Guidance on Implementation of Sections 60 – 63 of Investments and Securities Act 2007

Contents

Guidance on Implementation of Sec. 60 – 63 of The Investments and Securities Act 2007

1.0 Introduction

Sections 60 to 63 of the Investments and Securities Act of 2007 require public companies (subject to the reporting requirements of the Act) to include in their annual reports a report of management on the company's internal control system. A public company is required to file the auditors' attestation report as part of the annual report.

1.1 Certification in annual or periodic reports

In compliance with the provisions of section 60 of the Investments and Securities Act (ISA) 2007:

(1) A public company whose securities are required to be registered under this Act shall file with the Commission on a periodic or annual basis, its audited financial statements, and such other returns as may be prescribed by the Commission from time to time.

(2) The chief executive officer and the chief financial officer or officers or persons performing similar functions in a public company filing periodic or annual reports under subsection (1) of section 60, shall certify (format in appendix 1) in each annual or periodic report filed, that-

(a) the signing officer has reviewed the report;

(b) based on the knowledge of the officer, the report does not contain:

(i) any untrue statement of a material fact, or

(ii) omit to state a material fact, which would make the statement, misleading in the light of the circumstances under which such statement was made;

(c) based on the knowledge of such officer, the financial statements and other financial information included in the report fairly present in all material respects the financial condition and results of operations of the company as of and for the period presented in the report.

(d) the signing officers-

(i) are responsible for establishing and maintaining internal controls.

(ii) have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities particularly during the period in which the periodic reports are being prepared;

(iii) have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report;

(iv) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(e) the signing officers have disclosed to the Auditors of the company and Audit Committee -

(i) all significant deficiencies in the design or operation of internal controls which would adversely affect the company's ability to record, process, summarise and report financial data and have identified for the company's Auditors any material weakness in internal controls, and

(ii) any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls;

(f) the signing officers have identified in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

1.2 Duty of directors on internal controls

Internal control means policies, procedures, and practices put in place by management to ensure safety of assets, accuracy of financial records and reports, achievement of corporate objectives and compliance with laws and regulations (Sec. 61(3)). A public company shall establish a system of internal controls over its financial reporting and security of its assets and it shall be the responsibility of the board of directors to ensure the integrity of the company's financial controls and reporting (Sec. 61(1)).

The term "internal control over financial reporting" is the predominant term used by companies and auditors and best encompasses the objectives of the Investments and Securities Act (ISA) 2007.

In this guideline "internal control over financial reporting" is defined as:
A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

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

The definition of the term "internal control over financial reporting" reflected in this guideline encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives. This definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company'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 Commission's financial reporting requirements.

1.3 Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting

The board of directors of a public company shall report on the effectiveness of the company's internal control system in its annual report (Sec. 61(2)).

A company's annual report should include an internal control report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting (ICFR) for the company;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

A company is required to file, as part of the company's annual report, the attestation report of the registered public accounting firm that audited the company's financial statements.

Management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation requirements (See appendix 2 as adapted from The Committee of Sponsoring Organisations of the Treadway Commission).

However, the Commission does not mandate the use of a particular framework, such as the COSO Framework, in recognition of the fact that other evaluation standards exist (e.g. the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants ("CoCo") and the report published by the Institute of Chartered Accountants in England & Wales for Internal Control: Guidance for Directors on the Combined Code - known as the Turnbull Report are suitable frameworks that public entities could choose in evaluating the effectiveness of ICFR.) and that frameworks other than COSO may be developed in the future, that satisfy the intent of the Investments and Securities Act 2007 without diminishing the benefits to investors. The use of standard measures that are publicly available will enhance the quality of the internal control report and will promote the comparability of the internal control reports of different companies. This guideline requires management's report to identify the evaluation framework used by management to assess the effectiveness of the company's internal control over financial reporting.

Specifically, a suitable framework must: be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted; and be relevant to an evaluation of internal control over financial reporting.

1.4 Duty of auditor to report on internal controls of public companies

A company is required to file, as part of the company's annual report, the attestation report of the external auditors that audited the company's financial statements in addition to the report of the internal control system. The report in the annual report must contain a statement that the external auditors that audited the financial statements, included in the annual report, has issued an attestation report on management's evaluation of the company's internal control system. An auditor of a public company shall, in his audit report to the company, issue a statement as to the existence, adequacy and effectiveness or otherwise of the internal control system of the public company (Sec. 63)[1].

1.5 Auditor Independence Issues

The auditor is required to attest to management's assessment of internal control over financial reporting. Companies and their auditors should be mindful of regulations on auditor independence that prohibit an auditor from providing certain non-audit services to an audit client.

1.6 Material Weaknesses in Internal Control over Financial Reporting

Management of a company is precluded from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting. Management's report must include disclosure of any material weakness[2] in the company's internal control over financial reporting identified by management in the course of its evaluation.

1.7 Method of Evaluating

The methods of conducting evaluations of internal control over financial reporting will, and should, vary from company to company. In conducting such an evaluation and developing its assessment of the effectiveness of internal control over financial reporting, a company must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. Developing and maintaining such evidential matter is an inherent element of effective internal controls. The assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate the design, implementation and to test the operating effectiveness. Controls subject to such assessment include, but are not limited to: controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements; controls related to the initiation and processing of non-routine and non-systematic transactions; controls related to the selection and application of appropriate accounting policies; and controls related to the prevention, identification, and detection of fraud. The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, inquiry alone generally will not provide an adequate basis for management's assessment.

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[1] The statement should cover the design, implementation and test of effectiveness of the internal control system.

[2] A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes.

This evidential matter should provide reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered. The public accounting firm that is required to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting also will require that the company develop and maintain such evidential matter to support management's assessment.

1.8 Location of the report in annual financial statements

The report should be close to the corresponding attestation report (opinion page) issued by the company's independent audit firm, or in a portion of the document immediately preceding the companies' financial statement.

1.9 Registration by Auditors of public companies

Public accounting firms that –

(a) Prepares or issue any audit report with respect to a public company; or
(b) Plays a substantial role in the preparation or furnishing of an audit report with respect to a public company, must be registered with the Commission.

No person shall carry on the business of auditing a public company unless that person is registered by the Commission on such terms and conditions as may be prescribed from time to time (Sec. 62).

Appendix 1

CERTIFICATION

I, [identify the certifying individual], certify that:

a) I have reviewed this [specify report] of [identify company];

b) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

c) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;

d) The company's other certifying officer(s) and I:

   1) are responsible for establishing and maintaining internal controls;
   2) have designed such internal controls and procedures, or caused such internal controls and procedures to be designed under our supervision, to ensure that material information relating to the company, and its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   3) have designed such internal control system, or caused such internal control system 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 generally accepted accounting principles;
   4) have evaluated the effectiveness of the company's internal controls and procedures as of a date within 90 days prior to the report and presented in this report our conclusions about the effectiveness of the internal controls and procedures, as of the end of the period covered by this report based on such evaluation.

e) The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control system, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):

   1) All significant deficiencies and material weaknesses in the design or operation of the internal control system which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
   2) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control system.

f) The company's other certifying officer(s) and I have identified, in the report whether or not there were significant changes in internal controls or other facts that could significantly affect internal controls subsequent to the date of their evaluation including any corrective actions with regard to significant deficiencies and material weaknesses.

Name:_____ Designation: _____

FRC No:_____ Signature:_____ Date:_____

Appendix **2**

Committee of Sponsoring Organization of the Treadway Commission (COSO) Internal Control – Integrated Framework

Executive Summary

A2.0 Introduction

Internal control helps entities achieve important objectives and sustain and improve performance. COSO's *Internal Control—Integrated Framework (Framework)* enables organizations to effectively and efficiently develop systems of internal control that adapt to changing business and operating environments, mitigate risks to acceptable levels, and support sound decision making and governance of the organization.

Designing and implementing an effective system of internal control can be challenging; operating that system effectively and efficiently every day can be daunting. New and rapidly changing business models, greater use and dependence on technology, increasing regulatory requirements and scrutiny, globalization, and other challenges demand any system of internal control to be agile in adapting to changes in business, operating and regulatory environments.

An effective system of internal control demands more than rigorous adherence to policies and procedures: it requires the use of judgment. Management and boards of directors use judgment to determine how much control is enough. Management and other personnel use judgment every day to select, develop, and deploy controls across the entity. Management and internal auditors, among other personnel, apply judgment as they monitor and assess the effectiveness of the system of internal control.

The *Framework* assists management, boards of directors, external stakeholders, and others interacting with the entity in their respective duties regarding internal control without being overly prescriptive. It does so by providing both understanding of what constitutes a system of internal control and insight into when internal control is being applied effectively.

For management and boards of directors, the *Framework* provides:

- A means to apply internal control to any type of entity, regardless of industry or legal structure, at the levels of entity, operating unit, or function
- A principles-based approach that provides flexibility and allows for judgment in designing, implementing, and conducting internal control—principles that can be applied at the entity, operating, and functional levels
- Requirements for an effective system of internal control by considering how components and principles are present and functioning and how components operate together
- A means to identify and analyse risks, and to develop and manage appropriate responses to risks within acceptable levels and with a greater focus on anti-fraud measures
- An opportunity to expand the application of internal control beyond financial reporting to other forms of reporting, operations, and compliance objectives
- An opportunity to eliminate ineffective, redundant, or inefficient controls that provide minimal value in reducing risks to the achievement of the entity's objectives

For external stakeholders of an entity and others that interact with the entity, application of this Framework provides:

- Greater confidence in the board of directors' oversight of internal control systems
- Greater confidence regarding the achievement of entity objectives
- Greater confidence in the organization's ability to identify, analyse, and respond to risk and changes in the business and operating environments
- Greater understanding of the requirement of an effective system of internal control
- Greater understanding that through the use of judgment, management may be able to eliminate ineffective, redundant, or inefficient controls

Internal control is not a serial process but a dynamic and integrated process. The Framework applies to all entities: large, mid-size, small, for-profit and not-for-profit, and government bodies. However, each organization may choose to implement internal control differently. For instance, a smaller entity's system of internal control may be less formal and less structured, yet still have effective internal control.

The remainder of this Executive Summary provides an overview of internal control, including a definition, categories of objective, description of the requisite components and associated principles, and requirement of an effective system of internal control. It also includes a discussion of limitations-the reasons why no system of internal control can be perfect. Finally, it offers considerations on how various parties may use the Framework.

A2.1 Defining Internal Control

Internal control is defined as follows:

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

This definition reflects certain fundamental concepts. Internal control is:

- Geared to the achievement of objectives in one or more categories—operations, reporting, and compliance
- A process consisting of ongoing tasks and activities—a means to an end, not an end in itself
- Effected by people—not merely about policy and procedure manuals, systems, and forms, but about people and the actions they take at every level of an organization to affect internal control
- Able to provide reasonable assurance—but not absolute assurance, to an entity's senior management and board of directors
- Adaptable to the entity structure—flexible in application for the entire entity or for a particular subsidiary, division, operating unit, or business process

This definition is intentionally broad. It captures important concepts that are fundamental to how organizations design, implement, and conduct internal control, providing a basis for application across organizations that operate in different entity structures, industries, and geographic regions.

A2.2 Objectives of Internal Control

The Framework provides for three categories of objectives, which allow organizations to focus on differing aspects of internal control:

- Operations Objectives— these pertain to effectiveness and efficiency of the entity's operations,

including operational and financial performance goals, and safeguarding assets against loss;

- Reporting Objectives— these pertain to internal and external financial and non-financial reporting and may encompass reliability, timeliness, transparency, or other terms as set forth by regulators, recognized standard setters, or the entity's policies;
- Compliance Objectives— these pertain to adherence to laws and regulations to which the entity is subject.

A2.3 Components of Internal Control

Internal control consists of five integrated components.

A2.3.1 Control Environment

The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization. The control environment comprises the integrity and ethical values of the organization; the parameters enabling the board of directors to carry out its governance oversight responsibilities; the organizational structure and assignment of authority and responsibility; the process for attracting, developing, and retaining competent individuals; and the rigor around performance measures, incentives, and rewards to drive accountability for performance. The resulting control environment has a pervasive impact on the overall system of internal control.

A2.3.2 Risk Assessment

Every entity faces a variety of risks from external and internal sources. Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risks to the achievement of these objectives from across the entity are considered relative to established risk tolerances. Thus, risk assessment forms the basis for determining how risks will be managed.

A precondition to risk assessment is the establishment of objectives, linked at different levels of the entity. Management specifies objectives within categories relating to operations, reporting, and compliance with sufficient clarity to be able to identify and analyze risks to those objectives. Management also considers the suitability of the objectives for the entity. Risk assessment also requires management to consider the impact of possible changes in the external environment and within its own business model that may render internal control ineffective.

A2.3.3 Control Activities

Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment. They may be preventive or detective in nature and may encompass a range of manual and automated activities such as authorizations and approvals, verifications, reconciliations, and business performance reviews. Segregation of duties is typically built into the selection and development of control activities. Where segregation of duties is not practical, management selects and develops alternative control activities.

A2.3.4 Information and Communication

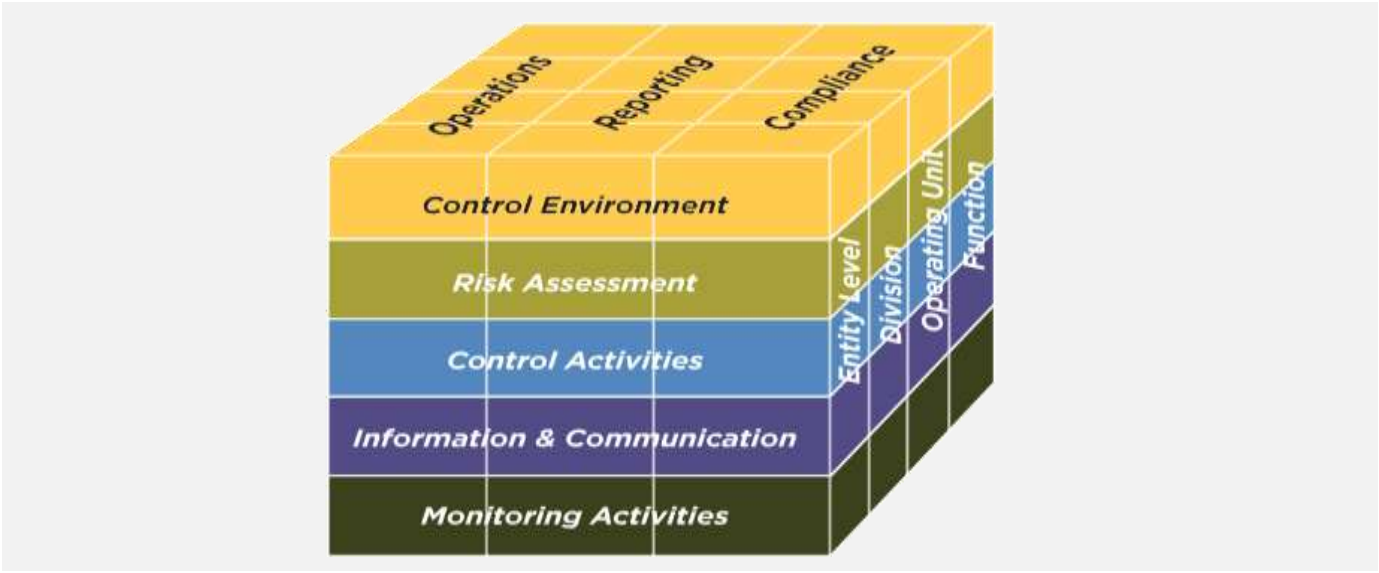
Information is necessary for the entity to carry out internal control responsibilities to support the achievement of its objectives. Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of other components of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining the necessary information. Internal communication is the means by which information is disseminated throughout the organization, flowing up, down, and across the entity. It enables personnel to receive a clear message from senior management that control responsibilities must be taken seriously. External communication is twofold: it enables inbound communication of relevant external information, and it provides information to external parties in response to requirements and expectations.

A2.3.5 Monitoring Activities

Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to effect the principles within each component, is present and functioning. Ongoing evaluations, built into business processes at different levels of the entity, provide timely information. Separate evaluations, conducted periodically, will vary in scope and frequency depending on assessment of risks, effectiveness of ongoing evaluations, and other management considerations. Findings are evaluated against criteria established by regulators, recognized standard-setting bodies or management and the board of directors, and deficiencies are communicated to management and the board of directors as appropriate.

A2.4 Relationship of Objectives and Components

A direct relationship exists between objectives, which are what an entity strives to achieve, components, which represent what is required to achieve the objectives, and the organizational structure of the entity (the operating units, legal entities, and other). The relationship can be depicted in the form of a cube.



- The three categories of objectives—operations, reporting, and compliance—are represented by the columns.
- The five components are represented by the rows.
- An entity's organizational structure is rep- resented by the third dimension.

A2.5 Components and Principles

The Framework sets out seventeen principles representing the fundamental concepts associated with each component. Because these principles are drawn directly from the components, an entity can achieve effective internal control by applying all principles. All principles apply to operations, reporting, and compliance objectives. The principles supporting the components of internal control are listed below.

A2.5.1 Control Environment

- The organization demonstrates a commitment to integrity and ethical values.
- The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control.
- Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
- The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
- The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

A2.5.2 Risk Assessment

- The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
- The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed.
- The organization considers the potential for fraud in assessing risks to the achievement of objectives.
- The organization identifies and assesses changes that could significantly impact the system of internal control.

A2.5.3 Control Activities

- The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
- The organization selects and develops general control activities over technology to support the achievement of objectives.
- The organization deploys control activities through policies that establish what is expected and procedures that put policies into action.

A2.5.4 Information and Communication

- The organization obtains or generates and uses relevant, quality information to support the functioning of internal control.
- The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control.
- The organization communicates with external parties regarding matters affecting the functioning of internal control.

A2.5.5 Monitoring Activities

- The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
- The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate.

A2.6 Effective Internal Control

The Framework sets forth the requirements for an effective system of internal control. An effective system provides reasonable assurance regarding achievement of an entity's objectives. An effective system of internal control reduces, to an acceptable level, the risk of not achieving an entity objective and may relate to one, two, or all three categories of objectives. It requires that:

- Each of the five components and relevant principles is present and functioning. "Present" refers to the determination that the components and relevant principles exist in the design and implementation of the system of internal control to achieve specified objectives. "Functioning" refers to the determination that the components and relevant principles continue to exist in the operations and conduct of the system of internal control to achieve specified objectives.
- The five components operate together in an integrated manner. "Operating together" refers to the determination that all five components collectively reduce, to an acceptable level, the risk of not achieving an objective. Components should not be considered discretely; instead, they operate together as an integrated system. Components are interdependent with a multitude of interrelationships and linkages among them, particularly the manner in which principles interact within and across components.

When a major deficiency exists with respect to the presence and functioning of a component or relevant principle, or with respect to the components operating together in an integrated manner, the organization cannot conclude that it has met the requirements for an effective system of internal control.

When a system of internal control is determined to be effective, senior management and the board of directors have reasonable assurance, relative to the application within the entity structure, that the organization:

- Achieves effective and efficient operations when external events are considered unlikely to have a significant impact on the achievement of objectives or where the organization can reasonably predict the nature and timing of external events and mitigate the impact to an acceptable level
- Understands the extent to which operations are managed effectively and efficiently when external events may have a significant impact on the achievement of objectives or where the organization can reasonably predict the nature and timing of external events and mitigate the impact to an acceptable level
- Prepares reports in conformity with applicable rules, regulations, and standards or with the entity's specified reporting objectives
- Complies with applicable laws, rules, regulations, and external standards

The Framework requires judgment in designing, implementing, and conducting internal control and assessing its effectiveness. The use of judgment, within the boundaries established by laws, rules, regulations, and standards, enhances management's ability to make better decisions about internal control, but cannot guarantee perfect outcomes.

A2.7 Limitations

The *Framework* recognizes that while internal control provides reasonable assurance of achieving the entity's objectives, limitations do exist. Internal control cannot prevent bad judgment or decisions, or external events that can cause an organization to fail to achieve its operational goals. In other words, even an effective system of internal control can experience a failure. Limitations may result from the:

- Suitability of objectives established as a precondition to internal control
- Reality that human judgment in decision making can be faulty and subject to bias
- Breakdowns that can occur because of human failures such as simple errors
- Ability of management to override internal control
- Ability of management, other personnel, and/or third parties to circumvent controls through collusion
- External events beyond the organization's control

These limitations preclude the board and management from having an absolute assurance of the achievement of the entity's objectives—that is, internal control provides reasonable but not absolute assurance. Notwithstanding these inherent limitations, management should be aware of them when selecting, developing, and deploying controls that minimize, to the extent practical, these limitations.

Appendix **3**

Guidance Regarding Management's Assessment on Internal Control Over Financial Reporting (ICFR) Under Section 61(2) of the Investments and Securities Act of 2007

A3 Introduction

This interpretive release provides guidance for management regarding its evaluation and assessment of internal control over financial reporting. The guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. An evaluation that complies with this interpretive guidance is one way to satisfy the evaluation requirements of Section 61(2) of the Investments and Securities Act 2007.

Management is responsible for maintaining a system of internal control over financial reporting ("ICFR") that provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Section 61(2) of the Investments and Securities Act 2007 requires management to annually evaluate whether ICFR is effective at providing reasonable assurance and to disclose its assessment to investors. Management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its assessment. This evidence will also allow a third party, such as the company's external auditor, to consider the work performed by management.

ICFR cannot provide absolute assurance due to its inherent limitations; it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. ICFR also can be circumvented by collusion or improper management override. Because of such limitations, ICFR cannot prevent or detect all misstatements, whether unintentional errors or fraud. However, these inherent limitations are known features of the financial reporting process, therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

The "reasonable assurance" referred to in this guideline mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs. Reasonableness is not an absolute standard of exactitude for corporate records. The Commission recognizes that while "reasonableness" is an objective standard, there is a range of judgments that an issuer might make as to what is "reasonable" in implementing Section 61(2) and the Commission's rules. Thus, the term "reasonableness" in the context of Section 61(2) implementation does not imply a single conclusion or methodology but encompasses the full range of appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.

This interpretive guidance:

- Explains how to vary evaluation approaches for gathering evidence-based on risk assessments;
- Explains the use of self-assessment and other on-going monitoring activities as evidence in the evaluation;
- Explains the purpose of documentation and how management has flexibility in approaches to documenting support for its assessment;
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas; and
- It allows for management and the auditor to have different testing approaches.

This Interpretive Guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require management to identify every control in a process or document the business processes impacting ICFR. Rather, management can focus its evaluation process and the documentation supporting the assessment on those controls that it determines adequately address the risk of a material misstatement of the financial statements. For example, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.

The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas. By following these two principles, we believe companies of all sizes and complexities will be able to implement our rules effectively and efficiently.

The Interpretive Guidance reiterates the Commission's position that management should bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides a reasonable basis for its annual assessment of whether ICFR is effective. This allows management sufficient and appropriate flexibility to design such an evaluation process.

Smaller public companies, which generally have less complex internal control systems than larger public companies, can use this guide to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances. We encourage smaller public companies to take advantage of the flexibility and scalability to conduct an evaluation of ICFR that is both efficient and effective at identifying material weaknesses.

The effort necessary to conduct an initial evaluation of ICFR will vary among companies, partly because this effort will depend on management's existing financial reporting risk assessment and control monitoring activities. After the first year of compliance, management's effort to identify financial reporting risks and controls should ordinarily be less, because subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls. Further, in each subsequent year, the documentation of risks and controls will only need to be updated from the prior year(s), not recreated anew. Through the risk and control identification process, management will have identified for testing only those controls that are needed to meet the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting) and for which evidence about their operation can be obtained most efficiently. The nature and extent of procedures implemented to evaluate whether those controls continue to operate effectively can be tailored to the company's unique circumstances, thereby avoiding unnecessary compliance costs.

The guidance assumes management has established and maintains a system of internal accounting controls as required by the Investment and Securities Act Section 61(3). Further, it is not intended to explain how management should design its ICFR to comply with the control framework management has chosen. To allow appropriate flexibility, the guidance does not provide a checklist of steps management should perform in completing its evaluation.

A3.1 Interpretive Guidance – Evaluation and Assessment of Internal Control Over Financial Reporting

The interpretive guidance addresses the following topics:

A. The Evaluation Process
   1. Identifying Financial Reporting Risks and Controls
      a. Identifying Financial Reporting Risks
      b. Identifying Controls that Adequately Address Financial Reporting Risks
      c. Consideration of Entity-Level Controls
      d. Role of Information Technology General Controls
      e. Evidential Matter to Support the Assessment
   2. Evaluating Evidence of the Operating Effectiveness of ICFR
      a. Determining the Evidence Needed to Support the Assessment
      b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR
      c. Evidential Matter to Support the Assessment
   3. Multiple Location Considerations

B. Reporting Considerations
   1. Evaluation of Control Deficiencies
   2. Expression of Assessment of Effectiveness of ICFR by Management
   3. Disclosures about Material Weaknesses
   4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR
   5. Inability to Assess Certain Aspects of ICFR

A3.2 The Evaluation Process

The objective of internal control over financial reporting ("ICFR") is to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles ("GAAP"). The purpose of the evaluation of ICFR is to provide management with a reasonable basis for its annual assessment as to whether any material weaknesses[3] in ICFR exist as of the end of the fiscal year.

To accomplish this, management identifies the risks to reliable financial reporting, evaluates whether controls exist to address those risks, and evaluates evidence about the operation of the

[3] See Note 2

controls included in the evaluation based on its assessment of risk[4]. The evaluation process will vary from company to company; however, the top-down, risk-based approach which is described in this guidance will typically be the most efficient and effective way to conduct the evaluation.

The evaluation process guidance is described in two sections. The first section explains the identification of financial reporting risks and the evaluation of whether the controls management has implemented adequately address those risks. The second section explains an approach for making judgments about the methods and procedures for evaluating whether the operation of ICFR is effective. Both sections explain how entity-level controls[5] impact the evaluation process, as well as how management should focus its evaluation efforts on the highest risks to reliable financial reporting[6].

Under the Commission's rules, management's annual assessment of the effectiveness of ICFR must be made in accordance with a suitable control framework's definition of effective internal control. These control frameworks define elements of internal control that are expected to be present and functioning in an effective internal control system.

In assessing effectiveness, management evaluates whether its ICFR includes policies, procedures, and activities that address the elements of internal control that the application control framework describes as necessary for an internal control system to be effective. The framework elements describe the characteristics of an internal control system that may be relevant to individual areas of the company's ICFR, pervasive to many areas, or entity-wide. Therefore, management's evaluation process includes not only controls involving particular areas of financial reporting, but also the entity-wide and other pervasive elements of internal control defined by its selected control framework. This guidance is not intended to replace the elements of an effective system of internal control as defined within a control framework.

A3.2.1 Identifying Financial Reporting Risks and Controls

Management should evaluate whether it has implemented controls that will achieve the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting). The evaluation begins with the identification and assessment of the risks to reliable financial reporting (that is, materially accurate financial statements), including changes in those risks. Management then evaluates whether it has controls placed in operation (that is, in use) that are designed to

[4] If management's evaluation process identifies material weaknesses, but all material weaknesses are remediated by the end of the fiscal year, management may conclude that ICFR is effective as of the end of the fiscal year. However, management should consider whether disclosure of such remediated material weaknesses is appropriate or required under Sec. 61(1) and Sec 61(2) of ISA 2007 or other Commission disclosure rules.

[5] The term "entity-level controls" as used in this document describes aspects of a system of internal control that have a pervasive effect on the entity's system of internal control such as controls related to the control environment (for example, management's philosophy and operating style, integrity and ethical values; board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; centralized processing and controls, including shared service environments; controls to monitor results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices. The terms "company-level" and "entity-wide" are also commonly used to describe these controls.

[6] Because management is responsible for maintaining effective ICFR, this guidance does not specifically address the role of the board of directors or audit committee in a company's evaluation and assessment of ICFR. However, we would ordinarily expect a board of director or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be reasonably knowledgeable and informed about the evaluation process and management's assessment, as necessary in the circumstances.

adequately address those risks. Management ordinarily would consider the company's entity-level controls in both its assessment of risks and in identifying which controls adequately address the risks.

The evaluation approach described herein allows management to identify controls and maintain supporting evidential matter for its controls in a manner that is tailored to the company's financial reporting risks (as defined below). Thus, the controls that management identifies and documents are those that are important to achieving the objective of ICFR. These controls are then subject to procedures to evaluate evidence of their operating effectiveness.

A3.2.1.1 Identifying Financial Reporting Risks

Management should identify those risks of misstatement that could, individually or in combination with others, result in a material misstatement of the financial statements ("financial reporting risks"). Ordinarily, the identification of financial reporting risks begins with evaluating how the requirements of GAAP apply to the company's business, operations and transactions. Management must provide investors with financial statements that fairly present the company's financial position, results of operations and cash flows in accordance with GAAP. A lack of fair presentation arises when one or more financial statement amounts or disclosures ("financial reporting elements") contain misstatements (including omissions) that are material.

Management uses its knowledge and understanding of the business, and its organization, operations, and processes, to consider the sources and potential likelihood of misstatements in financial reporting elements. Internal and external risk factors that impact the business, including the nature and extent of any changes in those risks, may give rise to a risk of misstatement. Risks of misstatement may also arise from sources such as the initiation, authorization, processing, and recording of transactions and other adjustments that are reflected in financial reporting elements. Management may find it useful to consider "what could go wrong" within a financial reporting element in order to identify the sources and the potential likelihood of misstatements and identify those that could result in a material misstatement of the financial statements.

The methods and procedures for identifying financial reporting risks will vary based on the characteristics of the company. These characteristics include, among others, the size, complexity, and organizational structure of the company and its processes and financial reporting environment, as well as the control framework used by management. For example, to identify financial reporting risks in a larger business or a complex business process, management's methods and procedures may involve a variety of company personnel, including those with specialized knowledge. These individuals, collectively, may be necessary to have a sufficient understanding of GAAP, the underlying business transactions and the process activities, including the role of computer technology, that are required to initiate, authorize, record and process transactions. In contrast, in a small company that operates on a centralized basis with less complex business processes and with little change in the risks or processes, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks.

Management's evaluation of the risk of misstatement should include consideration of the vulnerability of the entity to fraudulent activity (for example, fraudulent financial reporting, misappropriation of assets and corruption), and whether any such exposure could result in a material

misstatement of the financial statements. The extent of activities required for the evaluation of fraud risks is commensurate with the size and complexity of the company's operations and financial reporting environment[7].

Management should recognize that the risk of material misstatement due to fraud ordinarily exists in any organization, regardless of size or type, and it may vary by specific location or segment and by individual financial reporting element. For example, one type of fraud risk that has resulted in fraudulent financial reporting in companies of all sizes and types is the risk of improper override of internal controls in the financial reporting process. While the identification of a fraud risk is not necessarily an indication that a fraud has occurred, the absence of an identified fraud is not an indication that no fraud risks exist. Rather, these risk assessments are used in evaluating whether adequate controls have been implemented.

A3.2.1.2 Identifying Controls that Adequately Address Financial Reporting Risks

Management should evaluate whether it has controls[8] placed in operation (that is, in use) that adequately address the company's financial reporting risks. The determination of whether an individual control, or a combination of controls, adequately addresses a financial reporting risk involves judgments about whether the controls, if operating properly, can effectively prevent or detect misstatements that could result in material misstatements in the financial statements[9]. If management determines that a deficiency in ICFR exists, it must be evaluated to determine whether a material weakness exists[10].

Management may identify preventive controls, detective controls, or a combination of both, as adequately addressing financial reporting risks[11]. There might be more than one control that addresses the financial reporting risks for a financial reporting element; conversely, one control might address the risks of more than one financial reporting element. It is not necessary to identify all controls that may exist or identify redundant controls, unless redundancy itself is required to address the financial reporting risks. To illustrate, management may determine that the risk of a misstatement in interest expense, which could result in a material misstatement of the financial statements, is adequately addressed by a control within the company's period-end financial reporting process (that is, an entity-level control). In such a case, management may not need to identify, for purposes of the ICFR evaluation, any additional controls related to the risk of misstatement in interest expense.

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[7] Management may find resources such as International Standard on Auditing, ISA 240 -"The Auditor's responsibilities relating to fraud in an audit of the financial statements" helpful in assessing fraud risks and management override of controls.

[8] A control consists of a specific set of policies, procedures, and activities designed to meet an objective. A control may exist within a designated function or activity in a process. A control's impact on ICFR may be entity-wide or specific to an account balance, class of transactions or application. Controls have unique characteristics – for example, they can be: automated or manual; reconciliations; segregation of duties; review and approval authorizations; safeguarding and accountability of assets; preventing or detecting error or fraud. Controls within a process may consist of financial reporting controls and operational controls (that is, those designed to achieve operational objectives).

[9] Companies may use "control objectives," which provide specific criteria against which to evaluate the effectiveness of controls, to assist in evaluating whether controls can prevent or detect misstatements.

[10] A deficiency in the design of ICFR exists when (a) necessary controls are missing or (b) existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed.

[11] Preventive controls have the objective of preventing the occurrence of errors or fraud that could result in a misstatement of the financial statements. Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements. Preventive and detective controls may be completely manual, involve some degree of computer automation, or be completely automated. Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements. Preventive or detective controls may be completely manual, involve some degree of automation or be completely automated.

Management may also consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address the financial reporting risks. When more than one control exists and each adequately addresses a financial reporting risk, management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently.

Moreover, when adequate information technology ("IT") general controls exist and management has determined that the operation of such controls is effective, management may determine that automated controls are more efficient to evaluate than manual controls. Considering the efficiency with which the operation of a control can be evaluated will often enhance the overall efficiency of the evaluation process.

In addition to identifying controls that address the financial reporting risks of individual financial reporting elements, management also evaluates whether it has controls in place to address the entity-level and other pervasive elements of ICFR that its chosen control framework prescribes as necessary for an effective system of internal control. This would ordinarily include, for example, considering how and whether controls related to the control environment, controls over management override, the entity-level risk assessment process and monitoring activities[12], controls over the period-end financial reporting process[13], and the policies that address significant business control and risk management practices are adequate for purposes of an effective system of internal control. The control frameworks and related guidance may be useful tools for evaluating the adequacy of these elements of ICFR.

When identifying the controls that address financial reporting risks, management learns information about the characteristics of the controls that should inform its judgments about the risk that a control will fail to operate as designed. This includes, for example, information about the judgment required in its operation and information about the complexity of the controls.

At the end of this identification process, management has identified for evaluation those controls that are needed to meet the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting) and for which evidence about their operation can be obtained most efficiently.

A3.2.1.3 Consideration of Entity-Level Controls

Management considers entity-level controls when identifying financial reporting risks and related controls for a financial reporting element. In doing so, it is important for management to consider the nature of the entity-level controls and how those controls relate to the financial reporting element. The more indirect the relationship to a financial reporting element, the less effective a

[12] Monitoring activities may include controls to monitor results of operations and controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs.

[13] The nature of controls within the period-end financial reporting process will vary based on a company's facts and circumstances. The period-end financial reporting process may include matters such as: procedures to enter transaction totals into the general ledger; the initiation, authorization, recording and processing of journal entries in the general ledger; procedures for the selection and application of accounting policies; procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and procedures for preparing annual and quarterly financial statements and related disclosures

control may be in preventing or detecting a misstatement[14].

Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. These controls might affect the other controls management determines are necessary to adequately address financial reporting risks for a financial reporting element. However, it is unlikely that management will identify only this type of entity-level control as adequately addressing a financial reporting risk identified for a financial reporting element.

Other entity-level controls may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by themselves, adequately address financial reporting risks. For example, an entity-level control that monitors the results of operations may be designed to detect potential misstatements and investigate whether a breakdown in lower-level controls occurred. However, if the amount of potential misstatement that could exist before being detected by the monitoring control is too high, then the control may not adequately address the financial reporting risks of a financial reporting element.

Entity-level controls may be designed to operate at the process, application, transaction or account-level and at a level of precision that would adequately prevent or detect on a timely basis misstatement in one or more financial reporting elements that could result in a material misstatement of the financial statements. In these cases, management may not need to identify or evaluate additional controls relating to that financial reporting risk.

A3.2.1.4 Role of Information Technology General Controls

Controls that management identifies as addressing financial reporting risks may be automated[15], dependent upon IT functionality[16], or a combination of both manual and automated procedures[17]. In these situations, management's evaluation process generally considers the design and operation of the automated or IT dependent application controls and the relevant IT general controls over the applications providing the IT functionality.

While IT general controls alone ordinarily do not adequately address financial reporting risks, the proper and consistent operation of automated controls or IT functionality often depends upon effective IT general controls. The identification of risks and controls within IT should not be a separate evaluation. Instead, it should be an integral part of management's top-down, risk-based approach to identifying risks and controls and in determining evidential matter necessary to support the assessment.

Aspects of IT general controls that may be relevant to the evaluation of ICFR will vary depending upon a company's facts and circumstances. For purposes of the evaluation of ICFR, management only needs to evaluate those IT general controls that are necessary for the proper and consistent operation of other controls designed to adequately address financial reporting risks. For example, management might consider whether certain aspects of IT general control areas, such as program

[14] Controls can be either directly or indirectly related to a financial reporting element. Controls that are designed to have a specific effect on a financial reporting element are considered directly related. For example, controls established to ensure that personnel are properly counting and recording the annual physical inventory relate directly to the existence of the inventory

[15] For example, application controls that perform automated matching, error checking or edit checking functions

[16] For example, consistent application of a formula or performance of a calculation and posting correct balances to appropriate accounts or ledgers

[17] For example, a control that manually investigates items contained in a computer generated exception report

development, program changes, computer operations, and access to programs and data, apply to its facts and circumstances[18]. Specifically, it is unnecessary to evaluate IT general controls that primarily pertain to the efficiency or effectiveness of a company's operations, but which are not relevant to addressing financial reporting risks.

A3.2.1.5 Evidential Matter to Support the Assessment

As part of its evaluation of ICFR, management must maintain reasonable support for its assessment. Documentation of the design of the controls' management has placed in operation to adequately address the financial reporting risks, including the entity-level and other pervasive elements necessary for effective ICFR, is an integral part of the reasonable support. The form and extent of the documentation will vary depending on the size, nature, and complexity of the company. It can take many forms (for example, paper documents, electronic, or other media). Also, the documentation can be presented in a number of ways (for example, policy manuals, process models, flowcharts, job descriptions, documents, internal memorandums, forms, etc.). The documentation does not need to include all controls that exist within a process that impacts financial reporting. Rather, the documentation should be focused on those controls that management concludes are adequate to address the financial reporting risks.

In addition to providing support for the assessment of ICFR, documentation of the design of controls also supports other objectives of an effective system of internal control. For example, it serves as evidence that controls within ICFR, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company.

A3.2.2 Evaluating Evidence of the Operating Effectiveness of ICFR

Management should evaluate evidence of the operating effectiveness of ICFR. The evaluation of the operating effectiveness of a control considers whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The evaluation procedures that management uses to gather evidence about the operation of the controls it identifies as adequately addressing the financial reporting risks for financial reporting elements should be tailored to management's assessment of the risk characteristics of both the individual financial reporting elements and the related controls (collectively, ICFR risk). Management should ordinarily focus its evaluation of the operation of controls on areas posing the highest ICFR risk.

Management's assessment of ICFR risk also considers the impact of entity-level controls, such as the relative strengths and weaknesses of the control environment, which may influence management's judgments about the risks of failure for particular controls.

Evidence about the effective operation of controls may be obtained from direct testing of controls and on-going monitoring activities. The nature, timing and extent of evaluation procedures

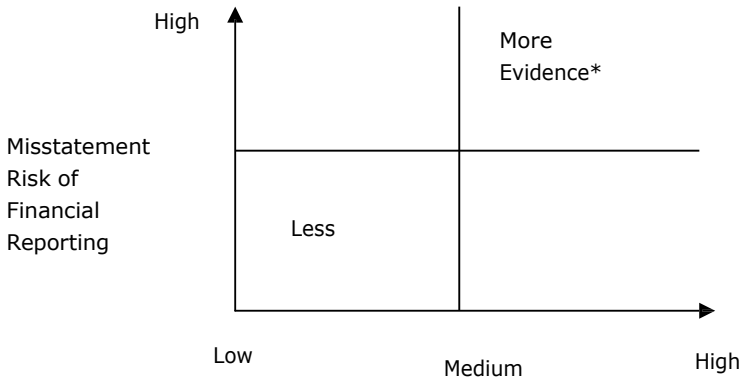
[18] The reference to these specific IT general control areas as examples within this guidance does not imply that these areas, either partially or in their entirety, are applicable to all facts and circumstances. As indicated, companies need to take their particular facts and circumstances into consideration in determining which aspects of IT general controls are relevant

necessary for management to obtain sufficient evidence of the effective operation of a control depend on the assessed ICFR risk. In determining whether the evidence obtained is sufficient to provide a reasonable basis for its evaluation of the operation of ICFR, management should consider not only the quantity of evidence (for example, sample size), but also the qualitative characteristics of the evidence. The qualitative characteristics of the evidence include the nature of the evaluation procedures performed, the period of time to which the evidence relates, the objectivity[19] of those evaluating the controls, and, in the case of on-going monitoring activities, the extent of validation through direct testing of underlying controls. For any individual control, different combinations of the nature, timing, and extent of evaluation procedures may provide sufficient evidence. The sufficiency of the evidence is not necessarily determined by any of these attributes individually.

A3.2.2.1 Determining the Evidence Needed to Support the Assessment

Management should evaluate the ICFR risk of the controls identified as adequately addressing the financial reporting risks for financial reporting elements to determine the evidence needed to support the assessment. This evaluation should consider the characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves. This concept is illustrated in the following diagram.

Determining the Sufficiency of Evidence Based on ICFR Risk



Risk of Control Failure

* The references to "more" or "less" include both the quantitative and qualitative characteristics of the evidence (that is, its sufficiency).

[19] In determining the objectivity of those evaluating controls, management is not required to make an absolute conclusion regarding objectivity, but rather should recognize that personnel will have varying degrees of objectivity based on, among other things, their job function, their relationship to the control being evaluated, and their level of authority and responsibility within the organization. Personnel whose core function involves permanently serving as a testing or compliance authority at the company, such as internal auditors, normally are expected to be the most objective. However, the degree of objectivity of other company personnel may be such that the evaluation of controls performed by them would provide sufficient evidence. Management's judgments about whether the degree of objectivity is adequate to provide sufficient evidence should take into account the ICFR risk.

Management's consideration of the misstatement risk of a financial reporting element includes both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to a misstatement that could be material to the financial statements.

As the materiality of a financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management's assessment of misstatement risk for the financial reporting element generally would correspondingly increase. In addition, management considers the extent to which the financial reporting elements include transactions, account balances or other supporting information that are prone to material misstatement. For example, the extent to which a financial reporting element: (1) involves judgment in determining the recorded amounts; (2) is susceptible to fraud; (3) has complex accounting requirements; (4) experiences change in the nature or volume of the underlying transactions; or (5) is sensitive to changes in environmental factors, such as technological and/or economic developments, would generally affect management's judgment of whether a misstatement risk is higher or lower.

Management's consideration of the likelihood that a control might fail to operate effectively includes, among other things:

- The type of control (that is, manual or automated) and the frequency with which it operates;
- The complexity of the control;
- The risk of management override;
- The judgment required to operate the control;
- The competence of the personnel who perform the control or monitor its performance;
- Whether there have been changes in key personnel who either perform the control or monitor its performance;
- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The degree to which the control relies on the effectiveness of other controls (for example, IT general controls); and
- The evidence of the operation of the control from the prior year(s).

For example, management's judgment of the risk of control failure would be higher for controls whose operation requires significant judgment than for non-complex controls requiring less judgment.

Financial reporting elements that involve related party transactions, critical accounting policies[20], and related critical accounting estimates[21] generally would be assessed as having a higher misstatement risk. Further, when the controls related to these financial reporting elements are subject to the risk of management override, involve significant judgment, or are complex, they should generally be assessed as having higher ICFR risk.

When a combination of controls is required to adequately address the risks related to a financial reporting element, management should analyze the risk characteristics of the controls. This is because the controls associated with a given financial reporting element may not necessarily share the same risk characteristics. For example, a financial reporting element involving significant

[20] Critical accounting policies" are defined as those policies that are most important to the financial statement presentation, and require management's most difficult, subjective, or complex judgments, often as the result of a need to make estimates about the effect of matters that are inherently uncertain

[21] Critical accounting estimates" relate to estimates or assumptions involved in the application of generally accepted accounting principles where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and the impact of the estimates and assumptions on financial condition or operating performance is material

estimation may require a combination of automated controls that accumulate source data and manual controls that require highly judgmental determinations of assumptions. In this case, the automated controls may be subject to a system that is stable (that is, has not undergone significant change) and is supported by effective IT general controls and are therefore assessed as lower risk, whereas the manual controls would be assessed as higher risk.

The consideration of entity-level controls (for example, controls within the control environment) may influence management's determination of the evidence needed to sufficiently support its assessment of ICFR. For example, management's judgment about the likelihood that a control fails to operate effectively may be influenced by a highly effective control environment and thereby impact the evidence evaluated for that control. However, a strong control environment would not eliminate the need to evaluate the operation of the control in some manner.

A3.2.2.2 Implementing Procedures to Evaluate Evidence of the Operation of ICFR

Management should evaluate evidence that provides a reasonable basis for its assessment of the operating effectiveness of the controls. Management uses its assessment of ICFR risk, to determine the evaluation methods and procedures necessary to obtain sufficient evidence. The evaluation methods and procedures may be integrated with the daily responsibilities of its employees or implemented specifically for purposes of the ICFR evaluation.

Activities that are performed for other reasons (for example, day-to-day activities to manage the operations of the business) may also provide relevant evidence. Further, activities performed to meet the monitoring objectives of the control framework may provide evidence to support the assessment of the operating effectiveness of ICFR.

The evidence management evaluates comes from direct tests of controls, on-going monitoring, or a combination of both. Direct tests of controls are tests ordinarily performed on a periodic basis by individuals with a high degree of objectivity relative to the controls being tested. Direct tests provide evidence as of a point in time and may provide information about the reliability of on-going monitoring activities. On-going monitoring includes management's normal, recurring activities that provide information about the operation of controls. These activities include, for example, self-assessment[22] procedures and procedures to analyze performance measures designed to track the operation of controls. Self-assessment is a broad term that can refer to different types of procedures performed by individuals with varying degrees of objectivity. It includes assessments made by the personnel who operate the control as well as members of management who are not responsible for operating the control. The evidence provided by self-assessment activities depends on the personnel involved and the manner in which the activities are conducted. For example, evidence from self-assessments performed by personnel responsible for operating the control generally provides less evidence due to the evaluator's lower degree of objectivity.

As the ICFR risk increases, management will ordinarily adjust the nature of the evidence that is obtained. For example, management can increase the evidence from on-going monitoring activities by utilizing personnel who are more objective and/or increasing the extent of validation through periodic direct testing of the underlying controls. Management can also vary the evidence obtained by adjusting the period of time covered by direct testing. When ICFR risk is assessed as high, the

[22] For example, COSO Framework defines self-assessments as "evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities

evidence management obtains would ordinarily consist of direct testing or on-going monitoring activities performed by individuals who have a higher degree of objectivity. In situations where a company's on-going monitoring activities utilize personnel who are not adequately objective, the evidence obtained would normally be supplemented with direct testing by those who are independent from the operation of the control. In these situations, direct testing of controls corroborates evidence from on-going monitoring activities as well as evaluates the operation of the underlying controls and whether they continue to adequately address financial reporting risks. When ICFR risk is assessed as low, management may conclude that evidence from on-going monitoring is sufficient and that no direct testing is required. Further, management's evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end.

In smaller companies, management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR. Knowledge from daily interaction includes information obtained by on-going direct involvement with and direct supervision of the execution of the control by those responsible for the assessment of the effectiveness of ICFR. Management should consider its particular facts and circumstances when determining whether its daily interaction with controls provides sufficient evidence to evaluate the operating effectiveness of ICFR. For example, daily interaction may be sufficient when the operation of controls is centralized and the number of personnel involved is limited.

Conversely, daily interaction in companies with multiple management reporting layers or operating segments would generally not provide sufficient evidence because those responsible for assessing the effectiveness of ICFR would not ordinarily be sufficiently knowledgeable about the operation of the controls. In these situations, management would ordinarily utilize direct testing or on-going monitoring-type evaluation procedures to obtain reasonable support for the assessment.

Management evaluates the evidence it gathers to determine whether the operation of control is effective. This evaluation considers whether the control operated as designed. It also considers matters such as how the control was applied, the consistency with which it was applied, and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. If management determines that the operation of the control is not effective, a deficiency exists that must be evaluated to determine whether it is a material weakness.

A3.2.2.3 Evidential Matter to Support the Assessment

Management's assessment must be supported by evidential matter that provides reasonable support for its assessment. The nature of the evidential matter may vary based on the assessed level of ICFR risk of the underlying controls and other circumstances.

Reasonable support for an assessment would include the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence.

The evidential matter may take many forms and will vary depending on the assessed level of ICFR risk for controls over each of its financial reporting elements. For example, management may document its overall strategy in a comprehensive memorandum that establishes the evaluation approach, the evaluation procedures, the basis for management's conclusion about the effectiveness of controls related to the financial reporting elements and the entity-level and other pervasive elements that are important to management's assessment of ICFR.

If management determines that the evidential matter within the company's books and records is sufficient to provide reasonable support for its assessment, it may determine that it is not necessary to separately maintain copies of the evidence it evaluates. For example, in smaller companies, where management's daily interaction with its controls provides the basis for its assessment, management may have limited documentation created specifically for the evaluation of ICFR. However, in these instances, management should consider whether reasonable support for its assessment would include documentation of how its interaction provided it with sufficient evidence.

This documentation might include memoranda, e-mails, and instructions or directions to and from management to company employees.

Further, in determining the nature of supporting evidential matter, management should also consider the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element that could result in a material misstatement of the financial statements. As these factors increase, management may determine that evidential matter supporting the assessment should be separately maintained. For example, management may decide that separately maintained documentation in certain areas will assist the audit committee in exercising its oversight of the company's financial reporting.

The evidential matter constituting reasonable support for management's assessment would ordinarily include documentation of how management formed its conclusion about the effectiveness of the company's entity-level and other pervasive elements of ICFR that its applicable framework describes as necessary for an effective system of internal control.

A3.2.3 Multiple Location Considerations

Management's consideration of financial reporting risks generally includes all of its locations or business units[23]. Management may determine that financial reporting risks are adequately addressed by controls that operate centrally, in which case the evaluation approach is similar to that of a business with a single location or business unit. When the controls necessary to address financial reporting risks operate at more than one location or business unit, management would generally evaluate evidence of the operation of the controls at the individual locations or business units.

Management may determine that the ICFR risk of the controls that operate at individual locations or business units is low. In such situations, management may determine that evidence gathered through self- assessment routines or other on-going monitoring activities, when combined with the evidence derived from a centralized control that monitors the results of operations at individual locations, constitutes sufficient evidence for the evaluation. In other situations, management may determine that, because of the complexity of judgment in the operation of the controls at the individual location, the risk that controls will fail to operate is high, and therefore more evidence is needed about the effective operation of the controls at the location.

Management should generally consider the risk characteristics of the controls for each financial reporting element, rather than making a single judgment for all controls at that location when deciding whether the nature and extent of evidence is sufficient.

[23] Management may determine when identifying financial reporting risks that some locations are so insignificant that no further evaluation procedures are needed

When performing its evaluation of the risk characteristics of the controls identified, management should consider whether there are location-specific risks that might impact the risk that control might fail to operate effectively. Additionally, there may be pervasive risk factors that exist at a location that cause all controls, or a majority of controls, at that location to be considered higher risk.

3.3 Reporting Considerations

3.3.1 Evaluation of Control Deficiencies

In order to determine whether a control deficiency, or combination of control deficiencies, is a material weakness, management evaluates the severity of each control deficiency that comes to its attention. Control deficiencies that are determined to be a material weakness must be disclosed in management's annual report on its assessment of the effectiveness of ICFR. Control deficiencies that are considered to be significant deficiencies are reported to the company's audit committee and the external auditor pursuant to management's compliance with the certificate requirements in Section 60 (2) e of the Investment and Securities Act 2007[24].

Management may not disclose that it has assessed ICFR as effective if one or more deficiencies in ICFR are determined to be a material weakness. As part of the evaluation of ICFR, management considers whether each deficiency, individually or in combination, is a material weakness as of the end of the fiscal year. Multiple control deficiencies that affect the same financial statement amount or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness if there is a reasonable possibility[25] that a material misstatement of the financial statements would not be prevented or detected in a timely manner, even though such deficiencies may be individually less severe than a material weakness. Therefore, management should evaluate individual control deficiencies that affect the same financial statement amount or disclosure, or component of internal control, to determine whether they collectively result in a material weakness.

The evaluation of the severity of a control deficiency should include both quantitative and qualitative factors. Management evaluates the severity of a deficiency in ICFR by considering whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement of a financial statement amount or disclosure; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The severity of a deficiency in ICFR does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement on a timely basis.

Risk factors affect whether there is a reasonable possibility[26] that a deficiency, or a combination of

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[24] Pursuant to Section 60 (2)e of the Investment and Securities Act 2007 management discloses to the practitioner and to the audit committee of the board of directors (or persons fulfilling the equivalent function) all significant deficiencies in the design or operation of internal controls which would adversely affect the company's ability to record, process, summarize and report financial data.

[25] There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable". The terns are defined as follows:

Probable: The future event or events are likely to occur.

Reasonably possible: The chance of the future event or events occurring is more than remote but less than likely

Remote: The chance of the future event or events occurring is slight.
The use of use of the phrase "reasonable possibility that a material misstatement of the financial statements would not be prevented or detected in a timely manner" is intended solely to assist management in identifying matters for disclosure under the Investment and Securities Act 2007. It is not intended to interpret or describe management's responsibility or modify a control framework's definition of what constitutes an effective system of internal control.

[26] The evaluation of whether a deficiency in ICFR presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range

deficiencies, will result in a misstatement of a financial statement amount or disclosure. These factors include, but are not limited to, the following:

- The nature of the financial reporting elements involved (for example, suspense accounts and related party transactions involve greater risk);
- The susceptibility of the related asset or liability to loss or fraud (that is, greater susceptibility increases risk);
- The subjectivity, complexity, or extent of judgment required to determine the amount involved (that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies (that is, when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement amounts or disclosures); and
- The possible future consequences of the deficiency.

Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in ICFR include, but are not limited to, the following:

- The financial statement amounts or a total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

Management should evaluate the effect of compensating controls[27] when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

In determining whether a deficiency or a combination of deficiencies represent a material weakness, management considers all relevant information. Management should evaluate whether the following situations indicate a deficiency in ICFR exists and, if so, whether it represents a material weakness:

- Identification of fraud, whether or not material, on the part of senior management[28];
- Restatement of previously issued financial statements to reflect the correction of a material misstatement[29];
- Identification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's

[27] Compensating controls are controls that serve to accomplish the objective of another control that did not function properly, helping to reduce risk to an acceptable level

[28] For purposes of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 60 Investments and Securities Act 2007 as well as any other members of senior management who play a significant role in the company's financial reporting process

[29] Regarding the correction of a misstatement, see applicable financial reporting standards on Accounting Policies, Changes in Accounting Estimates and Errors

ICFR; and

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

When evaluating the severity of a deficiency, or combination of deficiencies, in ICFR, management also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. If management determines that the deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP, then management should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

3.3.2 Expression of Assessment of Effectiveness of ICFR by Management

Management should clearly disclose its assessment of the effectiveness of ICFR and, therefore, should not qualify its assessment by stating that the company's ICFR is effective subject to certain qualifications or exceptions. For example, management should not state that the company's controls and procedures are effective except to the extent that certain material weakness (es) have been identified. In addition, if a material weakness exists, management may not state that the company's ICFR is effective. However, management may state that controls are ineffective for specific reasons.

3.3.3 Disclosures about Material Weaknesses

The Commission's rule implementing Section 60 (2) was intended to bring information about material weaknesses in ICFR into public view. Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that the material weaknesses exist, companies should also consider including the following in their disclosures:

- The nature of any material weakness,
- Its impact on the company's financial reporting and its ICFR, and
- Management's current plans, if any, or actions already undertaken, for remediating the material weakness.

Disclosure of the existence of a material weakness is important, but there is other information that also may be material and necessary to form an overall picture that is not misleading. The goal underlying all disclosure in this area is to provide an investor with disclosure and analysis that goes beyond describing the mere existence of a material weakness. There are many different types of material weaknesses and many different factors that may be important to the assessment of the potential effect of any particular material weakness. While management is required to conclude and state in its report that ICFR is ineffective when there are one or more material weaknesses, companies should also consider providing disclosure that allows investors to understand the cause of the control deficiency and to assess the potential impact of each particular material weakness. This disclosure will be more useful to investors if management differentiates the potential impact and

importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on ICFR from those material weaknesses that do not.

3.3.4 Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR

When a material misstatement of previously issued financial statements is discovered, a company is required to restate those financial statements. However, the restatement of financial statements does not, by itself, necessitate that management considers the effect of the restatement on the company's prior conclusion related to the effectiveness of ICFR.

While there is no requirement for management to reassess or revise its conclusion related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. The company should also disclose any material change to ICFR.

Similarly, while there is no requirement that management reassess or revise its conclusion related to the effectiveness of its disclosure controls and procedures, management should consider whether its original disclosures regarding effectiveness of disclosure controls and procedures need to be modified or supplemented to include any other material information that is necessary for such disclosures not to be misleading. With respect to the disclosures concerning ICFR and disclosure controls and procedures, the company may need to disclose in this context what impact, if any, the restatement has on its original conclusions regarding the effectiveness of ICFR and disclosure controls and procedures.

3.3.5 Inability to Assess Certain Aspects of ICFR

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR. For example, management may outsource a significant process to a service organization and determine that evidence of the operating effectiveness of the controls over that process is necessary. However, the service organization may be unwilling to provide either a Type 2 International Standard on Assurance Engagement, ISAE 3402 report or to provide management access to the controls in place at the service organization so that management could assess effectiveness[30]. Finally, management may not have compensating controls in place that allow a determination of the effectiveness of the controls over the process in an alternative manner. The Commission's requirements state that management's annual report on ICFR must include a statement as to whether or not ICFR is effective and the spirit of the Investment and Securities Act 2007 does not permit management to issue a report on ICFR with a scope limitation. Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in its report that ICFR is not effective.

[30] ISAE 3402, service organization control report defines a report on controls placed in operation and test of operating effectiveness, commonly referred to as a "Type 2 ISAE 3402 report." This report is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control over financial reporting on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives were achieved during the period specified.

REFERENCES

1. The Investments and Securities Act, 2007
2. The framework of The Committee of Sponsoring Organisations of the Treadway Commission (COSO).
3. The United States Securities and Exchange Commission Rule on Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.
4. The United States Securities and Exchange Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting.
5. ICAN Technical Guidance on Assurance Engagement to Report on Internal Control over Financial Reporting.
6. The Institute of Internal Auditors Research Report on Evaluating Internal Control Systems.
7. Protecting Investors through Audit Oversight (PCAOB) Standards on Auditing