sepac
Small Explorers and Producers Association of Canada

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Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunuvut

Dear Sirs/Mesdames:

Re: Proposed Multilateral Instrument 52-111 Reporting on Internal Control over Financial Reporting

Thank you for the opportunity to respond to the proposed Multilateral Instrument 52-111 Reporting on Internal Control over Financial Reporting (MI 52-111). The Small Explorers and Producers Association of Canada ("SEPAC") has not historically been involved in securities regulations in Canada. Our membership has now requested SEPAC become more involved, as it is clear to our members the markets are over-regulated for smaller oil and gas companies in Canada.

The conventional oil and gas industry needs to be able to access capital markets to grow and prosper. This industry is extremely capital intensive, and needs to continually raise money to explore and produce the oil and gas Canada requires. With the recent high prices, we acknowledge there is not a lot of sympathy for improving the conditions for the oil and gas industry. Our members know oil and gas prices are cyclical and over the long-term prices will

decrease to more normal levels. Oil and gas companies need to stay competitive to be able to provide long-term stability to the industry. The recent high prices reflect the fact there is a current shortfall of crude oil and natural gas reaching the North American market. With this environment, it is important to make conditions attractive to promote investment in this sector, as additional investment will result in finding more reserves of crude oil and natural gas, resulting in a more balanced the supply/demand equilibrium.

SEPAC represents over 400 oil and gas explorers and producers, who operate primarily in Western Canada. With the consolidation now occurring in the industry, it is these smaller companies who will step forward to expand the production of conventional crude oil and natural gas in the next decade and locate the future reserves necessary to do so. Currently, it has been relatively easy to access capital; however, even today as prices retreat from record highs, those investment dollars are becoming more difficult to raise. In conversations with our members and through responses received as a result of a direct questionnaire sent to them, SEPAC has determined that many new start-up companies are choosing to remain private. One of the reasons mentioned is the over-regulation of the public companies in Canada. I would like to indicate that our members are certainly supportive of ensuring that companies are operating to the highest ethical standards, providing timely, accurate and complete disclosure to shareholders, and ensuring investor confidence. We believe that certain recent proposals, such as MI 52-111, place too high an administrative cost on smaller companies. In addition, the initiatives take an extraordinary amount of time and effort from the Board of Directors and key management, while reducing the time more appropriately spent on the objectives to grow a profitable business for the shareholders.

Factors such as corporate governance and disclosure matters are very important to our sector to promote investment in the industry. For your information, SEPAC has about 50 members who trade on the TSX and approximately 60 members listed on the TSX Venture exchange. The rest are privately-held and most intent to stay private, unless they have significant capital needs.

The majority of SEPAC companies have five to 25 staff members, including part time employees or consultants. To keep administrative costs low, many services and systems are outsourced. Most companies are involved in numerous joint ventures. Any time an oil and gas company plans to drill a well, it often will find several partners to spread the risk of drilling wells that may cost anywhere from $100,000 to over $2,000,000 per well. The oil industry in Western Canada has developed over the decades through establishment of joint ventures, and as more companies are established, it has resulted in hundreds of thousands of joint ventures. As part of the joint venture agreement, the partners will pick an operator of the joint venture. The other joint venture partners have the ability to audit the specific costs and revenues of the specific venture upon adequate notice, but not the ability to review the operators systems. Given the number of joint ventures, and the different sizes of the joint venture partners, audits of operators would be unmanageable, especially given the different materiality of the partners. Imagine a small company with annual expenses of under $25,000,000 auditing a company such as Encana Corporation or Shell Canada, with a complex structure and a much larger materiality threshold.

We would like to focus on the specific nature of the proposed MI 52-111. First, we will discuss the conceptual issues of the proposal relating to smaller oil and gas companies, and then we will list some specific concerns we have with certain aspects of the proposal.

Conceptual issues concerning MI 52-111

1) Broadly speaking, it has become clear from certain well publicized corporate cases there may not have been enough focus on internal controls and their importance in timely and accurate financial reporting from the larger companies. SEPAC acknowledges and supports the need for more emphasis on internal controls -- from both the auditors' perspective and also that of senior management and the Audit Committee/Board of Directors. SEPAC companies continue to focus on the controls required to run their business.

2) SEPAC is concerned that Canada is trying to emulate the United States in bringing in a process to ensure that internal controls are adequate. The reason for implementation is a response to the corporate problems at Enron et al. Our concern is that many of these problems were not created by problems with internal controls. Rather, it appears that top level employees circumvented existing key controls. We therefore do not believe that a focus on the detailed internal controls would have prevented these past "blow-ups." It appears we are not solving the correct problem.

3) The primary concern that SEPAC believes must be addressed is the need to ensure the financial statements present fairly the financial position of the company. This should be the ultimate objective. We are troubled the very intensive work required to evaluate internal controls may take away from a company's efforts to ensure the financial statement preparation process properly states accurate financials. This is very important for smaller companies, as they lack the resources to perform an adequate study of controls. In effect, the CFO and Controller (if any), are the same people responsible for the internal control study as well as accurate financial statements. It is very difficult to maintain the proper focus on preparing complete, accurate, and timely financial statements, as well as proper documentation of internal controls without the necessary internal resources.

4) The United States is a very different market system than Canada, as it has hundreds of large companies with more than a $1 billion of market capitalization. These larger entities rely on internal controls to ensure proper accounting. In Canada, less than five percent of the companies have a market capitalization of greater than $500 million, and in fact these five percent comprise more than 90% of the total market capitalization in Canada. The Canadian markets have hundreds of smaller companies, many with less than 50 employees. SEPAC members want to ensure there is a thriving market for smaller entities in the future and that regulations such as this do not cause companies to stay private.

5) To adopt a strict process to certify internal controls for smaller companies is difficult, as many small companies will not be able to rely on internal controls. Many SEPAC companies may have a market capitalization of greater than $75 million, but have fewer than 25 employees, including fewer than five accountants. This results in a lack of segregation of duties and separation of functions. In fact, the primary control relies on the CEO and CFO signing all cheques and being aware of all significant transactions. It will be difficult to have these controls audited and not have many weaknesses. SEPAC is concerned that deficiencies in internal controls will be perceived negatively by the markets, when in fact; an issuer may have very strong

controls over financial reporting which are not given proper emphasis by the auditor based on the strict interpretation of MI 52-111.

6) Through discussions with investors in smaller oil and gas companies, they tell us they do not focus on a detailed process such as reviews of internal controls. They concentrate on accurate financial information and ensure the issuer has a strong management team and Board of Directors. These investors obtain the appropriate comfort from the implementation of MI 52-109, which requires the CEO and CFO to certify the accuracy of financial statements. It is our understanding that Calgary investors or investment dealers do not have a good understanding nor do they value MI 52-111, because they do not see its benefit to the oil and gas markets.

7) In many cases, the new requirement to review internal controls and then have them audited is a significant duplication of functions. Investors already assume that if the auditor has provided his or her audit opinion, that auditor has done the appropriate due diligence to ensure the financial statement is complete and accurate. This sign-off means the auditor has reviewed the material internal controls, where appropriate. Where it was not practical in a small company to have or rely on internal controls, then the auditor will perform the appropriate substantive tests to gain comfort in the accuracy of the financial statement. To have another independent auditor or consultant review the controls is not an effective use of limited cash resources.

8) It is my personal observation that the focus on internal controls has reverted to the days in the 1970's when I was an auditor. In those days, auditors spent significant time and effort as part of their standard audit process to evaluate and test key internal controls that could be relied upon for their audit. Then, the auditors would provide management and the Audit Committee with an assessment of these internal controls. It would then be up to management to adopt these recommendations to ensure the controls were improved. Rather than the current proposal that would have management document controls, have a second independent audit firm or consultant provide an opinion on the controls, and thirdly have the company's auditors do similar work to prepare an audit opinion. This involves several unnecessary and costly steps. I would suggest that an appropriate process would be to go back to the previous process described above, which would involve:

   i) Have the auditors, as part of their regular audit; assess the key controls that should be in place for that specific company.
   ii) The auditors would provide management and the Audit Committee with their assessments.
   iii) It would be incumbent on the Audit Committee to act on these recommendations as part of their Corporate Governance.
   iv) The CEO and CFO would review these results in their assessment as to whether the financial statements are accurate. I believe the CEO / CFO and Audit Committee would in this way get value for the audit, and would have to be able to explain to the Board of Directors how these results would be considered and implemented. This would save a significant amount of effort and costs, and would provide the issuer with useful information and a process that should give investors more comfort. Management and the audit committee of smaller companies would rely on the assessment of internal controls to assist them in developing and maintaining proper controls. This

information would also be helpful to support the certification required under MI 52-109.

9) As proposed, M 52-111 will not apply to venture companies, which is appropriate. However, we are concerned that at some stage the policy may "creep" into the Tier 1 TSX Venture companies, which we disagree with. In addition, as many oil and gas companies start on the TSX Venture and then "graduate" to the TSX, many companies that are TSX Venture issuers may be required to follow the policies of 52-111 in order to ensure they comply prior to TSX approval. Management, in expecting to grow beyond $75 million to $250 million and moving from the TSX Venture to the TSX, will need to have controls and systems to comply with the new rules from the beginning. This adds additional costs beyond a company's early growth stage expenses. It is not clear how 52-111 would apply in transition situations like this.

10) Recent experience from the United States indicates the costs of compliance were significantly more than estimated, and represented a very large increase in absolute G&A dollars. In addition, smaller companies have had a much more difficult and costly time completing the exercise. As a "small" company is much larger than most companies on the TSX, we would argue that companies with less than a $500 million market capitalization will have a more difficult and costly process.

Specific issues of concern in MI 52-111

1) Joint ventures

The proposal briefly discusses circumstances where the issuer has an interest in a joint venture. The proposal acknowledges that management may not always have access to the underlying entity to evaluate the issuer's control over financial reporting extending into the underlying entity. In cases where management cannot evaluate the issuer's internal controls, after taking reasonable steps, then the issuer is required to disclose this scope limitation in the internal report. It is also recommended that for all joint ventures created after MI 52-111 becomes effective should be negotiated to allow the issuer the necessary access to evaluate the internal controls of the operator of the joint venture.

As we discussed earlier, SEPAC member companies are involved in numerous joint ventures. Virtually all business is conducted by way of joint ventures. In some cases, the issuer will operate the venture and in many cases the issuer will be a partner in a joint venture operated by a third party. It appears this specific component of the recommendation is geared towards manufacturing or real estate joint ventures, and not to the oil and gas sector. It is not practical that each joint venture partner be given access to the operator's systems to evaluate internal controls. Nor is it practical for a non-operator to try and get access to numerous operator's systems and records to audit their internal controls. Each company will have its own systems and differing materiality that make this unworkable. In addition, we know that it is not possible or practical to request access to a major energy companies systems to audit / evaluate them, as the answer will certainly be no.

The differing materiality thresholds of a large joint venture partner and a small joint venture partner make the application of MI 52-111 inherently unfair as between them.

In these cases, a small oil and gas company will disclose that it has a deficiency and also the proportionate amount of its business that is affected by the limitation. This could be in excess of 50% of its revenues and expenses for a company that has chosen not to operate a majority of its assets. Conversely, the joint venture could be non-material to a senior issuer and the smaller entities would need to disclose a limitation related to its joint venture operations. SEPAC is concerned that companies identifying this limitation may be perceived poorly by the markets. As an aside, if it is not perceived poorly, this would tell us that the market does not see value in this internal control documentation and certification process created by MI 52-111. The reality is that management does not try to assess or evaluate the internal controls of the operator of the joint venture. The main factors to ensure accurate and complete information related to joint ventures is:

i) Management is continually (monthly or more frequently) reviewing the financial information of its joint ventures. This data is compared to expected information that is available to the production staff on the performance of the oil or gas wells.
ii) Management, through joint venture agreements has the right to audit the operations of the joint venture. Any discrepancies are identified at that time and adjusted accordingly.
iii) It should be noted that financial information received on joint ventures is often adjusted for costs of operations, as the allocation of costs to partners must be estimated until actual data is available. These are often called “13-month adjustments.” In addition, if a major company such as Encana Energy operates a joint venture, it may make adjustments to the partners on a regular basis. These adjustments may be small to Encana, but may be very significant to a smaller company. This will create a situation where the smaller partner has to report an unusually large adjustment in the current period. This is a reality of the industry, and no ability to audit the internal controls of a large operator will give the issuer comfort that a material adjustment will not occur.
iv) Given that public companies have to report earlier than in the past, trying to assemble a complete internal control report and then have it audited would be a difficult task in the tine frame available.

The issue of oil and gas joint ventures does not fit well into the internal control framework that is proposed. Additional discussion and clarification would most certainly be needed prior to implementation. This is another reason that the policy does not make sense for the oil industry, and specifically smaller companies under $500 million.

2) Outsourcing of service providers

Many oil and gas companies outsource many functions relating to the accounting function. These can include:

i) Financial accounting systems and support.
ii) Production accounting systems -- many companies have a consultant prepare information on their own system or spreadsheet.
iii) Land system, which is required to determine the ownership interest in a well or facility.

iv) Calculation of various royalty interests related to a well or facility.
v) Other computer-related systems that may be required.
vi) Marketing services, which determine how much the issuer, is to be paid for selling its products.
vii) Engineering and project management of significant capital expenditures projects.

This would require a significant coordination effort to review internal controls of these various entities. SEPAC already is aware that certain service providers would "push back" in providing access, as they are very concerned over privacy issues.

3) Available staffing

In Calgary, there is currently a shortage of qualified accountants and auditors. We have observed the time and effort and accounting staff required for companies to meet Sarbanes-Oxley 404, and we are very concerned there would be a tremendous strain on resources to devote to this internal control project. Certainly the proposal to phase in the recommendation is a step in the right direction; however it will not solve the problem. Virtually all oil and gas companies have a December 31 year-end for comparative purposes, so there will still be insufficient resources. In addition, many smaller companies already rely on consultants to help with production and financial accounting. Our members have already noticed a shortfall of qualified staff to assist in this documentation project. In addition, the audit firms are short-staffed and are importing less qualified personnel from around the world. These imported audit staff are not familiar with oil and gas operations and the internal controls that are required, so they cannot successfully do the audit work on a timely and cost effective basis.

In this sense, the policy once again is relatively unfair to smaller issuers; as such issuers generally are able to access such services only in lower priority to senior issuer clients.

Conclusion

SEPAC believes the costs of compliance to MI 52-111 far outweigh the benefits and therefore should not be implemented. The exemption provided to TSX Venture companies is beneficial as it recognizes the practical difficulties and costs smaller companies have to comply.

In addition, SEPAC recommends:

- Transitional rules need to be clarified for companies moving from the TSX Venture to TSX exchange. These companies may need some time to ensure full compliance so the natural progression of companies migrating from the TSX Venture to TSX is not stifled.
- The oil and gas industry is underpinned by complex joint ventures and multiple partners, both large and small. Additional study is required to determine the practicality of compliance for companies from $75 million to $500 million. SEPAC does not think this policy will solve the problem of providing accurate information for TSX companies.
- A regular review of the policy soliciting feedback from smaller market capital companies and the investors in this sector.

Thank you for your attention in this matter, and we look forward to further discussions on these proposed changes over the next few weeks.

Yours truly,

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