REGULATION
FEBRUARY 2001 update

ALBERTA SECURITIES COMMISSION

CHIEF ACCOUNTANT'S GROUP

2000 Financial Statement Review Program Report

The following report provides an overview of key issues identified during the Alberta Securities Commission's 2000 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 at an acceptable standard.

THE PROGRAM

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 reporting and to encourage high quality financial reporting in Canada. This review is separate from the CAG's review of offering documents such as prospectus filings, takeover bids and information circulars.

This program would not be possible without the assistance provided by various public accounting firms, particularly the "Big Five" Accounting Firms. They provide senior personnel on secondments ranging from three to five month terms.

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Chartered Accountants of Alberta

The professional time provided to the CAG in 2000 by two Big Five firms was slightly more than half that provided by three firms, two Big Five firms and one local Calgary firm, in 1999. Also, an ASC financial analyst participated in the 2000 program reflecting a refocusing of the Capital Markets Group from prospectus to continuous disclosure reviews.

Any public accounting firm interested in having a senior professional accountant gain valuable experience with the ASC in the areas of accounting, auditing, financial reporting and valuations should call the CAG before the end of March 2001 to discuss details of the program, including timing of secondment and compensation.

INTRODUCTION

During the summer and autumn of 2000, a sample of RIs' 1999 financial statements was reviewed in three key areas: (1) accounting policies and practices; (2) presentation and disclosure; and (3) adherence to professional and regulatory requirements. Annual reports, annual information forms, MD&A, press releases, material change reports, prospectus offerings, takeover bid documents, offering memorandums, information circulars and web sites 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 sample was taken from a population of approximately 800 RIs with head offices situated in Alberta. Forty-eight RIs, representing various industries and differing in size, were reviewed. Of these, ten senior and intermediate oil and gas companies were selected judgementally. The remaining 38 companies in the sample were selected randomly.

The financial statements of one RI in the sample had been prepared in accordance with US GAAP. No material deficiencies were found in these statements.

Total Assets:

	2000	1999
■ $0 - $5 million	20	39
■ $5 million - $25 million	10	14
■ $25 million - $100 million	4	12
■ $100 million +	14	18
	48	**83**

Type of Business and Audit Firms:

Oil and Gas	2000	1999
Big Five Firms	19	22
National Firms (offices in more than one province)	1	7
Local Practitioners	4	6
	24	**35**
Industrial and Other		
Big Five Firms	6	27
National Firms	2	6
Local Practitioners	6	3
	14	**36**
Mining		
Big Five Firms	2	1
National Firms	1	0
Local Practitioners	2	2
	5	**3**
Hi-Technology		
Big Five Firms	1	4
National Firms	2	1
Local Practitioners	2	4
	5	9
Total	**48**	**83**

OVERALL PROGRAM RESULTS

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

Of the above 11:

- 9 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.
- 2 were required to make changes to the accounting and refile their financial statements.

Deficiencies were classified as being either GAAP or GAAS deficiencies. As well, issues raised for the first time are segregated.

1. GAAP DEFICIENCIES

Reverse Takeover Accounting

Only a few RIs in the 2000 sample had been involved in an acquisition described as a "qualifying transaction" under the Canadian Venture Exchange's Capital Pool Company Program (formerly referred to as "major transaction" under the Alberta Stock Exchange's Junior Capital Pool Program). A review of the financial statements of these RIs found that only one RI had a significant error in its financial statements. The recording of the qualifying transaction should have followed reverse takeover accounting but did not. A material difference became evident upon review of the consolidated balance sheet at date of acquisition and subsequently. This has been corrected as an error and revised financial statements have been filed with the ASC.

The CAG is still concerned that the accounting for a qualifying transaction presents a big challenge to RIs and their auditors. For this reason, the text in the CAG's1999 report addressing this issue is attached as an appendix. In 1999 the CAG's review specifically targeted a large number of qualifying transactions to determine if proper accounting had been followed. The results identified significant deficiencies in the accounting. Please refer to the appendix for the summary information.

Interim Financial Reporting to Shareholders (*CICA Handbook* Section 1750)

Quarterly financial statements were reviewed and compared to disclosures contained in RIs' audited annual financial statements. Following are some anomalies found in the quarterly financial statements:

- Significant accounting adjustments were posted in the fourth quarter, e.g. amortization expense and impairment write downs of capital assets.
- There was different accounting treatment in the quarterly statements compared to the annual statements for the same type of item, e.g. expense classifications.
- Cash Flow Statement was not properly prepared as required by *CICA Handbook* Section 1540.
- Segmented disclosure was not presented as required under *CICA Handbook* Section 1701.

RIs need to have procedures in place to prepare quarterly financial statements in accordance with GAAP. Auditors may need to be consulted to ensure that accounting issues are dealt with properly and on a timely basis to avoid significant fourth quarter adjustments. Reliable, timely, relevant, comparable and consistently prepared interim and annual financial statements are considered a cornerstone of the information base upon which participants in the Canadian Capital Market depend. Investors, among others, usually rely upon interim financial statements as part of their assessment when determining merits of potential investments. **The results for this year's program indicate that improvement in the quality and content of future filings of interim financial statements must be made**. The CAG believes that RIs which prepare interim financial statements by rigidly following the guidance set out in the newly released *CICA Handbook* Section 1751 on "Interim Financial Statements" will find their statements become more comparable to other companies' interim statements; the statements will also provide additional information not previously required but certainly considered important by investors. **This new accounting standard is effective for public enterprises with fiscal year ends beginning on or after January 1**, **2001**. The standard is comprehensive. Interim financial statements should be prepared by an RI as a continuation of its annual financial statements unless changes have occurred which must be disclosed. If RIs are unclear about certain requirements of the new standard, they should consult with their auditors.

Annual Financial Statements

Stock Based Compensation Plans (EIC 98)

EIC 98 covers stock purchase plans, stock options, restricted stock and stock appreciation rights. Deficiencies included:

- Lack of accounting policy disclosure for plan(s).
- Lack of disclosure for instruments other than stock options, such as stock purchase plans and stock appreciation rights.
- Lack of description of the 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.
- Instances where the highest exercise price of options exceeded 150 percent of the lowest exercise price. This necessitated segregation of ranges of exercise prices with the following disclosure for each range: 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.
- Instances of lack of disclosure of the number and weighted-average exercise prices, or the weighted-average remaining contractual life of options that were exercisable at year-end.

Financial Instruments (*CICA Handbook* Section 3860)

Deficiencies included:

- For certain items identified as financial instruments there was lack of disclosure about foreign currency risks, interest rate risks, market risks, liquidity risks, credit risks, and fair value of instruments, if determinable.
- Lack of disclosure (or confusing presentation) of unrecognized gains/losses for financial instruments accounted for as hedges of anticipated future transactions.
- Lack of disclosure of the amount of loans available for use but not used.
- Inappropriate accounting for a financial instrument as equity rather than debt.

Cash Flow Statements (*CICA Handbook* Section 1540)

Deficiencies included:

- Lack of disclosure of interest received and paid and taxes paid in cash.

- Non-monetary items accounted for in the statement of cash flow rather than in the notes.
- Changes in non-cash working capital items shown as adjustment in operating activities, not in investing activities.
- Capital additions and disposals netted.
- Lack of disclosure of what comprised cash and cash equivalents

Canada/U.S. GAAP Reconciliation Note

Three RIs had specific notes reconciling their statements, prepared under Canadian GAAP, to what the statements would have shown if prepared under U.S. GAAP. Although no material deficiencies were found, one RIs statements contained a general comment at the beginning of the notes that there was no material difference in its financial statements as disclosed and what they would have been if the statements had been prepared under U.S. GAAP. However, contained in several of the notes to these statements were comments that particular items were significantly different under U.S. GAAP - where an amount had been calculated, the difference was disclosed. **For the benefit of all readers of the financial statements, RIs should keep the presentation of this information simple by concentrating the disclosure in one clearly identified note. The CAG reminds RIs that preparing Canadian/U.S. GAAP reconciliations may require significant involvement of U.S. GAAP experts.**

Comparative Financial Information (*CICA Handbook* Section 1500)

The notes to an RI's financial statements did not present information on a comparative basis for the earliest years. The audit opinion did not cover all comparative periods presented including those in the notes. To ensure that readers avoid inferring that comparative periods presented are unaudited, the CAG believes that the audit opinion should cover all financial statements. During the ongoing development of the Canadian Securities Administrators' Integrated Disclosure System and the Continuous Disclosure System projects, ASC staff (Staff) will address this issue with other jurisdictions.

Notes for the comparative financial statements were not provided for several material balance sheet and income statement items. In one situation, the comparative financials should have been provided since the company had been in existence for several years.

The CAG cautions preparers of financial statements and their auditors that comparative annual financial statements are required to be sent to shareholders and filed with the Commission. These financial statements must be prepared in accordance with GAAP. Audit opinions are required on both the current and comparative year financial statements.

Inventories and Assets Held for Resale (*CICA Handbook* Sections 1510 and 3030, EIC 41)

Two RIs had classified certain oil and gas well equipment as current assets under the category of inventory. Neither amount was material. Upon further enquiry with one RI it was represented that a portion of the inventory was held for resale. The CAG cautions financial statement preparers and their auditors that assets not held for resale or for sale in the normal course of business should not be classified as current assets. In addition to the above references for GAAP, the CAG believes that the accepted accounting practice in the oil and gas industry is to show assets held for use in development activities as long term assets unless a definitive plan has been established to sell such assets. The CAG is concerned that classification of equipment as a current asset distorts working capital and funds flow information regarding operating activities.

Development Costs (*CICA Handbook* Section 3450, EIC 55, AcG-11)

There were several instances where RIs in the hi-tech industry changed their policy regarding development costs from capitalization to expensing. Before an RI may expense all development costs, the RI must be reasonably certain that there is no future benefit with respect to the development costs and that these costs should not be carried forward to be matched against future revenues. In some instances it may be that the company is in the development stage and should follow CICA Accounting Guideline # 11. As part of the review, the correspondence between the CAG and RIs in the hi-tech industry e.g. software programming companies, revealed that none of the companies had defined development costs guidelines or criteria for supporting either capitalizing or expensing. One common response given for writing off certain development costs was: "Management of the company believes that in a competitive market, a product whose life is less than a year has no value. Therefore, all costs related to product development are written off." The CAG would like to see consistent treatment of development costs by RIs in the hi-tech industry. RIs' financial statement notes should be comprehensive and provide details as to the criteria management uses to determine when a cost should be capitalized or written off. This policy note should be supplemented with information on ongoing projects with expected dates of completion and potential of the product for commercialization, together with a cumulative history of projects developed over the past few years and a reconciliation of expenditures to date showing amounts capitalized and expensed. The CAG will target this area for review next year to determine if improvement has been made.

Debt – Long-Term or Short-Term (*CICA Handbook* Sections 1510 AND 3210)

There were instances where the RI did not adequately describe the financing agreement in place to justify the classification of short-term obligations as long-term.

The CAG cautions RIs and their auditors that adequate disclosure should be provided in the notes to the financial statements when it appears that a certain debt meets the criteria for classification as a current liability but is shown as long term. It was not evident from reading the notes to the statements that the lenders had no present intention of calling the loan(s) within the next fiscal year.

Future Income Taxes (*CICA Handbook* Section 3465)

The new Handbook Section 3465 came into effect for fiscal years beginning January 1, 2000 with early adoption recommended. Less than one quarter of the RIs had adopted the new income tax standard in 1999. For those companies which did adopt the standard in 1999, it was noted that some of the future income tax assets or liabilities had been incorrectly calculated and there was inadequate disclosure of loss carry forwards and expiry dates. RIs that adopt the standard in 2000 should be aware of a number of EIC abstracts issued on this standard to assist preparers and auditors in implementing a uniform approach to some complex situations.

Related Party Transactions (*CICA Handbook* Section 3840)

Handbook Section 3840 requires disclosure of the measurement basis used (i.e. carrying or exchange amount) for related party transactions. The financial statement review program results identified this area as one where disclosure can be improved substantially. In the majority of situations where this deficiency was noted, the amounts involved were material. In one situation, the transaction had been recorded at exchange amount (fair value) rather than carrying value. A gain was recognized but the assets remained within the consolidated group. The CAG asks preparers and auditors of financial statements to be extremely careful in the presentation of related party transactions and to follow, as closely as possible, the standards set out in the CICA Handbook and related EIC Abstracts.

Contractual Obligations (Commitments), and Contigencies (*CICA Handbook* Sections 3280 and 3290)

In several situations the financial statements of RIs in the oil and gas industry did not disclose either physical delivery contracts or transportation contracts. In one instance, the RI had committed to physical contracts in excess of the RI's production and there was a lack of disclosure of this loss exposure in the financial statements. The CAG is concerned that this area of financial reporting is not being given proper disclosure by management of oil and gas companies. GAAP, as discussed under *CICA Handbook* sections 3280 and 3290, requires that this information be disclosed if it is material or may become material. Because of the volatility of commodity prices in the oil and gas industry, contracts which seem immaterial may become material in the near future. RIs are required to disclose these material changes by filing material change reports but few, if any, seem to have done so. A practical solution is to have full disclosure of these contracts in the annual financial statements, including exposure to gains and losses if closed out at the balance sheet date, with updates on their status in interim financial statements. Disclosure of transportation contracts involving contingencies should also be made.

2. GAAS Deficiencies

Canadian Auditors and Their Knowledge About Foreign Jurisdictions (*CICA Handbook* Sections 5100 and 5600)

There were several situations where Canadian auditors provided an opinion on the consolidated financial statements of an RI with a subsidiary in a foreign jurisdiction. In terms of investments and operations, some of the foreign operations were significant. From responses to enquiries posed to the auditors of the respective reporting issuers, the CAG concluded that very little, if any, work had been done at the actual site locations of the foreign operations. In one situation, the CAG requested that the auditors consult knowledgeable professionals in the foreign jurisdiction and inquire if the foreign operation was subject to tax, labour, environmental and other laws that may or would create a material liability or material contingent liability. The CAG is concerned that some auditors may not have the required expertise to conduct a proper audit or auditing procedures in a foreign jurisdiction.

The *CICA Handbook* codifies standards which auditors must follow if they intend to issue an opinion on financial statements. The Handbook also discusses situations where an auditor may become involved in issuing an opinion on financial statements prepared under foreign GAAP. Both these sections should be reviewed for guidance when a Canadian auditor is providing an opinion that involves foreign operations. **Accounting firms with foreign affiliates should make use of these resources when conducting audits from Canada**. **Accounting firms with no affiliates should consider retaining an auditing firm in the foreign jurisdiction**. Determining the extent of audit procedures that should be conducted by foreign or Canadian professionals on foreign operations will depend upon many factors including the size of the foreign operations, internal controls, expertise of Canadian audit personnel assigned to the audit, and past experience with the client. At a minimum, the CAG would expect the auditor to conduct audit procedures designed to ensure that if there are any laws or regulations in a foreign jurisdiction which would impose material liabilities as a result of the foreign operations of the issuer, then this information is either accounted for or disclosed in a note to the financial statements.

Auditors' Report (*CICA Handbook* Section 5400)

There were instances where the wording in the Auditors' Report differed from the standard wording recommended by the CICA. One auditors' report had an incorrect date. The CAG cautions auditors to pay particular attention to their reports. By not following the wording suggested in the

CICA Handbook for a standard auditor's report, auditors may bring into question whether they meant to distinguish their report from the standard report. In other cases where differences in the text may have been unintentional, the errors in the report can be easily adjusted in future years.

3. Issues Raised Here for the First Time

Accounting Policies not Disclosed (CICA Handbook 1505)

The financial statements of several RIs did not include accounting policies that were relevant to the specific RI. Accounting policies that were not disclosed included:

- use of specific industry GAAP, e.g. real estate
- foreign currency translation e.g self-sustaining or integrated operations
- deferred exploration expenditures
- components of cash and cash equivalents in statement of cash flows
- stock based compensation plans in accordance with EIC - 98
- details of stage of development for development stage companies

Other Disclosure Issues

From an overall perspective, after having reviewed the financial statements of the 48 companies, it was found that there was a lack of detailed disclosure in various areas of the financial statements. Deficiencies included:

- Insufficient detail of accounts and notes receivable
- Unsupported classification of long-term receivable as short-term
- Unproven property costs excluded from the depletion calculation, prices used for the ceiling test, general and administrative expenses capitalized in the year
- Inappropriate classification of income from discontinued operations
- Inappropriate application of joint venture accounting
- Material amount of assets not subjected to amortization due to being in the development stage
- Supplemental earnings per share information on the income statement not shown in notes to the financial statements
- Poorly documented continuity of share capital
- Insufficient details on a business combination in prior year
- No disclosure of number of shares reserved to meet outstanding options

Continuous Disclosure Reporting Matters

Part of the Financial Statement Review Program included a review of other information on the public file. Deficiencies included:

- Lack of agreement between the information provided from other sources (i.e. Annual Information Form, Press Releases, Annual Reports etc.) with the information included in the financial statements
- Failure to issue material change reports when material changes occurred
- Inaccurate or old SEDAR profile information
- Out-dated financial information on web site
- Inadequate discussion of significant reserve revisions in reserves reconciliation presented in annual report

4. Communication Between CAG and RIS

Follow-Up Letters

A number of RIs asked for extensions for replying to the initial CAG review letter. Some RIs which asked for extensions replied within the extended period by providing a detailed response supporting positions taken. Other RIs either missed the extended deadline or met it but the response was poorly prepared and required a follow up letter(s) or phone call(s). These problems caused an unacceptable delay in the issuance of this report by about six weeks. **As a result of the experiences this year**, **in future programs the CAG will set a standard time frame for reply to initial and subsequent follow up enquiries**, **and will only consider requests for extensions in unusual circumstances**.

Program Objectives

The first objective is for the CAG to review the quality of the financial statements filed with the Commission since this information becomes public and is used in investment decisions. The second objective is to communicate findings from the program in a timely manner to all RIs and their auditors so that changes can be considered. To achieve these objectives, it is important for RIs to respond in a timely manner to requests for information made by the CAG.

5. Annual Financial Statements for Sample Reference

In an effort to assist RIs in improving their financial reporting, the CAG, for the first time, is identifying the annual financial statements of those RIs where only a few comments were raised and for which the responses were satisfactory. The CAG does not make any comment on individual aspects of the statements but asks RIs and their auditors to review the statements from an overall perspective.

These RIs are listed in alphabetical order. The financial statements for the RIs noted below have fiscal years ending December 31, 1999 and 1998 except for Cascade Metals Inc. which has October 31, 1999 and 1998 fiscal year ends:

- Anderson Exploration Limited
- Baytex Energy Ltd.
- Canadian Hunter Exploration Ltd.
- Canadian Natural Resources Limited
- Cascade Metals Inc.
- Gulf Canada Resources Limited
- Penn West Petroleum Ltd.
- Real Resources Inc.
- Talisman Energy Inc.

6. Conclusion

The CAG encourages all RIs and their professional advisors to consider the identified issues and 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 meet the standards of acceptability. The CAG encourages all accountants and auditors to continue to strive to achieve high-quality financial statement filings in the future.

Appendix

(Extract from 1999 Financial Statement Review Program)

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 following table 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.

REGULATION UPDATE is published by:

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