Continuous Disclosure Review Program

2007 Report

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

Office of the Chief Accountant

Alberta Securities Commission
February 2008

ASC
Alberta Securities Commission

Table of Contents

Executive Summary

The 2007 Report on the Review of Financial Statements, MD&A and Other Materials summarizes the Alberta Securities Commission's (ASC) review of continuous disclosure filings (CD reviews) made by Alberta-based reporting issuers (RIs) between January 1, 2007 and December 31, 2007 and discusses key issues that we believe will be of interest to all RIs.

There are approximately 920 RIs in Alberta. In 2007, we completed 236 CD reviews. We reviewed interim and annual financial statements and management's discussion and analysis (MD&A), annual information forms (AIFs), business acquisition reports (BARs) and certifications by chief executive officers and chief financial officers (the 52-109 Certificates).

We are generally satisfied that the annual audited financial statements meet the standards required by the Generally Accepted Accounting Principles (GAAP) determined with reference to the Canadian Institute of Chartered Accountants Handbook (CICA Handbook). However, we see room for improvement in the areas of MD&A and financial statement note disclosures. We see boilerplate, generic and vague disclosure, and disclosure that lacks sufficient depth to enable a reader to understand the issue being discussed. In some cases we observed that RIs repeated the disclosure presented in prior years' filings even though the adoption of recent accounting standards would require expanded disclosure.

We suggest disclosure improvements primarily in the following areas: related party transactions, financial instruments, MD&A, 52-109 Certificates, BARs, non-GAAP financial measures and interim financial statements. Our report also identifies other areas where disclosure could improve.

Looking forward, the CICA Handbook introduced a number of new financial reporting standards for 2008 fiscal year financial reporting. The majority of these changes reflect the convergence of Canadian GAAP with International Financial Reporting Standards (IFRS). Preparers of financial statements will note that the new standards tend to require more detailed disclosure in the financial statement notes, which is consistent with the principles-based IFRS model. RIs are reminded that upon first adoption of these new standards, we expect full disclosure of the adoption of the new standards in the financial statement notes for the applicable interim or annual reporting period and will be assessing compliance with this expectation in our review program for the 2008 year.

RIs should be aware that the rescission of National Policy 48 *Future-Oriented Financial Information* (NP 48) and its replacement by amendments to National Instrument 51-102 *Continuous Disclosure Obligations* (NI 51-102) effective December 31, 2007 introduced new requirements regarding the disclosure of forward-looking information (FLI). In addition, other amendments have been made to NI 51-102 effective December 31, 2007 that affect disclosure in the AIF and information circulars. NI 41-101 *General Prospectus Requirements,* which was published in final form December 21, 2007 and will take effect on March 17, 2008, was also accompanied by consequential amendments to other rules that will affect disclosure in the AIF, MD&A and information circulars. RIs and their advisors should continuously monitor changes to securities legislation and ensure that filings comply with the new requirements.

We also remind RIs to begin immediate preparations to ensure that re-tooling of accounting and recordkeeping systems, staff training and education for users of financial statements are in place well in advance of the 2011 transition date to IFRS.

1. Introduction

1.1 General

The continuous disclosure (CD) regime under securities legislation sets out the required continuous disclosure filings (CD documents) for RIs, including RIs' financial statements, MD&A, AIFs, BARs and 52-109 Certificates by a chief executive officer (CEO) and the chief financial officer (CFO). This report focuses on the areas where we believe improvement in the CD documents is necessary.

For this report, Staff reviewed CD documents filed by Alberta based RIs between January 1, 2007 and December 31, 2007. The key objectives of these reviews are to monitor the adequacy of filings and to assess their quality. However, we also take the opportunity to raise awareness with RIs and their advisers as to problem areas, with a view to improving the completeness, quality and timeliness of their disclosure.

Our objectives for the publication of this report are:

- to inform the filing community and the general public of our findings and our expectations;
- to update and educate RIs on key themes, hot topics and pitfalls to avoid when preparing their CD documents;
- to stimulate further dialogue between preparers of CD documents, their auditors and other advisers, and members of the audit committee, with the goals of improving the quality of filings and encouraging a higher standard of disclosure; and
- to challenge and encourage management of public companies to continuously improve their disclosure.

1.2 Summary of Findings and Themes

This is the seventeenth year that the ASC has commented on the quality of financial reporting and other CD documents filed by RIs. We are generally satisfied that the disclosure in annual audited financial statements are meeting the minimum standards required by the CICA Handbook. However, expectations are evolving. As business environments, securities laws and accounting rules become increasingly complex, RIs are expected to provide more qualitative discussion and analysis of financial impacts, potential variability, risks, trends and future outlooks in respect of their material transactions, financial results and financial position.

Regardless of the subject area (e.g., financial instruments, related party transactions, revenue recognition, MD&A), we continue to see boilerplate, generic or vague disclosure. In some cases we see RIs that repeat disclosure from prior years' filings even though the adoption of recent accounting standards, such as financial instruments or new circumstances, would require expanded disclosure. Generally, we see room for improvement in the areas of MD&A and financial statement note disclosure. RIs can provide more detail to supplement the information that is recorded in the financial statements and enhance the reader's understanding of what the financial statements do and do not disclose.

With the bulk of securities trading activity occurring in the secondary market, the focus of the securities regulatory system has shifted to CD. The 2005 amendments to National Instrument 44-101 *Short Form Prospectus Distributions* (NI 44-101) enable more RIs access to the short-form prospectus system by placing reliance on their CD documents. Along with the expectations that come as a result of the certification of annual and interim filings, management - in particular the certifying officers - must take greater care to ensure that financial statements and other CD documents present fairly all material aspects of their business in a timely, reliable and insightful fashion.

2. Results of Review

Sample Characteristics

Our findings were based on a review of CD documents filed by a sample of 236 RIs out of a total population of approximately 920 Alberta based RIs. The scope of RI reviews ranged from full reviews of all of an RI's CD documents to high-level examinations of CD documents (high-level review) or issue-oriented reviews concerning a particular type of CD document or a specific disclosure topic.

In 2007, we completed 236 CD reviews consisting of 57 full reviews, 75 high-level reviews and 104 issue-oriented reviews. The 2007 review program covered all of an RI's CD filings for the 2006 calendar year and all CD filings in 2007 up to the date that the review was closed. In the case of a full review, the ASC reviewed all of the RI's filings for the examination period to assess compliance. In the case of a high-level review, the ASC applied a risk-based methodology on selected RIs and a smaller sample of filings was reviewed. In the case of an issue-oriented review, staff focused on specific disclosure requirements or selected topics of interest.

Quantitative Results

As a result of our reviews, we took specific actions in 155 instances, including:

- 55 requests to amend and refile one or more CD documents;
- eight referrals to ASC's Enforcement Division;
- two RIs cease traded for key CD deficiencies;
- 11 RIs noted in default on the ASC's Reporting Issuer List (the RI List) for key CD deficiencies; and
- 79 instances in which RIs undertook to improve their disclosure in future.

Fewer than 155 RIs were the subject of these actions. One RI may have generated several outcomes because they were asked to amend and refile one or more CD documents and undertake to make a number of future improvements in one or more disclosure areas. Many of the requests to amend and refile CD documents related to observed deficiencies in compliance with Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings.*

3. Accounting and Disclosure Deficiencies

3.1 Related Party Transactions

We continue to see inadequate disclosure in the area of related party transactions. Because related parties have a pre-existing relationship, the overall assumption that a transaction occurs at arm's length does not apply. Therefore, RIs must ensure that disclosure is sufficient to enable readers to appreciate the terms and business purpose of such transactions. There is a strong argument that related party transactions, by their very nature, should always be considered material to the reader and, as such, RIs should strive to promote clear and transparent disclosure of a high standard in this area. However, we find in some instances the disclosure is boilerplate or offers insufficient insight to be useful to the reader.

In some cases, we have identified related party transactions in our review of an RI's other CD documents (e.g., AIF, information circular) but found no corresponding disclosure in the RI's financial statements and MD&A. This was observed in respect of, among other things, private placements and other financing transactions with related parties. In other cases, the terms of the related party transactions were discussed in detail in other CD documents but the financial statement and MD&A disclosure was insufficient. In one example, a debt held by a related party had a conversion feature that diluted shareholder interests. The fact that a related party held this convertible debt was not disclosed.

We also noted transactions between an RI and its executive officers or directors that appeared to be related party transactions but were not accounted for as such. When questioned, management responded that the transactions were not related party transactions because the independent members of the Board of Directors reviewed and approved of the transaction.

CICA Handbook paragraph 3840.04 identifies commonly encountered related party relationships. It specifies that directors serving on an independent committee of the board of directors to represent non-controlling interests are not considered to be related parties for the transaction under consideration. In our reviews, we found that some RIs incorrectly interpreted paragraph 3840.04 to mean that a transaction is not considered to be a related party transaction if an independent committee of the board of directors reviewed and approved the transaction.

In respect of financial statement disclosure, we noted the following deficiencies:

- no disclosure of the measurement basis used (CICA Handbook - paragraph 3840.46(d));
- no discussion of whether the transaction was in the normal course of business (CICA Handbook - paragraph 3840.51);
- failure to identify the related person or entities and to provide sufficient detail on the nature and terms of the related party relationship (CICA Handbook - paragraph 3840.46(a)); and

- insufficient description of the terms and conditions for the outstanding balances in respect of the amounts due to or from related parties, (CICA Handbook - paragraph 3840.46(e)).

Reminder: NI 51-102 contains additional disclosure requirements for transactions with related parties beyond those contemplated by the CICA Handbook. In particular, Form 51-102 F1 *Management's Discussion and Analysis* (the MD&A Form) requires MD&A discussion for all transactions involving related parties. The requisite disclosure should include adequate qualitative and quantitative characteristics such that the business purpose and economic substance of the transaction are clear. Many RIs simply restate the related party note from their financial statements in the MD&A Form. This may not be sufficient. As a result, the lack of discussion surrounding the business purpose of the transaction is a common disclosure deficiency.

When we identify related party deficiencies, we will often request that RIs provide enhanced disclosures in future filings. Depending on the magnitude of the deficiency, the RI may also be referred to the ASC's Enforcement Division for further action.

3.2 Financial Instruments

For financial instruments, the following CICA Handbook standards are effective for the annual and interim periods in fiscal years beginning on or after October 1, 2006:

- section 3855, *Financial Instruments - Recognition and Measurement*;
- section 3861, *Financial Instruments - Disclosure and Presentation*;
- section 1530, *Comprehensive Income*;
- section 3251, *Equity*; and
- section 3865, *Hedges*.

CICA Handbook sections 3862 and 3863 also came into effect for interim and annual periods after October 1, 2007. These new standards call for enhanced and detailed disclosure for each class of financial instrument. The detail required surpasses many of the disclosure requirements of past accounting standards. For example, these new standards call for expanded credit risk and liquidity risk disclosure, maximum exposures and sensitivity analysis. With the adoption of Handbook section 3862, generic interest, liquidity and credit-risk note disclosure from prior years' financial statements will not satisfy the new requirements.

In our reviews of first and second quarter 2007 interim financial statements and MD&A, we noted a significant difference in the quality of disclosure depending on whether RIs involved their auditors. In five of the cases we reviewed that RIs had no auditor involvement in their interim statements, the RI made no mention of adopting the new Handbook sections at all.

Whether or not a smaller RI obtains or is able to obtain auditor involvement in their interim financial statement process, we encourage all RIs to consider whether some expert advice may be warranted when complex new accounting standards are implemented.

The following deficiencies were also noted during the course of our review:

- CICA Handbook paragraph 3855.19 sets out financial instrument classifications. Some RIs simply copied sections from the CICA Handbook into their financial statement note disclosure but failed to clearly describe how the specific items on the RI's balance sheet were actually designated, classified and measured.

- Some RIs classified their instruments incorrectly. For example, one RI disclosed property plant and equipment as "other assets" and classified them as "held for trading", measured at fair value.

- Two RIs did not explicitly disclose the adoption of CICA Handbook section 3861. They argued that the new standards were not significantly changed from the old standards and that disclosure in the annual financial statements prepared under the old standard was therefore sufficient (e.g., interest risk, credit risk and fair values). However, readers of the financial statements could not infer that the RI had adopted section 3861 absent an explicit statement on the matter. CICA Handbook section 1506.28 also requires explicit communication of the initial adoption of a standard.

- Some RIs provided no disclosure of their risk management objectives, policies and risks (paragraphs 3861.36-3861.68). For example, some RIs had substantial debt at both fixed and variable interest rates, yet there was no disclosure of interest rate risk. In other cases, RIs relied on their year-end disclosure even when circumstances in subsequent interim reporting periods had changed due to new debt financing.

- In some cases, RIs did not provide all of the disclosure required under section 3861. Some observed deficiencies include:

    - no disclosure of the accounting policy for transaction costs (CICA Handbook - paragraph 3861.48(b));

    - no disclosure of the fair value for those financial assets and financial liabilities recorded at carrying amount on the balance sheet (CICA Handbook - paragraph 3861.69);

    - no or limited disclosure of the methods and significant assumptions applied in determining fair value for each class of financial assets and financial liabilities (CICA Handbook - paragraph 3861.72); and

  - no disclosure of the carrying amount for those financial assets and financial liabilities required to be or designated to be held for trading (CICA Handbook - paragraph 3861.80).

- In respect of the adoption of the CICA Handbook section 3865, *Hedges*, one RI disclosed adoption of the section but failed to disclose whether it had currently applied hedge accounting to any of its transactions. Another RI had not disclosed adoption of this section at all. Both RIs operated in a business where hedging of commodity prices was commonplace and both used derivative transactions.

3.3 MD&A

The objective of MD&A, as described in Part 1(a) to the MD&A Form, is to:

- help current and prospective investors understand what the financial statements show and do not show;
- discuss material information that may not be fully reflected in the financial statements, such as contingent liabilities, defaults under debt, off-balance sheet financing arrangements, or other contractual obligations;
- discuss important trends and risks that have affected the financial statements, and trends and risks that are reasonably likely to affect them in the future;
- provide information about the quality, and potential variability, of earnings and cash flows; and
- to assist investors in determining if past performance is indicative of future performance.

MD&A continues to be an area that requires more RI attention. We see boilerplate disclosure, disclosure that is simply an arithmetic analysis of the changes in account balances, or disclosure that repeats information from the notes to the financial statements. Such disclosure does not meet the MD&A requirements. For instance, a general statement citing a change in sales mix to explain an increase in revenues is not particularly useful to the reader. The MD&A should provide a more detailed explanation of what business factors contributed to the change in sales mix. More insight could be provided by including a discussion as to whether the business recently entered into a new market to trigger the sales mix change, or the specific industry or market factors that contributed to a shift in sales from a lower margin operating segment to a higher margin operating segment. One way to further enhance content may be for an RI to involve its staff at the operations level in drafting MD&A explanations.

We also saw information in RIs' public filings such as the AIF, financial statements, news releases or other public statements (e.g., web site information) that conflicted with the MD&A. In one case, we noted that an RI filed a news release disclosing that the RI was in violation of its bank covenants and its financial statements indicated a negative operating cash flow position for the period. However, the RI's MD&A liquidity section contained a generic statement that the RI would be able to meet its foreseeable operating needs by drawing on its cash flow from operating activities and its available bank facilities. This disclosure was incomplete and inaccurate. RIs should ensure that all disclosure is complete and consistent.

Common deficiencies we have noted in MD&A disclosure include:

- no or limited disclosure of capital resources (MD&A Form, Part 2, item 1.7);
- no or limited disclosure of liquidity (MD&A Form, Part 2, item 1.6);
- no fourth quarter disclosure (MD&A Form, Part 2, item 1.10);
- MD&A dated prior to the audit report (MD&A Form, Part 2, item 1.1);
- no disclosure of critical accounting estimates and policies (MD&A Form, Part 2, item 1.12); and
- no or limited discussion of management's outlook for the issuer (NI 51-102, Part 1, item (g)).

We observed that the "President's Message to Shareholders" included in many annual and interim reporting packages contained discussion that provided the reader with additional insights into the RI's operating performance, "performance metrics" and future outlook that supplemented the information in the financial statements and furthers the objective of MD&A as described in Part 1(a) of the MD&A Form. Unfortunately, this information is often not found in the MD&A. We suggest that much of the information in these presidents' messages should be disclosed in the MD&A, with the President's Message then highlighting and summarizing the details found in the MD&A.

Reminder: RIs should be aware that NP 48 *Future-Oriented Financial Information* was rescinded and that amendments to NI 51-102 effective December 31, 2007 introduced new requirements regarding the disclosure of FLI as well as the concept of financial outlook. A financial outlook is forward-looking information about prospective results of operations, financial position or cash flow that is based on assumptions about future economic conditions and courses of action that is not presented in the format of a historical balance sheet, income statement or cash flow statement. More specifically, FLI includes, but is not limited to information such as earnings guidance, revenue guidance and discussion of financial outlook published on websites, investor update materials and news releases. As such, financial outlooks are subject to FLI requirements regardless of whether this information is disclosed in the MD&A or elsewhere in the RI's disclosure record. RIs should ensure that they are familiar with the new FLI requirements and be aware of the new requirement to update any previous written FLI disclosed in the MD&A.

We understand that some management or boards of directors may be reluctant to expand MD&A disclosure beyond a quantitative discussion of the financial results because of liability concerns about inclusion of "softer" qualitative discussions, such as forward-looking elements in a CD document. Instead, such qualitative disclosure is limited to the president's message, investor presentations or similar marketing materials found on the RI's website. Aside from complying with FLI, RIs need to carefully consider the message that they are potentially sending to their investors from a corporate governance and disclosure practices perspective. To the average reader, the practice just described might imply that the RI is reluctant to stand behind statements about its business by limiting such statements to disclosure outside the scope of NI 51-102. Whether or not the subject disclosure is contained in the MD&A Form, any misrepresentations in the disclosure will be subject to secondary market civil liability provisions of the Alberta securities laws.

Identification of material deficiencies in MD&A will result in RIs being noted in default on the RI List until the MD&A Form is restated and refiled to fully comply with the substance of our requirements. In cases where the MD&A deficiency is not material, we will request that the RI improve their disclosure in future filings and those filings may be targeted for further review.

3.4 Certificates required by Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings* (MI 52-109)

For fiscal years ending after June 29, 2006, full annual (Form 52-109F1) and interim (Form 52-109F2) certificates are required. For earlier periods, transitional or modified certificates were permitted.

Filing of improper certificates continues to be one of the leading areas of identified deficiencies in the CD filings of our RIs. Certification deficiencies generally lead to an RI being noted in default on the RI List until the deficiencies are rectified.

One of the more common errors in the annual certification relates to the representation that the CEO and CFO have "evaluated the effectiveness of the issuer's disclosure controls and procedures as of the end of the period covered by the annual filings and have caused the issuer to disclose in the annual MD&A [their] conclusions about the effectiveness of the disclosure controls and procedures". Despite signing annual certificates containing this representation, we have found many instances of MD&A omitting any discussion of the conclusions about the effectiveness of disclosure controls and procedures. This omission brings into question whether adequate resources and attention are being used to ensure that the certifications are accurate.

We also noted situations when disclosure controls and procedures are discussed in the MD&A but an explicit conclusion as to their effectiveness is not provided. RIs should ensure that the MD&A provides an explicit statement of management's conclusions as to effectiveness. If any identified weaknesses in disclosure controls and procedures exist, these should be identified and discussed as part of the overall conclusions about the effectiveness of disclosure controls and procedures.

Other noted certification deficiencies were:

- filing a modified or transitional certificate when a full certificate is required;
- filing amended financial statements, MD&A or AIFs without filing new certificates. We also noted a few cases when no certifications were provided with interim and annual filings;
- filing certificates with no date or an incorrect date. The certificates should be dated as at the date of filing;
- amending wording in the certificates. MI 52-109 certificate forms should not be modified in any way; and
- filing certificates signed by someone other that the CEO or CFO. Only individuals acting in the capacity of CEO and CFO at the time of filing can provide certifications.

RIs should be aware that errors in financial statements or MD&A might bring into question some of the items certified by the CEO and CFO. The CEO and CFO are certifying that the filings do not contain misstatements or omissions of a material fact and that the financial statements, along with the disclosure in the other filings, present fairly in all material respects the RI's financial condition, results of operations and the cash flows for the period certified. Where material deficiencies exist in the financial statements, the ASC will likely question the certifications made by the CEO and CFO.

Reminder: In November 2007 we issued CSA Notice 52-319 *Status of Proposed Repeal and Replacement of Multilateral Instrument 52-109 Certification of disclosure in Issuers' Annual and Interim Filings* (MI 52-109). This Notice states that the proposed changes to MI 52-109 will include a significant change for venture issuers. The CEO and CFO of a venture issuer will no longer be required to certify that they have designed and evaluated the effectiveness of disclosure controls and procedures and internal controls over financial reporting. The resulting certificate will be accompanied by an explanation for investors as to how it differs from the full certificate required to be filed by RIs other than venture issuers. The ASC has issued an exemptive relief order (2007 ABASC 836) to permit venture issuers to file interim and annual certificates for periods ending on or after December 31, 2007 in a form that reflects this proposed change. The form of annual and interim certificate is set out in Appendix A and B to the exemptive relief order.

3.5 Business Acquisition Reports (BAR)

We continue to note significant deficiencies in compliance with the BAR requirements under NI 51-102.

Common deficiencies noted in BARs include:

- RIs are incorrectly applying the interim financial statement exemption under subsection 8.4(4) of NI 51-102 despite the fact that the acquisition constitutes a material departure from the business or operations of the RI immediately before the date of acquisition. Subsection 8.4(3) of NI 51-102 requires the inclusion of interim financial statements for the most recently completed interim period prior to the date of acquisition. Generally, if the issuer is a shell company, acquisitions conducted as part of an issuer's initial public offering are considered a material departure.

- The BAR contains adjustments to the pro forma financial statements that were not considered acceptable adjustments.

  Subsection 8.7(5) of the Companion Policy to NI 51-102 provides guidance on what constitutes an acceptable adjustment. Generally, an acceptable adjustment must be limited to those that are directly attributable to the specific acquisition transaction for which there are firm commitments, and for which the complete financial effects are objectively determinable. For example, adjustments for management salaries and bonuses are not appropriate in cases where details of new management contracts have not been finalized.

- Incorrect pro forma financial information.

  RIs relying on the acquisition of an oil and gas property exemption under section 8.10 of NI 51-102 should be aware of the pro forma operating statement requirement. Adding together the RI's full income statement to the operating statement of the acquired business is not appropriate. For the purposes of section 8.10, a pro forma operating statement requires an operating statement for the RI added together with an operating statement for the acquired business.

- Failure to file the BAR with respect to the acquisitions of an oil and gas property.

  In most instances, an acquisition of a business includes an oil and gas property; therefore a BAR is generally required. RIs should determine whether they have acquired a business and should refer to the applicable guidance in Part 8 of the Companion Policy to NI 51-102.

- Failure to file a BAR when the acquisition of a business met one of the significance test thresholds.

- Interim financial statements that did not comply with CICA Handbook section 1751 *Interim Financial Statements*. For example, the interim statements did not include any financial statement notes or failed to include the columns disclosing the three-month current and comparative quarters.

- The RI incorrectly described the accounting treatment as continuity of interest method when, in fact, continuity of interest accounting was not applied or applicable to that particular situation.

Date of Acquisition

RIs are reminded that the date of an acquisition is defined in NI 51-102 as the date of acquisition for accounting purposes. Under CICA Handbook paragraph 1581.19 the acquisition date is the date that the net assets or equity interest are received and the consideration is given or the control of the acquired enterprise is effectively transferred to the acquirer. Practically, this is the date that the RI will begin consolidating the results of the acquired business into its financial statements and may be different from the date used for working capital adjustments. It is important that the correct date of acquisition be determined since this affects the financial statements required to be included in the BAR.

Relief from BAR filing requirements

In some cases, an RI applied for and obtained relief in a prospectus for its significant acquisition disclosure but did not apply for similar relief for the purposes of filing a BAR. As a result, RIs are unable to meet the BAR filing deadlines. RIs are reminded that it is their responsibility to ensure that they understand their CD obligations and apply for any relief well in advance of the filing deadlines. Staff cannot recommend retroactive relief, so deficiencies after the fact could lead to requests to refile the BAR to correct the deficiencies, noting the RI in default on the RI List or referrals to ASC's Enforcement Division. Furthermore, an RI may be precluded from using the short-form prospectus system as a result of this deficiency being on their CD record.

3.6 Non-GAAP Financial Measures

CSA Staff Notice 52-306 *Non-GAAP Financial Measures* (CSN 52-306) outlines the expectation that RIs present non-GAAP measures with equal but no greater prominence to the most directly comparable measure calculated in accordance with GAAP. RIs reviewed often reconciled to the closest GAAP measure but the ensuing MD&A discussion focused exclusively on performance analysis derived from the non-GAAP measure. There was little or if any mention of the closest GAAP measure beyond the initial reconciliation exercise. RIs are reminded that it is necessary to give equal weight throughout the MD&A to the comparable GAAP measure.

We saw that the terms used to describe non-GAAP performance measures sometimes did not accurately reflect the measure. Some examples of this are:

- Cash from operating activities prior to change in non-cash working capital being described as cash flow rather than funds flow.

- Use of EBITDA (earnings before interest, taxes, depreciation and amortization) including adjustments for items other than interest, taxes, depreciation and amortization. We consider that the term "adjusted EBITDA" on its own is insufficiently descriptive or meaningful to the reader.

From time to time, we saw the use of subtotals in the statement of income such as “net earnings from continuing operations before the following expenses”, “net income from operations” or other similar subtotals. Commonly excluded from these subtotals were a number of items such as depreciation expense, amortization expense and interest income. Such presentation suggests that these items are not part of normal business activities when, in fact, they are. This is inappropriate because the CICA Handbook only allows the separate presentation of discontinued items and extraordinary items. Furthermore, this presentation results in a non-GAAP measure being presented in GAAP income statements.

When questioned about the use of non-standard subtotals in their statement of income, some RIs responded that they use subtotals to tie the non-GAAP measures discussion in MD&A to a number in the financial statements. This is not appropriate because reconciliations of non-GAAP measures should occur in the MD&A, not in the financial statements.

We continue to observe some RIs omitting a description, or providing merely boilerplate discussion of how management uses a non-GAAP measure and why. Very few RIs describe how management uses the measure and why management believes the measure is useful to readers. If the measure is not used internally, its usefulness in MD&A disclosures is questionable to external users.

3.7 Interim Financial Statements and Interim MD&A (Interim Filings)

We continue to find deficiencies in Interim Filings. We noted RIs with auditor involvement in their Interim Filings tend to have fewer deficiencies.

Some recurring issues found in Interim Filings include:

- no change in accrual amounts or balances from quarter to quarter despite changes to activity levels;
- substantial fluctuations in key balances or ratios with no further explanation in the MD&A;
- proposed transactions or initiatives discussed in one period with no follow-up disclosures found in subsequent filings;
- boilerplate language in MD&A that did not adequately explain the results of the period;
- no disclosure of adoption of new accounting policies;
- interim financial statement presentation inconsistent with the previous annual financial statements; and
- notes to interim financial statements not being updated from the year-end.

3.8 Non-Bank Sponsored Asset-Backed Commercial Paper (ABCP)

On October 29, 2007, the Accounting Standards Board (AcSB) issued a financial reporting commentary on ABCP. The AcSB outlined the relevant CICA Handbook requirements that should be considered for September 30, 2007 interim financial statements and for calendar year-end 2007 by RIs holding ABCP. A further updated commentary was published on January 18, 2008.

The ASC is currently reviewing RI disclosure in this area. Our findings to date indicate that there is generally room for improvement in the areas of MD&A disclosure and disclosure in the financial statement notes of fair value assumptions.

By their nature, ABCP are financial instruments. Therefore CICA Handbook section 3861.72 requires disclosure of the methods and assumptions used in determining fair values. We observed generic disclosure such as a discounted cash flow approach was used and that the approach required assumptions. However, the actual values used for those assumptions were not disclosed. This is insufficient. RIs should ensure that the detailed assumptions are disclosed in their year-end filings.

Many of the RIs reviewed disclosed that the fair value of their ABCP was determined using a discounted cash flow approach based on assumptions that were not supported by observable market prices or rates. In such circumstances, CICA Handbook paragraph 3861.72 requires disclosure of the impact on fair values for a range of reasonably possible alternative assumptions. None of the RIs we reviewed provided this information. RIs should provide some form of sensitivity analysis to satisfy this requirement.

RIs are also reminded that the MD&A Form requires disclosure of trends affecting an RI's liquidity. A common deficiency identified in our reviews was the need for RIs to more carefully consider the impact of the ABCP on their liquidity and provide more meaningful discussion of this in their MD&A.

In one review, an RI stated that it did not anticipate that its ABCP holdings would have a material effect on its operations or growth plans. However, the RI had a working capital deficiency, held a material amount of ABCP and required a significant amount of funds for its capital program commitments. Based on the disclosure provided, it was unclear to the reader how the RI intended to remedy the situation. We requested that the RI provide, in its future filings, further explanation of its plans for future capital expenditures, financing available to meet its commitments and plans, and whether these items were negatively affected by the uncertainty associated with the RI’s ABCP holdings.

3.9 Income Trusts

Distributable Cash

Distributable cash is a specific non-GAAP financial measure used by many income trusts. In July 2007, National Policy 41-201 *Income Trusts and Other Indirect Offerings* (NP 41-201) was amended. The majority of the amendments focused on our expectations about distributable cash disclosure. In our review, we saw RIs that did not provide the disclosure suggested by NP 41-201 amendments in their September 2007 Interim Filings. Item 6.5.2 of NP 41-201 recommends that RIs disclose how distributions are being funded when actual distributions are higher than either net income or cash from operating activities. Item 2.5 of NP 41-201 recommends that distributable cash be reconciled to cash from operating activities on the cash flow statement and that all reconciling items should be clearly identified and discussed.

In July 2007, the Canadian Performance Reporting Board (CPRB) also issued guidance with respect to disclosure surrounding distributable cash. At management's discretion, the RI may choose to satisfy the expectations set out in NP 41-201 by following the CPRB guidance.

During our reviews, we noted that some RIs are choosing to disclose two different distributable cash reconciliations, one that complies with the CPRB format and one that follows the guidance set out in NP 41-201. This is confusing to the readers and we discourage this practice.

NP 41-201 Undertakings

A number of income trust RIs filed with the ASC the NP 41-201 undertaking to provide financial information about operating entities, stating that they will take appropriate measures to ensure insiders of the operating entities comply with insider trading and reporting requirements and to annually certify that they continue to comply with their undertaking.

We noted a number of instances where this annual certification has not been filed on SEDAR concurrently with the filing of annual financial statements. RIs should be mindful of this annual filing requirement.

3.10 Other Observed Deficiencies

Revenue Recognition

One area of continuing concern is revenue recognition policy disclosure. Too often this disclosure is boilerplate or does not provide sufficient description to enable a reader to understand the sources and nature of the RI's revenue-generating activities. This is particularly problematic when revenue arrangements are not straightforward, the transaction is sufficiently complex making it difficult to meet the criteria described in CICA Emerging Issues Committee (EIC) 141 *Revenue Recognition*, or the transaction contains "multiple deliverables".

RIs should ensure that their revenue recognition policy complies with GAAP, provides sufficient detail and continues to be applicable in the face of an RI's changes in its business or its business environment. For example, when entering into a new market or a new contract, revenue recognition policies should be re-examined to determine whether these policies continue to be appropriate in the new circumstances. We have questioned RIs to determine whether it is appropriate for them to report revenue "gross as principal" versus "net as agent" when the financial statement note disclosure lacked sufficient clarity for the reader to understand the arrangement when compared to disclosure found elsewhere in the RI's CD documents (e.g., the AIF).

Definition of a Business

EIC 124 *Definition of a Business* provides criteria for the determination of when an enterprise has acquired a business. We saw one RI that accounted for a transaction involving the acquisition of two employment contracts as an acquisition of a business. In this particular case, we concluded that the transaction did not meet the definition of a business under EIC 124 criteria and asked that the accounting treatment be corrected.

Reservation in Audit Opinion

We require an auditor's report that opines on whether the financial statements present fairly the financial position, results of operations and cash flows for the RI for the current year and the prior comparative year. We saw a case in which the prior year's auditor's report for one RI included a reservation in respect of the opening inventory balance. A year elapsed and that RI filed its most recently completed year-end financial statements with a clean audit opinion for both years. The comparative column in the current year's financial statements included the same inventory balance on which the auditor had expressed a reservation in the prior year's audit report. Reservations on prior year's audit opinions must carry forward to the current year's audit report if the prior year's results appear in the comparative column of the current year's financial statements.

Restatements

We noted instances where different versions of financial statements or comparative information within financial statements were being filed by RIs with no explanation of the differences from a previous version or were not marked as "revised" or "amended". RIs should ensure that a notice accompanies any refiling to explain the changes.

Reminder: NI 51-102 section 11.5 outlines the procedures an RI needs to address in the event that it refiles a CD document or restates financial information for comparative periods for reasons other than an application of a new accounting standard or changes to an existing accounting standard.

Corporate Governance

We noted many cases when RIs failed to file their audit committee charter as required by section 5.1 and section 6.2 of Multilateral Instrument 52-110 *Audit Committees* (MI 52-110). If an RI fails to file their audit committee charter, we may place the RI on default on the RI List until the charter is filed.

During the course of our reviews, we occasionally questioned the independence of a member of the audit committee who was disclosed as being independent. For example, we observed a case in which a member of the audit committee was also a partner of a law firm that received fees from the RI. RIs should ensure that they carefully review relationships they have with members of their audit committee to determine whether the director meets the independence requirements outlined in MI 52-110.

Other common deficiencies

- If the RI is able to exert significant influence over the policy-making function for its investee, it is never appropriate to apply the cost method of accounting. This statement holds true even where there are significant restrictions placed on the RI's right or ability to obtain future economic benefits from the investee.

  Where an investment does not meet the traditional criteria to apply consolidation or equity accounting, the RI should consider the applicability of Accounting Guideline 15, *Consolidation of Variable Interest Entities* (VIE) (AcG-15). In these circumstances, the issuer should disclose information about nature of its involvement with the VIE, information about the VIE (e.g., purpose, activities, size) and the RI's maximum exposure to loss from that VIE.

- A change in percentage ownership of an investee resulted in changing the relationship from a control relationship to one of significant influence. As a result, the RI could no longer apply consolidation accounting to the investee. However, rather than applying equity accounting on the day that the RI ceased to have control, the RI incorrectly applied equity accounting on a "retroactive" basis.

- Boilerplate risk language disclosure found in the AIF and MD&A, including the description of an RI's environmental policies, environmental protection requirements, and exposure to environmental risk and critical accounting estimates in respect of environmental liabilities. (see NI 51-102F2 *Annual Information Form*, subsections 5.1(1)(k), 5.1(4) and 5.2 and MD&A Form section 1.12)

- No material change report was filed when a material change had occurred (e.g., upcoming material revision to financial statements, change in business, or reserve for loan losses). Section 7.1 of NI 51-102 specifies the material change reporting requirements.

- Development-stage disclosure required under section 5.3 of NI 51-102 was missing. When a venture issuer has not had significant revenue from operations in either of its last two financial years, the RI must disclose in its MD&A a breakdown of material expenditures by type. This disclosure is required for capitalized and expensed costs for the two most recently completed financial years and most recent comparative interim period. RIs in the mining business also need to present this analysis on a property-by-property basis.

  Development stage RIs should also consider the guidance in AcG-11 *Enterprises in the Development Stage* (AcG-11). Paragraph 33 of AcG-11 encourages disclosure of cumulative inception to date balances.

- The auditor's name was missing from the audit report. RIs are reminded that National Instrument 13-101 *System for Electronic Data Analysis and Retrieval* (SEDAR) requires that for mandated filings, including financial statements, the name of the company or person required to sign be clearly identified in the filing.

- RI's auditor was not registered with Canadian Public Accountability Board (CPAB).

4. Looking ahead

4.1 New financial reporting standards for 2008

The CICA Handbook contains a number of new financial reporting standards to keep in mind for 2008 fiscal year financial reporting. Many of these changes reflect the convergence of Canadian GAAP with IFRS. Preparers of financial statements will note that the new standards tend to require more detailed disclosures in the financial statement notes, which is consistent with the principles-based IFRS model. Some of these new standards include: *Going Concern* (section 1400), *Inventories* (section 3031), *Financial Instruments* (section 3862 and 3863), and *Capital Disclosures* (section 1535).

RIs are reminded that upon first time adoption of new standards, we expect full disclosure of the adoption of the new standards in the financial statement notes for the applicable period and we will assess compliance of this in our review program for the 2008 year.

4.2 IFRS

IFRS will come into effect in Canada in 2011. RIs must give serious attention to this development. The requirement for comparative financial statements means that the date of the transition to IFRS will be effectively January 1, 2010. Therefore, financial statement preparers will have less than two years to familiarize themselves with IFRS requirements, train staff and identify and make the necessary accounting system changes in time for adoption. An RI will also need sufficient time to educate investors in advance of the IFRS implementation date and should consider using MD&A as a training tool to discuss IFRS and its potential impact on the RI's financial statements.

IFRS 1 *First-time Adoption of International Financial Reporting Standards* provides mandatory guidance for issuers on first adopting IFRS and provides the structure for how to implement the changeover.

RIs should also keep in mind that preparation for IFRS adoption may necessitate substantial re-tooling of an RI's accounting and recordkeeping systems.

On February 13, 2008 CSA Concept Paper 52-402 was published regarding possible changes to securities rules relating to the changeover to IFRS. NI 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currency* (NI 52-107) sets out acceptable accounting principles for financial reporting by RIs. Domestic issuers must use Canadian GAAP; SEC issuers may use US GAAP; and foreign issuers can use IFRS.

The concept paper discusses three possible changes to our rules: (1)use of IFRS by domestic issuers before January1, 2011; (2)use of US GAAP by domestic issuers; and (3)reference to "IFRS as issued by the International Accounting Standards Board" or "Canadian GAAP". Interested parties are encouraged to comment on or before these issues before April 13, 2008. Comments received will be considered in developing proposed changes to NI 52-107.

5. Conclusions

The majority of the CD documents reviewed adhered to existing CD standards and accounting standards. However, we encourage RIs and auditors to strive for more detailed and meaningful disclosure in financial statements, MD&A and other CD documents.

Notwithstanding the significant increase in the number and complexity of new accounting standards and securities legislation for CD requirements, it is imperative that management of public companies and their financial advisers keep current, conduct a thorough analysis of new situations that occur and ensure that implementation of new standards reflects the spirit of those standards.

We urge management of RIs and their advisers to consult with the ASC, before filing, when new or complex situations arise or where the accounting treatment is not clear.

6. Contact ASC Personnel

Feedback on Reviews

The ASC welcomes comments on our review from RIs and their advisers. We endeavour not only to improve the process each year, but also to ensure that it is relevant to the current business environment.

Comments with respect to this report should be directed to:

Fred Snell, FCA, Chief Accountant, (403) 297-6553, fred.snell@seccom.ab.ca.

Jennifer Wong, CA, Associate Chief Accountant, (403) 297-3617, jennifer.wong@seccom.ab.ca.

Lara Gaede, CA, CFA, Associate Chief Accountant (403) 297-4223, lara.gaede@seccom.ab.ca. (on leave until November 2008)

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

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

Secondment to the Office of the Chief Accountant

In the past, public accounting firms have seconded staff to the Office of the Chief Accountant to participate in our review of filings. We thank them for their invaluable contributions. Any public accounting firm or public corporation that is interested in having a senior professional accountant gain valuable experience at the ASC in the areas of financial reporting including accounting, auditing, valuations, MD&A analysis and securities legislation should contact the Office of the Chief Accountant to discuss details of our secondment program.