

Continuous Disclosure Review Program

2006 Report

On the Review of
Financial Statements,
MD&A and Other
Materials

Alberta
Securities
Commission
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1. Introduction and Overview

1.1 General

Securities laws require public entities (“reporting issuers” or “RIs”) to file specific continuous disclosure (“CD”) documents with securities regulators including financial statements, management’s discussion and analysis (“MD&A”) and annual information forms (“AIF”). RIs headquartered in Alberta are subject to oversight by the Alberta Securities Commission. This is the sixteenth year that Staff has examined the CD documents filed by Alberta RIs with a view to improving the completeness, quality and timeliness of disclosure. This report is based on our review of documents filed with the ASC between January 1 and December 31, 2006 by a sample of RIs.

From a total of approximately 761 RIs, Staff selected 190 RIs for one of a full review of all of their filed materials, an issue-oriented review of a particular filed document or issue, or a high-level review of their filed materials. While we continue to note areas for improvement in the CD documents filed, overall we are generally satisfied with the quality of the disclosure being made by RIs headquartered in Alberta.

RIs and investors are becoming more focused on up-to-date and accessible information about RIs and their activities. Until recently, our regulatory system has focused on new offerings of securities and we examined RIs more closely at the time a long-form prospectus or an initial AIF was filed. Now, most RIs use the short-form prospectus system for their primary offerings, and the majority of investment activity occurs in the secondary market, which is much larger than the primary market. The short-form prospectus system allows faster access to the market and is based on RIs having on file with us a CD record that is up-to-date, accurate and complete in order for the market to be able to function as it should. This heightens the responsibility of RIs to ensure that their financial statements and other CD filings reliably, fairly and comprehensively portray the material aspects of their business, operations, development and relationships.

1.2 Summarized Observations

While we were generally satisfied with the level of disclosure by most RIs, this report does focus on a number of areas where improvement is warranted. One theme that runs through many segments of this report is the need to increase the specificity of disclosure. Users of CD documents are not interested in boilerplate disclosure or references to self-explanatory disclosure items in the financial statements or other CD filings. Instead, users are interested in understanding what is behind the historical results of the RI, what to expect in the future and the rationale behind the decisions made by management. Preparers of financial statements should ask themselves whether their MD&A (and other CD documents) accurately and fairly and communicates such information.

2. Results of Review

Sample Characteristics

The results in this report are based on 34 full reviews and 156 high-level or issue-oriented reviews out of a total of approximately 761 Alberta-headquartered RIs. RIs selected for reviews were listed on either the TSX or the TSX Venture Exchange and were audited by accounting firms registered with the Canadian Public Accountability Board.

Quantitative Results

As a result of our reviews, 32 RIs were required to amend and refile one or more of their continuous disclosure documents. A further 47 RIs agreed with our suggestions and undertook to incorporate disclosure improvements in future continuous disclosure filings.

2.1 Accounting and Disclosure Issues and Deficiencies

Related Party Transactions

Related party transactions and relationships are often not adequately described in CD documents. Complete disclosure of related party transactions is important to investors because the transactions are not subject to arm's length negotiation and are often unique. The relationships can be complex and RIs may be reluctant to fully describe relationships and transactions. Following are two examples of situations where we questioned the disclosure of related party transactions.

- Companies which meet prospectus and registration exemptions described in National Instrument 45-106 *Prospectus and Registration Exemptions* ("NI 45-106) can raise funds from the public without filing a prospectus. One of the exemptions allows companies who meet certain criteria to raise funds through the issuance of an offering memorandum. The Chief Accountant's Office selectively reviews filed offering memorandums to ensure compliance with NI 45-106. The offering memorandum of one issuer reviewed listed 13 different related parties. There were significant transactions among many of the related parties but the disclosure failed to explain the relationships among the parties or the business purpose behind the related party transactions. Form 45-106F2 *Offering Memorandum for Non-Qualifying Issuers*, section 1.2 requires that if any of the net proceeds of an offering are to be paid to a related party, disclosure of the name of the related party, the relationship to the issuer and the amount is required. Section 2.7 of the same form requires that the key terms of all material agreements with a related party be disclosed. In addition, audited annual financial statements are required in the offering memorandum for prescribed periods. These financial statements must comply with section 3840 of the CICA Handbook *Related Party Transactions* which requires: detailed disclosure of all related party transactions including a description of the relationship between the parties; a description of the transactions; the recognized amount of the transactions; the measurement basis used; amounts due to or from related parties and the terms and conditions relating thereto; contractual obligations with related parties; and contingencies involving related parties. The financial statements included in the offering memorandum did not comply with Generally Accepted Accounting Principles ("GAAP"). As a result of our review, this issuer was required to significantly revise its offering memorandum disclosure.

- In the second example, a RI had issued intercompany loans to a variety of related parties over a number of years. These loans were regularly written down or fully written off but followed by further loans to the same parties. The business purpose behind these transactions and the rationale for the continued lending were unclear. In addition, the RI paid significant management fees to some insiders of the RI. The related party transactions in this case were complex and not clearly described in any CD document of the RI. As a result, this RI is not trading pending satisfactory response to our queries regarding the transactions and the related disclosure.

While RIs appropriately disclosed most related party transactions, it is essential that stakeholders have sufficient information to clearly understand the business purpose and the accounting behind the related party transactions and that the minimum standards of GAAP and securities legislation be met.

Revenue Recognition

Revenue recognition is a recurring area of concern in our reviews. The CICA Handbook makes it clear that revenue should be recognized when the significant risks and rewards of ownership have transferred. As a result of our reviews, two examples of revenue recognition issues we noted were:

- **Use of cash basis rather than accrual basis of accounting in recording revenue for certain periods.** Canadian GAAP requires that RIs use the accrual method of accounting. We noted a RI who recorded a particular type of revenue initially using the accrual method but then switched to the cash method for a time but then reverted to using the accrual method. This RI did not amend its financial statements despite the fact that the amount was material and this resulted in the note to the financial statements describing the policy for revenue recognition being incorrect for the period in which cash-based accounting was used. In addition, it caused fluctuations in many key ratios. The RI acknowledged the error, which it had not detected prior to filing the incorrect financial statements. We required reissuance of corrected financial statements, MD&A and certificates for the affected periods.
- **Gross versus net recording of revenue.** EIC-123 *Reporting Revenue Gross as a Principal versus Net as an Agent* states that an enterprise should consider whether it is acting as principal in a transaction. Specifically, a RI should consider whether it takes title to the products, and has risks and rewards of ownership, or whether it acts as an agent or broker, with compensation on a commission or fee basis. We noted a RI who, though clearly acting as an agent, recorded the revenues and expenses on a gross basis, materially overstating both revenue and expenses during the periods in question. We required reissuance of corrected financial statements, MD&A and certificates for the affected periods.

Investors must be able to understand the sources and nature of a RI's revenue. RIs should ensure that their revenue recognition policy is clear, complies with GAAP and is applied consistently. All new types of contracts or revenue generating activities should be carefully analyzed at inception to ensure that the revenue recognition policy being used is appropriate. In addition, in a multiple-stage earning process, it is necessary to consider the individual elements in the earning process and link them to revenue recognition. It is also important that revenue recognition policy is clearly described in a RI's financial statements.

Segmented Information

Financial statements are required to include note disclosure about a RI's business segments pursuant to CICA Handbook section 1701 *Segment Disclosures*. We have queried various RIs regarding their disclosure of business segments.

An operating segment is defined in CICA Handbook section 1701.10 as “a component of an enterprise: (a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses related to transactions with other components of the same enterprise), (b) whose operating results are regularly reviewed by the enterprise’s chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and (c) for which discrete financial information is available.”

We noted numerous examples where the segments disclosed in a RI’s financial statements do not coincide with the segments discussed in the MD&A, elsewhere in the annual report or in another CD document. RIs must consider the criteria set out in the CICA Handbook above to determine their segments and consistently discuss only those segments in their CD documents.

Another observation related to segmented information relates to the use of the aggregation criteria outlined in CICA Handbook section 1701.18. One or more operating segments can be aggregated if they have similar economic characteristics and if they are similar in a number of other areas including: the nature of the products or services; the nature of the production processes; the type or class of customer for the products or services; the methods used to distribute the products or services; and the nature of the regulatory environment. RIs must ensure that they meet all of the criteria listed in this paragraph prior to aggregating their operating segments. We noted some instances where it appeared that the aggregation criteria were being used incorrectly. These RIs were required to provide support for their positions and to expand their disclosure in future financial statements.

We also noted instances of RIs not making the required disclosure concerning identified reporting segments. CICA Handbook section 1701.30 states, “An enterprise should disclose a measure of profit or loss and total assets for each reporting segment.” This paragraph goes on to list other suggested disclosure that should be made if the chief operating decision maker regularly reviews the measure or if the measure is included in the measure of segment profit or loss reviewed by the chief operating decision maker. Many RIs disclose only a measure of profit or loss and perhaps total assets. Few RIs disclose any of the other measures suggested by CICA Handbook section 1701.30 including revenues from external customers, interest revenue/expense, amortization of capital assets and others.

From time to time, RIs ask us if they are permitted to exclude segmented disclosure from their financial statements for competitive reasons. The Accounting Standards Board of CICA stated in its “Basis for Conclusions” for section 1701 that a competitive harm exemption was inappropriate.

Continuity-of-Interests Accounting

EIC-89 Exchanges of Ownership Interests Between Enterprises Under Common Control - Wholly and Partially-Owned Subsidiaries includes a discussion of continuity-of-interests accounting. When a business combination occurs between businesses under common control, the transfer is accounted for using the carrying values of the net assets. This is often referred to as continuity-of-interests accounting and is reflected in the financial statements of the ongoing entity by showing the combined results of the businesses for the periods for which they were under common control.

We noted several examples of situations where carrying values were used due to common control but the historical results of the combined entities were not disclosed. The financial statements disclosed that continuity-of-interests accounting was used but only the results of the acquired company from the date of acquisition onwards were included. The continuity-of-interests method requires both the use of the carrying value and the disclosure of historic financial results for the combining entities - we expect RIs to properly apply the method.

Purchase Price Allocations

When a business combination occurs, RIs are required by the CICA Handbook to disclose the allocation of the purchase price among the net assets purchased. While we have found that RIs are generally providing such a breakdown in the notes to their financial statements, we have noted that improvements could be made in both the notes to the financial statements and the MD&A with respect to the description of the business combination and the particular assets and liabilities acquired. Often the descriptions are so vague that they provide little or no meaningful information to readers. While not specifically mandated by the CICA Handbook or securities legislation, the involvement of a professional valuator (either internal or external) to assist in properly identifying and valuing acquired assets and liabilities and valuing them may be beneficial to some RIs.

Variable Interest Entities

ASC Staff participated in a CSA targeted review of selected RIs to assess compliance with AcG-15 *Consolidation of Variable Interest Entities*. AcG-15 applies when an entity is subject to control on a basis other than ownership of voting interest and is effective for annual and interim periods beginning on or after November 1, 2004. A variable interest entity ("VIE") is essentially an entity that does not have sufficient equity at risk to finance its activities without financial support. AcG-15 requires that a RI consolidate a VIE when it has a contractual, ownership or other financial interest that will absorb a majority of the VIE's expected losses or receive a majority of the VIE's expected residual returns.

In our review, we focused on industries where RIs are more likely to have an interest that may require consolidation. We reviewed the financial statements of each RI to gain an understanding of whether and how the guideline was applied. We requested from the RI a detailed description of the process undertaken to identify any potential variable interests, the analysis used by the RI to support their decision, and the types of controls RIs had in place to ensure that all variable interests were correctly identified. We concluded that compliance with AcG-15 was adequate. Despite these positive results, identification of VIEs can be very complex and we encourage RIs to continue to closely examine all their contracts and relationships to ensure that they properly identify all variable interest entities and determine the primary beneficiary of the VIE.

Cash Flow Statements

Cash flow statements are generally well done. However, there are two issues which tend to recur:

- **Use of a subtotal in the cash flow from operating activities section of the cash flow statement.** This subtotal is often captioned "Cash Flow from Operations" or "Cash Flow" even though it represents cash from operating activities before changes in non-cash working capital. As noted in CSA Staff Notice 52-306 *Non-GAAP Performance Measures*, non-GAAP performance measures should not be part of GAAP financial statements. In the event that an uncaptioned subtotal is included as part of the cash flow from operating activities section of the cash flow statement, the only item reconciling the subtotal to cash from operating activities should be changes in non-cash working capital. For a further discussion of the disclosure requirements pertaining to non-GAAP performance measures, please see the 'Other Non-GAAP Performance Measures' section on page 8 of this report.
- **Recording non-cash transactions on the cash flow statement.** We still see instances where non-cash transactions such as shares issued on the purchase of capital assets are appearing on the cash flow statement despite the fact that CICA Handbook section 1540.46 clearly states that this is not in accordance with GAAP and despite the practice being clearly inconsistent with the very nature and purpose of a statement focusing strictly on the cash items.

Disclosure of Complex Transactions

We noted a number of instances of poor disclosure of complex transactions during this reporting period. Often these transactions involve related parties. It is vital that stakeholders be able to understand the linkages between various accounts, parties and transactions even when they span a number of years.

- In one instance, a RI purchased an asset through the issuance of shares and debt. The disclosure in the notes to the financial statements regarding this transaction was inconsistent with disclosure in other CD documents filed by the RI. There were amendments to the price per share of the issued securities and the RI later paid a portion of the debt through a further issuance of securities. This was a complex transaction that the RI did not fully disclose in any of its CD documents. The RI undertook to more completely disclose this issue and any similar issues in future financial statements.
- In another example, a RI entered into related party transactions with a number of entities over a number of years. These transactions resulted in the transfer of cash out of the RI. The RI did not disclose the business purpose behind the related party transactions. Given the complexity of the transactions, the time period over which the transactions occurred and the RI's lack of disclosure in its CD filings, it was very difficult to understand the flow of funds. This RI is subject to a cease trade order until our queries have been satisfactorily addressed.
- Another RI described its notes payable and receivable such that they appeared to be intercompany balances between the parent and its subsidiaries rather than between the consolidated entity and third parties. As a result, it appeared that the RI had not appropriately consolidated its financial statements. This same RI also entered into a number of unusual, material transactions that were not disclosed in its CD documents. One of their arrangements resulted in the RI earning substantial dividends from nominal investments in private companies. It was unclear why these private companies would pay such substantial dividends on such small investments. We determined that the owners of the private companies received other monetary benefits as a result of the payment of their dividends and the RI actually only kept a small percentage of the dividends received. Neither of these facts was disclosed and the accounting used was not correct. We required this RI to restate annual and interim financial statements and MD&A as well as certificates for a number of periods to properly record and describe the nature of these transactions.

The common thread in all of these examples is that RIs did not present transactions that were a material part of the financial statements in a clear and understandable manner that would provide useful information to a stakeholder. Significant effort is required by RIs to ensure that they provide clear communication in the CD documents for all material, complex transactions. Where we note deficiencies in disclosure surrounding these types of transactions, RIs will likely have to restate and refile their CD documents with more complete disclosure.

RIs are reminded that stakeholders do not have the same ability as the regulators to question a RI's CD disclosure. It is essential that the CD record of a RI clearly describe any complex or related party transactions.

Distributable Cash and Other Income Trust Disclosure

CSA Staff Notice 51-319 *Report on Staff's Second Continuous Disclosure Review on Income Trusts* was published on August 4, 2006. It was based on a targeted review of 45 income trust RIs across Canada. A significant number of the RIs examined had deficiencies noted in their disclosure. In addition, ASC Staff conducted numerous high-level and full continuous disclosure reviews of Alberta-based income trusts.

Deficiencies in disclosure pertaining to distributable cash were a significant concern. Our reviews indicated that there is little consistency in this measure between RIs or even from one period to the next by the same RI. Though the term “distributable cash” is commonly interpreted to be a measure of the cash which the RI could pay out to its unit holders, it is not currently defined by securities regulations.

We believe that the make-up of distributable cash is a function of each individual RI's operating, financing and investing needs. Nonetheless, we have recently proposed clarifications to current staff notices and policies to provide increased guidance as to how distributable cash should be disclosed. CSA Staff Notice 52-306 *Non-GAAP Performance Measures* was revised in August 2006. National Policy 41-201 *Income Trusts and Other Indirect Offerings* (“NP 41-201”) was published for a 90-day comment period on December 21, 2006.

One of the more important changes proposed to the guidance is the clarification that distributable cash is a cash flow measure, not an operational performance measure. The implication of this is that the distributable cash calculation should begin with cash flow from operating activities rather than any other measure. Historically, trusts have begun their reconciliations with net income, EBITDA (earnings before interest, taxes, depreciation and amortization) or some other adjusted earnings or cash flow measure. The reconciliation should begin with a GAAP cash flow measure, cash from operating activities. Beginning with an adjusted cash flow measure such as funds from operations (which is the term generally used to apply to cash from operating activities prior to changes in non-cash working capital) is not permitted under NP 41-201. Adjusting for changes in non-cash working capital is discouraged. RIs must adequately support and disclose all reconciling required to reconcile cash flow from operating activities to distributable cash.

We noted another common deficiency that resulted from the disclosure surrounding the source of funding actual cash distributions. Often, RIs report significant differences between the computed distributable cash figure and the actual cash distributions made with little or no discussion of the reason for this difference. Where actual distributions exceed cash from operating activities, we expect the disclosure to explain the source of the distributions, the effect on the sustainability of future distributions and whether there is an economic return of capital inherent in the distribution.

Aside from distributable cash disclosure, other common issues were: poor or boilerplate discussions of liquidity, risks and uncertainties and overall performance and results of operations; use of other non-GAAP performance measures without following the appropriate guidance in CSA Staff Notice 52-306 *Non-GAAP Performance Measures*; not appropriately testing goodwill for impairment in a timely manner; not including complete disclosure of executive compensation due to the use of an external management company; not appropriately assessing whether a material change had occurred; and not filing material contracts.

One specific item of disclosure that we will be expecting in future MD&A of income trust RIs relates to the announcement on October 31, 2006 that trusts will be taxed effective in 2011. Trust RIs will need to consider the implications of this announcement on their goodwill, future income taxes and general disclosure regarding expectations for the future.

Other Non-GAAP Performance Measures

CSA Staff Notice 52-306 *Non-GAAP Performance Measures* describes Staff's expectations surrounding disclosure of non-GAAP measures. This Notice was issued in 2003 (revised in 2006). We were disappointed to still find numerous deficiencies by many RIs surrounding disclosure of non-GAAP performance measures.

We noted instances where RIs inappropriately included non-GAAP financial measures in GAAP financial statements. These include use of adjusted income subtotals (e.g., income before one-time loss) and incorrectly describing the subtotal of cash from operating activities prior to changes in non-cash working capital as cash flow or cash flow from operations.

CSA Staff Notice 52-306 states "Specifically, issuers should:

1. state explicitly that the non-GAAP financial measure does not have any standardized meaning prescribed by GAAP and is therefore unlikely to be comparable to similar measures presented by other issuers;
2. present with equal or greater prominence than the non-GAAP financial measure the most directly comparable measure calculated in accordance with GAAP;
3. explain why the non-GAAP financial measure provides useful information to investors and how management uses the non-GAAP financial measure;
4. provide a clear quantitative reconciliation from the non-GAAP financial measure to the most directly comparable measure calculated in accordance with GAAP, referencing to the reconciliation when the non-GAAP financial measure first appears in the disclosure document;
5. explain any changes in the composition of the non-GAAP financial measure when compared to previously disclosed measures."

In the MD&A, RIs generally complied with the requirement to disclose that the non-GAAP measure does not have any standardized meaning and is unlikely to be comparable to similar measures presented by other RIs. However, we noted numerous RIs failed to disclose the most directly comparable GAAP measure with equal prominence, to explain why the non-GAAP measure provides useful information to investors and most RIs did not explain how management uses the non-GAAP measure. We will continue to question the completeness of RIs' disclosure in these areas in 2007.

Certifications and Conclusions about Effectiveness of Disclosure Controls and Procedures

We were disappointed to discover numerous deficiencies in filings under Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings* ("MI 52-109"). This led to a CSA issue-oriented CD review that culminated in CSA Staff Notice 52-315 *Certification Compliance Review* being published in September 2006. While most RIs in the review (96%) filed the correct form of certificate, 28% of the RIs did not disclose their conclusions about the effectiveness of their disclosure controls and procedures in their annual MD&A. This is a significant non-compliance level.

MI 52-109 requires the certificate mandated by Form 52-109FT1 *Certification of Annual Filings During Transition Period* for years ending on or before March 30, 2005 and the certificate mandated by Form 52-109FT2 *Certificate of Interim Filings During Transition Period* for any interim periods that ended prior to the end of the first financial year in respect of which the RI is required to file an annual certificate in Form 52-109F1 *Certification of Annual Filings* ("Form 52-109F1"). Modified annual or interim certificates are permitted for financial years ending on or before June 29, 2006 that allowed Form 52-109F1 and Form 52-109F2 *Certificate of Interim Filings* ("Form 52-109F2") certificates to exclude certain representations. Complete annual and interim certificates required by Form 52-109F1 and Form 52-109F2, respectively, are required for all subsequent periods.

As noted in our review, many RIs made no disclosure whatsoever regarding the effectiveness of the disclosure controls and procedures in their MD&A even though they certified that they had done so. This brings into question whether the CEO and CFO are taking the certificates they are signing seriously and whether they have given appropriate consideration to the other elements of the certificate that they have signed.

We required numerous Alberta RIs to restate and refile both MD&As and certificates due to:

- deficient or non-existing disclosure in the annual MD&A regarding disclosure controls and procedures;
- incorrect form of certificates being filed;
- incorrect date on the certificates;
- certificates not being re-filed when amended financial statements and/or MD&A are filed; and
- correction of conclusions regarding the effectiveness of disclosure controls to describe any deficiencies, how the deficiencies were rectified and whether the disclosure controls were effective at the date of filing the revised certificates.

RIs are reminded that for year-ends after June 29, 2006, the annual certificates must be in Form 52-109F1. As indicated above, prior to this date RIs were permitted to file a transitional form (for financial years ending prior to March 31, 2005) or a modified version of the full form (for financial years ending on or before June 29, 2006).

Deficiencies in meeting the requirements of MI 52-109 will likely result in a RI being added to the default notation on the RI List maintained on the ASC website. Please see refer to the 'Reporting Issuers List' section of this report on page 15.

RIs in general, and CEOs and CFOs specifically, are reminded that whenever a CD document is filed for the first time or later refiled, a certificate is required as of the date of each filing. Care should be taken that the representations contained in the certificates are accurate prior to their execution.

Environmental Reporting

National Instrument 51-102 *Continuous Disclosure Obligations* ("NI 51-102"), section 7.1 requires RIs to disclose material changes immediately, and any material facts, risks and uncertainties relating to their operations in their MD&A and AIF. In addition, Form 51-102F2 *Annual Information Form* ("Form 51-102F2") requires: disclosure of the financial and operational effects of environmental protection requirements on the RI's capital expenditures; earning and competitive position in the current financial year and the expected effect in future years; a description of environmental policies that are fundamental to operations, such as policies on a RI's relationship with the environment and the steps taken to implement them; and risk factors relating to the RI and its business, including environmental and health risks. This disclosure is typically boilerplate risk disclosure. However, investors are increasingly interested in RIs' environmental policies and results and the effect on future operations. As a result of this increased interest, we will increase our focus on the adequacy of this disclosure in future CD reviews and encourage RIs to improve their disclosure by increasing the specificity of any environmental risks likely to affect the RI.

Material Contracts

NI 51-102, section 12.1 (e) requires that contracts of a RI that materially affect the rights of its security holders must be filed on SEDAR. Section 12.2 states that any material contract, other than one entered into in the normal course of business, must be filed. RIs should ensure that they file all documents that meet the definition of a material contract. We found that some RIs are not filing documents that should be considered material contracts or are not filing amended agreements when they have revised terms of a material agreement.

Press Releases

Certain revisions to NI 51-102 were effective on December 29, 2006. One revision was the addition of Item 11.2 to the Companion Policy to NI 51-102 that indicates that RIs should file a press release with refiled documents outlining the changes from the original document. As this is a new requirement and is not something all RIs have historically done on a voluntary basis, we remind RIs of the need to file a press release along with revisions to any other CD document.

Unsigned Audit Reports

NI 51-102, sections 4.1 and 8.4 require annual financial statements of a RI and acquired company respectively to be accompanied by an auditor's report. Auditors must sign this report. Staff noted some reports where there is nothing in the space designated for a signature or, alternatively, that only the word "signed" is found. In other cases, the auditor's report is not on the letterhead of the auditor and contains only the word "signed". It should be apparent from review of the audit report not only that it has been signed but also which accounting firm has signed the report.

Change of Auditor

NI 51-102, section 4.11 requires certain documentation to be filed with us when there is a change in auditor. This section includes a requirement for a letter to be filed with the securities commission from both the former and successor auditor. We noted instances where RIs failed to file this reporting package or failed to file the package within the mandated timelines. RIs could receive a default notation on the RI list due to these deficiencies. Please see the section of this report titled, 'Reporting Issuer List' for more information on the default notation.

Business Acquisition Reports (BARS)

The requirements for BARS can be found in NI 51-102, Part 8. This Part requires that a BAR be filed within 75 days of the date of acquisition. The BAR must contain historical financial statements of the business acquired and pro forma financial statements for the RI. These rules are consistent with the acquisition financial statements required under the prospectus rules. Some of the common deficiencies noted were:

- RIs did not always file BARS before the 75 day deadline;
- RIs sometimes did not file BARS at all;
- RIs filed operating statements instead of required full financial statements, without any exemptive relief being obtained;
- RIs filed complete acquisition financial statements in a prospectus but then did not update the statements in the BAR to a more current date as required by Part 8 and did not obtain the relief necessary to obtain an exemption from updating the statements; and

- RIs made adjustments to pro forma financial statements that did not fit within the limitation relating to acceptable adjustments suggested in NI 51-102 CP 8.7(5).

Deficiencies can lead to being found in default of securities legislation and potentially being cease traded. RIs must ensure that they either obtain required relief prior to the filing deadline or ensure that their BAR is in compliance with NI 51-102.

Annual Information Form (AIFs)

We have noted the following deficiencies through our review of AIFs:

- RIs often disclosed GAAP as a risk factor. GAAP is the set of rules and guidance that mandates how RIs present financial statements and should not be discussed as a risk factor.
- There is often standard wording in an AIF discussing forward-looking information. Some RIs indicated that they are not obligated to update this information. RIs must indicate that they will update forward-looking information where required by securities legislation.

Audit Committee and Corporate Governance

CSA Staff Notice 52-309 *Audit Committee Compliance Review* was published in January 2006. It summarizes the results of an issue-oriented CD review focused on compliance with Multilateral Instrument 52-110 *Audit Committees* ("MI 52-110"). This review covered the independence and financial literacy of audit committees as well as audit committee charters.

We did not identify any issues surrounding the financial literacy of audit committee members.

We did question whether some audit committee members had a material relationship with the RI that would affect the determination of whether they were independent for the purposes of MI 52-110. There were a few instances where we required RIs to change the composition of their audit committees.

We noted some deficiencies in audit committee charters, which we requested be improved and refiled in the future. We identified a few cases where the audit committee charter was not filed at all and we requested that this be rectified.

The CSA is currently in the process of completing a follow-up issue-oriented CD review in this area. Once the results have been compiled, a CFA Staff Notice will be issued containing summarized results along with commentary on any common areas of deficiency.

The CSA is also currently conducting an issue-oriented review of National Instrument 58-101 *Disclosure of Corporate Governance Practices* ("NI 58-101"). The results of this review are not yet available. However, through other CD reviews, we noted instances where some disclosure required by NI 58-101 are missing.

RIs could receive a default notation on the RI list due to deficiencies from the requirements of MI 52-110 and NI 58-101. Please see the section of this report titled, 'Reporting Issuer List' for more information on the default notation.

Interim Financial Statements and MD&A

In general, we have found that the quality of the interim financial statements warrants improvement. This may be due to less or no involvement from external auditors, some RIs feeling less focus needed, shorter deadlines for interim financial reporting or a perception that GAAP requirements for interim financial statements are minimal or non-existent. While it is appropriate to refer back to the notes and policies in the most recent annual audited financial statements rather than replicate all of the notes in the interim statements, there are still certain disclosure mandated by CICA Handbook section 1751.14 that RIs must include. We noted instances where some required disclosure have not been made. In addition, the related interim MD&A must be at a level sufficient to provide useful information to users. Please refer to the Other MD&A Issues section below for observations on common deficiencies in this area.

Other MD&A Issues

The quality of MD&A has generally improved compared to 2005. However, a number of areas remain where improvements can be made:

- **Results of operations.** This discussion should not be a mechanical reproduction of amounts contained in the income statement. RIs should explain significant accounts, relationships, events and transactions so that the reader clearly understands the RI's results for the period and the factors behind changes in those results.
- **Summary of quarterly results and any fourth quarter fluctuations.** RIs are required to disclose specified quarterly information for their last eight quarters. This disclosure is sometimes missing. RIs are also required to discuss and analyze any fourth quarter events or items affecting their financial condition or results. We often find unusual fluctuations in the fourth quarter that are not discussed in adequate depth or, more often, are not discussed at all. These changes could signify changes in operations, policy, or estimates; acquisitions/dispositions; error corrections; or some other change in the organization. It is important that RIs address these changes in such a manner that the reader will understand the reasons behind quarterly changes, the nature of the changes, as well as the amounts.
- **Liquidity and capital resources.** This disclosure should be an informative discussion that encompasses more than reference to figures in the financial statements. Many RIs provide minimal discussion in this area. Disclosure should describe the RI's current working capital position, required working capital and how these could affect the future operations or capital expenditures of the RI. Availability of financing and details of existing financing arrangements may also be relevant to discuss.
- **Forward-looking information.** RIs are encouraged to increase the specificity of forward-looking information in the MD&A to ensure that readers are provided with a useful and realistic picture of management's expectations for the future as well as allowing readers to make their own assessments. Generally, RIs limit their discussion to past performance and do not explain the implications on future prospects. We are proposing changes to our requirements surrounding forward-looking information. The proposed changes were published for comment on December 1, 2006 as part of further amendments to NI 51-102.
- **Ceiling test and other material write-downs.** RIs should discuss any ceiling test adjustments or other significant adjustments or impairment provisions in the MD&A. Such discussion could include the reasons for the adjustment and how it was calculated. A number of RIs made no reference to this type of significant adjustment in their MD&A.

- **Outstanding share data.** RIs often did not disclose outstanding share data. This information is required in the MD&A by Item 1.15 of 51-102F1 Part 1.
- **Quarterly and annual information.** RIs sometimes did not disclose the required summary of quarterly results and selected annual information.
- **Financial instruments.** RIs often did not include the detailed disclosure required in relation to financial instruments. This information was sometimes missing and often incomplete. Such information is needed to enhance the reader's understanding of such instruments.
- **Projects without revenue.** Many smaller RIs that were involved in significant projects that were not yet generating revenues gave little real insight into the project for readers. The MD&A should describe the project, the RI's plan for the project and its status, expenditures made, as well as anticipated timing and costs.

Other Financial Statement Deficiencies

Following is a list of other miscellaneous financial statement deficiencies that we noted:

- RIs often did not provide accumulated amortization for each class of capital asset.
- RIs did not disclose whether they used the treasury stock method in calculating diluted earnings per share.
- RIs often did not detail the specific items to which estimates are applied in measurement uncertainty notes.
- RIs often omitted disclosure regarding cash distributions from the financial statements of income trusts.
- CICA Handbook Section 3870.68 (b) requires the disclosure of the weighted average grant-date fair value of options granted during the year. RIs sometimes omit this required disclosure.

2.2 Short Form Prospectus and Rights Offering Circular Deficiencies

Following is a list of deficiencies noted in these offering documents:

- RIs often did not disclose the minimum proceeds required.
- RIs identified that certain conditions had to be satisfied in order for a standby commitment to be effective, but did not explain or detail these conditions.
- RIs often provided a weak explanation for the use of proceeds. RIs would often state that they would use the proceeds for capital expenditures but they did not provide detail regarding the projects or specific uses for the proceeds.
- Often RIs noted that the proceeds will be used to repay indebtedness; however, the amounts to be repaid have not been provided as required by Item 4.1 of Form 44-101F1 *Short Form Prospectus* ("Form 44-101F1").
- RIs often did not express the over-allotment option as a percentage as required by Instruction 2 of Item 1.10 (6) of Form 44-101F1.

- While income trust RIs did file their Credit Facility Agreements (that include covenants and borrowing limits), they did not usually disclose covenants in the trust's prospectus as required by National Policy 41-201 *Income Trusts and Other Indirect Offerings*, 2.7. Income trust RIs should ensure that this discussion of covenants is included in any prospectuses filed.

2.3 SEDAR

The provision of current and reliable information by RIs is essential to the efficient operation of the capital market. This includes a RI's "profile" on the System for Electronic Document Analysis and Retrieval ("SEDAR"), which provides vital information, including contact information, about a RI that is relied on by capital market participants and securities regulators. SEDAR profiles must, therefore, be accurate. In the course of our reviews, we noted numerous profiles that were out of date or otherwise not accurate. We encourage all RIs to review and update the information provided in their profile regularly.

Additional information regarding SEDAR and the SEDAR filer manual is available at www.sedar.com or at www.albertasecurities.com under the section "Company Disclosure and Compliance".

2.4 Reporting Issuers List

Effective September 2006, the ASC replaced the weekly defaulting issuer list posted on its website with a Reporting Issuers list ("RI list") that is updated each business day. The RI list identifies:

- RIs that are reporting issuers in Alberta;
- Alberta RIs noted in default of certain requirements of Alberta securities laws; and
- Alberta RIs whose securities are the subject of a general cease trade order issued by the ASC.

ASC Policy 51-601 *Reporting Issuers List* ("Policy 51-601") provides the procedures followed by staff for placing a RI in default for key continuous disclosure documents and the content therein.

The appendix attached to Policy 51-601 lists key deficiencies considered in registering a default notation on the RI list. Items that may lead to a default include:

- Staff detect and confirm a deficiency related to the failure to file specified continuous disclosure documents;
- significant content related deficiencies; and
- the failure to comply with any other requirement not specifically identified as a ground for a potential default notation.

RIs should note that Staff might register a default notation on the RI list, as a result of a CD review, without prior notification to the RI. In this circumstance staff will provide notification of the default to the RI in the CD comment letter from staff. In certain circumstances a RI will receive a limited amount of time to remedy a deficiency prior to the notation of a default on the RI list. Staff will provide the applicable details in their CD comment letter.

3. Conclusion

Based on the 2006 CD Review, we believe that the quality of financial reporting is at a satisfactory level. However, there is room for improvement.

One of the more significant areas of non-compliance with disclosure requirements over the past year was involved the certificate requirements in MI 52-109. RIs should closely review the requirements and ensure that they are complying with the provisions of this instrument.

ASC staff are focusing more on transactions and disclosure in the secondary market. The total value of equity issuances in 2005 was \$49 billion, compared to a total value of secondary market trading in that year of \$1.1 trillion. We are increasingly reliant on the CD record of the RI rather than simply ensuring that disclosure is up-to-date as of the filing of a primary offering document. As a result Staff will continue to focus our reviews on the CD record of RIs headquartered in Alberta.

The strongest message to come from our 2006 CD Review is the need for more attention by RIs to providing clear, useful disclosure to investors. Boilerplate disclosure is not helpful. Instead, RIs should consider whether their disclosure fairly and accurately portrays their business and operations with sufficient clarity and specificity to enable readers to understand management decisions and to make their own investment decisions.

It is Staff's intention that this report assists RIs in improving their continuous disclosure record in the future.

Consultations with Reporting Issuers

Management of RIs and their advisers who have questions or difficulties in the preparation of CD materials or accounting and auditing issues are welcome to consult ASC Staff provided the ASC or another regulator is not already dealing with the matter and the matter is not part of a court proceeding. Staff expects that the inquirers will have fully researched the matter before we are contacted.

Feedback on the Reviews

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

4. Contact ASC Personnel

To discuss any aspect of this report, please contact:

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4th Floor, 300-5th Avenue S.W.
Calgary, Alberta
T2P 3C4
(403) 297-6454

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Lara Gaede, CA, CFA, Associate Chief Accountant (403) 297-4223 or lara.gaede@seccom.ab.ca

Tom Graham, CA, Director, Corporate Finance (403) 297-5355 or tom.graham@seccom.ab.ca

Agnes Lau, CA, Associate Director, Corporate Finance (403) 297-8049 or agnes.lau@seccom.ab.ca

Secondment to Chief Accountant's Office

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

