

**Off Balance Sheet Items
Final Audit Report
Report Nr. 18/10
December 6, 2010**

Distribution:

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Introduction

In accordance with our FY 2010 Audit Plan, EDC Internal Audit performed an audit of Off Balance Sheet Items. EDC has off balance sheet items in the form of financing commitments of approximately \$8.8B CAD and contingent liabilities of approximately \$25.9B CAD. In addition, EDC has significant interest in variable interest entities for which we are not considered the primary beneficiary. Accordingly, they are also treated as off balance sheet items. These VIEs have assets of approximately \$5.5B CAD, and estimated maximum exposure of \$3.6B CAD.

Audit Objectives & Scope

The overall objective of the audit was to evaluate the design effectiveness of the controls to ensure the completeness of amounts reported for financing commitments, contingent liabilities and variable interest entities. Controls to ensure accurate presentation and disclosure in the notes to the financial statements were examined as a secondary objective. The audit addressed the following ERM risk elements: system risk, information and infrastructure risk, and financial management and reporting risk.

Audit fieldwork was performed from August to October 2010.

Internal Audit Opinion

In our opinion, the processes surrounding the preparation of the note disclosure for Off Balance Sheet Items is *Well Controlled*¹. Key controls have been effectively designed. Some moderate² issues were noted and are described in the following section.

Audit Findings & Recommendations

1. Medium Term Overdue Balance and Pending Claims

The contingent liability note disclosure is compiled in part from listings extracted from EDC's claims and recoveries system (CRS). These listings include Medium Term Overdue balances reported by policyholders and claims received by EDC that are pending payment. The contingent liability note is also compiled from listings extracted from EDC's Medium Term Insurance (MTIP) system. These listings show policy liability from the day the policy becomes active in MTIP until the end of the policy claims period. For medium term policies where the policyholder has reported an overdue balance or filed a claim with EDC, the contingent liability is reported on both reports resulting in duplicate amounts in the note disclosure. In

¹ Our standard audit opinions are as follows:

- **Strong Controls:** Key controls are effectively designed and operating as intended. Best in class internal controls exist. Objectives of the audited process are most likely to be achieved.
- **Well Controlled:** Key controls are effectively designed and operating as intended. Objectives of the audited process are likely to be achieved.
- **Opportunities Exist to Improve Controls:** One or more key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process may not be achieved. The financial and/or reputation impact to the audited process is more than inconsequential. Timely action is required.
- **Not Controlled:** Multiple key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process are unlikely to be achieved. The financial and/or reputation impact to the audited process is material. Action must follow immediately.

² The ratings of our audit findings are as follows:

- **Major:** a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk is more than inconsequential. The process objective to which the control relates is unlikely to be achieved. Corrective action is needed to ensure controls are cost effective and/or process objectives are achieved.
- **Moderate:** a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk to the process is more than inconsequential. However, a compensating control exists. Corrective action is needed to avoid sole reliance on compensating controls and/or ensure controls are cost effective.
- **Minor:** a weakness in the design and/or operation of a non-key process control. Ability to achieve process objectives is unlikely to be impacted. Corrective action is suggested to ensure controls are cost effective.

order to prevent the duplication of items, we recommend that Insurance Accounting develop procedures that will be performed quarterly to identify and remove any duplicate items.

Rating of Audit Finding - Moderate

Action Owner - Manager, Insurance Accounting & Canada Account

Due Dates - Q4 2011

2. Overdue Balances and Pending Claims Reports

As part of the evaluation of the contingent liability note, Internal Audit evaluated the foreign currency translation rates used in the CRS reports. We noted that the reports generated from CRS do not use foreign exchange rates that are consistent with Financial Reporting. In addition, we noted that the CRS reports do not properly record the liability on policies where EDC is not liable for the full overdue and/or claim. In EDC's ARI insurance program it is common for EDC to only assume 90% of the contingent liability, however the CRS report records the full liability, which results in an overstatement of the contingent liability. We recommend that the CRS system generated reports be evaluated to determine if the foreign currency translation rates and insurance ratios can be modified to meet the needs of Insurance Accounting.

Rating of Audit Finding - Moderate

Action Owner - Manager, Insurance Accounting & Canada Account

Due Dates - Q2 2011

3. Short Term Insurance Exposure Report

As part of the evaluation of the contingent liability note, Internal Audit evaluated the foreign currency translation rates used in the short term insurance (STI) exposure report generated from Globex. We noted that the STI exposure report does not use foreign exchange rates that are consistent with Financial Reporting. In addition, we noted that the STI exposure report does not consistently account for policyholders who declare quarterly. While the majority of STI policyholders declare sales volumes monthly, some larger policyholders declare sales volume on a quarterly basis. We noted that some of the quarterly declarations are treated in the same manner as the monthly declarations, which is inconsistent with the expected method for quarterly declarers. We recommend that the STI exposure report be evaluated to determine if the foreign currency translation rates can be modified to meet the needs of Insurance Accounting. We also recommend that Insurance Accounting determine the appropriate treatment for quarterly declarers and that the report be modified to ensure that all policyholders who declare quarterly are treated in a consistent manner.

Rating of Audit Finding - Moderate

Action Owner - Manager, Insurance Accounting & Canada Account

Due Dates - Q2 2011

4. Timing of Policy Issuance in MTIP

As identified in Internal Audit's Invoicing and Collections - CIB audit report dated September 14, 2010, we noted that coverage is being provided to policyholders prior to receiving premium payments. Receiving premium payment is often the trigger to transfer a policy from MBC to MTIP where the policy is issued. The timing difference between the coverage start date and the date the policy is issued in MTIP results in incomplete contingent liability note disclosure. As part of the Invoicing & Collections - CIB audit, we recommended that procedures be established to ensure MBC transactions are sent to MTIP on a timely basis. As part of the Off Balance Sheet audit, we recommend that Insurance Accounting formalize its procedures at quarter end to verify that all policies have been issued in MTIP, and therefore are appropriately included in the contingent liability note. These procedures should be performed for CIB and PRI products.

Rating of Audit Finding - Moderate

Action Owner - Manager, Insurance Accounting & Canada Account

Due Dates - Q2 2011

Conclusion

The audit findings and recommendations have been communicated to and agreed by management, who has developed action plans that are scheduled for implementation no later than Q2 2011. We would like to thank management for their support throughout the audit.