REGULATION update

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ALBERTA SECURITIES COMMISSION

CHIEF ACCOUNTANT'S GROUP

1998 Financial Statement Review Program Report

ALBERTA·SECURITIES·COMMISSION

The following report provides an overview of key issues identified during the Alberta Securities Commission's 1998 review of financial statements. The information is published to assist issuers and their professional advisors to achieve and maintain high standards of financial reporting.

Introduction

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

During the summer of 1998, the CAG reviewed a sample of RIs' 1997 financial statements in three key areas: (1) accounting policies and practices; (2) standard of presentation and disclosure; and (3) adherence to professional and regulatory requirements. Press releases and material change reports were also reviewed.

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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, imposing a cease trade order 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 1998 sample was selected from a population of approximately 1,000. Sixty-three RIs representing various industries and sizes of organizations were included:

From among RIs qualifying under the prompt offering prospectus system	4
RIs, the shares of which had an aggregate trading value greater than $20 million during 1997	24
Selected at random	35
	63

- Of the 63 RIs, four were selected which qualify under the prompt offering prospectus system, 24 RIs with trades of greater than $20 million were reviewed, and 35 issuers with share capital greater than $2 million were selected at random.

Types of Business and Audit Firms

Industrial and Other	**1998**	**1997**
Big Five	9	10
National Firms	2	8
Local Practitioners	4	6
	15	**24**
Mining		
Big Five	9	4
Local Practitioners	8	10
	17	14
Oil and Gas		
Big Five	27	8
Local Practitioners	4	3
	31	11
Total	**63**	**49**

In addition, several forecasts were reviewed.

Overall Results

The program resulted in:

- 41 RIs being sent letters noting possible minor GAAP deficiencies, with recommendations for correcting them in the future.
- 22 RIs being asked to respond to the CAG regarding possible material GAAP or GAAS deficiencies.

Of the above 22:

- 21 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.
- One file was sent to the Market Standards Branch for possible further action.

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

Material GAAP Issues

There was a general lack of disclosure in the notes to the financial statements surrounding acquisitions.

When the acquisition transactions were on a non-monetary basis (i.e. shares for shares), the market price used was not based on an active, liquid market. In all cases, the company had obtained ASE acceptance for the valuation of the shares and this valuation was used to account for the cost of the acquisition. However, this valuation was a relative, not a fair market, valuation and resulted in several over and at least one under valuation of the cost of the acquired companies for accounting purposes.

In two cases, the acquisition disclosure within the Statement of Changes of Financial Position was summarized and it appeared the acquisition was at a value less than that actually paid.

As well, there were problems in accounting for “share for asset” exchanges. In most cases, RIs recorded the share for asset exchange at a “deemed” share price for which there was no independent valuation to support the price or at the share's trading price at the time of the transaction.

It is crucial to remember that, because the market for shares issued in the transaction may not be active and liquid (and the quoted value may therefore not represent fair market value), the “legal” share price is not necessarily fair market value and is probably not the appropriate share price for accounting purposes.

To determine the most appropriate accounting valuation for a business combination or measuring a share for asset (or share) exchange, these key factors should be considered:

✔ *If shares are issued as consideration for the shares of another company or an asset, is the fair market value of the shares issued clearly evident?*

Criteria to consider include major control blocks of shares and, where there are control blocks, whether the control blocks are escrowed or are subject to hold periods, as well as whether an active and liquid market exists for the shares.

If the fair market value of the shares issued is not clearly evident, the transaction should be measured at the fair market value of the assets acquired or, if this is not clearly evident, at carrying cost to the vendor.

- ✔ *If the net assets of the RI issuing the shares to acquire an interest in another company or asset are relatively easy to value (e.g., a company holding cash only),* it is generally inappropriate to use a higher per share value.
- ✔ *To determine whether an active and liquid market exists, consider whether the number of shares to be issued exceeds the total shares traded in the prior two to four months.* If it does, an active and liquid market does not usually exist. As a result, the quoted market value should usually be discounted or, in some cases, the vendor's carrying cost should be used.
- ✔ *Does the proposed accounting method reflect substance over form* (i.e. does it "make sense?" Would a reasonably prudent investor have paid that much for the acquisition, in cash?).

Year 2000 disclosure

None of the issuers tested had sufficiently disclosed the Year 2000 contingency in their financial statements. The larger companies referred to the Year 2000 issue in their annual report, as part of Management, Discussion and Analysis.

The majority of the companies agreed that disclosure of the Year 2000 issue was warranted, based on AcG10. But at the time of completing their financial statements, the new guideline had not been issued, and they believed Section 3290 did not require disclosure of the contingencies. All agreed that additional disclosure will be made in their next annual filings.

Financial Instruments

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

Measurement Uncertainty

With the majority of issuers, there was a general note to cover measurement uncertainty, but no specific reference to a particular area was made as required by Section 1508. In other cases, the "uncertainty" was specific but may not have been a measurement uncertainty. For example, some of the full cost oil and gas producers disclosed that measurement uncertainty existed with respect to the expected future cash flows, site restoration provisions and depletion. In fact, no accounting "measurement uncertainty," may have existed, assuming the reserve reports were not part of the "accounting uncertainty."

Future Oriented Financial Information (FOFI)

A comparison was made of actual to forecasted net income for nine oil and gas royalty trusts and one company which distributes petroleum products. The results showed an average forecast of $0.83 per unit compared to actual results of $1.69 per unit for four royalty trusts in 1996 and for 1997 an average forecast for the remaining entities of $2.32 per unit compared to actual results of $1.21 per unit. All nine trusts compared FOFI to actual in either interim financial statements or in the MD&A. Two of the nine updated FOFI and one trust, because of a material change, should have updated FOFI but did not.

Future Site Restoration

A lack of disclosure existed within this area. Details of the amount expensed or incurred during the year in several RIs' financial statements were lacking. The additional information provided, in response to the CAG request, however, indicated no obvious mistakes or errors. RIs agreed to providing additional disclosure in future filings.

Share Capital

There was a lack of information provided within the share capital area. Expiry dates of options and warrants were omitted in several cases. Details of increases in share capital appeared to have been over-summarized.

Mineral exploration properties

In several cases, it was apparent that the carried costs may have been overstated. These RIs elected to not write down the carried amount of the properties even though activity had ceased. In addition, information on individual properties could be improved in some cases. Based on the CICA Handbook, the disclosure may be sufficient, but the additional information suggested in the CICA Research Study would be highly desirable.

Related Party Transactions

In several situations, the disclosure did not result in the reader being fully informed particularly when there were non-monetary, related party transactions. There is an apparent lack of understanding surrounding what is meant by "the culmination of the earnings process". We believe it is that point when the earnings are reliably determined and not subject to later adjustment as a result of the consideration not realizing its face value (e.g., if cash is the consideration and there are no commitments, the earnings process is complete). Some argue that related party transactions need not be disclosed since they are not "material." We believe that both qualitative and quantitative aspects of the transaction should be considered.

Capital assets (Oil & Gas)

There was incorrect wording in the accounting policy note relating to the capital assets in a significant number of RIs. The Full Cost Accounting Guideline in the CICA Handbook states future net revenues mean future revenues, less operating, development and restoration costs, but some RIs disclosed future net revenues as being before restoration costs. All agreed to the wording change in the next financial statement filing.

U.S. GAAP reconciliation

As part of 1998's program, two RIs' U.S. GAAP reconciliation notes were reviewed. No apparent deficiencies were noted. We intend to ask the Securities and Exchange Commission in the US to review our reviews.

1999 File Reviews

The ASC is moving to a program of continuous review of RIs' continuous disclosure. When fully developed, analysts will have a number of RIs assigned to each of them and they will follow “their” RIs on a continuous basis. The goal is to improve each analyst's knowledge of the RI on a current basis in order that any problems can be identified as they arise rather than after the fact. When the RI files a prospectus, the analyst should be in a better position to review it more quickly and issue a receipt. They would be responsible for continuous review of financial statement filings, press releases and material change reports, as well as any prospectus reviews.

Canadian Regulatory System – Mutual Reliance

The securities commissions across Canada have entered into mutual reliance agreements. Beginning in 1999, RIs will deal primarily with the commission in the province of their head office. This “principal regulator” will be responsible for reviewing prospectuses, continuous disclosure and applications, on behalf of all the other applicable jurisdictions. For example, RIs filing a prospectus in various provinces will, in most circumstances, receive a comment letter from their principal regulator only. That principal regulator will deal with any other applicable commissions. This should reduce the time and effort of both RIs and commissions. There will still be some exceptions; if a non-principal regulator disagrees with the principal regulator, the non-principal regulator may “opt-out” and would then deal directly with the RI. It is believed this new system will result in greater cooperation and harmonization between commissions and thus greater efficiency.

Conclusion

The CAG encourages all RIs and their auditors to consider the above issues. If unsure, the CAG asks that issuers and professional advisors consult with their colleagues for guidance. The CAG is also available to assist RIs on a pre-filing basis, provided all the facts are clearly presented.

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

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Institute of Chartered Accountants of Alberta
580 Manulife Place, 10180 - 101 Street
Edmonton, Alberta T5J 4R2
Phone (780) 424-7391, Fax (780) 425-8766

Questions regarding this topic may be directed to **Henry R. Lawrie, FCA,** chief accountant at the Alberta Securities Commission in Calgary (phone 403/297-7252) or **Christopher M. Courtland, B.Comm, CFE, CA**, deputy chief accountant (phone 403/297-4223).

For additional copies of this publication, please visit our ICAA Web site (www.icaa.ab.ca) or contact **Christine Ebbers**, practice review assistant (e-mail: c.ebbers@icaa.ab.ca).

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