1.1.2 OSC Staff Notice 51-712 – Corporate Finance Review Program Report – August 2003

OSC STAFF NOTICE 51-712
CORPORATE FINANCE REVIEW PROGRAM REPORT – AUGUST 2003

1. Introduction

For the past two years, the Ontario Securities Commission's Corporate Finance Branch (the CF Branch) has issued a year-end report on the progress of its Continuous Disclosure Review program (the CD Review Program). This year we have expanded the scope of our report to address our reviews of prospectus activities as well. OSC Staff Notice 11-719 *A Risk-based Approach for More Effective Regulation* outlines our risk-based approach to prospectus and CD reviews.

This report covers the period April 1, 2002 to March 31, 2003.

In addition to our review programs, the CF branch is involved in a range of day-to-day activities and policy-making initiatives. These are beyond the scope of this report.

2. Summary

We think that the results of our review programs for this year demonstrate a continuing increase in their effectiveness. Over the past three years, the great majority of Ontario-based companies, including all of the larger ones, have heard from us in one way or another. Some companies have heard from us on numerous occasions. We raised a wide range of issues, and these resulted in a significant volume of measurable outcomes.

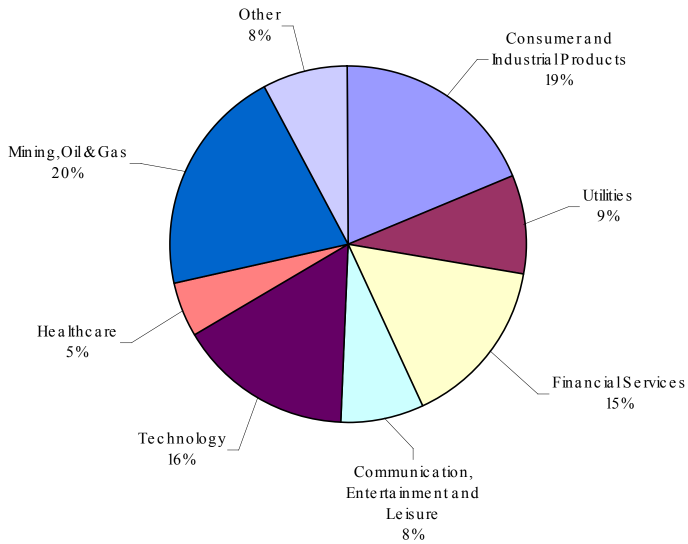
We aim to be as transparent as possible in communicating our activities. We hope that the information in this report provides a reasonable basis for you to assess the scope and effectiveness of our review programs. To provide useful information on specific issuers, we began during the year to publish on our website the names of companies that refiled or restated continuous disclosure documents as a result of our reviews. We also hope that the issues identified in this report will assist preparers, boards and audit committees, users and others in anticipating areas that may be contentious. We emphasize however that when we carry out a full disclosure review of an issuer, we assess the whole spectrum of that issuer’s disclosure, and do not confine ourselves to examining a few predefined areas.

As described in section 3, the proportion of reviews that resulted in no significant outcomes was lower this year than last. This partly reflects the kinds of issues we focused on this year, rather than a pervasive decline in the quality of information in the disclosure documents reviewed. Overall, we think the standard of disclosure is improving. However, the nature and extent of the matters we describe in this report clearly make the point that there remains a long way to go.

3. Overview of Corporate Finance Activities

In OSC Staff Notice 51-703 *Implementation of Reporting Issuer Continuous Disclosure Review Program, Corporate Finance Branch* we stated that the OSC’s goal is to conduct a CD review once every four years on average, for reporting issuers with an Ontario head office. Between April 1, 2002 and March 31, 2003, we completed 217 reviews of preliminary prospectuses, 85 of which included an element of CD review. We also completed 194 CD reviews that were not related to a prospectus. We completed 411 reviews in all, including 279 CD reviews, which represents some 19% of active Ontario-based reporting issuers.

Our reviews were drawn from the following industries:



We carried out fewer CD reviews this year than last, because we focused much of our efforts on the larger TSX-listed Companies. The companies we reviewed represent significantly more than 25% of the total market capitalization of the TSX. Overall, 64% of the companies reviewed were listed on the TSX.

Of the 194 CD reviews not connected with a prospectus:

- 44 were part of a targeted review of TSX 100 companies. We report on this initiative in section 4 of this Notice.

- 45 were part of a targeted review of executive compensation practices. We reported on this project in November 2002 in CSA Staff Notice 51-304 *Report on Staff's Review of Executive Compensation Disclosure.*

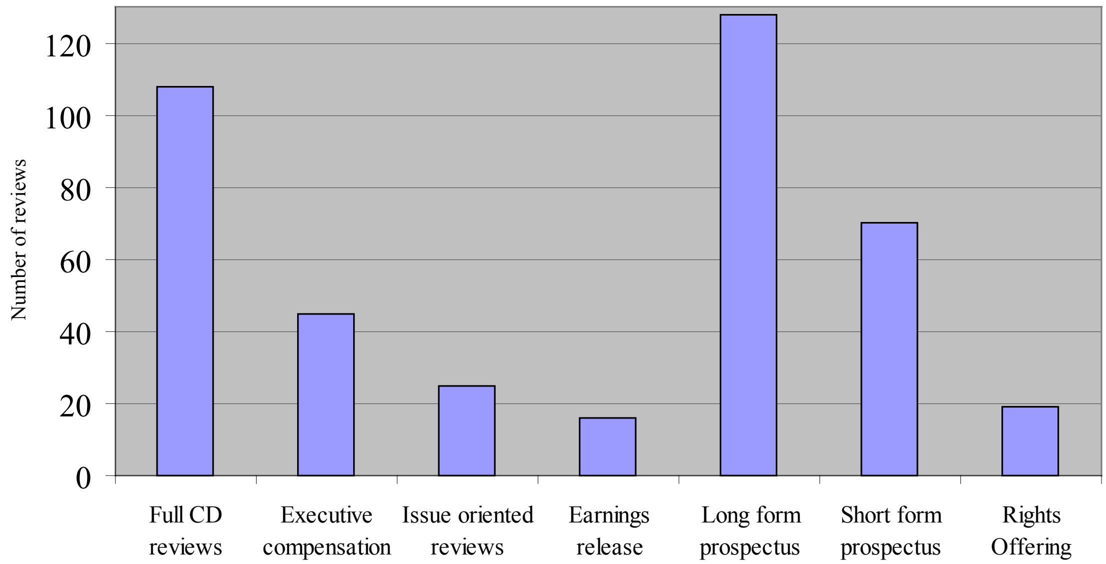
- 16 were part of a review of non-GAAP measures in earnings releases, which we reported on in OSC Staff Notice 51-706 *Continuous Disclosure Review Program* with follow-up comments in part 6(a) of this notice.

- 65 were other full reviews.

- 24 were other issue-oriented reviews, responding to items identified through our daily reviews of media reports, investor complaints, routine application processes, or through other sources.

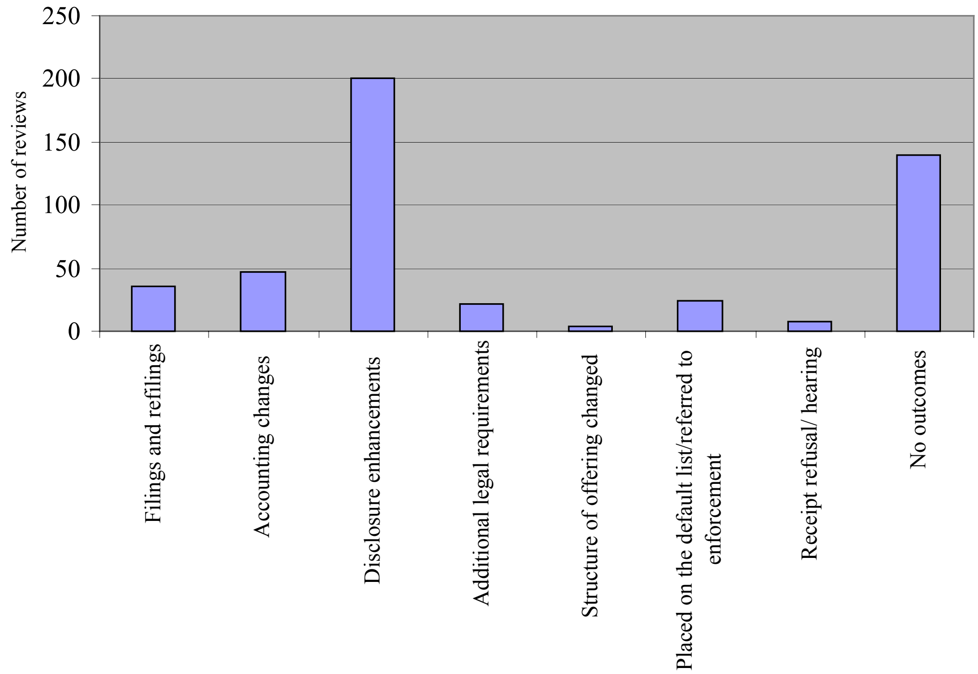
The 217 reviews of preliminary prospectuses were made up of 128 long form prospectus reviews, 70 short form prospectus reviews and 19 rights offering prospectus/circular reviews. Last year we reviewed 314 prospectuses. The difference from year to year reflects lower filing volumes due to market conditions. As discussed in Staff Notice 11-719, when appropriate, we review the continuous disclosure record of issuers qualifying for the short form prospectus system as part of a CD review, rather than at the time of the offering.

Our review activities for the year ended March 31, 2003 are summarized in the following table:



4. Outcomes of Corporate Finance Activities

The outcomes of our 411 completed reviews are summarized below. More than one outcome could be reported for each file.



- 54% of our prospectus reviews and 39% of our CD reviews resulted in no significant changes.

  For CD reviews, the proportion of reviews that resulted in no significant changes is lower than last year, when the equivalent number was 57%. However, we do not think that this reflects a greater incidence of disclosure problems in the general issuer population. During the year, we focused on a number of areas (executive compensation, earnings releases) where the quality of disclosure has long been unacceptable, and accordingly we found change to be necessary in many cases. Also, as we continually enhance our risk-based approach to continuous disclosure reviews, we believe we are becoming more effective in finding and focusing on the companies that have disclosure problems.

In general, a larger percentage of prospectus reviews result in no significant changes. We think that this reflects the high degree of involvement and review by issuers, underwriters, counsel and auditors in preparing the offering documents.

- In 9% of our reviews, we identified filings that were so deficient that the issuers were required to refile continuous disclosure materials, or to file materials that had not previously been filed.

  Many of the refilings related to issues identified in interim financial statements, such as a failure to disclose notes to the interim financial statements and/or the correct comparative periods for the income and cash flow statements. We are disappointed that even though the OSC's rules and the CICA's standard on interim financial statements have been in place for over two years, we continue to identify basic errors and omissions in this area.

- In 10% of our reviews, a change was required to some aspect of the issuer's accounting. These accounting changes were generally implemented on a retroactive basis in the first financial statement filing following the completion of our review.

- Some of the issues that led either to a refiling or to a retroactive accounting change are listed below. During the year we began publishing on our website the names of companies that refiled or restated continuous disclosure documents as a result of an OSC review. Our approach to this area is described in OSC Staff Notice 51-709 *Refilings and Corrections of Errors as a Result of Regulatory Reviews*. Some of the examples that follow relate to files that were completed before the implementation of our website list.

  - *Cash flow statement* - including changes in short term investments as an operating rather than an investing activity; including tenant inducements as an investing rather than as an operating activity;

  - *Revenue recognition* – recognizing revenue on a gross basis, when a net basis was appropriate; recognizing recovered expenses as revenue rather than as a reduction of the relevant expense category; including a non-recurring gain within revenue;

  - *Business combinations* - failing to identify all intangible assets acquired;

  - *Hedging* – immediately recognizing a gain that should have been deferred over two years;

  - *Cost deferral* - deferring expenditures that should have been expensed as incurred;

  - *Classification of debt vs. equity/measurement at fair value* - recording as a liability an element of purchase consideration that should have been included in equity, and failing to record that amount at fair value;

  - *Asset valuation* - not writing down portfolio investments to recognize a permanent impairment in their value; not writing off uncollectible trade receivables;

  - *Income statement presentation* – improperly presenting funds from operations on the face of the income statement, failing to include an income statement in financial statements;

  - *Discontinued operations* – improperly classifying impairment of assets relating to continuing operations as part of discontinued operations;

  - *Tax* – not recognizing the effect of a change in substantively enacted tax rates in the correct period;

  - *Pro forma financial statements* – making pro forma adjustments not in compliance with OSC Rule 41-501 *General Prospectus Requirements*;

  - *Earnings per share* – omitting earnings per share/unit disclosure;

  - *Going concern note* –either omitting or making inadequate disclosure of going concern uncertainty;

- 42% of our outcomes represented commitments by issuers to enhance some aspect of their disclosure in future filings. A significant number of these commitments related to executive compensation and non-GAAP earnings measures. Other areas included:

  - *Revenue recognition* – many companies committed to enhance their revenue recognition policies;

- *MD&A* – several companies agreed to provide more comprehensive MD&A disclosure in both their financial statements and prospectus documents;

- *Business acquisitions* – several companies agreed to expand their disclosure with respect to business acquisitions and significant corporate investments;

- *Tax* – companies provided expanded tax-related disclosure in the offering document for complex structures and/or transactions - for example, regarding the tax treatment on distributions from various asset-backed securities;

- *Resource properties: technical report information updates* – companies updated production information disclosed in the prospectus, which was extracted from previously filed technical reports, to reflect current market conditions for the minerals discussed;

- *Website disclosure* – website changes included removing outdated analysts reports, and correcting various misleading links;

• 5% of our outcomes represented additional legal requirements imposed on the issuer of an offering document. The majority of these resulted from undertakings filed with securities regulators in connection with reporting obligations for income trust structures. Other additional legal requirements include the following:

  - *Subscription receipts* – companies added disclosure in the "Statutory Rights of Withdrawal and Rescission" section, clarifying that purchasers of subscription receipts would continue to have civil liability remedies, including remedies for damages, that are provided to purchasers of common shares under securities legislation.

5. Review of TSX 100 Companies

During the year, major corporate accounting failures in the United States raised a number of issues concerning transparency and disclosure, the adequacy of corporate governance structures, the independence of the auditor and the effectiveness of the audit process. As part of our response to these issues we carried out a full review of the Ontario-based companies in the TSX 100 that had not been reviewed in the past year. We also discussed with staff of the other provincial commissions how they are approaching the TSX 100 companies based in those provinces. Where those companies were not a current focus for the other provinces, we carried out full reviews of some of those companies as well.

As described in OSC Staff Notice 51-703, a CD review normally focuses on publicly available documents. However, on this occasion we expanded the scope of our work by reviewing a greater range of materials. We requested and reviewed, on a confidential basis, minutes of audit committee meetings, management presentations and other meeting materials on disclosure issues presented to the Board and/or the Audit Committee. We also reviewed "management letters" received from the companies' auditors.

To provide us with additional perspective on these companies, we requested copies of recent analyst reports. In addition, we requested that the companies provide us with a summary of recent steps that they had taken (if any) to enhance their internal policies and processes for financial reporting and disclosure and corporate governance.

These additional steps allowed us to form a fuller and more informed understanding of the quality of disclosure made by the companies. They also allow us to provide findings on certain aspects of corporate governance and related issues.

(a) Corporate Governance

Our reviews did not include a comprehensive examination or merit-based assessment of the adequacy and effectiveness of corporate governance procedures. We did not attend meetings and, as discussed below, the minutes of the meetings were often not substantive in nature. However, we noted that almost all the companies we reviewed disclosed their approach to corporate governance in a manner consistent with TSX listing requirements. We made the following observations pertaining to the companies' oversight of financial reporting and disclosure:

• In 83% of our TSX 100 reviews it was evident that the audit committees regularly discuss financial reporting risks, internal controls and risk management.

• In 86% of the reviews it was evident that audit committees have an oversight function with respect to external and internal audit and have discussions surrounding auditor independence. Many companies have recently addressed auditor rotation by establishing formal policies.

- Many audit committees hold in-camera meetings with their external and internal auditors without management present.

- 69% of the companies reviewed had engaged their external auditors to provide a review of the interim financial statements.

- Some audit committees are requesting more detailed reports from management in order to further educate themselves about the day to day operations of the business.

Almost all the companies we reviewed had carried out some kind of recent assessment of their policies and procedures for financial reporting and corporate governance. They provided to us a summary of the recent steps they had taken to examine their policies and processes surrounding financial reporting. These included many initiatives we thought were positive steps towards improved corporate governance. Some of the more common steps include:

- Some companies informed us that they are placing emphasis on recruiting directors that are independent of the Company and possess financial expertise.

- Companies are ensuring that their audit committees consist only of outside directors.

- Many companies are providing enhanced education and training for their directors.

- Several companies are in the process of establishing a corporate code of ethics for employees, management and board members.

- Most companies commented on their auditor independence policies, involving restrictions on non-audit work carried out by external auditors.

Other recent steps that we found noteworthy were:

- establishing a risk management team or enhanced risk management reporting to the board

- increased vigilance with respect to special purpose entities, both operationally and in terms of disclosure

- creating a directors' website to facilitate timely and frequent dissemination of information to the directors; and

- unannounced internal audits performed at the request of the audit committee.

We are placing increasing emphasis on good corporate governance and will take the quality of their corporate governance practices into account when determining at what interval these companies should be subject to a follow-up review.

(b) Accounting and disclosure

We corresponded with the companies on various matters, with a variety of resulting outcomes. Two files remain in progress as of the date of this report.

One review resulted in a restatement of the 2001 annual financial statements. The restatement resulted from inappropriate deferral and amortization of a payment that should have been written off immediately.

The majority of the outcomes were enhancements to disclosure – financial statements, MD&A or other required filings. 50% of the companies reviewed agreed to modify some aspect of their disclosure on a prospective basis.

- The majority of these enhancements relate to revenue recognition. Companies agreed to provide more comprehensive disclosure with respect to revenue and to include discussion on the treatment of such things as warranties, returns and contingent inventory.

- Several companies agreed to include the outstanding share data disclosure required by National Instrument 62-102 - *Disclosure of Outstanding Share Data*. Companies are required to disclose the number of shares outstanding as of the latest practicable date.

- A few companies agreed to provide enhanced disclosure of non-GAAP earnings measures discussed in their MD&A filings. One company agreed to remove this information from its income statement.

- We requested that companies include more disclosure in their Information Circulars regarding stock compensation and executive compensation plans.

14% of the companies reviewed committed to various other modifications including:

- undertaking to prepare minutes for audit committee meetings.

- enhancements to corporate disclosure polices.

- clarification regarding their policies surrounding material change reporting.

Some of the more common matters arising in these reviews are discussed in the following section. Other areas where we raised questions included:

- how restructuring and obsolescence provisions were determined, and the basis for subsequent amendment.

- how reportable business segments were determined.

- disclosure of the terms and conditions of financial instruments.

6. Accounting and Financial Reporting Matters

In this section we comment in more detail on some of the areas that arose most commonly in our reviews this year.

(a) Non-GAAP earnings measures

We noted that 78% of the companies included in our review of TSX 100 companies are now following (in all respects) the expectations of CSA Staff Notice 52-303 *Non-GAAP Earnings Measures*. We requested that several other companies improve the disclosure of their use of non-GAAP earnings measures.

As described in OSC Staff Notice 51-706 we had previously reviewed the earnings releases of Ontario-based TSE 300 companies to assess whether issuers were meeting the expectations set out in Staff Notice 52-303. Towards the end of the year, we carried out a follow-up study, focusing in detail on the TSX 60 companies (including those not based in Ontario).

We found a general improvement in how companies met the expectations set out in the Staff Notice. Forty companies either did not use non-GAAP earnings measures, or used non-GAAP earnings measures and met all of the expectations set out in the Staff Notice. The remaining twenty companies did not meet all of the expectations. These companies commonly failed to:

- state explicitly that the non-GAAP earnings measures used in the earnings releases had no standardized meaning and were therefore not comparable with measures used by any other companies

- explain the objectives for using non-GAAP earnings measures

- provide a clear quantitative reconciliation between the non-GAAP earnings measures and their most direct comparable GAAP earnings measures.

Some of our most frequently occurring concerns include:

- Some companies failed to identify the earnings measures used in their earnings releases as non-GAAP earnings measures. Although earnings measures like EBITDA and EBIT are common, they are *not* considered to be measures derived in accordance with GAAP. There is no standardized definition for these measures: for example, some companies exclude non-recurring charges and minority interests from EBITDA, while others do not.

- Companies generally provide an explanation for their use of non-GAAP earnings measures, but these explanations usually contain boilerplate language and are not very meaningful. For example, the explanations often consist of assertions that these measures better communicate performance, or that management thinks shareholders or analysts prefer these measures, or that it is industry practice to utilize these measures. We expect companies to discuss fully the meanings of these measures and the reasons why management believes these measures are useful to investors.

- Non-GAAP earnings measures are sometimes used to eliminate or smooth items identified as non-recurring, infrequent or unusual. We discourage this practice, particularly when the nature of the charge or gain is such that it is reasonably likely to recur in the near future, or there has been a similar charge or gain in the recent past. Even when adequately disclosed, such use of non-GAAP earnings measures can still be inherently misleading.

Once again, we remind issuers that regulatory action might be taken against issuers that disclose information in their earnings releases in a manner considered misleading and therefore potentially harmful to the public interest.

(b) Business Combinations

In 23% of our reviews of the TSX 100 companies, we raised questions in the general area of accounting for business combinations. These questions often related to the implementation of CICA 1581 Business combinations *and CICA 3062* Goodwill and other intangible assets*. Issues included:*

- inadequate attempts to identify and value all intangible assets acquired in a business acquisition
- how intangible assets were valued, including how it was determined that a particular intangible asset had an indefinite useful life
- whether phase one of the initial impairment test had been carried out
- whether goodwill had been adequately assessed for impairment
- how reporting units were identified

Similar issues often arose during the year in our other reviews as well. In general, we continue to find a general lack of rigor in the application of the standards. We have also questioned in some cases whether auditors had obtained sufficient appropriate evidence to support the conclusion expressed in their report. On one occasion during the year, we requested that more audit work be carried out.

Specific issues include:

(i) Recognition of Intangible Assets

CICA 1581 requires that intangible assets be recognized if they result from contractual or other legal rights; or they are capable of being separated from the acquired enterprise. Appendix A to CICA 1581 provides additional guidance and examples of intangible assets that meet the criteria for recognition.

When the issuer's disclosure record or the nature of the acquiree suggests that intangible assets were acquired, but none were recognized, we will generally request from the issuer documentation prepared at the time of the acquisition that will demonstrate to us that the standards were properly applied. Independent professional advisors can be very helpful, and in some cases may be necessary, in identifying intangible assets that are required to be recognized under the standards. We will routinely request information regarding the expertise of the individuals involved in making these determinations.

We often noticed a weak understanding of the standards as they relate to recognizing customer-related intangible assets. The standards are clear that contractual rights, even if they are not in written form, may give rise to intangible assets; this includes customer relationships that arise from contractual rights. Difficulty in determining values for such intangible assets is not an acceptable reason for failing to recognize an appropriate value for such intangible assets under the standards.

(ii) Measurement of Intangible Assets

Independent professional advisors are often required in determining the fair value of intangible assets, particularly for issuers acquiring companies in certain technology, research or biomedical related industries.

We remind issuers and their advisors that it causes us significant concern when an issuer engages its auditor to provide valuation services. Issuers sometimes try to justify the engagement of their auditors in valuation services by citing the relative immateriality of the results. However, it is our view that regardless of materiality, the appearance of an auditor's objectivity is impaired by the auditor's involvement in the valuation. In extreme cases, such concern might lead us to request the re-audit of the financial statements.

Some issuers told us that because their customer or supplier contracts are at "market price", no related intangible asset need be recognized. However, a stable contractual relationship has value in itself, and the terms and conditions of a contract are as important as the price when valuing a contract. Issuers should consider all aspects of their contracts before concluding that their "market price" contracts need not be recognized and valued.

We would also like to draw issuers' attention to the recently issued CICA EIC 137 *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*. In particular, there is a need to consider assumptions such as expectations of future contract renewals and other benefits when valuing contracts.

(c) Income Taxes

Our reviews identified several respects in which the requirements of CICA Handbook Section 3465 *Income Taxes* were not consistently applied. For example:

- In a business combination, no future tax liability was recognized in respect of the temporary difference between the fair values of acquired assets and liabilities and their tax values

- Income tax assets and liabilities were not remeasured at the balance sheet date to reflect the effect of substantively enacted changes in income tax rates

- The requirement to recognize future income tax assets that are more likely than not to be realized was not followed. This most often reflects recognition of a future income tax asset when there is insufficient favourable evidence in support of its realization. However, sometimes favourable evidence exists that is not taken into account in assessing the realization of income tax assets. For example, when a company assesses the carrying values of its capital assets for impairment, it prepares estimates of future cash flows. The assumptions underlying these estimates are relevant to assessing the realization of unused tax losses.

- Some of the required disclosures are not always provided including the nature and effect of temporary differences, the major components of income tax expense and a reconciliation of the income tax rate.

(d) Management Discussion & Analysis (MD&A)

Issues that we raised in this area during our review of the TSX 100 companies included:

- inadequate information regarding significant changes in financial condition.

- lack of discussion of the activities of a material special purpose entity

- the use of pro-forma results in annual MD&A, in a way that is more prominent than the GAAP information

- inadequate disclosure of financial instruments or significant contingencies.

We are currently carrying out an issue-oriented review of MD&A disclosures by TSX-listed issuers. The primary objective of the review is to improve compliance with the management's discussion and analysis (MD&A) disclosure requirements as set out in OSC Rule 51-501 *AIF and MD&A*. At the time of writing, we have issued most of the initial comment letters to the selected issuers, and the issues most commonly identified include:

> *Liquidity and Capital Resources*- many issuers fail to provide an in-depth discussion of their ability to generate adequate cash in the short term and long term. This includes failing to disclose known trends in the issuer's liquidity, and requirements relating to working capital.
>
> *Risks and Uncertainties* - many issuers fail to provide an analysis of the risks and uncertainties that are relevant to understanding the issuer's financial condition, changes in financial condition and results of operations.
>
> *Results of Operations* - many issuers fail to provide a quantitative and qualitative analysis explaining fluctuations of amounts in the financial statements. Issuers merely restate amounts available in the financial statements and provide a superficial explanation.
>
> *Segments* – we questioned whether several issuers adequately complied with CICA 1701 *Segment disclosures*, and noted a corresponding lack of sufficient analysis in the MD&A.

We will report later in the year on the initial results of our MD&A review.

(e) Material change reporting

In approximately 35% of our reviews of the TSX 100 companies, we raised questions about how the company had determined that a particular event should not be disclosed as a "material change" (as defined). Examples of areas in which we raised this issue include:

- business acquisitions

- significant changes to provisions or unusual write-downs

- litigation settlements
- common share offerings
- changes in senior management

While these events were generally communicated to the public through a press release, the Securities Act (Ontario) sets out specific reporting requirements for events that constitute material changes. In such cases, we generally assess the procedures that a company has in place to determine when a material change report is required. Most companies have established such procedures. However, in general, we feel companies often take too limited a view of whether a particular event may be a material change. Part 4 of National Policy 51-201 Disclosure Standards *contains useful guidance on making these determinations.*

(f) Basis of accounting

We raised several questions on how companies selected the appropriate basis of accounting for a particular corporate investment. For example:

- We questioned the use of proportionate consolidation instead of full consolidation, where it was not evident that the relationship was a joint venture
- We questioned the use of consolidation instead of equity accounting, when the percentage ownership did not appear sufficient to constitute a control position
- We questioned the use of the cost basis, where there was evidence that significant influence exists.

In many cases, these questions reflected inadequate disclosure by the company of the economic substance of the investment, and of why a certain accounting method was chosen.

(g) Employee future benefits

We believe that disclosures relating to accounting for employee future benefits could frequently be enhanced in many respects.

CICA 3461 *Employee future benefits* contains several disclosure requirements that are not consistently provided. Also, given the complexity of this area, we believe that the additional disclosures encouraged by CICA 3461 are frequently necessary for a fair presentation in accordance with GAAP. The principles set out in CICA 1508 *Measurement uncertainty* are also relevant in assessing the appropriate level of disclosure. Areas where additional disclosure may be appropriate include the major factors and assumptions underlying the accounting for the pension plan, major sources of data and key elements of methodologies applied in calculating plan liabilities, and how measurement uncertainty is incorporated in the actuarial valuation process. Section 1508 also requires information about the extent of measurement uncertainty.

Companies often do not address employee future benefits in their MD&A. The omission is particularly troubling when the pension plans have a significant deficit, or are subject to particular uncertainty. Appropriate disclosure in the annual and quarterly MD&A may include discussion of:

- the reconciliation of the accrued benefit asset/liability to the funded status of the plan(s);
- significant changes in methodologies;
- the impact on the plan(s) of current developments such as restructuring, disposal of business segments, business combinations etc.;
- the potential impact of a change in the assumed rate of return or discount rates;
- the differences between past and expected future experience, as well as a sensitivity analysis that shows the financial impact on the entity as a result of a hypothetical change to pension assumptions;
- the anticipated contribution for next year and subsequent years, including whether the entity is expected to be required by legislation to increase contributions, and its ability to fund future contributions;
- any expected increase in pension expense in the next year (i.e. as a result of a significant unamortized actuarial loss incurred in the current year).

Given the pension plan's significance to many stakeholders, and the inherent uncertainty and potential volatility of the reported amounts, we also believe that companies should consider more rigorously whether it is necessary to provide disclosures in between the dates of the annual financial statements to reflect events during the course of the year. Depending on the nature of the event, this updating could either be included in the interim financial statements or be reported separately as a material change.

Companies should also ensure that employee future benefits are correctly reflected in the cash flow statement. While many of the changes in reported amounts are due to non-cash items, pension payments are cash flows and should be reported as such under operating activities.

(h) Combined Financial Statements

In a few instances combined financial statements were provided in an offering document even though they did not appear to fit the situations in which CICA 1600 *Consolidated financial statements* contemplates this kind of presentation. For example, subsequent to a number of property acquisitions from various third parties, issuers prepared combined financial statements combining the results of operations for the various properties. No common control or common management existed over the various properties during the period for which the financial statements were combined.

Although paragraph 1600.04 of the CICA Handbook does not explicitly prohibit the presentation of combined financial statements in situations where common control or management does not exist, companies should be cautious in how they use these statements. When assets were not under common control or management, and their historical results were subject to different accounting policies and management strategies that differ from those to be applied subsequent to the acquisition, it may be materially misleading simply to combine those results for presentation purposes. We have, on more than one occasion, refused to allow the inclusion in an offering document of combined financial statements that were not under common control or management.

(i) Pro Forma Financial Statements

Pro forma financial statements, included in a prospectus as the result of an acquisition, frequently include inappropriate pro forma adjustments. Specifically, the adjustments are not consistently limited to those that are directly attributable to a specific completed or proposed transaction for which there are firm commitments (see paragraph 3.17 of the Companion Policy to OSC Rule 41-501).

We have often seen adjustments related to future proposed events for which no commitments exist. Also, estimates of the impact of committed transactions on other indirectly-related items are sometimes included as pro forma adjustments. As stated in subsection 3.17 (6) of the Companion Policy to Rule 41-501, *Acceptable Adjustments,* only those adjustments for which the complete financial effects are objectively determinable should be included. We have sometimes refused to allow the inclusion in an offering document of pro forma information that contains inappropriate adjustments.

(j) Changes to Offering Structures

On a number of occasions, issuers relying on prospectus exempt distributions under National Instrument 45-101 *Rights Offerings* were required to change the structure of their offering in order to maintain their prospectus exempt status.

The requirement that prohibits a rights offering under the rights offering prospectus exemption, if the result would be an increase in excess of 25% in the number or amount of outstanding securities, is not being carefully applied. Sometimes in prospectus exempt rights offering distributions, warrants are attached with the common shares, which if exercised in addition to the common shares being distributed, would exceed the 25% threshold as detailed in subsection 2.2 of NI 45-101. When it is not reasonable to determine whether the warrants will be converted within 12 months from the date of the offering, we have requested revisions (and accompanying disclosure) to the structure of the offering and warrant indentures to ensure that the warrants may not be converted until one year from the date of the final rights offering circular. This step is necessary in order to exclude the warrants from the calculation for the purposes of the prospectus exemption.

7. Other Matters

(a) National Instrument 43-101 *Standards of Disclosure for Mineral Projects*

Based on our reviews of technical reports, disclosure documents, applications for exemptive relief, and on answering public inquiries and discussion with industry and other regulators, we believe that the qualified person's role in the issuer's disclosure has gained acceptance. Consequently, greater consultation and review occurs prior to the release of scientific and technical information to the public, and better information is available on SEDAR to investors. In general, technical reports are following the disclosure requirements of NI 43-101. However, other aspects of scientific and technical disclosure, such as websites and press releases, are generally less satisfactory. We believe that this demonstrates a need for greater involvement by qualified persons in preparing and reviewing all aspects of technical disclosure.

Our reviews identified the following major issues:

(i) Issuers not filing technical reports when required under Part 4.2 of NI 43-101

We see this primarily in connection with Annual Information Forms, and acquisitions of mineral resources and mineral reserves. Technical reports are required on properties that are material to the issuer and must generally be filed concurrently with the disclosure document. The only exception relates to an issuer's initial disclosure of mineral resources and/or mineral reserves and/or a preliminary assessment; in these cases the issuer has 30 days to file the technical report.

(ii) Inappropriate disclosure of mineral resources and mineral reserves

Only the five categories established by the CIM are permitted: proven and probable mineral reserves; and measured, indicated and inferred resources. Categories such as geological, drill-indicated, mineable, extractable, potential, insitu and global are not acceptable.

Disclosure of metal content must be accompanied by tonnage and grade of each category of resource/reserve.

Inferred mineral resources must not be totaled with other categories of mineral resources.

(iii) Lack of supporting information when disclosing historical resources and reserves

An issuer may disclose mineral resources and mineral reserves estimated prior to February 1, 2001. However, we often find that the required supporting disclosure is not provided. The disclosure must include:

- the source, relevance and reliability of the historical estimate
- whether CIM definitions have been used and if not, an explanation of the differences
- a discussion of any recent estimates or data

If an issuer acquires a property with historical reserves and resources, the requirement for a technical report is triggered once the issuer carries out work on the property and discloses mineral resources and mineral reserves. The report must be filed in 30 days.

(iv) Incomplete disclosure accompanying sampling results

Common deficiencies include lack of disclosure of the name of the assay laboratory and the type of sampling (i.e. channel, representative chip).

(v) Preliminary assessments: lack of cautionary language and failure to profile

When inferred mineral resources are used in an economic evaluation (scoping study level), then this constitutes a preliminary assessment that requires cautionary language about the speculative nature of inferred mineral resources, uncertainties about the preliminary assessment being realized, and the basis and assumptions of the assessment. Reporting issuers in Ontario need to file a copy of the proposed disclosure, the preliminary assessment and supporting technical report with staff five days prior to the disclosure.

(vi) Naming the qualified person

Under NI 43-101, the qualified person should be named in all written disclosure except news releases. However, the TSX and TSX Venture Exchange require that the qualified person be named in news releases as well.

(b) SEDAR Filings

(i) Profiles

We again remind issuers of their responsibility for maintaining an accurate and current SEDAR filer profile, as set out in NI 13-101, *System for Electronic Document Analysis and Retrieval (SEDAR).* The launch of SEDI, the electronic insider reporting system, provides another important reason that the profiles be kept up to date, since the information in the SEDAR profiles is automatically transferred over to SEDI.

(ii) Changing the status of documents filed

We remind issuers to carefully check their SEDAR filings before they are filed. Once a document has been filed, we only make it "private" in very limited circumstances. If an error is discovered in a document already filed on SEDAR, then the issuer should file the amended document on SEDAR with an explanation of the corrections or changes made; however, the original document will generally not be removed from the public record.

(iii) New OSC fees

SEDAR has been changed to reflect the new OSC fee structure and associated fee forms. For further information, see OSC Rule 13-502, *Fees*.

8. Current Activities

Our major current project is our issue-oriented review of MD&A.

We are also in the process of conducting an issue-oriented review of selected elements of disclosure made by income funds. This is a coordinated project among the BC, Quebec and Manitoba Securities Commissions, under which a total of 41 income funds have been selected for review, including 19 Ontario based income funds.

We are also carrying out around 25 “Real-time reviews.” The subjects of these reviews are primarily larger and more complex companies that, for one reason or another, we consider to have a higher risk profile. Unlike a conventional CD review, in which the file remains open for a discreet period of time and is closed once all questions have been satisfactorily resolved, a real-time review file will remain open until our assessment of the risk profile changes. The file will be subject to ongoing review of all SEDAR filings, news articles, press releases, trading patterns and the issuers’ website. For such companies, we also listen to analyst calls as they are delivered. Material issues will be put to the issuer as they are identified.

We will report on all of these initiatives later in the year.

The OSC’s current rule-making agenda contains several projects that carry significant implications for our review programs. For example, proposed National Instrument 51-102, *Continuous Disclosure Obligations*, contains numerous new or amended requirements that will be monitored in our reviews once the instrument is implemented. We also anticipate that our reviews will contain an increasing emphasis on corporate governance matters, especially following the implementation of our proposed rules for the structure and functioning of audit committees.

Our reviews will also focus on major recently issued or anticipated accounting standards. As discussed above, issues relating to business combinations form a large part of our current agenda. Other areas of interest, in addition to those already discussed, include proposed accounting standards on financial instruments and hedge accounting. We will also focus on several of the Abstracts issued by the Emerging Issues Committee, such as EIC-134, *Accounting for Severance and Termination Benefits*, and EIC-135, *Accounting for Costs Associated with Exit and Disposal Activities (Including Costs Incurred in a Restructuring).*

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