

REGULATION

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update

ALBERTA SECURITIES COMMISSION

CHIEF ACCOUNTANT'S GROUP

Preliminary results of 2002 Financial Statement Review Program

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ALBERTA SECURITIES COMMISSION

 Chartered
Accountants
of Alberta

PURPOSE AND TIMING

The Chief Accountant's Group (CAG) of the Alberta Securities Commission (ASC)—henceforth referred to as "Staff"—is issuing the preliminary findings of its annual Financial Statement Review Program (Program) to achieve two objectives. First, the CAG believes that it is beneficial for the investing public to know about the overall quality of financial reporting by Alberta headquartered public companies. Second, it is helpful for preparers and/or auditors of financial statements to be aware of any repetitive and significant deficiencies found through the Program that, if avoided in the future, will improve on the comparability and transparency of information contained in financial statements.

This report focuses on the results from review of the annual and interim financial statements up to mid-

November 2002. A final report will be issued in March 2003 incorporating updated results as well as comments on Staff's findings on the quality of management discussion and analysis (MD&A).

THE PROGRAM

The findings of the Program are based upon the review of financial statements and other public disclosure documents of a selected number of public companies. While the selection process is intended to be representative of the entire population of Alberta public companies, readers are cautioned that the conclusions and results may not be.

The Program is designed to monitor the adequacy of filings by companies with respect to the most recent

TABLE OF CONTENTS

Purpose and Timing.....	1	Other Accounting and Disclosure	
The Program	1	Items to Consider	6
Methodology	2	Management Discussion and Analysis (MD&A) ...	7
Modification to Current Year's Program	2	Current Results Compared to Prior	
Sample Selection	2	Year's Findings	7
New Issues Under Review	2	Reference Sources for Quality	
Goodwill	2	Financial Reporting.....	7
Royalty/Income Trust Fees	3	Communication Between CAG and	
Other GAAP Matters.....	5	Management of Entities	7
		Conclusion.....	7

annual audited financial statements, the current and prior year interim unaudited financial statements, and, where applicable, the management discussion and analysis (MD&A), the annual information form (AIF), and material change reports.

METHODOLOGY

All reviewers in the Program are chartered accountants. They have significant experience gained from working in large public accounting firms and industry. Two of the reviewers were seconded from a Big Four accounting firm.

The reviewer reads the interim and annual financial statements and accompanying notes and assesses whether full and adequate disclosure has been made in conformity with accepted standards and, where applicable, industry practices. All other information on the public record is scanned and matters of interest and/or significance are identified and cross-referenced to the interim and annual statements.

Based upon the reviewer's findings, a letter is sent to the public company's Chief Financial Officer with a copy to the company's auditor asking for clarification on certain financial statement items and/or suggesting ways to improve disclosure in the future. To ensure a consistent approach, either the Chief Accountant or the Deputy Chief Accountant reviews each letter and supporting material prior to issuance.

MODIFICATION TO CURRENT YEAR'S PROGRAM

In response to investors' demand for more information about the quality of financial reporting in the Alberta capital markets and to specifically address those major problems identified by US regulators as contributing to the financial failures of several large US companies, Staff has increased the sample number of financial statements that are being reviewed. When the entire Program has been completed in March 2003, the financial statements and other related public disclosure documents of approximately 85 companies will have been reviewed.

Reviewers are asking many issuers direct questions about the areas that have caused problems in financial reporting for US based public companies. The four areas are: (1) recognition of revenue prematurely or recognition of non-existent revenue, (2) capitalization of expenditures that should be treated as period costs, (3) deficient disclosure of related party transactions, and (4) use of special purpose vehicles, created mostly for off-balance sheet financing, that were accounted for incorrectly.

SAMPLE SELECTION

Results in this report were compiled from staff's review of 57 companies' financial statements. Five of these companies are public but their shares are not traded on an exchange. Securities of 23 of these companies are listed on the Toronto Stock Exchange and 29 are listed on the TSX Venture Exchange. Of the Toronto Stock Exchange listed entities, 20 were audited by Big Four accounting firms.

NEW ISSUES UNDER REVIEW

The following issues are being explored by the CAG. These are issues that should be resolved before the next group of annual audited financial statements are issued to the public. The CAG has consulted with counterparts at the British Columbia and Ontario Securities Commissions, with the ASC's Financial Advisory Committee, and with technical partners at the Big Four accounting firms; and, it has forwarded these issues to the Emerging Issues Committee (EIC) of the Canadian Institute of Chartered Accountants (CICA) for deliberation.

GOODWILL

Should goodwill be recognized when an oil and gas exploration business is acquired and the excess purchase price cannot be allocated to any of the acquired assets as contemplated by the CICA business combinations standard?

When an oil and gas exploration business (includes companies, trusts, partnerships etc.) is acquired and Section 1581(formerly Section 1580) of the CICA Handbook is considered the appropriate standard to follow in determining the proper accounting for the transaction, should goodwill be recognized?

Paragraph 1581.40 (a) states that the cost of the purchase should be allocated to the assets acquired and liabilities assumed of the acquired business, except for amounts related to goodwill and future income taxes recognized by the acquired business before its acquisition, based upon their fair values at the date of acquisition.

Paragraph 1581.46 states that the values placed by an acquirer on the assets and liabilities of an acquired business are to be determined based on their fair values, without reference to their values for tax purposes, or tax bases.

Paragraph 1581.43(f) states that a general guide used to arrive at fair value for natural resources for purposes of the purchase equation is estimated or appraised values.

Paragraph 1581.47 discusses how the future tax asset or liability should be determined for the allocation of the purchase price and refers to CICA Handbook Section 3465 for guidance on measurement of these amounts.

Paragraph 1581.40(b) states that if there is any excess of the purchase price over the net of the amounts assigned to assets acquired and liabilities assumed including the amounts assigned to either future tax assets and/or future tax liabilities, this difference should be recognized as goodwill.

By following these Handbook paragraphs, it is possible that the fair value assigned to oil and gas exploration assets is insufficient to absorb the majority of the purchase price. As a result, a difference is created between the amount assigned to net assets purchased and the purchase price.

Prior to the introduction of Sections 1581 and 3465, the balancing item in the purchase equation would always be allocated to property, plant and equipment and goodwill was never recorded. The reasoning for this position is that the only assets with future revenue potential are the reserves/resources. Therefore, the final purchase price allocation would ignore the requirement that fair value be assigned to individual assets and liabilities acquired.

By applying the new business combinations and income tax standards in a technical manner, goodwill can arise. Although this result may seem nonsensical to business people, the accounting treatment complies with GAAP.

An example may illustrate the point more clearly.

Assume Company A acquires Company B, an oil and gas exploration business, for \$1100. The carrying value of Company B's property, plant and equipment is \$1000. There is debt of \$200, future tax liability of \$350 and shareholders' equity of \$450. There is no tax base for these assets. The estimated fair value of the oil and gas properties without regard to tax base is \$1400. The tax rate is 35%.

Allocation of the purchase price using a technical interpretation of GAAP is as follows:

Property, plant, and equipment	\$1400
Debt assumed	(200)
Future tax liability	(490)
Entry to balance equation (i.e. goodwill)	<u>390</u>
Purchase price	<u>\$1100</u>

If the "entry to balance" is allocated to the property, plant and equipment, then the future tax liability has to be recalculated. If the entry is to recognize goodwill, then the \$390 would be recorded as goodwill and subject to an impairment test.

At this point, Staff has not focussed on how fair value of oil and gas properties should be determined, but we are exploring possible acceptable methods. Staff is also considering what may be an appropriate impairment test(s) that must be performed periodically if goodwill is

recognized. Methods used to determine fair value of assets and impairment of goodwill must result in comparability among companies.

In lieu of following the technical interpretation of GAAP in the allocation of the purchase price, the more common approach has been to balance the equation by allocating any residual to property, plant and equipment, thus not creating any goodwill. See below for the results and compare to the previous allocation:

Property, plant and equipment (balancing figure)	\$2000
Debt assumed	(200)
Future tax liability (based on asset gross up method)	<u>(700)</u>
Purchase price	<u>\$1100</u>

Based on this application of GAAP, property, plant and equipment is recorded at an amount greater than fair value which appears to conflict with the requirements of CICA Handbook Section 1581. Staff also notes that EIC 99 may suggest that goodwill not be recognized separately in the natural resources industries.

Staff's review of 2001 and 2002 financial statements indicates some entities recognized goodwill for oil and gas business acquisitions but the majority did not. It was not apparent if the acquirers that did not record goodwill on acquisitions could support an assigned value at least equal to fair value of the property, plant and equipment without regards to the tax base. It seems likely that if the underlying net assets of acquired businesses had few or no tax bases, then the values assigned to the property, plant and equipment would be greater than fair value. Pending guidance from the EIC, Staff will continue to monitor the application of Section 1581 and, in particular, the methods used to determine the fair values.

It should be noted that SEC Staff expects registrants to apply "Business Combinations" standard FAS #141 properly. Regardless of the industry in which the acquired business operates in, if the assigned fair values to the net assets acquired less the future tax component is less than the purchase price of the acquisition, a residual results and is labelled "goodwill." Cross-border filers should be aware of this SEC Staff position.

ROYALTY/INCOME TRUST FEES

If a Royalty or Income Trust has entered into an exclusive management agreement with a company, should fees payable to the management company that are specified in the agreement and that are based upon the purchase price of capital assets or businesses acquired by the trust be capitalized as part of the purchase price, or be expensed as period costs?

Royalty and/or Income Trusts usually run their operations by entering into exclusive agreements with management companies set up specifically to provide services that would otherwise have to be provided by the trust itself. The functions carried out by a management company include not only day to day operations but also finance, personnel, strategic planning, and asset and business acquisitions and dispositions. Usually the principals behind the management company are former managers of the trust's initial business. These management companies charge a base fee for their services and most charge additional fees based upon pre-defined performance goals or other criteria that are achieved or completed by the trust (e.g. if a trust's distributable cash is above a stated threshold for a period of time or if the trust purchases or sells capital assets or businesses). Fees paid to the management company are not necessarily related to time and quality of services provided since the trust is a captive client of the management company.

Accounting practice has developed whereby fees payable under these management agreements related to the acquisition of capital assets or businesses by a trust are capitalized as part of the purchase price. The rationale supporting this accounting treatment is the fee structure was negotiated at arm's length between the initial underwriters of the trust, the trust's board of directors, and the management company; and fees represent what would be paid to a third party if the third party was involved in acquiring capital assets or businesses. Staff accepts that there is some merit in this position, but believes that it may be too narrow and legalistic. Staff believes that this whole area needs to be further explored and more explicit direction provided. Staff's view on this issue follows.

Staff does not accept that all structured fees as established in a written management agreement, that may be considered by a trust as payable to an external party and directly attributable to an acquisition, should be capitalized. EIC Abstract 114 (formerly EIC 42) states that allocations of internal costs, including the costs of maintaining an acquisitions department, are not incremental costs and should be recognized as expenses when incurred. If management and/or other personnel are employed directly by the trust, then any internal compensation paid by the trust and identified as relating to an acquisition would not be capitalized. Because a trust may have agreed to obtain the equivalent personnel services from another entity, which may be viewed as legally external, is this sufficient justification for accounting purposes to say that these fees are external, would not otherwise be incurred, and should be capitalized as part of the cost of the purchase as required by GAAP?

In Staff's view, a trust is no different from any other profit making business. It operates to stay in business and needs competent management to strategically determine its direction including acquiring and disposing of assets and businesses. What is the justification for capitalizing fees if

an acquisition has been successful, yet the same services will have been provided for unsuccessful acquisitions? Can we distinguish between the services provided? Staff equates the additional fees payable under the management agreement and specifically related to an acquisition as akin to a bonus paid to internal personnel for successful accomplishments.

At this time, the CAG will monitor the current practice. We will question capital asset or business acquisition fees paid to a trust management company that appears excessive in relation to a corresponding market place fee for similar services and that is capitalized as part of the purchase price. This accounting issue may not be relevant for some trusts since there is a current trend among the larger trusts to buy back these management agreements and employ personnel directly. The following paragraphs discuss the accounting for buyouts of existing trust management contracts.

How should a management services agreement between a trust and the owners of a management company be accounted for when the trust buys out the contract or buys out the management company? Would the accounting be different if the employees of the management company are paid incentives to continue their employment with the trust?

Some trusts have recently entered into transactions to purchase their long-term management agreements or to buy out the management company in exchange for cash or trust units or a combination of both. The negotiated terms may require that a portion of the payment be placed in a time release escrow with no restrictions and/or part of the payment may be withheld if certain key employees of the former management company do not remain with the trust for a set time period.

Should the costs to buy out the agreement or the management company be expensed as a period cost if there is no requirement to provide any future service to the trust? If there is a time payout of the settlement amount with a requirement that future services be provided by the personnel of the former management company, should the settlement be considered deferred compensation and amortized in some rational manner?

Unless there is some unique circumstance surrounding the "internalization of management and operational services" in which services were previously provided by agreement between the trust and a management company, Staff takes the view that the cost of the buyout should be expensed in the period the transaction is consummated. However, Staff acknowledges that there could be some complexities involved in these transactions, including management agreements that may have several fee components. For example, a base fee, reimbursement of certain expenditures fees, performance fees, additional fees when capital assets and businesses are either acquired or disposed of and a net profits interest fee. In determining the proper accounting for

these buyouts or “management internalization transactions,” the trust should consider each component of the existing agreement. Until the EIC provides guidance, trusts should consult with their auditors on this issue.

OTHER GAAP MATTERS

The following items are noted to assist preparers in improving disclosures.

REVENUE RECOGNITION AND DISCLOSURE

Staff found that for many companies—other than those in the oil and gas exploration business—financial statements contained, at best, little or poor disclosure regarding accounting policies for revenue recognition. In some cases, Staff was unable to determine what type of business the company was involved in or the nature of its revenues. Since the financial statements must stand on their own, Staff strongly suggests that management review their current disclosure in this area and expand it when it appears deficient or weak. Auditors should be insisting on more detailed disclosure in this critical accounting area.

Preparers and auditors should review SEC Staff Accounting Bulletin # 101 for a better understanding of the complexity of revenue recognition and the requirement for financial statements to clearly explain how an entity recognizes revenue.

CONTINUITY OF INTERESTS ACCOUNTING USED BY ROYALTY/INCOME TRUSTS

Royalty/Income trusts have become attractive investment vehicles in recent years. The current trend is for a company to turn itself into a trust or spin off the majority of its operations to a trust. Accounting applied to this transition is inconsistent.

CICA Handbook Section 3840 holds the key in determining the proper accounting. Paragraph 3840.33 states that an enterprise may enter into an agreement to set up a wholly owned subsidiary and transfer assets to it in contemplation of the subsidiary issuing shares to unrelated parties either before or after the transfer. Such a transfer is measured at the carrying amount of the assets to the parent company since there is no substantive change in the ownership interests in the transferred assets at the time the transfer was arranged. In certain circumstances, Handbook Section 1625-Comprehensive Revaluation of Assets and Liabilities might be applicable.

If the shares of a company are exchanged for units of a newly created trust, there is no change in the interests of the owners. All that has happened is the original owners have an interest in essentially the same underlying assets and liabilities but through a different legal vehicle. The carrying values of the underlying assets and liabilities that were spun into the trust would be unchanged.

If a company spins off a division or subsidiary to a newly created trust and distributes these trust units to existing shareholders, then the original carrying values should be the basis for the net assets because no change in the beneficial ownership has occurred.

The above scenarios should be accounted for using the “continuity of interests” approach. This means the amounts assigned to the assets and liabilities are at their carrying values and the historical operating results are brought forward and shown by the trust as comparative information on the statements of income and cash flows.

In a more complex scenario, money is raised in a newly created trust which then purchases an interest in a division or subsidiary of another entity. The question arises as to whether the division or subsidiary’s net assets bought by the trust should be recorded at fair value or at carrying value. Staff has seen financial statements prepared both on the continuity of interests basis and on a purchase (fair value) basis. Each circumstance must be assessed individually.

If financial statement preparers and auditors are unsure of what financial statements are required for a newly created trust, please arrange for a consultation with a member of the Chief Accountant’s Group. We anticipate that the EIC may be looking at this whole area in the near future.

CEILING TEST CALCULATION FOR ENTITIES FOLLOWING FULL COST ACCOUNTING

With the introduction of the CICA Handbook Section 3465 on Income Taxes, the calculation of Part I of the ceiling test may provide exaggerated results which could impact comparability among entities. Consider an entity acquiring oil and gas assets that do not have a corresponding tax base. The entity will gross up the amount included in the cost centre to accommodate the creation of a future tax liability. The grossed up amount could be significant to the cost centre and could cause a required write down under Part I of the ceiling test because the net amount (carrying values of oil and gas assets less related future tax liabilities) of the cost centre is only considered in Part II of the ceiling test.

If a business is acquired and the oil and gas assets are considered not to have a tax base, then future taxes must be calculated on the fair value assigned to the assets acquired. The allocation of fair value to oil and gas assets acquired can be significantly higher than on a net of future tax basis. Because of the inclusion of these higher values in the cost centre, there may be a writedown under Part I of the ceiling test sooner than would have been required under prior applications of the test. Only when the net assets in the cost centre are compared to future net revenue less income taxes, will the ceiling test be comparable for all entities. A Task Force established by the CICA has looked at the Full Cost Accounting Guideline with respect to this issue, and we anticipate some guidance in the near future.

STOCK BASED COMPENSATION

CICA Handbook Section 3870 covering stock based compensation and other stock based payments is effective for public companies with fiscal years beginning on or after January 1, 2002. Staff's review was limited to the 2002 first and second quarter interim financial statements of entities because the majority of these companies have December year-ends. Two of the issues identified in our previous year's report on the Program continue to be issues for the 2002 review. These are:

- (1) Lack of description of the stock option plan(s), including the general terms of awards under the plan(s) such as vesting requirements, the maximum term of options granted, and the number of shares authorized for grants of options or other equity instruments
- (2) Instances where the highest exercise price of options in a range exceeded 150 per cent of the lowest exercise price in that range. This should have resulted in segregation of ranges of exercise prices with disclosure for each range consisting of: the number, weighted-average exercise price, weighted-average remaining contractual life of options outstanding, and the number and weighted-average exercise price of options currently exercisable.

The 2003 Program will examine these areas more critically, so Staff cautions financial statement preparers and auditors to pay close attention to the required accounting and related disclosure.

RELATED PARTY TRANSACTIONS

Once again, Staff found that the disclosure in this sensitive area could be improved. The deficiencies noted included:

- 1) no or insufficient disclosure of the terms of outstanding asset or liability amounts with related parties,
- 2) improper descriptions of the relationship with the related party involved in the transaction,
- 3) unclear descriptions of the nature of transactions,
- 4) no description of the measurement basis used including a lack of explanation of the carrying value and exchange amount.

The CAG requests that preparers and their auditors be extremely careful in the presentation of related party transactions information and to follow, as closely as possible, the standards set out in the CICA Handbook and related EIC Abstracts.

OTHER ACCOUNTING AND DISCLOSURE ITEMS TO CONSIDER

Although the following deficiencies occurred less frequently in the sample of financial statements that were reviewed, Staff believes that by bringing these to the attention of financial statement preparers and public accountants, ongoing financial reporting can only be improved.

Accounting Policy Notes:

- 1) cash and cash equivalents not defined
- 2) no measurement uncertainty note when there appears to be amounts where uncertainty exists
- 3) no product warranty described

Statement of Cash Flows:

- 1) classification of cash flows between investing and financing were incorrect
- 2) non-cash items or transactions included in statement

Segment Disclosure:

- 1) none provided for either current and/or comparative period
- 2) no disclosure of factors used to identify segments or types of products or services from which segments derive revenue

Interim Financial Statements:

- 1) no disclosure of changes in share capital from prior period
- 2) new requirements of CICA 1751 were ignored
- 3) reference to changes in accounting policies during period not made
- 4) inconsistent with annual financial statements presentation
- 5) significant changes from prior period not disclosed

Capital Leases:

- 1) no or partially provided disclosure

Shareholders' Equity:

- 1) no disclosure of shares reserved to meet option obligations

Income Taxes:

- 1) no details of what assets and liabilities for book and tax comprise the temporary differences
- 2) no disclosure of expiry dates of tax losses not recognized in statements

- 3) no note reconciling statutory tax rate to effective tax rate
- 4) statutory rate reduction not evident in disclosure—netted in “other”

Earnings Per Share:

- 1) denominator in calculation not disclosed
- 2) anti-dilutive securities not disclosed

Financial Instruments:

- 1) interest rate risk and credit risk not disclosed
- 2) classification between debt and equity instrument was improper

MANAGEMENT DISCUSSION AND ANALYSIS (“MD&A”)

Staff has not performed detailed reviews of MD &A. However, our general observation is that the MD&A, especially for smaller entities, is not informative and lacks discussion of major issues facing the entity and the environment it operates in. While the MD&A prepared by larger companies was better, some companies provided only superficial information, repeated numeric information readily available from reading the financial statements, and used vague expressions when unpleasant matters had to be discussed. In the next report on the findings of the Program, Staff will critically address major deficiencies in MD&A disclosure.

CURRENT RESULTS COMPARED TO PRIOR YEAR’S FINDINGS

- 1) Information contained in the Statement of Cash Flows has improved.
- 2) Disclosure about derivatives and derivative activity of companies has seen marked improvement. Disclosure of physical contracts entered into by resource entities has improved.
- 3) Disclosure of the reclamation and site restoration accruals and cash outlays has improved. EITF Abstract #2002-6 states that cash paid out in a period related to reclamation and/or site restoration should be considered an operating activity for purposes of the Cash Flow Statement. Staff anticipates this will become GAAP in Canada.

REFERENCE SOURCES FOR QUALITY FINANCIAL REPORTING

There are several excellent sources where preparers of financial statements can look to for examples of quality financial reporting. Annually, the *National Post* newspaper and *Oilweek* each sponsor a financial reporting awards event where professional accountants, financial analysts, and public relations personnel review a number of public companies’ financial statements and choose the best. Explanations for their choices are provided. Further, the CICA publishes annually “Financial Reporting in Canada”, a survey of the annual reports of 200 Canadian Public Companies. This text provides many examples of good financial statement disclosures. And finally, we must not overlook that there are very good financial reporting examples that can be found in reviewing the financial statements of U.S. headquartered companies. Companies that make up the Dow Jones Industrial Average composite are an example.

COMMUNICATION BETWEEN CAG AND MANAGEMENT OF ENTITIES

Staff appreciates the complexity of some issues raised by our review process and understands the time that is needed by issuers and their advisors to respond adequately to these comments. To date, Staff has enjoyed good cooperation from issuers in the conduct of the 2002 Program.

CONCLUSION

Staff has completed the first part of the financial statements reviews of 57 companies. It is evident that in certain areas improvement can be made and the CAG expects this to occur in the short-term. If preparers and their auditors are unsure of any accounting, auditing, or financial reporting matter, they should approach the CAG for assistance.

Accounting standards are complex and are being issued more frequently than in past years. Everyone involved in the preparation, audit, and release of information to the public must be current on requirements so that the public investor has confidence in this information. There is an expectation that professional accountants will maintain a high level of knowledge of accounting standards.

The quality of the financial statements reviewed is at an acceptable level. Given the current climate focusing on greater transparency the CAG anticipates that, as preparers and auditors become more familiar with new standards, the quality of financial statements should improve in the future. The CAG encourages all issuers and auditors to continue to strive to achieve high-quality financial reporting.

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