REGULATION update

APRIL 2002

ALBERTA SECURITIES COMMISSION

CHIEF ACCOUNTANT'S GROUP

Final results of
2001 Financial Statement Review Program

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This final report provides an overview of the results of the 2001 Alberta Securities Commission's Financial Statement Review Program. Commission Staff believes that it is very important to communicate the results of this program in order that issuers and their advisors can consider the points raised when preparing financial statements. As an overall commentary, Staff found that the majority of financial statements reviewed not only met the minimum accounting and disclosure standards but achieved a very good level of quality in the financial reporting disclosures. The deficiencies identified in this report are the exceptions and should be viewed in this manner.

In recent months, investors, analysts and certain sectors of the general public have become very critical of financial statements that contain transactions that are not transparent, meet only the minimum standards for accounting and financial reporting, and appear not to have adhered to the spirit of the standards. Company officers, audit committee members, and the auditors should be very cognizant of the current mood of investors, analysts and securities regulators during the preparation, review and approval and audit of interim and annual financial statements and should strive to improve the information presented in the statements, thereby increasing the confidence statement users will attach to the reliability of financial statements.

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Chartered Accountants of Alberta

THE PROGRAM

Through its Financial Statement Review Program, the Chief Accountant's Group (CAG) of the 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 encourage quality financial reporting in Alberta and Canada. This review is in addition to 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. These firms provide senior personnel on secondments ranging from three to six months. The professional time provided to the CAG in 2001 by a national mid-size accounting firm and a large local accounting firm was significant to the functioning of the program. Two Commission analysts also participated in the program, reflecting the ongoing focus on continuous disclosure matters.

Any public accounting firm or public corporation that is interested in having a senior professional accountant (minimum five years experience as a professional accountant) obtain valuable experience with the ASC in the areas of accounting, auditing, financial reporting and valuations should call the CAG to discuss details of the program, including timing of secondment and compensation.

INTRODUCTION

During the summer and autumn of 2001, a sample of RI's 2000 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. In addition to the review of the financial statements, the CAG reviewed annual reports, annual information forms, management's discussion and analysis, press releases, material change reports, prospectus offerings, takeover bid documents, offering memorandums, information circulars and websites. Information from these sources, if material, was verified to the financial statements for proper accounting treatment and adequate disclosure.

If the CAG finds departures from Canadian generally accepted accounting principles (GAAP) or Canadian generally accepted auditing standards (GAAS), the CAG may, depending upon the severity of these departures:

- Request the RI to consider modifying disclosure in future filings
- Request the RI to change financial statements and/or issue press releases to inform the investing public
- Issue a cease trade order against the RI; maintain the order until the deficiency is corrected.

SELECTION

The sample was taken from a population of approximately 850 RIs with head offices situated in Alberta. 71 RIs, representing various industries and sizes of companies, were selected and their financial statements and other public information were reviewed. Of these, six senior and intermediate oil and gas exploration companies were chosen judgementally. The remaining 65 companies in the sample were selected randomly. Key characteristics about the sampled companies are outlined below.

Total Assets:

	2001	2000
■ $0 - $5 million	33	20
■ $5 million - $25 million	14	10
■ $25 million - $100 million	9	4
■ $100 million +	15	14
	71	**48**

Type of Business and Audit Firms:

Oil and Gas		
Big Five Firms	30	19
National Firms (offices in more than one province)	3	1
Local Practitioners	12	4
	45	**24**
Industrial and Other		
Big Five Firms	12	6
National Firms	1	2
Local Practitioners	0	6
	13	**14**
Mining		
Big Five Firms	2	2
National Firms	1	1
Local Practitioners	2	2
	5	**5**
Hi-Technology		
Big Five Firms	5	1
National Firms	1	2
Local Practitioners	2	2
	8	5
Total	**71**	**48**

RESULTS

- 69 RIs 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
- 1 RI was required to make changes to the accounting and refile its financial statements
- 1 file remains open at March 11, 2002

GAAP MATTERS

Interim Financial Reporting to Shareholders (CICA Handbook Section 1751)

Interim financial statements were reviewed and compared to disclosure contained in the audited annual financial statements of RIs. The CAG noticed that the quality of interim financial statements disclosure improved as RIs gained more experience in their preparation. Some of the anomalies found in the interim financial statements included:

- Significant accounting adjustments posted in the fourth quarter, e.g. write downs of assets
- Required adoption of new accounting policies in interim period but only reflected at year-end
- Periodic costs and allocations ignored, e.g. amortization expense or income tax provision
- Lack of continuity of certain items from one period to the next
- Cash Flow Statement with items of a non-cash nature included
- No disclosure that the new Income Tax Section of the *CICA Handbook* had been adopted in the interim period nor disclosure on what the effect was on the company for having adopted this new standard
- Several companies' income tax provisions improperly calculated
- No comment made that the interim statements followed the same accounting policies as the annual statements
- No comment made that the interim statements should be read in conjunction with the prior annual statements
- Presentation inconsistent with the annual statement presentation
- No disclosure that the new Earnings Per Share Section of the *CICA Handbook* had been adopted; use of old terminology in disclosing EPS, indicating that several companies had not adopted the new standard
- No disclosure of share information to be included with interim financial statements or accompanying the interim statements (National Instrument 62 - 102 requires this disclosure)

The problems noted above can be dealt with very easily. The CAG believes that once RIs and their advisors become more familiar with the new *CICA Handbook* Standard on Interim Financial Reporting, these concerns will disappear. The CAG cautions RIs that "out of the ordinary" transactions may require assistance from the RI's auditor to ensure that the interim reporting is prepared to a standard expected of a public company. When an RI has an adjustment in the fourth quarter that should have been accounted for in a prior interim period, it reduces the comfort level that investors have with the RI's information. Although there is a cost, auditors should be consulted when irregular or unusual transactions occur and have to be accounted for in a timely manner. Reliable, timely, relevant, comparable, and consistently prepared interim and annual financial statements are considered a cornerstone of the information relied upon by participants in the Canadian Capital Market. The CAG believes that RIs that prepare interim financial statements by adhering to the guidance set out in *CICA Handbook* Section 1751 will find their statements are more comparable to other companies' interim statements and investors will reward companies that achieve this quality reporting.

Annual Financial Statements

Cash Flow Statements (CICA Handbook Section 1540)

The CAG observed that a number of Cash Flow Statements in the sample contained errors. To improve the information communicated by this very important financial statement, preparers and their advisors should pay careful attention to *CICA Handbook* Section 1540, which covers Cash Flow Statements. Preparers should also look at other companies' financial statements for examples of acceptable disclosure. Some specific deficiencies in the Cash Flow Statements were:

- Lack of disclosure of interest paid, and cash flows arising from income taxes
- Non-cash items disclosed in the Statement of Cash Flow rather than in the notes, such as:
    - The tax effect of the renounced expenditures relating to flow-through shares
    - The tax effect of share issue costs
    - The share capital issued to acquire non-cash assets
- Changes in non-cash working capital items shown as adjustment in operating activities that should have been shown as adjustment in either investing activities and/or financing activities
- Capital additions and disposals netted
- Lack of disclosure of what comprised cash and cash equivalents
- Lack of disclosure of cash and cash equivalents forming part of the net assets acquired in a business combination
- Treatment of the cash outlay for future site restoration expenditures as investing activities. These expenditures, although not material, were not shown as a separate item nor disclosed in the notes. The CAG is considering what is the proper classification for such expenditures, i.e., operating, financing or investing. Preparers should note the direction provided by SEC Staff and the information contained in SFAS No. 143.

Stock-Based Compensation Plans (EIC 98)

EIC 98 covers stock purchase plans, stock options, restricted stock and stock appreciation rights. Results this year show only a slight improvement in the disclosure on Stock-Based Compensation Plans compared to last year's disclosures. The CAG believes that these deficiencies, as noted below, can be addressed in the future preparation of notes to financial statements. *CICA Handbook* Section 3870 came into effect for public companies with fiscal years starting January 1, 2002. This section should be reviewed closely to ensure proper implementation in this area. Specific deficiencies included:

- No continuity schedule showing the options outstanding at the beginning of year, and movements during the year
- 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 per cent of the lowest exercise price, thus requiring segregation of ranges of exercise prices with disclosure for each range consisting of: the number, weighted-average exercise price, weighted-average remaining contractual life of options outstanding, and the number and weighted-average exercise price of options currently exercisable
- Lack of disclosure of the number, 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)

More informative disclosure on financial instruments was provided by companies this year. However, there continued to be a lack of adequate disclosure about foreign currency risks, interest rate risks, market risks, liquidity risks and credit risks. The information needed to meet the disclosure standard for these risks should be readily available. The CAG asks RIs and their auditors to pay particular attention to this disclosure when preparing the coming year's annual financial statements.

RIs normally disclosed the net exposure for specific identifiable financial instruments at the most recent balance sheet date. For transparency, consideration should be given to disclosing, if applicable, gross exposures of specific identifiable categories at the balance sheet date and a summary of total gross exposures for the period. If exposure to financial instruments during the period is significantly different from the exposure at the balance sheet date additional information at the balance sheet date should be provided on the activity level in financial instruments.

Future Income Taxes (CICA Handbook Section 3465)

The new *CICA Handbook* Section 3465 on Income Taxes came into effect for fiscal years beginning January 1, 2000. This is one area that requires improvement going forward. The CAG understands that when a new and complex standard is introduced, it may take several years for all RIs and their advisors to fully comprehend and properly apply the standard. Our review identified several deficiencies that can be corrected in future preparation of financial statements. These deficiencies were predominant in smaller companies.

- Lack of disclosure of the nature and tax effect of temporary differences, unused tax losses and income tax deductions
- Lack of disclosure of significant offsetting items included in future income tax assets and liabilities balances
- No disclosure of the effects of the change in adopting this accounting policy
- Lack of disclosure of non-capital tax losses, expiry date of these losses and their country of origin
- Absence of a note reconciling the income tax rate or expense (recovery) related to the income (loss) for the period to the expected statutory tax rate or expense (recovery).

Related Party Transactions (CICA Handbook Section 3840)

The CAG has seen no improvement in disclosure on related party transactions from the same concerns raised in last year's report. *CICA Handbook* Section 3840 requires disclosure of the measurement basis used (i.e. carrying or exchange amount) for related party transactions. The CAG believes that it is insufficient to say a transaction was conducted at the "exchange amount" since this term has no meaning for most investors. We believe that a reference to how the transaction amount was determined, and a statement that the amount approximates fair value, should be made. In the alternative, a statement should be made as to why a fair value could not be determined for the transaction. Two other disclosure deficiencies in this area were: (1) no or insufficient disclosure of the terms of outstanding asset or liability amounts with related parties; and (2) improper description of the relationship of the related party involved in the transaction. The CAG asks preparers and their auditors to be extremely careful in the presentation of related party transactions information and to follow, as closely as possible, the standards set out in the *CICA Handbook* and related EIC Abstracts.

Investors and analysts' concerns about full and complete disclosure of related party transactions in financial statements issued by public companies has been aroused by Congressional hearings into the collapse of a major energy trading and pipeline company. Please be advised that the CAG will focus on this area in the 2002 Financial Statement Review Program.

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

This year, the CAG observed that some of the RIs in the oil and gas industry were disclosing physical delivery contracts and/or transportation contracts. This is an improvement over last year's results. The CAG once again reiterates that any RI, which has entered into contracts related to physical delivery of goods or services or contracts related to transportation services which are or may become material to the operations of the RI, should disclose the main particulars of the contracts in the notes to the financial statements. The CAG believes that this disclosure is required under GAAP in *CICA Handbook* Sections 3280 and 3290. Because of the volatility of commodity prices in the oil and gas industry, contracts that are entered into by RIs one day 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. For transparency and where applicable, consideration should be given to disclosing gross exposures of specific identifiable physical contracts at the balance sheet date and a summary of total gross exposures for the period. If exposure to physical contracts during the period is significantly different from the exposure at the balance sheet date, additional information at the balance sheet date should be provided on the activity level. Disclosure of transportation contracts involving contingencies should also be made. Management of RIs, especially those in the oil and gas industry, should pay particular attention to this required disclosure.

Disclosure of the amount of expenditures yet to be incurred and renounced under contractual flow-through share agreements was absent. In most cases, the remaining obligation was material to the operations of the RI. The CAG reminds RIs and their auditors that this type of contractual obligation, if material, must be disclosed.

Canada/U.S. GAAP Reconciliation Note

Several RIs had specific notes reconciling their statements, prepared under Canadian GAAP, to what the statements would have shown if prepared under US GAAP. No material deficiencies were found in our review. Because US GAAP is complex, we repeat our suggestion from last year that RIs should involve US GAAP experts in the preparation of these reconciliations as a measure of prudence.

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

Several RIs had classified certain oil and gas well equipment as current assets under the category of inventory. Although the amounts were not material to the financial position of any of the RIs, the CAG is concerned that showing these assets as current rather than as part of property plant and equipment could distort the working capital amount and funds flow from operations. This same concern was raised in last year's report. In the opinion of the CAG, 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 asks financial statement preparers and their auditors to remedy this aspect of reporting in the coming year.

Reclamation and Site Restoration ("R&SR") Expenditures

Several oil and gas exploration companies did not provide adequate disclosure about the method of determining R&SR expenditures on an accrual basis. These same companies did not disclose the actual cash outlay for R&SR expenditures in the current and comparative year. A few RIs did not accrue a periodic provision for R&SR with a corresponding liability reflected on the Balance Sheet. These RIs stated that the salvage value of the equipment would be sufficient to cover the cost of the R&SR. The CAG believes that both the accounting and disclosure in this area is deficient. The CAG expects that in some future situations, these figures will become material and this information should be available. The CAG believes that salvage value of equipment will not be sufficient to cover the costs of R&SR. Therefore, RIs who have not established a policy for R&SR should do so immediately and all RIs should provide more detail on how the accrual for R&SR has been determined.

SEC Staff state that cash outlays for actual reclamation expenditures should be shown as cash flow from operating activities in the Statement of Cash Flows. SFAS No. 143 will come into effect for US companies in calendar 2002. This new standard raises the possibility that the cash outlay for R&SR may be considered a financing, investing or operating activity for purposes of the Statement of Cash Flows. RIs and their auditors should discuss this matter to determine the proper treatment. Until Canadian GAAP has been determined, all RIs should clearly disclose the actual yearly cash outlay either on the face of the Statement of Cash Flows or in a note to the financial statements.

Accounting for a Qualifying Transaction

A few of the RIs in the 2001 sample had been involved in an acquisition described as a "qualifying transaction" under the Canadian Venture Exchange's Capital Pool Company Program. The majority of these transactions are accounted for as reverse takeovers. Our current review indicated that the qualifying transactions had been accounted for properly. This is a major improvement compared to prior years' results. The CAG applauds the noticeable improvement in the accounting for qualifying transactions. The CAG encourages RIs and their advisors to continue to pay particular attention to the facts of each qualifying transaction to ensure the proper accounting is adopted.

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. These deficiencies were not pervasive in the sample. The policies not disclosed included:

- Product warranty treatment
- Foreign currency translation, e.g., self-sustaining or integrated operations
- Details of stage of development for development stage companies
- Research and development expenditures
- Earnings per share
- Composition of cash and cash equivalents
- Stock-based compensation plans
- Details of full cost accounting followed, as outlined in AcG # 5
- Revenue recognition
- Impairment tests for deferred costs and goodwill
- Hedging approach for derivatives
- Joint operations accounting
- Measurement uncertainty note disclosure used as "boiler plate" rather than specific situation

Other Disclosure Issues

We also found a lack of detailed disclosure in various other areas, including:

- Crude oil inventory carried at sales price less selling expenses and not at lower of cost and market
- Loan with 364 day term should be shown as current liability unless a contractual agreement with lender exists that allows a roll over - see new EIC 122 on this matter
- Terms of note receivable and related classification as current or long term asset
- Percentage ownership interests in certain long-term investments
- Ownership interest diluted below control level but continued to consolidate
- Lack of comparative information in certain notes
- Period of amortization very lengthy, useful life of capital assets appeared too long
- Criteria for calculating net recoverable amount not disclosed
- Classification of operating income very confusing
- Identifying that certain assets were pledged as collateral
- Information on capital leases deficient on gross amount of leases, expiry dates, future minimum lease payments and imputed interest amounts
- Share capital changes in a period and value attributed to certain share transactions
- Segmented information not provided, including comparative information
- No disclosure by several oil and gas exploration companies on the dollar amount of properties excluded from the depletion calculation

GAAS Deficiencies

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

Although we did not note any problems involving Canadian auditors performing their audit work on an RI's foreign operations, the CAG reminds Canadian auditors that this could be a problem area. When a Canadian auditor provides an opinion on the financial statements of an RI which has foreign operations, there should be sufficient information available to the auditor to determine what effect, if any, the foreign laws and practices may have on the RI's operations. To obtain assurance on matters in a foreign jurisdiction, the auditor may need to consult knowledgeable local professionals who understand laws and business practices in the foreign jurisdiction. Results obtained from the use of these professionals may indicate that a material liability/contingent liability exists in the RI's foreign operation(s).

Canadian Auditors Auditing Financial Statements Filed with the SEC

The CAG reminds RIs that any audited financial statements filed with the United States Securities & Exchange Commission must have been audited in accordance with US GAAS. US GAAS is similar to Canadian GAAS but is not identical. RIs should ensure that their auditors are aware of this and have taken the necessary steps to comply with the US SEC requirement.

Auditor's Standard Report (CICA Handbook Section 5400)

There were several instances where RIs operating in the real estate industry included both a "Statement of Cash Flow From Operations" and a "Statement of Cash Flows" as part of their complete sets of financial statements. The auditor's report did not refer to the Statement of Cash Flow From Operations in either the introductory or opinion paragraphs. The CAG believes that an individual financial statement included as part of a complete set of financial statements, subject to audit, should be specifically referred to in the auditor's report. Further, the reference to Cash Flow From Operations is incorrect since the actual figure shown on the statement is a "Funds Flow From Operations." The CAG cautions RIs and their auditors to pay particular attention to the terminology used in financial statements.

In several files, a few other deficiencies were found:

- Report not dated or not double-dated for subsequent event note
- No reference to Canadian GAAP or GAAS or country of origin of auditor
- No reference to prior year being audited by another auditor (or disclosed in notes either)
- Reference in auditor's report to different time period actually covered by financial statements
- Reference in auditor's report to a Statement of Changes In Financial Position rather than Statement of Cash Flow
- Audit report date different from management report date

Continuous Disclosure Reporting Matters

Part of the Financial Statement Review Program included a review of other information on the public file. This portion of the review indicated an improvement from last year's results. The two continued deficiencies for a number of reporting issuers were:

- The information provided from other sources (i.e. annual information form, press releases, annual reports etc.) did not agree to the information included in the financial statements
- Material change reports were not issued when material changes occurred

COMMUNICATION BETWEEN CAG AND RIs

A number of RIs asked for extensions to the requested time frame for replying to our review letters. Some RIs then replied within the extended period by providing a thoughtful response that supported 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 extensions cause a delay in closing files and issuing a final report on the results of the program. In future, the CAG expects a more timely and complete response from RIs in the conduct of this program.

ANNUAL FINANCIAL STATEMENTS THAT CAN SERVE AS MODELS

In an effort to assist RIs in improving their financial reporting, the CAG is once again identifying several companies' annual financial statements that can serve as models for full disclosure and proper accounting. For a few of the financial statements identified, Staff raised some deficiencies that were satisfactorily responded to and which were ultimately identified as minor in nature. The CAG does not make any comment on individual aspects of the statements but asks RIs and their auditors to review these annual financial 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, 2000 and 1999:

- Agrium Inc.
- Alberta Energy Company Limited
- Alliance Pipeline Limited Partnership
- Badger Daylighting Inc.
- Nexen Inc.
- Petro-Canada
- Raptor Capital Inc.

CONCLUSION

The CAG encourages all RIs and their professional advisors to consider the above issues. If unsure, the CAG 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 has found that most of the financial statements reviewed meet a high standard of quality. The CAG encourages all accountants and auditors to continue to strive to achieve high-quality financial reporting.

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This report has only been made available on the ICAA website at www.icaa.ab.ca, and the Alberta Securities Commission website at www.albertasecurities.com

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