REGULATION update

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ALBERTA SECURITIES COMMISSION

CHIEF ACCOUNTANT'S GROUP

1999 Financial Statement Review Program Report

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The following report provides an overview of key issues identified during the Alberta Securities Commission's 1999 review of financial statements and related disclosures. The information is published to assist issuers and their professional advisors to achieve and maintain high standards of financial reporting. It should be noted that these issues are the exceptions; most financial reporting is of a very acceptable standard.

INTRODUCTION

Through its Financial Statement Review Program, the Chief Accountant's Group (CAG) of the Alberta Securities Commission (ASC) reviews financial statements filed by reporting issuers (RIs) pursuant to the Continuous Disclosure requirements of the *Alberta Securities Act*. The purpose of the program is to monitor and encourage quality financial reporting in Canada. This review is in addition to the CAG's review of prospectus filings.

During the summer of 1999, the CAG reviewed a sample of RIs' 1998 financial statements in three key areas: (1) accounting policies and practices; (2) presentation and disclosure; and (3) adherence to professional and regulatory requirements.

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Annual reports, annual information forms, management's discussion and analysis, press releases and material change reports were also reviewed.

Program results are summarized below. Depending on the perceived severity of the departures from generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS), the CAG may respond by:

- Requesting the RI to consider modifying disclosure in the future;
- Requesting the RI to change financial statements and/or issue press releases to inform the investing public; and
- In rare cases, recommending a cease trade order be imposed on the RI until the error is corrected.

To avoid similar problems in the future, the CAG encourages issuers and their advisors to review these results.

SELECTION

The 1999 sample was selected from a population of approximately 1,000 RIs. Eighty-three RIs representing various industries and sizes of organizations were included. In addition to the "regular issuers" reviewed, 25 companies which had completed a Junior Capital Pool (JCP) offering and which had recently completed their "Major Transaction" were selected for review. These companies are included in the table below.

As part of 1999's program, six RIs' US GAAP reconciliation notes were reviewed. No material deficiencies were noted.

As well, 10 royalty trusts were reviewed on an overall basis looking at general disclosures for this type of entity. These entities are not included in the table below.

Total Assets:

$0 - $5 million	39
$5 million - $25 million	14
$25 million - $100 million	12
$100 million +	18
	83

Type of Business and Audit Firms:

Industrial and Other	**1999**	**1998**
Big Five	29	18
National Firms	10	2
Local Practitioners	9	12
	48	**32**

Oil and Gas		
Big Five	7	27
National Firms	22	0
Local Practitioners	6	4
	35	31
Total	**83**	**63**

OVERALL RESULTS

The program resulted in:

- 63 RIs were sent letters noting possible minor GAAP deficiencies with recommendations for correcting them in the future.
- 20 RIs were asked to respond to the CAG regarding possible material GAAP or GAAS deficiencies.

Of the above 20:

- 12 were asked to deal appropriately with the noted deficiencies, if similar circumstances arise in the future. Some were asked to adjust their next interim statements or their next annual statements.
- 8 were required to make changes to the accounting and refile their financial information.

The majority of possible material GAAP deficiencies occurred when acquisition transactions were on a non-monetary basis (i.e. shares for shares) and the market price used was not based on what was considered to be an active, liquid market.

MATERIAL GAAP ISSUES

Accounting for Acquisitions

In reviewing the accounting for the Major Transaction for JCP companies, there were problems encountered with the accounting for the issuance of shares when the acquisition was not accounted for as a reverse take-over. The table below summarizes the results of the review.

Method of accounting for Major Transaction	**RIs Examined**	**Material Errors in Accounting**
Reverse Take-Over	9	-
Purchases for cash	5	-
Continuity of Interests (Poolings)	2	-
Purchase of business in exchange for share consideration	2	1
Purchase of assets in exchange for share consideration	7	5
Totals	**25**	**6**

The material errors in accounting were due to the shares issued being valued at their quoted value at the time of the transaction or at the assumed value of the company or assets being acquired.

It is anticipated that most Major Transactions should be accounted for using the reverse take-over method of accounting or the continuity of interests (pooling) method of accounting. The JCP company typically has a few hundred thousand dollars of cash as its only material asset. In most cases the value of the company or assets it is acquiring is several times the value of the JCP's cash. In the transaction the JCP typically issues shares as consideration as it often does not have sufficient cash to complete the purchase. In those rare situations where the JCP is actually the acquirer and it issues shares, the accounting for the shares issued should be as follows.

Since at the time of the transaction the JCP company's net assets are primarily cash, it is the view of the staff of the ASC (Staff) that any shares issued in these circumstances should be valued at the per share book value of the JCP. The value of the JCP is the cash the JCP company has plus an amount to give recognition to the fact that the JCP is a public company, divided by the number of shares outstanding prior to the major transaction (Cash Value Per Share). Staff generally allows between $75,000 to $100,000 for the value of the public listing.

Staff believes that this value is clearly evident and is more objective than virtually all of the other proposed values. It typically is not appropriate to use the quoted price at the time of the transaction as the number of shares being issued in the major transaction is many times the monthly volume of shares trading. As such, the market cannot be considered active and liquid. The quoted price is therefore not an appropriate base for determining value. As the JCP has only cash, it is always more accurate and easier to determine the value of the assets of the JCP than to determine the value of the company or assets that it is acquiring in the major transaction. This is the case even if there exists an independent valuation report or an independent reserve report on the company or assets acquired.

Staff also believes that the Cash Value Per Share of the JCP should be used even when related parties are involved, there is a substantive change in ownership, and independent evidence of value, as the culmination of the earnings process has rarely, if ever, occurred.

The shares issued in the transaction sometimes will have a value attributed to them for "legal" purposes. This is often the value that is accepted by the Alberta Stock Exchange (ASE) when it is evaluating the major transaction. However, for accounting purposes [which must be fair value (or cost) not relative fair value] this value is usually in excess of the value that should be used. An example would be where the ASE uses estimated fair value for their purposes, but for accounting purposes cost would be used. Another example would be where the ASE uses a quoted value but that value cannot be used for accounting because the market is not active and liquid. The RI should use the lower value described previously, but it may want to disclose in the notes to the financial statements that the shares have a different prescribed value than the value used for accounting purposes.

Care should be taken in recording these transactions. If they are later determined by Staff to have been recorded incorrectly, the issuer will be required to issue corrected financial statements, obtain a revised audit report in accordance with paragraphs 5405.12 to .18 of the *CICA Handbook,* issue a news release and issue a material change report. Failure to do so may result in Staff recommending a cease trade order be issued against the RI.

OTHER ISSUES

This section describes areas of weakness in disclosure and presentation which, while usually not material, detract from the quality of reporting.

Stock Exchange Considerations

In some cases, the ASE will accept financial disclosures and auditor involvement for their purposes, which will differ from those which will be subsequently required by the ASC. ASC requirements should be anticipated as part of any financial information provided to the ASE.

Goodwill Accounting Policy

EIC 64 states a company should disclose how it determines whether there is a permanent impairment in value of the unamortized portion of goodwill, regardless of whether impairment exists. Although all RIs reviewed disclosed the amortization period for goodwill, most RIs, including a number of those which recorded a goodwill write down, did not disclose the company's policy for determining permanent impairment.

Cash Flow per Share

In several instances, the caption used by RIs for cash flow per share information was vague and did not adequately describe its composition. EIC 34 states the term "cash flow per share", without additional modifiers, should be used only if it refers to all cash flows, including cash flows from financing and investing activities.

Segment Disclosure

CICA Handbook Section 1701 became effective for fiscal years beginning on or after Jan. 1, 1998 and the changes required by this section were well implemented by the majority of RIs. It was noted that in some circumstances the results of operations prepared for "the senior decision maker", and presented in the annual report, included a segment analysis that was not consistent with that included in the financial statements. In other circumstances it appeared that the reportable segments had been aggregated to a level that seemed contradictory to the various segments disclosed in the annual report. In these situations, clearer disclosure would include an expanded discussion surrounding the determination of reportable segments or, in the case where segment information is not presented, the rationale supporting this position.

Forecasts

RIs should take care when disclosing projections. If they consititute FOFI (future oriented financial information), follow-up is required. Even if not FOFI, follow-up may be required in the form of a material change report.

Joint Venture and Equity Accounted Investments

In several situations, the extent of joint venture and equity accounted activity were important factors in evaluating the financial position and results of operations of the RI. In these circumstances, the presentation of summarized financial information of the "investee" entity would be of benefit and should be considered for inclusion.

Future Income Taxes

Some RIs, which adopted the new standard of accounting for income taxes, the liability or future tax method, did not correctly calculate the future tax liability with respect to assets acquired other than in a business combination. These RIs simply multiplied the temporary differences by the effective tax rate. This is not correct. A gross up calculation is required and discussed in paragraphs 3465.43 to .45 of the *CICA Handbook*. An example is provided.

This new treatment may have an effect on Part I of the ceiling test for oil and gas properties if the cost base for income tax purposes is significantly different from the accounting value. This issue is unlikely to be addressed by the CICA unless requests are made.

Flow Through Shares

Disclosures could be improved through the provision of additional details with respect to the contractual obligations to incur qualifying expenditures. Additional disclosures to consider may include the timing of the contractual obligation and the renunciation period including the effect of non-compliance. This would assist users in attempting to determine, or estimate, the timing of future cash flows, the effect on current resources and the extent of contracted commitments.

Financial Instruments, Commitments and Contractual Obligations

Section 3860's definition of financial assets and financial liabilities is very broad and includes cash, accounts receivable, accounts payable, long term debt and notes receivable and payable. The CAG noted an improvement over last year's disclosure but still found that a number of RIs' financial statements lacked or had inadequate disclosure of fair value, interest rate risk, credit risk and currency exposure information, and gains and losses both recognized and unrecognized, relating to their financial instruments.

Forward contracts involving the physical delivery of commodities may not be financial instruments. However, similar disclosures should be considered when the future effects are likely to be material. Disclosures should be made whenever there are material obligations to buy or sell at fixed prices, including the fixed prices, volumes and timing.

Measurement Uncertainty

Staff believes Section 1508 is directed to specific items, not measurement uncertainty in a general sense. Section 1508.06 indicates "The nature of a measurement uncertainty that is material should be disclosed." A generic description in addition to, but not in place of, a discussion of specific matters will be accepted.

Capital Assets (Oil and Gas)

With respect to ceiling test calculations, restoration costs should be in Part I, not Part II, of the Guideline, as they are property specific. The CICA has revised this Guideline.

Quarterly Reporting

In several cases, the interim financial statements prepared were of low quality and contained numerous significant and non-significant GAAP deficiencies. Examples of such deficiencies include:

- year to date income statement balances that decrease in each successive quarter;
- large, unexplained adjustments in the fourth quarter;
- failure to disclose changes in commitments and contingencies;
- a change in the method of accounting for a transaction from interim financial statements to year end financial statements with no apparent change in the underlying transaction; and
- significant transactions, which occurred during the year and were reported in the year end financial statements but were not recognized in interim financial statements.

The CAG believes the interim financial statements are an important source of information to investors. RIs are encouraged to improve their quarterly financial statements.

Using the Work of a Specialist - Oil and Gas Reserve Reports

Section 5360.14 of the *CICA Handbook* requires that, when an auditor uses the work of a specialist, the auditor should obtain reasonable assurance that "accounting data provided by the client to the specialist is appropriate" and be satisfied that “the findings appear to be reasonable”. With respect to reliance on oil and gas reserve reports, staff believes procedures (on a test basis) similar to the following should be considered:

- comparing historical operating statements to reserve reports by property;
- tying oil and gas facilities leases to reserve reports unless they are capital leases on the balance sheet;
- comparing prices in gas and transportation contracts to reserve reports; and
- discussing the reserve reports with the reserve evaluator.

Disclosure Issues

Overall, there was some lack of detailed disclosure in many areas of the financial statements. Specific areas where disclosure was lacking included:

- details of share capital, stock options, warrants, and shares reserved to meet outstanding options;
- details of debt repayment dates and terms;
- separate disclosure of income statement items as required by Section 1520 (“Income Statement”);
- details of amount and expiry dates of income tax loss carry forwards;
- material contractual obligations and commitments, especially where future losses could occur; and
- in some companies the reconciliation of the income tax expense to the statutory income tax rate was not done. This reconciliation should be done even if the company is in a loss position.

RIs agreed to provide additional disclosure in future filings. We did note an improvement in the site restoration and Year 2000 disclosures which were both cited in last year’s report as areas needing additional disclosures.

REVIEW OF ROYALTY TRUST FINANCIAL STATEMENTS

Royalty trusts are an investment vehicle that entitles unit holders to a distribution based upon an agreement. Some investors appear to be unsophisticated users of financial statements.

The assets are not owned directly by the trust. A separate company (Op Co) owns the assets and relinquishes the rights to most of the profits (typically 99%) to the trust.

In examining the royalty trust financial statements, two main items hampered comparability of the trusts:

1. Basis of Presentation

Of the trusts examined, two presented only the assets of the trusts, two were presented on a combined basis with Op Co and six were presented on a consolidated basis with Op Co. Although the combined statements stated that transactions between the trust and Op Co had been eliminated, it may be confusing to certain investors if a trust prepared on a combined basis is compared to a trust prepared on a consolidated basis.

2. Statement of Distributable Income

The amounts that are to be distributed to unit holders are based on a trust agreement and the basis for calculating distributable income varies greatly among the trusts. For example, in some trusts the distributions are based on cash income, while others are based on accrual income. Some trusts factor net borrowing or repayments of long-term debt into the distribution while other trusts do not. Also, certain trusts deduct a portion of, or all, capital expenditures in arriving at distributable income.

Nine of the 10 trusts examined had a statement of distributable income (the 10th provided a similar analysis in the annual report). However, there were a variety of ways the statement was prepared. Some statements started with accounting net income and made adjustments to this amount in arriving at distributable income. Others presented line by line analysis of what is included in distributable income and then adjusted for working capital changes, if distributable income was to be on a cash basis. Others presented a line by line analysis on a cash basis.

Because of the various methods used it was difficult to compare one trust to another in analysing what was actually being distributed. It is the view of Staff that a standard statement of distributions should be adopted. Staff prefers the statements that start with net income on an accrual basis and show the reconciliation to distributable income as that method clearly outlines how distributable income differs from what is presented in the statement of income.

Staff hopes that such trusts will agree on definitive guidance on the statement of distributable income in the near future in order to enhance the comparability of these trusts. A copy of this report has been sent to them.

FINANCIAL STATEMENTS IN PROSPECTUSES

Although not part of the Financial Statement Review Program, the following information is provided to update RIs on recent issues in prospectus reviews and the proposed new rules governing financial statements to be included in prospectuses.

Acquisitions - Historical Financial Statements

RIs should contemplate the proposed new rules which require audited historical financial statements with respect to acquisitions. The number of years required is based on a sliding scale which compares historical assets, revenue and income of the acquired business to those of the RI (possibly changing to a comparison of purchase price to book assets of the acquirer in place of revenue). If the comparable balances in the acquired entity are less than 20% of the issuer's balances, then no financial statements of the acquired business are required; if the comparable balances are 20% to 40% of the issuer's balances, then one year of historical financial statements are required; if the balances are 40% to 50% then two years' financial statements must be included; and if comparable balances are greater than 50% then three years are required. An exemption for purchases of oil and gas producing properties is being sought but may not be obtained. All RIs, including oil and gas RIs, are encouraged to review the new rules and respond.

Pro Forma Financial Statements

In preparing pro forma financial statements, issuers should keep in mind that pro forma adjustments should be easy to follow and should tie directly from the notes to the pro forma financial statements.

Qualifications in Auditors' Reports for Opening Inventory

It is likely that audit reports, qualified with respect to opening inventory, will no longer be accepted with respect to the most current year.

FAC - FINANCIAL ADVISORY COMMITTEE

This committee is comprised of seven CAs from public practice and one from industry, two investment bankers and a lawyer. Members of the committee provide advice to Staff, usually on an informal, very prompt, basis. If requested, the committee establishes a panel to hear and provide more formal opinions on accounting and related matters. The committee last met in November 1999 and considered many of the topics described here as well as the following:

COPrS (Canadian Originated Preferred Securities)

Staff of the ASC and other commissions may require disclosure (outside the financials) as to what the results would be if these were treated as debt.

Review Engagement Reports in Prospectuses

Staff of the ASC and jurisdictions other than British Columbia will ask that they not be included. If British Columbia is the principal jurisdiction, ASC staff will not object to their inclusion.

Active and Liquid Market - EIC 76

Clarification is to be sought. Staff believes the number of shares to be issued generally should not exceed about three months trading volumes or the market should not be considered active and liquid.

SURVEY ON DISCLOSURES OF CONTRACTS IN THE FINANCIAL STATEMENTS OF OIL AND GAS PRODUCERS

A survey of the year end financial statements of 24 oil and gas producers was undertaken to determine the types of disclosures, and the level of details of the disclosures, made in respect of oil and gas commitments and contingencies for purchases and sales. We grouped the disclosures in five categories.

	Number of disclosures
1. The first was contracts to sell fixed quantities at fixed prices. In this category, we intended to include only contracts that would be settled through the delivery of product.	13
2. The second category was contracts for transportation or processing at a fixed price.	7
3. The third category was contracts to buy fixed quantities at fixed prices. For this category, we intended to include only contracts which would be settled through the acceptance of product.	4
4. The fourth category was for contracts where the company had received payment in advance for quantities to be supplied in the future.	3
5. The fifth category was financial instruments. This category included transactions that must be settled in cash, and not by the delivery or acceptance of product.	17

It was sometimes difficult to determine the terms of settlement of a contract or commitment from disclosures in the financial statements. We sometimes couldn't ascertain whether a given contract was to be settled in cash or by delivery of product. Therefore, our categorization is subject to our interpretation. The best descriptions allowed the reader to easily assess the type, timing and magnitude of the arrangements as well as their fair value and the treatment of gains and losses. Staff considers such disclosures to be normally required under generally accepted accounting principles.

2000 REVIEWS

The ASC is moving, ultimately, to a program of continuous review of RIs' continuous disclosure. When fully developed, analysts will have a number of RIs assigned to each of them and they will follow "their" RIs on a continuous basis. The goal is to improve each analyst's knowledge of the RI on a current basis in order that any problems can be identified as they arise rather than afterward.

MUTUAL RELIANCE REVIEW SYSTEM

The securities commissions across Canada have developed a mutual reliance review system (MRRS). Under the MRRS, RIs deal primarily with the commission in the province of their head office. This "principal regulator" is responsible for reviewing prospectuses, continuous disclosure and applications on behalf of all other jurisdictions. For example, an RI filing a prospectus in various provinces will, in most circumstances, receive a comment letter from their principal regulator only. This should reduce the time and effort of both RIs and commissions. There will still be some exceptions; if a non-principal regulator disagrees with the principal regulator, the non-principal regulator may "opt-out" and would then deal direct with the RI. It is believed this new system will result in greater cooperation and harmonization among commissions and thus greater efficiency. RIs used the system in 1999 on a test basis. This system came into effect on Jan. 1, 2000.

CONCLUSION

The CAG encourages all RIs and their professional advisors to consider the above issues. If unsure, the CAG asks that issuers and professional advisors consider consulting with their colleagues. The CAG is also available to assist RIs on a pre-filing basis.

Despite the above areas of concern, the CAG stresses that most of the financial statements filed not only meet, but exceed, standards of acceptability. The CAG encourages all accountants and auditors to continue to strive to achieve high-quality financial statement filings in the future.

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