Alberta Securities Commission
Chief Accountant's Group

2002 Financial Statement Review Program
Final Report

The Chief Accountant's Group ("CAG") of the Alberta Securities Commission ("ASC") is pleased to present its findings on the 2002 Financial Statement Review Program ("Program"). This final report contains specific and general observations about the quality of financial statements ("statements") and related Management Discussion & Analyses ("MD&A").

This report continues to focus primarily on the accounting and disclosure adopted by entities for out of the ordinary type transactions that are considered complex in nature and that normally require considerable analysis and professional judgement. The report comments on how the CAG believes certain transactions could be reported. The report also highlights note disclosures that could be improved.

For the first time, the report comments on the overall quality of MD&A and provides specific observations that may assist in both improving the dialogue and influencing the approach to MD&A.

Results are based on the review of 92 public entities' statements out of a population of about 800 entities that have registered with the ASC as the principal securities regulator.

An interim report on this Program was issued in December 2002 and can be found at www.albertasecurities.com (select "capital markets" and then "accounting"). Only the major and recurring concerns commented on in the interim report will be reiterated in this final report.

Financial Reporting - Gains Can Be Made With Little Effort

Certain notes to the statements of a few entities were not informative. Staff strongly believes that the quality of these statements would be enhanced significantly if more attention is placed on providing transparent and complete note disclosure. The four recurring areas, found in other than the largest 50 TSX listed companies, are discussed below.

Research and Development Costs

We noted instances where the capitalization criteria for development costs, the definition of when commercial production has commenced and the tests conducted to measure impairment of capitalized costs were not adequately disclosed in accounting policy notes. In several instances, research costs that appeared to meet the threshold of being material were not separately disclosed on the Statement of Income.

Staff recommends that management of entities with research and development projects review the disclosure requirements of CICA HB Section 3450 *Research and Developments Costs* to obtain a better understanding of the disclosure requirements.

Long Term Debt

Maturity dates of long term debt were not provided. This is basic disclosure as required by CICA HB Section 3210 *Long-Term Debt*. Staff believes that this may be an oversight that can easily be corrected in the future.

Foreign Currency

Several entities had operations outside of Canada but did not disclose their foreign currency translation accounting policy. Further, some did not disclose the gain or loss arising from foreign currency translations. While in some cases the translation gain or loss may not have been material, Staff reminds preparers of statements that CICA HB Section 1650 *Foreign Currency Translation* requires disclosure of the accounting policy followed by an entity and, where material, the amount of any foreign exchange gain or loss.

Flow Through Shares

Staff 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 the amount of expenditures or at the time the expenditures were actually incurred. The majority of situations reflected the future income tax liability when the actual expenditures were incurred.

CICA HB Section 3465.69 states: "The cost of future income taxes related to the resulting temporary difference is recorded as a cost of issuing the securities to the investors when the expenditures are renounced." In situations where a company applies the "look back rules" and the company has renounced but has not expended the funds in that fiscal year, a question arises as to whether a future income tax liability exists as at that fiscal year end. The application of the income tax rules set out in the Income Tax Act allows a company to renounce the contractually agreed to amount of the flow through share offering and deems the expenditures to have been made. This renouncement and concurrent deemed expenditures for tax purposes appears to result in no temporary difference between the cash amount sitting on the books and ear marked as flow through share monies and the tax amounts. When the cash is spent on eligible expenditures, the expenditures will have no corresponding tax base and it is at this time there appears to be a temporary difference.

Staff does not have a preference for either treatment as long as there is adequate note disclosure of how the future income tax liability has been recorded. This issue has been forwarded to the CICA Emerging Issues Committee for consideration.

Interim Report - Recurring Note Disclosure Deficiencies

Stock-Based Compensation Plans (EIC 98 and HB 3870)

EIC Abstract # 98 *Stock-Based Compensation Plans-Disclosures* covers stock purchase plans, stock options, restricted stock and stock appreciation rights. We noted a number of instances where the description of the plan(s), including the general terms of awards under the plan(s) as set out in EIC #98 had not been disclosed.

A new CICA HB Section 3870 *Stock Based Compensation and Other Stock Based Payments* (incorporating requirements of EIC # 98) came into effect for public companies with fiscal years starting on or after January 1, 2002. Staff points out that this new HB Section, specifically paragraph 3870.67(b), requires disclosures not previously asked for in EIC 98.

Paragraph 67(b) essentially asks for disclosure of the weighted average grant-date fair value of options granted during the year. And, if the exercise prices of some of the options granted during the year differ from the market price on the grant date, the options should be classified into categories which provide the number of options with: (1) weighted average fair values equal to the weighted average exercise prices, (2) weighted average fair values exceeding the weighted average exercise prices, and (3) weighted average fair values less than the weighted average exercise prices.

Staff reminds statement preparers and auditors that the disclosures required by Section 3870 are important to investors and should be given sufficient attention when financial statements are being prepared.

Related Party Transactions

The CAG continues to find instances of inadequate disclosure of related party transactions. The need for transparent disclosure in this area is more important than ever because of investor confidence concerns. The two concerns are (1) transactions are partially disclosed or not disclosed at all; and (2) inadequate or no description of the transactions and their significance. Staff also believes that disclosures regarding exchange amount and fair value are helpful to readers. This could include disclosure that fair value is equivalent to exchange amount (if it can be substantiated) or that fair value could not be determined. Staff did observe that the identities of the related parties, as required under GAAP, appear to be properly disclosed in most situations.

Staff will continue to monitor disclosure in this area and may seek to have statements reissued with the appropriate and complete related party disclosure.

Revenue Recognition

Staff noted a number of instances where issuers did not disclose their revenue recognition accounting policy(ies) and other disclosures did not clarify the nature of the revenues nor the related accounting policy. Staff believes that the significant revenue recognition policies are crucial to understanding the issuer's business and, therefore, should always be disclosed.

Staff suggests that preparers and auditors familiarize themselves with CICA HB Sections 3400 *Revenue*, 1701 *Segment Disclosures* paragraph .29(b), Ontario Securities Commission Staff Notice 52-701 and SEC Staff Accounting Bulletin # 101 for a better understanding of the complexity of revenue recognition and the requirement for statements to clearly explain how an entity earns its revenue.

GAAP Interpretations - Be Careful

Aggressive Tax Strategies

Through Staff's discussions with management and auditors of several entities it became evident that these entities had participated in tax strategies that may be considered aggressive. There was no disclosure in the statements about the risks of the strategy including the probability that the taxation authorities could challenge the way in which the transaction(s) was carried out.

Staff cautions preparers and auditors of financial statements that the accounting and/or disclosure of the terms of a transaction(s) subject to uncertainty, including taxation matters, should comply with CICA HB Sections 3290 *Contingencies* and 1508 *Measurement Uncertainty.*

The disclosure may be a simple statement such as: "The enterprise follows tax strategies that may, at times, be challenged by Canadian Customs and Revenue Agency. Until the timeframe for reassessment has been statute barred or the taxation authorities have reviewed and not objected to the tax filings, there is always the possibility that a reassessment can occur. Management has determined during the preparation of the financial statements whether a tax asset should be established based on the likelihood of the tax strategy being challenged".

Immediate Write-Off of Acquired Significant Oil and Gas Producing Properties

In our reviews we found that one company, out of a number of entities, had made business acquisitions of oil and gas exploration companies and had taken an immediate write off of a significant portion of the assigned values to the acquired oil and gas properties. The write off resulted from the company following the CICA Full Cost Accounting Guideline #5 which requires a ceiling test be performed on the carrying values of oil and gas properties held in each cost centre at the time each interim set of financial statements is prepared. The other entities, all following full cost accounting, relied upon the clause in the Guideline that permits deferring any write off for up to two years if the write off relates to a recent significant acquisition and the impairment is considered temporary. The accounting treatment of taking an immediate write off of a recent significant acquisition will be addressed in the proposed new Full Cost Accounting Guideline #5 ensuring, on a go forward basis, that there will be consistent application in this area by all entities following full cost accounting.

Unusual Terms in a Joint Venture Agreement

Oil and gas entities that expand their operations outside of Canada often enter into joint venture or similar type agreements that may contain clauses that are unusual and could be detrimental to the entity in certain situations. Users of statements need to be informed of these unusual terms and the disclosures outlined in CICA HB Section 3280 *Contractual Obligations* and Section 3290 *Contingencies* should be provided. Some entities may wish to expand their MD&A to disclose complex and/or unusual terms in agreements.

Staff reminds preparers and auditors to be vigilant about disclosure of unusual terms in agreements that may materially affect how users of statements assess an entity's potential obligations.

Full Cost Accounting Guideline #5 - Ceiling Test

The price used for estimating future net revenue should be the current price as of the measurement date. During periods of rapidly fluctuating prices, issuers may use average prices for periods up to twelve months prior to the measurement date. This could result in a write-down being postponed.

Staff observed that some statement preparers have been very aggressive in applying this concept of pricing in the ceiling test. Although there is no definition or guidance in explaining this concept, Staff will challenge any entity that appears to have exaggerated what a reasonable observer would consider "periods of rapidly fluctuating prices".

The CICA Accounting Standards Board has recently issued an exposure draft proposing amendments to Full Cost Accounting Guideline #5. The proposed approach to the ceiling test will change considerably, eliminating this area of concern.

Special Purpose Entities

Staff did find that special purpose entities were used in a limited number of cases. In our reviews we found it difficult to determine from both the statements and the MD&A whether a special purpose vehicle had been used. We also found that the terms of the arrangements were not well enunciated and this required Staff to make extensive enquiries to firstly, understand circumstances surrounding the transaction and secondly, to determine whether the accounting adopted had followed guidance set out in the CICA HB.

Staff reminds statement preparers and auditors that if an entity is using either a special purpose entity or variable interest entity then this fact should be clearly disclosed in the statements and in the MD&A. The entity should follow all the disclosure requirements set out in CICA Accounting Guidelines # 12 *Transfers of Receivables* and # 15 *Consolidation of Variable Interest Entities.*

Topical Discussions of GAAP

When an oil and gas exploration, development and producing entity ("EDP") is acquired, does this constitute the acquisition of a business as contemplated by CICA HB Section 1581 *Business Combinations* and EIC Abstract #124 *Definition of a Business* (in the U.S., FASB Statement # 141 and EITF # 98 - 3 and SEC Staff Manual of Corporation Finance)? If a producing property(ies) is purchased directly, is this the acquisition of an asset(s) or a business?

Staff is researching this topic because management of several entities firmly believe that the acquisition of an EDP should be treated as the acquisition of assets. If this is not the acquisition of a business, the Business Combinations section of the CICA HB would not be followed and goodwill would never be recorded.

Staff's preliminary research on this complex topic found that the SEC Staff's Manual of Corporation Finance ("Manual") relates specifically to what traditional financial statements or operating statements disclosure is required when an oil and gas property or an EDP is acquired. The requirement for disclosure, as commented in the Manual, applies to both prospectus filings and continuous disclosure filings. According to an SEC Staff member, the guidance in the Manual focuses on required disclosure and does not address whether the acquisition of an EDP or producing oil and gas properties constitutes the acquisition of a business under U.S. GAAP. The SEC Staff member commented that the determination of whether a particular acquisition constitutes the acquisition of a business under U.S. GAAP is based on individual facts and circumstances. Nonetheless, the SEC Staff generally believes that the acquisition of an EDP or producing oil and gas properties normally would constitute the acquisition of a business under FASB Statement # 141or the EITF consensus on Issue 98-3, *Determining Whether a Non-monetary Transaction Involves Receipt of Productive Assets or of a Business*. In applying the guidance in Issue 98-3, it would appear that the acquisition of a producing oil and gas property would have the inputs, processes, and outputs to be considered a business. As such, FASB Statement # 141 would apply in accounting for the acquisition of the property. SEC Staff encourages prefiling consultations if an entity and its auditor believes that the acquisition of an EDP or the acquisition of oil and gas properties should be treated as the acquisition of an asset.

ASC Staff, Canadian Securities Administrators' (CSA) Staffs and OSC Staff have expressed in the Companion Policies of National Instrument ("NI") 44 -101 Short Form Prospectus Distributions and OSC Rule 41 - 501 General Prospectus Requirements that the acquisition of an oil and gas producing property is the acquisition of a business. The recently issued proposed NI 51 - 102 *Continuous Disclosure Obligations*, subject to a comment period, contains similar guidance.

Because it may be difficult, in certain situations, for statement preparers and auditors to assess whether the acquisition of an EDP constitutes the acquisition of a business, it is the intention of ASC Staff to conduct additional research and provide, at a future date, some practical guidance on this topic.

When an EDP is acquired, how should the fair value assigned to reserves and to undeveloped land be determined?

Judgement is required in any assessment of determining fair value. There is usually no single answer but rather a range of what is considered acceptable for a fair value amount. The oil and gas industry like most other industries has some quirks that should be considered in the determination of fair value. In most situations, market value is not available and an economic model is used to estimate fair value. This model requires discounting future cash flows and depends to a great extent on the reserve quantities estimated by a reserve evaluation engineer. Petroleum evaluation engineers evaluate proved producing reserves, proved undeveloped reserves, probable reserves and undeveloped land. No value is attributed to possible reserves/resources.

In situations where an entity retains the services of a petroleum evaluation engineer and he/she issues a reserve volume and discounted cash flow report, the preparers and auditors of the related statements will normally extract information from this type of report to calculate period depletion and determine for entities following full cost accounting if an impairment has occurred under the ceiling test calculation.

CICA HB Section 1581 *Business Combinations* requires that when the purchase price paid by the acquirer is allocated to the assets and liabilities acquired it should be based on fair values ignoring the tax values of the respective assets and liabilities. The proposed new Full Cost Accounting Guideline requires that if impairment is determined, the value against which the carrying amount of the cost centre should be measured is the fair value. We strongly suggest that the preparers and auditors have discussions with the petroleum evaluation engineer and confirm that the reserves and corresponding commodity prices used in the reserve report would not be materially different if information extracted from the report is to be used in determining "fair value". If it would be materially different then some adjustments will have to be made to the information.

When a Royalty Trust acquires another royalty trust should the allocation of the purchase price from a consolidation perspective be attributed to the underlying assets and liabilities held in the operating entity of the acquired trust and should a future tax liability be recorded for any temporary difference existing between the allocated purchase price assigned to the net assets and the underlying tax values in the operating company? Or, should the temporary differences be viewed from the trust level and since the trust distributes all its cash, no future tax liability would be set up?

Staff believes that the purchase price should be allocated to the underlying assets and liabilities in the acquired consolidated entity. If, as a result of the allocation, there exists temporary differences in a legal entity(ies) holding the net assets and the entity is subject to tax, then the trust should establish a future tax liability based on the temporary differences. Staff believes this approach is supported by CICA HB. Section 3465 *Income Taxes,* Section 1581 *Business Combinations* and Section 1600 *Consolidated Financial Statements*. It is the view of Staff that EIC Abstract # 107 *Application of CICA 3465 to Mutual Fund Trusts, Real Estate Investment Trusts, Royalty Trusts and Income Trusts* does not provide sufficient comprehensible guidance on how to treat temporary differences in royalty/income trusts.

To ensure that this matter is dealt with in the appropriate forum, Staff has circulated a discussion paper on the issue to the ASC's Financial Advisory Committee for review and discussion. Upon receiving comments from the Committee, it will be determined whether the matter should be forwarded to the EIC for discussion and guidance.

Management Discussion and Analysis

MD&A is attracting more attention from investors and analysts especially since the accounting scandals that occurred in U.S. based public companies in the past two years. MD&A should focus on relevant information and opinions that management believes will supplement the disclosure contained in financial statements. MD&A should enable users of the information to view the business through the eyes of management. The onus is on management to provide the information and insights that readers may not otherwise have access to.

Staff, with hindsight, can compare actual events and known trends to previously issued MD&A and make observations where improvements can be made.

The following are Staff's observations about the quality of MD&A.

1) there was no discussion in the MD&A regarding:

   - large swings in revenue and expenses, especially between interim periods
   - major components of working capital and expectations for the future
   - 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 was to be adopted

2) there was limited discussion in the MD&A regarding:

   - details of related party transactions - this should 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

3) information expected to be discussed in the MD&A was found in other documents such as the AIF, or annual report

4) analysis focussed more on past performance rather than a balance between past and forward looking analysis

5) complex financial instruments were not explained in a manner that an investor would easily understand; simple examples and diagrams to explain concepts should have been provided to assist investors

6) terminology, specific to certain industries, was not defined or adequately explained

7) use of broad and non specific statements that were too generic and did not provide the reader with insight into how the entity operates and where management/directors intended to go

8) numerous press releases should have been summarized in MD&A to reinforce significant events that the entity had been involved and where the entity was going

Useful guidance to MD&A preparers includes the following:.

- In Canada, the CICA has issued draft guidance titled "Management's Discussion and Analysis - Guidance on preparation and disclosure". In May 2003, CICA issued the first of several planned "Interpretative Releases" ("IR"). Each IR will cover a topic that should be included in MD&A and will provide supplementary guidance e.g. a topic such as Off Balance Sheet Financing.

- Additional guidance is provided in OSC Staff Notice 51 - 501, CSA National Instrument 44 - 101F2 and BCSC Staff Notice 51 - 901.

- Copies of two surveys that Financial Executives International Foundation sponsored in June and May 2002 provide good examples of how MD&A can be improved. These can be viewe d, for a small contribution to the Foundation, at www.fei.org.

- SEC Staff reviewed MD&A filings and their comments can be found at www.sec.gov/divisions/corpfin/fortune500rep.htm

Non-GAAP Earnings Measures - Don't Fall Into the Trap

Staff noted several situations where the income statements of royalty trusts, income trust and real estate investment trusts contained a line item labelled "distributable cash flow". In other instances, the income statements of several companies identified a subtotal for "operating income" but it was obvious that certain items normally considered part of operating income had been excluded from the subtotal.

Staff reminds preparers and auditors that "distributable cash flow" is a non-GAAP earnings measure and should not be disclosed on the face of the income statement. *CSA Staff Notice 52 - 303* provides guidance on the use of non-GAAP earnings measures and required disclosures. Preparers and auditors of statements should become familiar with this notice and understand the restrictions placed on the use of non-GAAP earnings measures.

On the other matter of "operating income", Staff found that several income statements did not follow the presentation recommendations of OSC Staff Accounting Communique # 6 *Income Statement Presentation,* whereby items, usually expense categories, that should be part of the amounts considered in arriving at "operating income", were excluded.

Staff recommends that preparers and auditors of statements familiarize themselves with this Communique and ensure that income statement presentations follow the guidance provided.

Communication Between CAG and Management of Entities

Management of a few entities responded to questions posed by Staff by either providing vague answers or not fully addressing all aspects of matters raised. Staff cautions management that failure to provide timely and well reasoned responses to the issues will result in the file being kept open, additional comment letters being issued and the very real possibility of delays in the ASC's prospectus vetting process if the entity decides to go to market for capital.

Feedback on the Program

Staff welcomes comments, both positive and negative, from issuers and auditors on the Program. We endeavour to not only improve the Program 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. Issuers and auditors are generally adopting a more cautious and questioning approach to accounting for specific transactions and reporting in general. Accordingly, Staff has assumed a more sceptical and 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 Program should be directed to Fred Snell, FCA Chief Accountant, Alberta Securities Commission - see end of report for address.

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 the program.

Conclusion

The majority of the statements reviewed adhered to existing standards of financial reporting and GAAP. However, the CAG encourages issuers and auditors to strive for more detailed and transparent disclosure in the statements. Every effort should be made to ensure that the disclosure is in plain language.

The many concerns raised by investors about the deficiencies in financial statements of U.S. based public companies means it is no longer acceptable, even in Canada, to provide the minimum disclosures as required by the CICA HB. Interpretations of GAAP should consider the economics of each situation when GAAP doesn't specifically address the issue.

Notwithstanding the significant increase in the number and complexity of new accounting standards and auditing standards, and disclosure requirements issued by securities regulators, it is imperative that management of public companies and their financial advisers keep current, conduct a thorough analysis of new situations that occur and ensure that implementation of new standards is done within the spirit of those standards.

The CAG continues to encourage management of entities and their financial advisers to request prefiling meetings with ASC Staff when new or complex situations arise and the accounting treatment is not clear.

Corresponding with CAG

Questions or comments on the content of this report are welcomed. Please contact either Fred Snell, FCA Chief Accountant or Chris Courtland, CA Deputy Chief Accountant at: Alberta Securities Commission, Fourth Floor, 300 - 5th. Avenue S.W. Calgary, Alberta T2P 3C4 or by e-mail at fred.snell@seccom.ab.ca or chris.courtland@seccom.ab.ca.

Comments on the Financial Statement Review Program process can be communicated directly to Fred Snell at either the postal or electronic addresses noted above.