of the Instrument requires management of an issuer to evaluate the effectiveness of internal control over financial reporting. The Instrument does not define "management". We would expect that management, for the purposes of the Instrument, includes the chief executive officer and chief financial officer of an issuer, or in the case of an issuer that does not have a chief executive officer or chief financial officer, all persons performing similar functions to a chief executive officer or chief financial officer; however, we believe that it should be left to the discretion of the chief executive officer and chief financial officer (or persons performing similar functions to a chief executive officer or chief financial officer), each acting reasonably, to determine the other members of management for the purposes of the Instrument.

(2) Where an issuer does not have a chief executive officer or chief financial officer, each person who performs similar functions to a chief executive officer or chief financial officer must participate in the evaluation of the effectiveness of the issuer's internal control over financial reporting. It is left to the discretion of the issuer, acting reasonably, to determine who those persons are.

[1] This section is derived from the "Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" issued by the SEC on June 18, 2003 (the SEC Release) – see "C. Quarterly Evaluations of Internal Control over Financial Reporting – 3. Final Rules".

(3) In the case of an income trust reporting issuer (as described in proposed National Policy 41-201 *Income Trusts and Other Indirect Offerings*) where executive management resides at the underlying business entity level or in an external management company, we would generally consider the chief executive officer and chief financial officer of the underlying business entity or the external management company to be persons performing functions in respect of the income trust similar to a chief executive officer and chief financial officer.

(4) In the case of a limited partnership reporting issuer with no chief executive officer and chief financial officer, we would generally consider the chief executive officer and chief financial officer of its general partner to be persons performing functions in respect of the limited partnership reporting issuer similar to a chief executive officer and chief financial officer.

2.3 **Scope of evaluation -**

(1) The assessment of an issuer's internal control over financial reporting should be based upon procedures sufficient to evaluate its design and to test its operating effectiveness.[2]

(2) The controls subject to such assessment include:

(a) controls over initiating, authorizing, recording, processing and reporting significant accounts and disclosures and related assertions included in the financial statements;

(b) controls related to the initiation and processing of non-routine and non-systematic transactions, such as accounts involving judgments and estimates;

(c) controls related to the selection and application of appropriate accounting policies that are in accordance with the issuer's GAAP;

(d) anti-fraud programs and controls;

(e) controls, including information technology general controls, on which other controls are dependent;

(f) controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger, to initiate, authorize, record and process journal entries in the general ledger and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations and reclassifications); and

(g) controls that have a pervasive impact such as those within the control environment, including the "tone at the top", assignment of authority and responsibility, consistent policies and procedures and issuer wide programs that apply to all locations and business units.[3]

[2] This section is derived from the SEC Release – see "B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting – 3. Final Rules – d. Method of Evaluating".

[3] This section is derived from the SEC Release – see "B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting – 3. Final Rules – d. Method of Evaluating" and the proposed CICA Standard.

(3) The nature of an issuer's testing activities will largely depend on the circumstances of the issuer and the significance of a control. Inquiry alone, however, will not generally provide an adequate basis for management's assessment. This statement should not be interpreted to mean that management personally must conduct the necessary activities to evaluate the design and test the operating effectiveness of the issuer's internal control over financial reporting. Activities, including those necessary to provide management with the information on which it bases its assessment, may be conducted by non-management personnel acting under the supervision of management. Management, however, has overall responsibility for the preparation of the internal control report.[4]

2.4 **Control framework for evaluation -**

(1) The Instrument does not mandate the use of a particular control framework in recognition of the fact that other evaluation standards exist and may be developed in the future that may satisfy the intent of the Instrument.

(2) A suitable control framework should:

(a) be free from bias;

(b) permit reasonably consistent qualitative and quantitative measurements of an issuer's internal control over financial reporting;

(c) be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of an issuer's internal control over financial reporting are not omitted; and

(d) be relevant to an evaluation of internal control over financial reporting.

(3) Without limiting the generality of subsections (1) and (2), the following control frameworks satisfy our criteria for the purposes of section 2.2 of the Instrument:

(a) the *Risk Management and Governance (formerly: Guidance of the Criteria of Control Board*) published by The Canadian Institute of Chartered Accountants;

(b) the *Internal Control – Integrated Framework* published by The Committee of Sponsoring Organizations of the Treadway Commission; and

(c) the *Turnbull Report* published by The Institute of Chartered Accountants in England and Wales.

(4) The control frameworks referred to in subsection (3) include in their definition of "internal control" three general categories: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and

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[4] This section is derived from the SEC Release – see "B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting – 3. Final Rules – d. Method of Evaluating".

regulations. The term "internal control over financial reporting", as defined in the Instrument, is a subset of internal controls addressed in these control frameworks. The definition in the Instrument does not encompass the elements of these control frameworks that relate to effectiveness and efficiency of an issuer's operations and an issuer's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the securities regulatory authorities' financial reporting requirements.[5]

2.5 **Evidence -**

(1) The Instrument requires that an assessment of the effectiveness of internal control over financial reporting be supported by evidence. We expect this evidence to include information about the design of internal control over financial reporting and the testing processes used by management. We believe that this evidence should provide reasonable support:

(a) for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions in the issuer's financial disclosure; and

(b) for the conclusion that the tests were appropriately planned and performed and that the results of the tests were appropriately considered.[6]

(2) To provide reasonable support for management's assessment of the effectiveness of internal control over financial reporting, the evidence should include:

(a) the design of controls over relevant assertions related to all significant accounts and disclosures in the financial statements;

(b) information about how significant transactions are initiated, authorized, recorded, processed and reported;

(c) sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur;

(d) a listing of controls designed to prevent or detect fraud, including who performs the controls and related segregation of duties;

(e) a listing of controls over period-end financial reporting processes;

(f) a listing of controls over safeguarding of assets; and

(g) results of management's testing and evaluation.[7]

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[5] This section is derived from the SEC Release – see "B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting – 3. Final Rules – a. Evaluation of Internal Control Over Financial Reporting" and "A. Definition of Internal Control – 1. Proposed Rule and 3. Final Rules".

[6] This section is derived from the SEC Release – see "B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting – 3. Final Rules – d. Method of Evaluating".

[7] This section is derived from the proposed CICA Standard.

(3) The evidence may be in written or non-written form.

(4) The evidence may be in bound or loose-leaf form or in photographic film form or may be entered or recorded by any system of mechanical or electronic data processing or by any other information storage device that is capable of reproducing any required information in intelligible form within a reasonable time.[8]

2.6 **Subsidiaries, variable interest entities, joint ventures, equity and portfolio investments -**

(1) ***Underlying entities -*** An issuer may have a variety of long term investments. In particular, an issuer may have any of the following interests (referred to in this section as underlying entities):

(a) an interest in an entity which is consolidated because the issuer controls that entity (a subsidiary);

(b) an interest in an entity which is consolidated because it is a variable interest entity (a VIE);

(c) an interest in an entity which is proportionately consolidated because the issuer jointly controls that entity (a joint venture);

(d) an interest in an entity which is accounted for using the equity method because the issuer has significant influence over that entity (an equity investment); or

(e) an interest in an entity which is carried at cost because the issuer has neither control nor significant influence over that entity (a portfolio investment).

In this section, the term entity is meant to capture a broad range of structures, including, but not limited to, corporations.

(2) ***Evaluation of effectiveness of internal control over financial reporting -*** If an issuer has an interest in an underlying entity, the nature of that underlying entity will impact the procedures required to be undertaken by management in its evaluation of the effectiveness of the issuer's internal control over financial reporting.

(3) ***Expectations regarding access to underlying entity -*** In the case of an issuer with an interest in a subsidiary, we expect management to have access to the subsidiary to evaluate the issuer's internal control over financial reporting extending into the subsidiary.

In the case of an issuer with an interest in a joint venture or a VIE, we acknowledge that management may not always have access to the underlying entity to evaluate the issuer's internal control over financial reporting extending into the underlying entity. We expect management to take all *reasonable* steps to evaluate the issuer's internal control over financial reporting. It is left to the discretion of management, acting reasonably, to determine what constitutes "reasonable steps".

[8] This requirement is similar to requirements in federal legislation (such as the *Canada Business Corporations Act* and *Trust and Loan Companies Act*).

In the case of an issuer with an interest in a portfolio investment or an equity investment, management will often not have access to the underlying entity to evaluate the issuer's internal control over financial reporting extending into the underlying entity.

(4) ***No access -*** When management does not have access to the underlying entity to evaluate the issuer's internal control over financial reporting extending into the underlying entity:

(a) in the case of an issuer with a material interest in a joint venture or a VIE, management is required to disclose this scope limitation in the internal control report. This disclosure should include the magnitude of the amounts proportionately consolidated or consolidated into the issuer's annual financial statements.

(b) in the case of an issuer with an equity investment or a portfolio investment, management should evaluate the effectiveness of the internal control over financial reporting that was required to be designed under Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings* (MI 52-109). These requirements are discussed in subparagraph 5.6(5)(c)(ii) and paragraph 5.6(5)(d) of the companion policy to MI 52-109.

(5) ***Factors affecting access -*** Whether management has the necessary access to a joint venture or a VIE to evaluate an issuer's internal control over financial reporting extending into the joint venture or VIE is a question of fact. While the factors to consider in making this assessment are the same as those listed in paragraph 5.6(5)(f) (in the case of a joint venture) or paragraph 5.6(5)(g) (in the case of a VIE) of the companion policy to MI 52-109, the outcome of the analysis may be different. Management may have the ability to evaluate the effectiveness of internal control over financial reporting extending into the joint venture or VIE even though the chief executive officer and chief financial officer (or persons performing similar functions to a chief executive officer or chief financial officer) do not have the ability to design internal control over financial reporting extending into the joint venture or VIE.

For all joint ventures and VIEs created on or after **[insert the date the Instrument comes into force]**, we expect an issuer to negotiate for the necessary access to evaluate the issuer's internal control over financial reporting extending into the joint venture or VIE.

2.7 **Business acquisitions -**

(1) ***General expectation -*** Except as discussed in section 2.6, we expect management to have access to each consolidated or proportionately consolidated entity to evaluate an issuer's internal control over financial reporting extending into the entity. We acknowledge, however, that it may not be feasible to assess an issuer's internal control over financial reporting extending into a business as at the end of a financial year during which the business was acquired by the issuer.

(2) ***Factors affecting feasibility of assessing internal control over financial reporting extending into an acquired business -*** Whether it is feasible for management to assess an issuer's internal control over financial reporting extending into a business as at the end of a financial year during which the business was acquired by the issuer is a question of fact. It may depend on, among other things:

(i) whether the business acquired has been subject to the Instrument, the U.S. federal securities laws implementing the internal control report requirements in sections 404(a) and (b) of the Sarbanes-Oxley Act or substantially similar requirements;

(ii) the size and complexity of the business acquired;

(iii) the terms of the acquisition agreement;

(iv) the length of time between the date of the acquisition agreement, the closing date of the acquisition and the date of management's assessment of internal control over financial reporting; and

(v) whether the business was acquired under a hostile take-over bid.

(3) ***Disclosure of scope limitation -*** If it is not feasible for management to assess an issuer's internal control over financial reporting extending into a business as at the end of a financial year during which the business was acquired by the issuer, management is required to disclose this scope limitation in the internal control report. This disclosure should include the magnitude of the amounts relating to the acquired business consolidated into the issuer's annual financial statements.

2.8 **Interaction between the Instrument and MI 52-109 -** Nothing in the Instrument relieves a chief executive officer and chief financial officer (or persons performing similar functions to a chief executive officer or chief financial officer) of their obligations under MI 52-109.

PART 3 - INTERNAL CONTROL AUDIT REPORT

3.1 **No separate engagement -**

(1) Section 3.3 of the Instrument provides that the participating audit firm that prepares the auditor's report on the financial statements must be the same as the participating audit firm who prepares the internal control audit report. Because the participating audit firm is required to audit management's assessment of internal control over financial reporting, management and the participating audit firm will need to coordinate their processes of documenting and testing the internal control over financial reporting. However, we remind issuers and participating audit firms that the independence provisions of the rules of professional conduct adopted by the provincial and territorial institutes of Chartered Accountants prohibit a participating audit firm in Canada from providing certain non-audit services to an audit client. Under these rules of professional conduct, participating audit firms may assist management in documenting internal control over financial reporting without compromising their independence. When the participating audit firm is engaged to assist management in documenting internal control over financial reporting, management must be actively involved in the process. We remind issuers and participating audit firms that under the rules of professional conduct management cannot delegate its responsibility to assess its internal control over financial reporting to the participating audit firm. The Instrument does not amend the rules of professional conduct.[9]

(2) The evaluation of independence for the purposes of signing the internal control audit report is distinct from the evaluation of independence for the purposes of signing the auditor's report on

[9] This section is derived from the SEC Release – see "B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting – 3. Final Rules – b. Auditor Independence Issues".

the financial statements. The CICA Standard and the PCAOB Standard require a participating audit firm to be independent in order to sign the internal control audit report.

(3) Under the CICA Standard and the PCAOB Standard, to qualify as independent, the participating audit firm should not:

(a) act as management or as an employee of an issuer;

(b) audit its own work;

(c) serve in a position of being an advocate for an issuer; or

(d) have a mutual or conflicting interest with an issuer.

(4) Under the rules of professional conduct of the provincial and territorial institutes of Chartered Accountants, participating audit firms are prohibited from providing certain non-audit services to issuers above a specified size threshold. In certain circumstances, however, the rules of professional conduct allow these services to be provided to smaller issuers. When such services are provided to an issuer, the issuer's audit committee and the participating audit firm should evaluate whether the participating audit firm's independence has been impaired for the purposes of signing an internal control audit report. In doing so, the audit committee and the participating audit firm should evaluate carefully the nature of the services provided to determine whether the participating audit firm:

(a) has acted as a control or has designed a control for the issuer; and

(b) will be auditing its own work in signing the internal control audit report.

(5) Non-audit services which should be considered carefully in an evaluation of independence for the purposes of signing an internal control audit report include:

(a) preparation of the annual financial statements for the financial year in respect of which the internal control audit report is provided; and

(b) design or implementation of a hardware or software system that aggregates source data underlying the annual financial statements for the financial year in respect of which the internal control audit report is provided.

3.2 **Combined audit reports -** Under the CICA Standard and the PCAOB Standard, a participating audit firm may prepare a "combined audit report" in relation to an issuer, which combines the auditor's report on the financial statements with the internal control audit report. In determining whether a "combined audit report" should be filed, the participating audit firm and the issuer should consider whether the auditor's report on the financial statements is expected to be included or incorporated by reference in another document that may be filed or delivered to the securities regulatory authorities.

PART 4 – REFILED ANNUAL MD&A

4.1 **Refiled annual MD&A -** If the annual MD&A for a financial year is refiled but the annual financial statements for that financial year are not refiled, it will not be necessary to refile the internal control report and internal control audit report for that financial year.

PART 5 – EXEMPTIONS

5.1 **Issuers that comply with U.S. laws -**

(1) The exemptions in section 7.3 of the Instrument are based on our view that the investor confidence aims of the Instrument do not justify requiring issuers to comply with the internal control report and internal control audit report requirements in the Instrument if such issuers comply with substantially similar requirements under U.S. laws, as those laws may be amended from time to time.

(2) As a condition to being exempt from the internal control report and internal control audit report requirements under section 7.3 of the Instrument, issuers must file the reports that they filed with the SEC in compliance with its rules implementing the requirements prescribed in sections 404(a) and 404(b) of the Sarbanes-Oxley Act.[10]

PART 6 – LIABILITY FOR REPORTS CONTAINING MISREPRESENTATIONS

6.1 **Liability for internal control reports containing misrepresentations -**

(1) Officers providing an internal control report containing a misrepresentation potentially could be subject to quasi-criminal, administrative or civil proceedings under securities law.

(2) Officers providing an internal control report containing a misrepresentation could also potentially be subject to private actions for damages either at common law or, in Québec, under civil law, or under the *Securities Act* (Ontario) when amendments which create statutory civil liability for misrepresentations in continuous disclosure are proclaimed in force. The liability standard applicable to a document required to be filed with the Ontario Securities Commission, including an internal control report, will depend on whether the document is a "core" document as defined under Part XXIII.1 of the *Securities Act* (Ontario). Internal control reports are currently not included in the definition of "core document" but would be included in the definition of "document".

(3) In any action commenced under Part XXIII.1 of the *Securities Act* (Ontario) a court has the discretion to treat multiple misrepresentations having common subject matter or content as a single misrepresentation. This provision could permit a court in appropriate cases to treat a misrepresentation in an issuer's financial statements and a misrepresentation made by officers in an internal control report that relate to the underlying financial statements as a single misrepresentation.

[10] The provisions of this part are similar to the provisions of Part 6 of the companion policy to MI 52-109.

(4) Liability for misrepresentations under Part XXIII.1 of the *Securities Act* (Ontario) is limited to, among others, each officer of the issuer who authorized, permitted or acquiesced in the release of the internal control report. The term "officer" is defined in the *Securities Act* (Ontario) to include certain persons acting in specified positions as well as persons designated as "officers" in an issuer's by-laws. Accordingly, it is possible that certain members of management that are involved in the preparation of the internal control report are not "officers" and as a result, are not exposed to liability under Part XXIII.1 of the *Securities Act* (Ontario) for a misrepresentation in an internal control report.

6.2 **Liability for internal control audit reports containing misrepresentations -**

(1) Participating audit firms providing an internal control audit report containing a misrepresentation potentially could be subject to quasi-criminal, administrative or civil proceedings under securities law.

(2) Participating audit firms providing an internal control audit report containing a misrepresentation could also potentially be subject to private actions for damages either at common law or, in Québec, under civil law, or under the *Securities Act* (Ontario) when amendments which create statutory civil liability for misrepresentations in continuous disclosure are proclaimed in force. The liability standard applicable to a document required to be filed with the Ontario Securities Commission, including an internal control audit report, will depend on whether the document is a "core" document as defined under Part XXIII.1 of the *Securities Act* (Ontario). Internal control audit reports are currently not included in the definition of "core document" but would be included in the definition of "document".

(3) In any action commenced under Part XXIII.1 of the *Securities Act* (Ontario) a court has the discretion to treat multiple misrepresentations having common subject matter or content as a single misrepresentation. This provision could permit a court in appropriate cases to treat a misrepresentation in an auditor's report on the financial statements and a misrepresentation in an internal control audit report that relates to the auditor's report on the financial statements as a single misrepresentation.[11]

[11] The provisions of this part are similar to the provisions of Part 7 of the companion policy to MI 52-109.