

## **OSC Staff Notice 51-706, *Continuous Disclosure Review Program Report - November 2001***

### **1. Introduction**

The Continuous Disclosure Team of the Ontario Securities Commission's Corporate Finance Branch intends at least annually to issue a report on the progress of its Continuous Disclosure Review program (the "CD Review Program"). The purpose and scope of the CD Review Program were described in OSC Staff Notice 51-703, *Implementation of Reporting Issuer Continuous Disclosure Review Program, Corporate Finance Branch*.

In addition to the CD Review Program, the CD team is involved in a range of day-to-day activities and policy-making initiatives. These are beyond the scope of this report.

### **2. Overview Of Activities**

In OSC Staff Notice 51-703, Staff stated that the OSC's goal is for reporting issuers with an Ontario head office to be subject to a CD review, on average, once every four years. Full-scale implementation of the CD Review Program commenced on July 1, 2000. Between that date and March 31, 2001, 148 CD reviews were commenced by the CD team. Of these reviews, 75 were carried out as part of a targeted review of revenue recognition practices. Staff reported on this initiative in February in OSC Staff Notice 52-701 - *Initial Report on Staff's Review of Revenue Recognition Practices*. The other 73 reviews commenced by the CD team consisted mainly of full reviews, along with various issue-oriented reviews to follow up on items identified through staff's daily reviews of media reports, by an investor complaint, or through other sources.

As described in Staff Notice 51-703, corporate finance team staff also reviews a selection of CD materials at the same time as the "full review" of a prospectus and as part of the review of rights offerings circulars. 159 CD reviews of this kind were carried out during the year. In total therefore, 307 CD reviews were commenced during the year to March 31, 2001, representing some 18% of Ontario-based reporting issues. As noted, the CD Review Program had not been fully implemented during the first three months of the year. The focus of this report will be on the 148 CD reviews conducted outside of a prospectus context. In future years, we intend to issue a more comprehensive report on the results of all CD reviews, including those conducted by the corporate finance teams.

On the whole, staff was satisfied with the results of the CD Review Program for this year. Very few CD reviews were carried out in which staff failed to raise comments on potentially material issues. However, issuers generally responded to these comments in sufficient detail such that only limited further follow-up by staff was necessary.

In answer to approximately one third of the reviews conducted to date, the issuer made a commitment to staff to change some aspect of its accounting or disclosure. In most of these cases, staff and the issuer agreed that these changes would acceptably be implemented within their next filed financial statements, either on a prospective or retroactive basis depending on the facts. In three cases however, staff required that the issuer's historical financial statements be

retroactively changed. Staff of the Corporate Finance Branch works closely with the Enforcement Branch when determining the type of regulatory action necessary when staff believes a reporting issuer has breached the Act. It was not necessary however, during the year to March 31, 2001 to deal with any financial statement-related matters arising from the CD Review Program through enforcement action.

Staff of the CD team continues to participate on the CSA Continuous Disclosure Mutual Reliance Review System committee. The committee is working toward developing a system of mutual reliance for continuous disclosure review, with the broad goal of ensuring that all reporting issuers in Canada, including foreign issuers, are treated equitably regardless of their principal regulator. Among other things, OSC staff informs CD staff in other provinces of matters arising on CD reviews in progress and consults with staff in the other provinces to ensure a consistent approach to issues, or to benefit from industry-specialist expertise in the other jurisdictions, or for other reasons.

### **3. Accounting and Financial Reporting Matters**

Following are some of the areas of accounting or financial reporting in which comments are most commonly raised by staff in the course of a CD review, or in which staff entered into particularly lengthy or significant discussions with issuers during the year to March 31, 2001:

#### *Revenue Recognition*

US GAAP contains numerous authoritative pronouncements on specific aspects of revenue recognition that have no direct counterpart in Canada. These pronouncements in many areas extend the broad principles set out in CICA 3400, *Revenue*. In the Spring 2000 issue of *Perspectives*, the Office of the Chief Accountant of the OSC put issuers on notice that the fundamental accounting concepts pertaining to revenue recognition are similar under both US and Canadian GAAP. Accordingly, Staff advised issuers and their auditors to carefully consider the basis in Canadian authoritative literature for all revenue recognition policies that differ from the interpretations set out in US GAAP, and particularly from those set out in SEC Staff Accounting Bulletin 101, *Revenue Recognition*.

After this edition of *Perspectives*, staff of the Continuous Disclosure team undertook a targeted review of revenue recognition practices. Staff reported on this initiative in February in OSC Staff Notice 52- 701 - *Initial Report on Staff's Review of Revenue Recognition*. Since issuing its report, staff has continued to correspond with issuers in order to resolve all open matters. In particular, staff has concentrated on matters relating to revenue recognition when right of return provisions and price protection arrangements exist, as discussed in sections 5.2 (1) and 5.2 (2) of OSC Staff Notice 52- 701. In one case to date, an issuer made a retroactive change to its presentation of such arrangements.

Staff also entered into discussions with issuers on revenue related matters outside the context of the issue-oriented review program. In one case, for instance, the issuer changed its presentation to reflect a particular income source on a gross basis rather than as a reduction of operating expenses.

A final report on this review program will be issued next year.

### *Segment Disclosures*

Staff generally assesses the segment disclosure contained in the notes to the financial statements against the way in which the issuer organizes its MD&A or Annual Report or other corporate communications. Staff questions cases where it appears that segments are being inappropriately aggregated for purposes of the financial statements. EIC-115, *Segment Disclosures - Application of the Aggregation Criteria in CICA 1701*, has clarified when operating segments would or would not have "similar economic characteristics" for purposes of applying the aggregation criteria. Subsequent to the issuance of EIC-115, staff has closed several open files on this matter after receiving a commitment by the issuer to amend the presentation of its segment disclosures.

### *Restructuring and Impairment Charges*

Restructuring and impairment charges continue to have a material impact on the financial statements of many issuers. Staff continues to place significant emphasis on whether restructuring and impairment charges and other write-downs have been appropriately recognized, both with respect to their amount and timing. For example, staff frequently requests a detailed explanation of how an issuer applied the criteria set out in EIC-60, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, including the application of all conditions relevant to determining a "commitment date" for an exit plan. Staff may request detailed documentation, including material presented to the board, in supporting the accounting treatment. Staff also places emphasis on ensuring that all disclosures required by EIC-60 are provided by issuers. Staff entered into discussions during the year on whether certain costs were of a business reengineering nature, such that they should be expensed as incurred, rather than restructuring costs qualifying for accrual.

### *Contingencies*

Staff emphasizes that the notes to an issuer's financial statements should contain appropriate disclosure of all matters required under generally accepted accounting principles. It is not sufficient that such disclosure be available elsewhere on the public record - for example in the MD&A. During the year, staff requested that the notes to an issuer's financial statements be expanded to include significantly greater detail regarding outstanding litigation, claims and contingencies.

### *Impaired Loans*

Staff entered into an extended discussion with an issuer regarding the application of CICA Handbook Section 3025, *Impaired Loans*. Staff took the view that the concepts set out in that Handbook Section had been applied inconsistently, resulting in inappropriate patterns of income recognition on the impaired loans. The issuer ultimately restated its previously issued financial statements.

### *Differences With Accounting Principles Generally Accepted In The United States (US GAAP)*

When the financial statements contain a reconciliation to US GAAP, staff reviews the reconciliation to assess in particular whether the reconciling items are indicative of a potential misapplication of Canadian accounting standards. Where a reconciling item's basis in

authoritative literature is unclear, staff will likely question the treatment of the item. Staff is especially likely to question the treatment of a reconciling item for which the fundamental principles are similar in both Canada and the US, but for which more specific guidance is available under US GAAP; staff may question in such cases why the additional US literature was not considered in determining the appropriate application of Canadian principles.

#### *Hedge Accounting*

Staff entered into discussions with issuers, primarily from the natural resource sector, on various hedge accounting matters. In some cases staff requests a detailed explanation of the rationale and analysis underlying the application of hedge accounting, including a request for such items as schedules of the hedging instruments= projected cash flows and maturity dates. Staff assesses whether the hedging instruments have been appropriately designated as hedges and whether those hedges are effective in the circumstances. Following these discussions, one issuer retroactively reversed its application of hedge accounting for certain financial instruments.

#### *Earnings And Cash Flow Measures Differing From Generally Accepted Accounting Principles*

Staff has found cases where issuers have prepared their financial statements in accordance with GAAP, but used non-GAAP earnings presentations as a basis for the disclosure contained in their Management's Discussion and Analysis. MD&A should provide an analysis of the financial statements as presented. It is not appropriate to exclusively base the discussion in the MD&A on a basis of presentation other than that used in the issuer's financial statements. Where an issuer wishes to provide supplemental analysis of information prepared on an alternate basis, the basis of preparation should be clear and should not constitute a misleading presentation.

Staff has also identified instances of issuers who have complied with GAAP in their financial statement filings but have used non-GAAP bases of presentation for earnings or cash flows in other areas of their disclosure. In one case, an initial earnings press release communicated the issuer's results with reference to an adjusted amount that excluded amortization, restructuring and other charges; the amounts calculated under GAAP became available only later on issuance of the issuer's interim financial statements. In another case, the issuer used a non-GAAP basis of presentation for earnings on their website. In all such cases, staff considers whether the measures used by the issuer are clearly labelled and defined, whether their basis of calculation is clear, and overall whether they amount to a misleading presentation of the issuer's activities. Staff proposes to issue more detailed guidance in this area.

#### *Other areas*

Some other areas on which questions were raised on CD reviews during the year were:

- lease accounting principles;
- application of equity accounting;
- amortization periods for goodwill and capital assets;
- basis for deferral and amortization of deferred charges;
- discrepancies between financial statement disclosure and that provided elsewhere with regard to going concern uncertainties; and

the application of the "more likely than not" criterion to future income tax balances.

#### **4. Defaulting Reporting Issuers**

The CD team monitors compliance by reporting issuers with the obligations under the Act and Regulations and administers the OSC's policy relating to the imposition of cease trade orders. Recently, staff published OSC Policy 51-601, *Reporting Issuer Defaults*, which replaces OSC Policy 2.5, *Certificates of No Default under Subsection 71(8) [72(8)] and List of Defaulting Issuers Under Subsection 71(9)[72(9)] of the Securities Act* ("Policy 2.5"). This policy sets out the guidelines followed and the factors considered by the Commission in determining if a reporting issuer is in default, maintaining a list of defaulting reporting issuers and issuing certificates of no default under the Act.

The policy provides that even if financial statements or other continuous disclosure documents have been filed within the prescribed time period, an issuer will be considered to be in default if it is determined that a deficiency in those documents is so significant as to constitute a default. While this provision in the policy is similar to an existing provision in Policy 2.5, it more broadly applies to deficiencies in any part of an issuer's CD record, not just financial statements as was the case with Policy 2.5. The policy will also be applied much more actively than Policy 2.5 was in the past.

The policy provides that in almost all cases issuers will be notified in advance of any intent to treat it as being in default and such an issuer can request a hearing before the Commission.

The default list has recently been made available to the public for the first time, via the OSC website.

##### *Cease Trade Orders*

In April 2001, staff issued OSC Policy 57-603, *Defaults by Reporting Issuers in Complying with Financial Statement Filing Requirements*. Among other things, OSC Policy 57-603 states that when a defaulting reporting issuer satisfies the defined Alternate Information Guidelines, the Commission will generally respond to a default in complying with financial statement filing requirements by issuing a cease trade order only on certain directors, officers and insiders (a "Management and Insider CTO"), rather than on trading in the issuer's securities as a whole. A cease trade order on the issuer's securities as a whole (an "Issuer CTO") will generally be issued only when the default has continued for more than two months.

In most cases, when an issuer cease trade order is issued within less than two months from the default date, it indicates that the issuer has not followed the Alternate Information Guidelines set out in OSC Policy 57-603. Staff recommends that investors in securities that are cease traded in such circumstances should communicate with directors or officers of the issuer, to understand the reasons why the issuer did not follow the policy in order to preserve liquidity for the issuer's security holders.

Staff took a highly proactive approach to its monitoring of defaults arising on financial statement

filing requirements by Ontario-based companies having December 31, 2000 year-ends. In late April, 2001, letters were sent to each of the approximately 500 issuers that had not already filed annual financial statements due to be filed by May 22, 2001. The letter summarized OSC Policy 57-603 and the procedures necessary to avoid the imposition of an issuer cease trade order. Where no response was received to these letters and the issuer failed to file before the due date, staff followed up with telephone calls. Every issuer was provided ample opportunity to avoid the issuance of an issuer CTO.

82 Ontario-based reporting issuers failed to file their financial statements on the due date. Of those issuers, 24 filed within a few days and no further action was taken. Of the remainder, 8 complied with the Alternate Information Guidelines in the policy and staff therefore issued Management and Insider CTO's for those companies. Issuer CTO's were imposed on 47 of the remaining 50 companies (the remaining 3 applied to cease to be reporting issuers).

These numbers compare favourably to the previous year in that fewer Ontario-based issuers failed to file their financial statements on the due date (91 were identified in the previous year). However, of those defaulting reporting issuers, a relatively greater number received Management and Insider CTO's in the previous year (17 in 2000 compared to 8 in 2001), despite changes in staff practice designed to increase the incidence of Management and Insider CTO's.

In view of the large number of defaulting issuers that failed to satisfy the Alternate Information Guidelines, staff is more actively assessing the possibility of enforcement action as an appropriate response. Staff believes that when an issuer does not even follow the Alternate Information Guidelines, it generally indicates a substantial disregard of the public interest by the issuer's officers and directors. As noted in Policy 57-603, in particular cases staff may, under section 127 of the Act, seek orders from the Commission against a defaulting issuer's officers and directors to obtain sanctions such as reprimands, orders to resign, or orders that securities law exemptions do not apply. Similar action may be taken by staff in connection with issuers with a significant and consistent history of filing defaults. In such cases, staff will consider whether the issuer's filing track record demonstrates a persistent disregard of the public interest by the issuer's officers and directors.

#### *Violations of Cease Trade Orders*

Staff reminds issuers that activities such as share consolidations or proxy solicitations made in connection with statutory amalgamations and other material transactions constitute trades or acts in furtherance of a trade. Any such activities by a company that is subject to an issuer cease trade order will generally constitute a violation of that order and may lead staff to undertake enforcement action against the issuer.

## **5. Other Continuous Disclosure Matters**

### *Material Change Reports*

In the course of a CD review, staff reviews the adequacy of the issuer's compliance with requirements to report material changes on a timely basis. In reviewing core disclosure documents such as financial statements and MD&A, staff assesses whether major transactions or

events disclosed in those documents would have constituted material changes at the time that they took place, and if so, whether material change reports were filed. Where an issuer has been deficient in this regard, staff seeks a credible commitment from management to comply with all requirements going forward. A recurring failure to comply with securities law could provide a basis for enforcement action. Also, the Director assesses such matters for purposes of determining - in the context of issuing a prospectus receipt - whether sufficient concerns exist with respect to the past conduct of the issuer's officers and directors to afford reasonable grounds for belief that the business of the issuer will not be conducted with integrity and in the best interests of its security holders.

#### *Selective Disclosure*

In July 28, 2000, staff issued OSC Staff Notice 53-701, *Staff Report on Corporate Disclosure Survey*. In it, staff recommended that companies formulate written corporate disclosure policies addressing such areas as limiting the number of authorized company spokespersons, opening up access to conference calls, and disseminating information more broadly through the use of technology. In April 2001, the Canadian Securities Administrators issued for comment CSA Policy 52-701, *Disclosure Standards*, which encompassed many of the recommendations of OSC Staff Notice 53-701. To support these informational and policymaking activities by the OSC and the CSA, the CD team requests, as part of its CD and prospectus reviews, information regarding the issuer's policies and procedures for complying with the relevant sections of the Securities Act. Staff also requests a copy of the issuer's written disclosure policy, if one exists. Staff provides feedback on areas that do not appear to be addressed by the issuer's policy, and encourages boards and audit committees and others to consider this feedback in assessing the adequacy of the issuer's disclosure practices. Areas where issuer policies are often found by staff to fall short of the CSA notice recommendations include: materiality definitions, guidance on how to conduct analyst calls and meetings, and action plans for market rumours and unintentional selective disclosures. In the future, staff may follow up with issuers that have received such feedback, and issue a report on the results of this exercise.

#### *Financial Reporting in an Economic Downturn*

Reporting issues relating to the current economic downturn have been one area of focus of recent continuous disclosure reviews and are likely to continue to draw the attention of staff for the foreseeable future. In this regard, staff will assess an issuer's accounting for asset impairments, discontinued operations, and contingencies and consider whether going concern disclosure should be provided in the issuer's circumstances. As part of our review of MD&A, staff will assess whether issuers have provided an adequate discussion of the impact, if any, of a continuing economic downturn on the enterprise's operations and future prospects.

## **6. Administration Of The CD Review Program and Related Matters**

#### *Amendments to OSC Staff Notice 51-703*

In the course of implementing the CD Review Program, various aspects of the procedures set out in OSC Staff Notice 51-703, *Implementation of Reporting Issuer Continuous Disclosure Review Program, Corporate Finance Branch* have been amended or streamlined. In particular:

Staff does not generally send a notification letter to an issuer at the time that the issuer is selected for CD review. Instead, staff's initial comment letter will generally be the first communication received by the issuer. In all cases where a review has been conducted, a closing letter will be sent to the issuer.

The notice indicates that reporting issuers will be selected for review depending on the application of selective review criteria which have been designed to identify those issuers at the greatest risk of filing deficient disclosure. Reporting issuers with an Ontario head office will be subject to this screening process at least once a year, generally upon the filing of their annual financial statements. A review may also be triggered at other points during the year as a result of staff's daily review of the financial press, as a result of investor complaints or referrals from other branches of the Commission, or for other reasons.

The notice indicates that files selected for review will be subjected to one of three levels of review: full, issue-oriented and limited. In practice, all reviews are likely to be either full or issue-oriented. The screening process described above constitutes in effect a limited review that is carried out annually on all issuers. However, unless an issuer is identified by the screening process for further review, this process is not counted as a CD review for purposes of the four year target described above.

The notice indicated that certain Continuous Disclosure Team staff had been dedicated to the review of insider trade report filings on an ongoing basis. Due to a reorganization of the Corporate Finance Branch, responsibility for review of insider trade report filings is no longer contained within the CD team. The work done by staff to assess compliance with insider reporting requirements will be communicated separately. However, a CD review may include a review of insider reporting, including a comparison of the insider reports with other information on the public record. For example, staff questioned one issuer about a discrepancy between the amount and value of a holding in a corporate investment as reported in a prospectus filed by the issuer, and the amount and value indicated by the issuer's insider reports.

#### *SEDAR filings*

Staff reminds issuers of their responsibility for maintaining an accurate filer profile and filing record on SEDAR. Documents that are wrongly categorized on SEDAR cause unnecessary difficulty for investors or others that consult the SEDAR record, and in some cases could cause an issuer to be placed on the default list even when a document has been filed within the time period required by the Act. Common errors include the filing of MD&A under "Annual Information Form" rather than separately under "MD&A" and the filing of press releases under "Other," when they should be specifically labelled as press releases. The primary contact information frequently appears to be out of date.

#### *Exemptive Relief Applications*

Issuers are reminded that applications requesting exemptive relief should be filed with the Ontario Securities Commission as early as possible and preferably at least two weeks prior to when the relief is needed.



## 7. Current Activities

In December 2000, Staff published the final drafts of OSC Rule 51-501, *AIF and MD&A*, and OSC Rule 52-501, *Financial Statements*. OSC Rule 51-501 reformulated OSC Policy 5.10, *Annual Information Form* and also introduced a requirement for interim MD&A. OSC Rule 52-501 reformulated sections 7 to 11 of the Regulation by setting out the contents of interim and annual financial statements. The rule provides for significantly enhanced interim financial statements which include notes and a balance sheet, among other things.

Staff is currently conducting an issue-oriented review of interim financial reporting to assess compliance by issuers with the relevant sections of these new rules and with CICA Handbook Section 1751, *Interim Financial Statements*. The review will focus primarily on first quarter interim financial statements and MD&A filed by issuers for the quarter ended March 31, 2001. A screening process will be applied to identify issuers to be subjected to a detailed issue-oriented review. Staff anticipates that approximately 100 issuers will be selected for such a review. The results will be communicated shortly in a separate notice. Future issue-oriented reviews may focus on annual MD&A, on executive compensation disclosure, or on other matters.

In addition to this issue-oriented review, staff will concentrate on meeting its goal of carrying out approximately 300 additional reviews during the year ended March 31, 2002, including reviews to be carried out in connection with reviews of prospectuses and rights offerings circulars.

Questions may be referred to:

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