

CONTINUOUS DISCLOSURE REVIEW PROGRAM

# 2003 REPORT

*December 2003*

## TABLE OF CONTENTS

i	Overview	6	GAAP and GAAP Interpretations
i	Observations	7	Reference Sources For Quality Financial Reporting
	Disclosure Quality Differences	7	Management's Discussion and Analysis
	Financial Statements	9	MD&A Results – Current vs. Prior Year
	MD&A	9	NI 51-102 Continuous Disclosure Obligations
	Initial AIFs	11	Non-GAAP Financial Measures
	Material Change Reports	11	Other Continuous Disclosure
1	Introduction		Annual Information Forms
1	The Process		Material Change Reports
	Sample Characteristics		Gratuitous Public Information
	Quantitative Analysis of Comments	13	Topical Areas
2	Accounting and Disclosure Deficiencies		Income Trusts
	Revenue Recognition		Disclosure of Oil and Gas Reserves Information
	Related Party Transactions	14	Conclusions
	Income Tax		Accounting
	Statement of Cash Flows		Management's Discussion & Analysis
	Interim Financial Statements		Other Continuous Disclosure
	Stock Based Compensation		Gratuitous Information
	Accounting Policies	15	Consequences
	Financial Instruments	15	Feedback on the Reviews
5	2002 discussions – an update	16	Secondment to Chief Accountant's Office
	Flow Through Shares	16	Contacting ASC Personnel
	Business or Asset Acquisition		
	Royalty Trust Acquired – any future tax liability?		

This is the thirteenth year that the Alberta Securities Commission has conducted its review of the quality of continuous disclosure of Alberta reporting companies.

For this report, the ASC reviewed filings received during 2003 from a sample of 88 companies of various sizes headquartered in Alberta.

## OVERVIEW

Each year, we see an improvement in the quality of disclosure by Alberta reporting companies<sup>1</sup> and, overall, we are satisfied that companies are adhering to acceptable levels of reporting. Our follow-up of companies reviewed in prior years indicates a high level of adoption of our suggestions for improvement. We also receive feedback that indicates many advisors and companies use our report as a resource in preparing and improving their financial disclosure materials.

Although the majority of reviews indicate satisfactory compliance, we do see a number of recurring continuous disclosure deficiencies, particularly in financial statement presentation. The requirements of the CICA Handbook are clear and unambiguous for most, if not all, of the areas noted and compliance is not an onerous obligation for companies. We will continue to pay close attention to these areas in 2004 and request re-filings of materials where companies have made incomplete or incorrect disclosures.

Companies that do not meet the reporting requirements will be identified as ‘defaulting issuers’ and placed on a defaulting issuers list on the ASC website starting in the Spring of 2004. Enforcement action against the company, its officers and directors will be considered in cases of more serious breaches of reporting requirements.

We continue to encourage all companies to strive for the highest level of transparency and quality in disclosure documents to foster investor confidence in Alberta’s capital markets.

## OBSERVATIONS

Overall, we noted a difference in the quality of filings between large and small companies, as well as specific concerns with disclosure documents as described below.

### *Disclosure Quality Differences*

Generally, the information provided by large organizations met the requirements mandated by existing accounting standards and, with respect to MD&A and AIF filings, was very informative and transparent.

The information provided by small companies was often missing disclosure, especially for interim financial statements and MD&A, and, in a limited number of filings, the information was poorly prepared. When small companies did prepare MD&A, it was usually very brief, focussed mainly on past performance and appeared not to be as useful to an investor as it could have been. There was little or no commentary about future plans and expectations.

The majority of mid-size companies prepared more balanced MD&A discussing past performance with commentary about developing trends and expectations for future operations.

<sup>1</sup> For purposes of this report, the term “companies” refers to all reporting issuers including income trusts, limited partnerships and corporations.

### ***Financial Statements***

Many of the same deficiencies were identified this year as in the past years' reviews. The five most recurring areas of concern are:

**Revenue Recognition** Many small companies were vague about their accounting policy for revenue recognition. We found accounting policies without adequate explanation of how revenue was generated and at what point in the transaction cycle it was recognized. In a few situations, we could not tell what industry the company operated in because of insufficient disclosure about revenue.

**Related Party Transactions** We found that most companies disclosed in their financial statements that a related party transaction had occurred but some did not provide the information required by GAAP. Disclosure is deficient for financial statements even when such details are in the MD&A or another filed document, such as an annual report, since financial statements must stand on their own.

**Income Taxes** Three deficiencies were noted:

- ▶ no disclosure of items that comprised temporary differences;
- ▶ no disclosure of adjustments between the statutory tax rate and the effective tax rate used to calculate a company's tax provision; and
- ▶ a few companies disclosed all their tax loss expiry dates, even though some of the losses had been recognized as future tax assets. Such disclosure is only required for those losses not recognized as future tax assets.

**Statement of Cash Flows** We noted a number of instances where cash flows were not properly classified between operating, investing and financing activities, as well as the improper inclusion of non-cash items or transactions in the statement.

**Interim Financial Statements** We continued to observe a number of companies that did not meet the minimum standards of disclosure for interim financial statements as set out in the CICA HB Section 1751. In particular, we noted deficient disclosure regarding changes in capital, accounting policy changes and changes in financial statement presentation.

### ***Management's Discussion and Analysis***

Overall, we believe that companies can improve MD&A. While some companies provide an excellent analysis and discussion on certain required disclosures, they provide minimal information in other areas. A few mid-size companies prepared excellent MD&A, probably because the nature of their businesses is not as complex as large companies. Small companies are usually very brief in their discussions and require more thorough analysis.

We identified five areas in MD&A that, if addressed immediately by all companies, will provide the greatest improvement in the quality of MD&A.

**Volatility of revenue and expenses** Some companies had large swings in revenue and expense categories between current and prior reporting periods, but there was no explanation in the MD&A for these swings.

**Working capital** We found little or no discussion about working capital needs and companies' plans to finance future requirements. This is especially important disclosure for companies that have cyclical businesses and that require significant working capital during periods where operations cannot generate sufficient cash flows.

**Effects of adopting a new accounting policy** Many companies' MD&A lacked discussion of new accounting standards that were issued but not adopted by the company at the time of preparing the MD&A. This disclosure should comment on the impact of the standard on a company's operations and, if available, estimates of the accounting effect on the financial statements.

**Balancing discussion between past performance and forward looking analysis** A common weakness of all companies is a tendency to place more emphasis on past performance with little or no discussion of the future implications based on past results. Companies need to supplement this discussion with information about conditions, trends, events and risks or uncertainties that will likely impact future prospects.

**Location of information** MD&A must be comprehensive and must provide the required information as specified in securities legislation. A few companies provided portions of MD&A in documents other than the MD&A and did not specifically incorporate the other documents, or the relevant parts thereof, by reference.

### ***Initial Annual Information Forms***

We often observed limited discussions in three areas:

- ▶ “General Development of the Business” including a discussion on history of the business, significant acquisitions and dispositions, and trends,
- ▶ the description of the business, and
- ▶ MD&A.

### ***Material Change Reports***

Our review of MCRs suggests that large companies provided more concise and fact-based MCRs. Small companies tended to convey a more promotional tone in the MCR text.

Some small companies issued press releases that we believe disclosed a material change but the company did not provide a MCR. These companies should have filed MCRs to ensure the public record was complete and to comply with securities laws. In addition, some of the information or events announced in press releases that did not happen were not followed up by a subsequent public announcement indicating the change from the original press release.

## INTRODUCTION

This is the thirteenth year that the Alberta Securities Commission has conducted its review of the quality of continuous disclosure of Alberta reporting companies. The purpose of this review program is to:

- ▶ identify continuous disclosure deficiencies that need to be addressed and ensure satisfactory action is taken;
- ▶ gauge the overall quality of disclosure among Alberta companies; and,
- ▶ provide guidance to companies to continue to improve the overall calibre of disclosure in Alberta.

For this report, the ASC reviewed filings received during 2003 from a sample of 88 Alberta companies out of a total of 775 companies headquartered in Alberta

New to the process this year was a quality assessment by our engineering and geology staff of oil and gas reserve and evaluation reports filed by some of the sample companies.

## THE PROCESS

Our findings were based upon the review of financial statements, MD&A, MCRs, AIFs, prospectus and takeover bid documents, information circulars, press releases, websites and other public disclosure documents filed by the sample companies.

Chartered accountants carried out all reviews with the assistance of our engineering, geology and legal professionals. Each review followed a rigorous process including a comprehensive initial review of all filings, a supervisory review, extensive research on novel issues, discussion among ASC professionals on unusual and complex matters and, finally, a written communication sent to companies outlining possible deficiencies and other concerns.

### *Sample characteristics*

Of the 88 Alberta companies sampled:

- ▶ 45 had shares listed on the Toronto Stock Exchange;
- ▶ 39 had shares listed on the TSX Venture Exchange;
- ▶ 4 had no listing on any exchange.

We reviewed all public documents filed by these companies, but focussed our attention on their annual and interim financial statements, annual and interim management discussion and analysis (MD&A), annual information forms (AIF) and material change reports (MCR).

### *Quantitative analysis of comments*

- ▶ Approximately 250 questions seeking additional information were raised in letters sent to the companies.
- ▶ Over 1,700 specific comments were raised in the letters that related to accounting standards, particular transactions or possible disclosure deficiencies.
- ▶ Five documents had to be refiled (one set of annual financial statements, two sets of interim financial statements, one auditors' report and one material change report).

- ▶ The Commission received written acknowledgements that about 800 of the specific comments raised will be reviewed in detail by the respective companies and considered for adoption in their next filings. Another 900 specific and general comments were resolved to the ASC's satisfaction. We intend to follow up with those companies that indicated they would consider changes to their future filings.

## **ACCOUNTING AND DISCLOSURE DEFICIENCIES**

The information provided by financial statements is extremely important to investors in making investment decisions and assessing management stewardship. Our reviews were conducted from the perspective that financial statements must stand on their own and comply with GAAP.

The most common deficiencies found in the financial statements of the sample companies are highlighted below. Please refer to the appropriate section of the Canadian Institute of Chartered Accountants (CICA) Handbook (HB) for the complete requirements in each area. Many of these issues are not new in 2003, and have been discussed in our prior reports.

### ***Revenue Recognition***

"Revenue Recognition – measurement and disclosure" should be more descriptive in the financial statements, especially for small companies. Disclosure by oil and gas exploration companies was generally adequate. For other companies, we found situations where the accounting policies did not provide adequate explanation of how revenue was generated and at what point in the transaction cycle revenue was recognized. In other cases, we could not determine the nature of a company's business or industry due to insufficient revenue disclosure. CICA's Emerging Issues Committee (EIC) will issue two abstracts in 2004 that provide further guidance on revenue recognition. We believe that proper application of these abstracts will minimize identified problems, and we will monitor the application of these abstracts to determine whether they contribute to enhanced disclosure and reporting of revenue.

### ***Related Party Transactions***

Companies must provide complete and transparent information about their operations, especially when a related party transaction has taken place. Companies with transactions that are subject to CICA Handbook Section 3840, Related Party Transactions, must comply fully with the entire requirements of this HB section.

Some companies provide detailed information on related party transactions in their MD&A. This is acceptable and we believe that it enhances the quality of financial reporting, as long as the information supplements the disclosure required by GAAP in the financial statements.

We observed three major deficiencies in the area of related party transactions:

- ▶ relationship between the company and the other party was not described;
- ▶ description of the transaction was brief and vague; and
- ▶ terms of payment or the terms of the negotiated consideration agreed to between the parties was not fully disclosed.

To illustrate our concern, the following is an example of deficient related party disclosure:

“During the current year, the corporation purchased equipment from a related party for \$500,000. Included in accounts payable at year end is an amount of \$250,000 still owing on this equipment.”

This note does not provide sufficient information about the transaction and would result in several questions:

- ▶ What is the relationship of the “related party” to the company – an officer, director, major shareholder or some other relationship?
- ▶ What is the measurement basis for the transaction – is it carrying value, an agreed upon exchange amount or fair value?
- ▶ What are the terms of payment and how does this relate to any balance owing – interest rate, pledge of the equipment against the outstanding balance, any contingencies or other terms?

An investor may also have questions about this type of transaction:

- ▶ Why was the equipment purchased from a related party and not from an arm’s length party?
- ▶ What is the fair value for this equipment or why can’t fair value be determined?
- ▶ Is the equipment new or used and will it be used in the operations of the corporation?
- ▶ Who negotiated the terms of the purchase price for the parties involved?

The additional information, beyond that mandated by GAAP, could be provided in the financial statements but most companies would consider it more appropriate to discuss it in the MD&A.

The perennial problem of deficient related party transactions disclosure is that it contravenes the concept of transparency in reporting. Disclosure of these transactions should not only adhere to accounting standards for recognition and disclosure, but should also provide investors with any other information needed to understand the circumstances surrounding the transaction.

### ***Income Tax***

The measurement and disclosure of income tax provisions and future income tax assets and liabilities is a challenging area for those preparing financial statements and for public accountants. There has been an improvement in this information since the introduction of the HB Section on Income Taxes in January 2000, but three deficiencies continue:

- ▶ no disclosure of the nature and tax effect of the temporary differences, unused tax losses and tax reductions that give rise to future tax assets and liabilities;
- ▶ no reconciliation of the items that created a difference between the expected tax provision based on the statutory tax rate and the actual tax provision based on the effective tax rate; and
- ▶ disclosure of expiry dates for tax losses not recognized as future tax assets not provided, or expiry dates provided for all tax losses even though some of the losses had been recognized as future tax assets.

Some companies that have implemented a tax strategy that may be subject to interpretation or whose operations are complex have disclosed an uncertainty regarding taxes in the notes to the financial statements. The note also might state that management is satisfied with the adequacy of the income tax provision. Commission staff encourages such disclosures.

### ***Statement of Cash Flows***

The Statement of Cash Flows was not prepared in accordance with GAAP by several small companies. Two areas that require improvement are:

- ▶ cash flows must be properly classified between operating, investing and financing activities; and
- ▶ non-cash items or transactions should be excluded from the statement.

Investors are increasingly focused on cash flows. As a result, companies should review their process for preparing cash flow statements and ensure that they meet the required accounting standards for both measurement and disclosure.

### ***Interim Financial Statements***

We continue to find a number of deficiencies with interim financial statements. The most frequent can be attributed to filings made by small companies and include:

- ▶ no disclosure of changes in share capital, if material, from the prior financial statement period;
- ▶ no reference to changes in accounting policies during the period, and the effect of such changes on the current and prior periods;
- ▶ presentation of the interim period financial statements was inconsistent with the annual financial statements presentation, and no explanation of why the presentation format had changed; and
- ▶ significant changes to comparative financial statements but no explanation for the changes.

NI 62-102 currently requires that for each interim period, a company must describe details of its equity. This information may be filed as part of the notes to the interim financial statements, as part of MD&A or filed as a stand-alone document. Commencing with financial year ends beginning on or after January 1, 2004, the details of a company's equity for each interim and annual period must be discussed in the MD&A. The information must be as of the latest practicable date after the relevant period-end. For details of this additional MD&A requirement, see section 5.4 of the recently implemented rule, NI 51-102.

### ***Stock Based Compensation***

Disclosure on stock based compensation plans has improved compared to last year, but some companies still do not provide a complete description of the stock option plan. This includes the general terms of awards under the plan, such as vesting requirements, the maximum term of options granted, and the number of shares authorized for grants of options or other equity instruments.

We observed some situations where the information on a stock based compensation plan could be found in a company's other continuous disclosure documents. However, GAAP requires that the information about the plan be disclosed in the financial statements.

### *Accounting Policies*

Several small companies did not disclose accounting policies with respect to:

- ▶ composition of cash and cash equivalents as shown on the Statement of Cash Flows;
- ▶ measurement uncertainty where there appeared to be amounts in the financial statements subject to uncertainty; and
- ▶ product warranty accounting.

### *Financial Instruments*

Some companies did not address either interest rate risk or credit risk in the notes to the financial statements. In several responses to inquiries by Commission staff, companies took the position that a “boiler plate note” on measurement uncertainty should cover the concerns about interest rate and credit risks. It is our position that such a “boiler plate note” does not cover interest rate risk or credit risk adequately. We believe that when particular risks are material to a company, they should be discussed separately and completely.

## **2002 DISCUSSIONS – AN UPDATE**

### *Flow Through Shares*

In our last report, we observed that the future income tax liability for accounting purposes related to the issue of flow through shares was recorded by companies either at the time the company renounced an amount of expenditures, equivalent to the amount raised under the flow through share offering, or at the time the expenditures were actually incurred. Other companies recorded the tax liability when the flow through shares were issued.

The EIC is reviewing this issue. Until a consensus is reached and guidance is provided by the EIC, we recommend that the notes to the financial statements adequately disclose the accounting method followed by the company.

### *Business or Asset Acquisition*

In our last report, we considered the following questions:

- ▶ Is the acquisition of an oil and gas exploration, development and producing entity an acquisition of a business, as contemplated by HB Section 1581 Business Combinations and EIC Abstract #124, Definition of a Business?
- ▶ If a producing property is purchased directly, is this the acquisition of an asset or a business?

During our review, we found all transactions of this nature treated as business acquisitions.

We noted one situation involving a company in the energy service industry where the company considered the transaction(s) to represent the acquisition of a group of assets rather than a business and accounted for the transaction as the acquisition of assets. The transaction was structured such that the capital assets in the target entity were acquired first and then the shares were acquired.

We indicated to the company that, in our view, a business had been acquired, albeit in two steps. In this particular situation, there was no requirement to change the accounting. The purchase price was

allocated to identifiable assets and liabilities and with the two-step approach, the tax values for the capital assets equalled the assigned fair values, thereby not requiring any goodwill to be set up.

One of the key criteria in assessing whether an acquisition is that of a business or an asset is whether the revenue stream is the same before and after the transaction, e.g. a producing oil well's cash flow.

If companies encounter a situation where there is some difficulty in determining whether a business or an asset has been acquired, ASC staff can assist companies in this matter.

#### ***Royalty Trust Acquired – any future tax liability?***

We pointed out in last year's review that under HB Section 1581, Business Combinations, the purchase price in acquiring a royalty trust might be allocated to the underlying net assets that produced the revenue stream. If, as a result of this allocation, there existed temporary differences between the assigned fair values and the tax bases, then a future tax liability should be established. This was based on the assumptions that the revenue producing assets were held in an operating company that was subject to tax and the value of the purchase lay in the underlying net assets since the royalty interest held in the acquired royalty trust is considered a pass through security.

The issue has been discussed by the Financial Advisory Committee (FAC) of the ASC who are of the view that the royalty trust vehicle is established to pay out to the royalty trust unitholders all non-essential cash produced from assets owned by an operating company. They believe the value of what was acquired rests in the royalty interest held directly by the royalty trust and the royalty interest should be considered an asset. Since all the cash flows received from ownership of the royalty interest are paid to trust unitholders, there is no expected future tax liability that will occur in either the acquired royalty trust or in the operating company; therefore, for accounting purposes, no future income tax should be created at the date of the acquisition based on temporary differences.

Royalty trusts are structured to pass the taxable income through to the owners of the trust who will pay taxes based on their own circumstances. Although the operating companies usually borrow some money from third parties to maximize the cash payout, and the principal of these loans must be repaid from after-tax dollars, the likelihood of the operating company incurring a sufficiently large tax obligation to warrant the establishment of a future tax liability is remote.

Given the complexity of such transactions, companies and their advisers should carefully review the structure to minimize the risk of unintended tax consequences and ensure that the accounting properly reflects the legal structure adopted.

## **GAAP AND GAAP INTERPRETATIONS**

There were a few situations that involved the proper interpretation of GAAP. The introduction of "Generally Accepted Accounting Principles", HB Section 1100 on October 1, 2003 clarifies the relative authority of various accounting pronouncements and other sources of guidance. We will be looking at accounting practices that have developed in certain industries that are not supported by this new section. In addition, we will be monitoring two areas for consistency in application of GAAP:

**Parts Inventory** Equipment parts that are used in the construction or development of capital assets are being categorized by some companies as inventory and shown in current assets. Since this “parts inventory” will not be realized in the normal sales cycle of the company, the proper treatment is to show the equipment parts as a capital asset, as per HB Section 3061.04.

**Government Assistance** Some government assistance programs attach conditions that require repayment of the assistance by the company if certain criteria are not achieved. The application of accounting for these types of assistance has not been consistent between companies even though in certain situations the criteria appears to be similar for companies in the same industry.

In some cases, the company accounts for the assistance by establishing a liability for the complete amount at the time of receipt explaining in the notes to the financial statements why a liability exists. In other cases, the company reduces the related expenditure, whether capital or expense, and indicates in the notes to its statements that it believes that it will achieve the criteria and does not anticipate repaying the assistance.

The accounting treatment of any government assistance must be in accordance with HB Section 3800. Therefore, as circumstances change with respect to the assistance, the effect on the financial statements for the reporting period in which a change may have occurred, must be re-evaluated, and if necessary, the appropriate accounting reflected in the statements.

## **REFERENCE SOURCES FOR QUALITY FINANCIAL REPORTING**

There are several excellent sources to reference when preparing financial statement that provide examples of quality financial reporting.

*Oilweek Magazine* sponsors 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. The CICA organizes a Corporate Reporting Awards event where representatives from the Toronto Society of Financial Analysts, the Canadian Institute of Investor Relations, the Social Investment Organization, the International Institute for Sustainable Development and the Institute of Corporate Directors, and several chartered accountants, select those public companies whose financial reporting they consider the best. The CICA also publishes annually “Financial Reporting in Canada,” a survey of the annual reports of 200 Canadian public companies. This publication provides many examples of good financial statement disclosures.

## **MANAGEMENT’S DISCUSSION AND ANALYSIS**

MD&A is an important supplement to information provided by annual and interim financial statements. MD&A is a narrative explanation, through the eyes of management, of how a company performed during the period covered by the financial statements, and of its financial condition and future prospects. The onus is on management to provide the insight about the company to which investors do not otherwise have access. Good news as well as bad news must be discussed.

Following are our observations about MD&A:

- ▶ No discussion in the MD&A regarding:
  - large swings in revenue and expenses, especially between interim periods
  - major components of working capital and expectations regarding future working capital requirements
  - possible sources of future capital, including whether internally generated cash flows will meet future capital requirements
  - reasons for selecting one accounting policy over another or the effects on the entity if a new accounting standard were to be adopted
- ▶ Limited discussion in the MD&A regarding:
  - details of related party transactions, both qualitative and quantitative, which would supplement financial statement disclosure
  - interim periods operations and future trends
  - risks associated with financial instruments
  - total amount of working capital and expectations for the future
  - environmental or regulatory changes affecting the entity
- ▶ Information expected to be discussed in the MD&A found in other documents, such as the AIF or annual report
- ▶ Analysis focussed more on past performance rather than balanced between past and forward looking analysis
- ▶ Complex financial instruments not explained in a manner that an investor would easily understand; simple examples and diagrams could assist investors
- ▶ Terminology, specific to certain industries, not defined or adequately explained
- ▶ Use of broad, generic and non-specific statements that did not provide the reader with insight into how the entity operates and the directors' and management's plans for it

Useful guidance for preparing MD&A includes the following:

- ▶ In Canada, the CICA has issued "Management's Discussion and Analysis – Guidance on preparation and disclosure". Interpretative Releases supplement this guidance. Additional guidance is provided in NI 51-102F1, OSC Staff Notice 51-501, CSA NI 44-101F2, and BCSC Staff Notice 51-901.
- ▶ The SEC published interpretive guidance regarding Management's Discussion and Analysis of Financial Condition and Results of Operations on December 19, 2003. The guidance is intended to generate more meaningful disclosure in MD&A and can be found at [www.sec.gov/rules/interp/33-8350.htm](http://www.sec.gov/rules/interp/33-8350.htm)

- ▶ Copies of two surveys that Financial Executives International Foundation sponsored in May and June 2002 provide good examples of how MD&A can be improved. These can be viewed, for a small contribution to the Foundation, at [www.fei.org](http://www.fei.org).

## **MD&A RESULTS – CURRENT VS. PRIOR YEAR**

A comparison of the results of MD&A reviewed this year to last year's observations did not indicate any noticeable improvement in content or quality. We anticipate this will change in the near future since MD&A is being used more and more by investors who demand timely, quality and relevant information to assist in their investment decisions. If investors' expectations are not met, it is conceivable that their attention will focus more on those companies that provide the better information.

## **NI 51 – 102 CONTINUOUS DISCLOSURE OBLIGATIONS**

The Canadian Securities Administrators recently adopted NI 51-102 Continuous Disclosure Obligations and Companion Policy 51-102CP in late 2003. The instrument sets out the harmonized continuous disclosure requirements for reporting issuers in Canada. The Companion Policy provides staff's interpretations on certain aspects of the rule to assist in its consistent application. Details are found in the required forms that are highlighted below:

- ▶ Form 51-102F1 Management's Discussion & Analysis
- ▶ Form 51-102F2 Annual Information Form
- ▶ Form 51-102F3 Material Change Report
- ▶ Form 51-102F4 Business Acquisition Report
- ▶ Form 51-102F5 Information Circular
- ▶ Form 51-102F6 Statement of Executive Compensation

The new continuous disclosure requirements include disclosures that have not previously been required by the ASC, modifications to existing requirements and changes in various deadlines depending on the categorization of a company. The categorization of a company as a venture issuer will dictate which requirements are applicable and which filing deadlines apply.

The definition of *venture issuer* is: “a reporting issuer that, as at the applicable time, did not have any of its securities listed or quoted on any of the Toronto Stock Exchange, an exchange registered as a “national securities exchange” under section 6 of the 1934 Act, the NASDAQ Stock Market or a marketplace outside of Canada and the United States of America.”

The filing deadlines for financial statements are:

- ▶ Annual – The deadlines for filing annual financial statements will be reduced under the new requirements. For non-venture issuers the deadline is 90 days after the year end, and for venture issuers the deadline is 120 days after the year end. Companies must file annual MD&A at the same time as annual financial statements.

- ▶ **Interim** – The deadlines for filing interim financial statements will be reduced under the new requirements for non-venture issuers to 45 days from the period end. The deadline remains the same for venture issuers at the current 60 days. At the same time as the interim financial statements are filed, companies must also file interim MD&A.

The implementation of NI 51-102 will require all companies to file interim financial statements and interim MD&A commencing with companies whose financial years begin on or after January 1, 2004. Annual MD&A is to be prepared in accordance with Form NI 51-102F1 and interim MD&A is an update of the annual.

If companies are filing MD&A for the first time under these new requirements and the MD&A is for an interim period, they will have to provide the full MD&A disclosure as if it were for an annual period. MD&A for subsequent interim periods will then be an update of the first period's MD&A. If companies early adopt, the MD&A requirement can be satisfied by preparing an MD&A on the annual financial statements for a fiscal year ended prior to January 1, 2004.

**Annual Information Form (AIF)** Only non-venture companies are required to file AIFs under NI 51-102. The form of AIF differs somewhat from the AIF previously in effect in the short form prospectus regime. Certain items were moved from the AIF to MD&A.

Items that were not 'offering specific' were moved into the AIF from the short form prospectus. It is anticipated that there will be consequential amendments to the short form prospectus instrument to enable companies to file their AIFs under the continuous disclosure requirements and have it considered for eligibility for the short form system to avoid having to file duplicate AIFs.

**Business Acquisitions Reports (BAR)** A new requirement that is applicable to all companies is the requirement to file a BAR prepared in accordance with NI 51-102F4 for all significant acquisitions as defined in NI 51-102. The BAR is required within 75 days of the accounting acquisition date and must include up to two years of audited financial statements for the acquired business.

The BAR requirements will be applicable to significant acquisitions if the agreement was entered into on or after March 30, 2004. The concept of providing financial statements for significant acquisitions has been in place in connection with prospectus distributions for several years. This requirement is similar to that of the SEC for significant business acquisitions.

**Material Change Report** The requirements for material change reports remain essentially unchanged.

**Information Circular** The proxy solicitation and information circular requirements are substantially similar to existing requirements. The requirements for prospectus-type disclosure have been extended to a broader class of transactions and a broader group of entities involved in the transaction.

**Statement of Executive Compensation** The Statement of Executive Compensation is based on the OSC Form 40. The changes are not substantial and were made to clarify the requirements and to use plain language.

## NON-GAAP FINANCIAL MEASURES

CSA Staff Notice 52-306 was issued November 14, 2003 and provides guidance on the use of non-GAAP financial measures. This notice supersedes CSA Staff Notice 52-303, non-GAAP earnings measures. See ASC website for notice.

## OTHER CONTINUOUS DISCLOSURE

### *Annual Information Forms*

The AIF is intended to provide background information that is essential to a proper understanding of the nature of an issuer and its operations and prospects. The focus should be on external factors that affect the company specifically. We have identified three areas that require more complete disclosure by management when preparing the AIF:

- ▶ Item 3 in the Form requires information on the general development of the business, including a discussion covering a three-year history of the company, any significant acquisitions and dispositions of businesses in that period, and a discussion of trends.
- ▶ Item 4 in the Form requires a narrative description of the business, including details of reserves and land positions if the business is in the resource industry.
- ▶ Item 6 in the Form requires an MD&A.

We review all initial AIFs to ensure they are completed properly before they are accepted, after which the issuer may offer securities using a short form prospectus under the POP system.

### *Material Change Reports*

One of the most important documents that must be filed as part of a company's continuous disclosure record is an MCR. Section 146 of the Act states:

- “where a material change occurs in the affairs of a reporting issuer, the reporting issuer shall, subject to the regulations,
- (a) “promptly issue and file with the Executive Director a news release authorized by a senior officer disclosing the nature and substance of the material change, and”
  - (b) “prepare and file with the Executive Director a report of the material change within 10 days from the day on which the change occurs.”

A “material change” is defined in the Act as:

“when used in relation to the affairs of an issuer, means a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement the change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the board of directors is probable.”

MCRs must be filed on SEDAR to be considered to have been filed with the ASC.

We observed a pattern with both the frequency of MCR filings and the relative quality of the information. It appears that the size of the company correlates to the treatment given to information in the MCR. The following table outlines our general observations on MCR filings:

	LARGE COMPANIES	MID-SIZE COMPANIES	SMALL COMPANIES
<i>Frequency of MCR filings</i>	very infrequent	moderate	very infrequent
<i>Tone of Message</i>	concise and adequate	reasonable detail, some promotional	promotional
<i>Frequency of Press Releases (excluding an MCR filing)</i>	moderate to few	moderate	very frequent

The quality of both press releases and MCRs filed by large and mid-size companies appears to be good. With respect to small companies, the use of a press release to make promotional statements should be avoided when the information in the press release constitutes disclosure of a material change. Filing of a MCR would also be required. Management of small companies must pay close attention to information being issued to the public and ensure they are complying with the Securities Act.

#### ***Gratuitous Public Information***

Companies often have a great deal of information in the public domain, which is not required to be filed with the ASC. As such, there is no standard to which we can refer when assessing the content and quality of this gratuitous information except that the information should not be misleading. Examples are press releases that are not related to a material change, speeches or presentations made by management of companies including any printed or electronic information handed out at these functions or meetings, annual reports, business plans, special reports e.g. valuation report on a company and most common, articles in newspapers and on various websites.

Staff has not specifically reviewed the above noted sources (we may target information from these sources in the future) but does cross check the accuracy of the information to that which has been filed by a company pursuant to requirements of the Act.

Overall, Staff found that the larger the company, the greater the consistency of this information with the information contained in documents that are required to be filed under the Act. Information on large companies' websites was very current while the websites of small companies was often stale.

Large companies provided good information in their annual reports while some small companies had no annual report or provided little information. However, small companies used press releases quite frequently to promote what they were doing (refer to comments previously made on material change reports).

## TOPICAL AREAS

### *Income Trusts*

In the past two years, there have been a number of new income trust offerings and reorganizations of corporate entities into income trusts. On October 24, 2003, the CSA published proposed National Policy 41-201 Income Trusts and Other Direct Offerings (the policy) for comment. This can be found on the ASC website under “Securities Law and Policy, Regulatory Instruments.”

The policy is expected to be adopted in all jurisdictions in Canada in early 2004. Many of the principles set out in it are already in practice and reflect ASC’s comments raised during past prospectus filings and our continuous disclosure reviews.

The policy provides guidance on disclosures in offering documents. In particular, CSA members expect “the offering generally to be described in a simple, clear, and readable manner to ensure that investors understand the nature of their investment.” In addition, the policy also summarizes the CSA’s view of how the existing regulatory framework applies to non-corporate issues (such as income trusts) and other indirect offerings, in order to minimize inconsistent interpretations and better ensure that the intent of regulatory requirements is preserved. Although the policy singles out prospectus disclosures, the principles may also be applicable to other offering documents (such as information circulars) and an income trust’s ongoing continuous disclosure record.

The policy also outlines our expectations about providing sufficient information to enable an investor to understand the business of the underlying operating company. This includes the applicability of insider reporting requirements in circumstances where the income trust does not control the operating entity (i.e. less than 50% ownership). Other principles outlined in the policy include, but are not limited to, suggestions for clearer disclosures about distributable cash, non-GAAP measures, refinancing risks, prospectus liability, returns of capital versus returns on capital, comparative financial information (where the transfer of the operating entity’s business into the income trust is accounted for at carrying amounts) and other pertinent information to allow the investor to better understand the unique attributes specific to income trust units.

### *Disclosure of Oil and Gas Reserves Information*

National Instrument 51-101 Standards of Disclosure for Oil and Gas Activities was recently introduced by the CSA. It is effective for filings that include audited financial statements for a financial year that includes or ends on December 31, 2003. Essentially this rule requires companies in the oil and gas business to provide information on reserves and undiscounted and discounted cash flows in a format as set out in the rule. The rule contains definitions of reserves and outlines the additional information on reserves and cash flows and land positions that a reporting issuer must provide. The information must be provided annually.

Each company subject to this national instrument is required to file annually a report prepared by independent qualified reserves evaluator(s) or auditor(s) on the company’s reserves as at the last day of the company’s most recently completed financial year. The report can only be prepared by a non-independent reserves evaluator(s) or auditor(s) if the ASC or another CSA member has granted an exemption.

## CONCLUSIONS

### *Accounting*

We have completed a review of 88 companies' financial statements. The results indicate that the financial statements in this sample group generally adhered to existing standards of financial reporting and GAAP. Overall, the respective statements of financial position, operations and cash flows provided required information at an acceptable level of quality that appears to have met the expectations of the general investing public.

Nevertheless, we encourage companies to strive for enhanced quality disclosure in financial statements and to adopt an attitude of complete transparency in all financial reporting activities. We are concerned with the number and nature of recurring deficiencies, particularly in financial statement presentation. The requirements of the CICA Handbook are clear and unambiguous for most, if not all, of the areas noted and compliance is not an onerous obligation for companies. We will focus closely on these areas in 2004 reviews and request refilings of materials where companies have made incomplete or incorrect disclosures.

We are willing to consult with public accountants and others who prepare financial documents on accounting, auditing or financial reporting matters, provided the matter is not already being dealt with by the ASC or another regulator and is not part of a court proceeding. We expect that the matter will have been researched prior to contacting our staff.

Staff and the investing public expect that professional accountants will maintain a superior knowledge of accounting standards, notwithstanding the fact there are a number of new standards recently implemented and more planned for the future.

For the benefit of investors, we encourage companies to provide disclosure in plain language.

### *Management's Discussion & Analysis*

MD&A prepared by reporting issuers is attracting more critical attention from analysts, securities regulators and investors today than ever before. These groups are demanding more informative and useful information about identifiable future trends and they expect a complete and honest discussion about stated goals that the company believes are achievable. The focus should be balanced between what has been achieved, what has not been achieved and what is coming in the future. If there is going to be an error in the balancing act, it should err on the side of providing more "future looking information."

We see considerable potential for companies to increase the quality of their MD&A, including the adoption of an easy to follow format and an attempt to reduce the amount of text written in legalese. As more and more companies prepare MD&A for interim and annual filings, we expect companies will become comfortable with explaining, in plain language, what the company has accomplished and where it is going.

### *Other Continuous Disclosure*

This is the first year that we have focussed part of our review on several key documents (AIFs and MCRs) that form part of a company's public record. Our comments on the quality of these filings has been kept at an overview perspective because of the initial need to understand the general approach that the majority of reporting issuers take in the preparation of these documents.

Generally, the quality of AIFs and MCRs is good for larger companies. We have found that the smaller the company, the less information provided or the more promotional the tone of the text. We expect that as companies focus more attention on these two documents, our existing concerns will reduce.

### ***Gratuitous Information***

Information provided by large companies is usually very concise and reflects a high quality of preparation whether the information is required to be filed with the ASC or is gratuitous, such as that found on a website or in an annual report.

Small companies tend to use press releases as a promotional medium and should be extremely careful not to trigger a breach of the Act by issuing information that a reasonable observer would consider material. We suggest that small companies implement a review process internally that would require any information intended for public release to be cleared by an officer of the company who has experience in these matters. It may be appropriate to consult a securities lawyer in certain circumstances.

## **C O N S E Q U E N C E S**

Companies that do not meet the reporting requirements will be identified as ‘defaulting issuers’ and placed on a defaulting issuers list on the ASC website starting in Spring 2004. Enforcement action against the company, its officers and directors will be considered in cases of more serious breaches of reporting requirements.

We continue to encourage all companies to strive for the highest level of transparency and quality in disclosure documents to foster investor confidence in Alberta’s capital markets.

## **F E E D B A C K O N T H E R E V I E W S**

We welcome comments from companies and public accountants on the continuous disclosure review process. We endeavour to not only improve the process each year, but also to ensure it is relevant to the current business environment.

The “crisis of confidence” in financial reporting in the United States is also relevant to Canada. Companies and public accountants are generally adopting a more cautious and questioning approach to accounting for specific transactions and reporting in general. Accordingly, we have maintained our questioning approach in the current year’s reviews and anticipate this will continue.

Our reviews are carried out on a “cold” basis. Some queries may, at first glance, appear to have obvious answers or relate to immaterial items. Often, the seemingly obvious is only obvious to those involved in the preparation of the financial statements, and not to those detached from the process.

Comments with respect to the Financial Statements and MD&A Reviews should be directed to Fred Snell, FCA, Chief Accountant, Alberta Securities Commission.

Comments and questions related to Continuous Disclosure and General Observations should be directed to Ken Parker, CA, Director, Capital Markets, Alberta Securities Commission.

## **SECONDMENT TO CHIEF ACCOUNTANT'S OFFICE**

Any public accounting firm or public corporation that is interested in having a senior professional accountant obtain valuable experience with the ASC in the areas of financial reporting, including accounting, auditing, valuations and MD&A analysis, should contact the Office of Chief Accountant to discuss details of our secondment program.

## **CONTACTING ASC PERSONNEL**

To discuss any aspect of this report, please contact:

**Alberta Securities Commission**

4th Floor, 300 – 5th Avenue S.W.

Calgary, Alberta T2P 3C4

[www.albertasecurities.com](http://www.albertasecurities.com)

**Fred Snell**, FCA, Chief Accountant (403) 297-6553 or [fred.snell@seccom.ab.ca](mailto:fred.snell@seccom.ab.ca)

**Chris Courtland**, CA, Deputy Chief Accountant (403) 297-4223 or [chris.courtland@seccom.ab.ca](mailto:chris.courtland@seccom.ab.ca)

**Ken Parker**, CA, Director, Capital Markets (403) 297-3251 or [ken.parker@seccom.ab.ca](mailto:ken.parker@seccom.ab.ca)

**Agnes Lau**, CA, Deputy Director, Capital Markets (403) 297-8049 or [agnes.lau@seccom.ab.ca](mailto:agnes.lau@seccom.ab.ca)

**Mavis Legg**, CA, Manager, Securities Analysis (403) 297-2663 or [mavis.legg@seccom.ab.ca](mailto:mavis.legg@seccom.ab.ca)