1.1.4 OSC Staff Notice 51-715, Corporate Finance Review Program Report – October 2004

OSC STAFF NOTICE 51-715
CORPORATE FINANCE REVIEW PROGRAM REPORT – OCTOBER 2004

1. Introduction

The Ontario Securities Commission's Corporate Finance Branch (the CF Branch) is issuing a year-end report on some of the activities carried out by the branch. This report covers the period April 1, 2003 to March 31, 2004. We believe that the issues identified in this report will assist advisers, company management, boards and audit committees, users and others in complying with disclosure requirements.

In addition to our review programs, the CF branch is involved in a range of other day-to-day activities and policy-making initiatives. These are not addressed in this report.

2. Summary of our Risk-Based Approach for CD Reviews and Prospectus Reviews

A risk-based approach to file selection is becoming increasingly common among the world's major securities regulators as a method to prioritize among many possible activities. In recent years, we have been basing these decisions increasingly on risk, and focusing our efforts where the potential risks are highest. Various selection criteria are used to identify issuers whose disclosure is most likely to be materially improved or brought into compliance with securities law or accounting standards as a result of staff review, or whose potential impact on the markets is significant. The criteria change over time; for example, as certain disclosure related issues rise to greater public prominence, or as consensus or controversy develops around particular accounting or disclosure practices. For more information on A Risk-based Approach for More Effective Regulation, see OSC Staff Notice 11-719 (25 O.S.C.B. 8410).

An issuer's Continuous Disclosure (CD) and Prospectus filings may be subject to full reviews, issue-oriented reviews, real-time reviews or screening reviews.

a) *Full Reviews: CD* - consist of an examination of the issuer's disclosure record at least for the past year. In addition to all regulatory filings, we may examine trading activity, industry data and analyst reports. These files remain open for a discrete period of time and usually involve correspondence with the issuer.
Prospectuses – involves a complete review of the prospectus and any documents incorporated by reference.

b) *Issue-Oriented Reviews* – focus on a specific legal, accounting or other regulatory issue or possibly a particular industry.

c) *Screening Reviews*: CD - these are carried out for issuers that are identified as lower-risk based on screening criteria. These reviews also consist of an examination of the issuer's disclosure record for the past year, but are somewhat less detailed and do not usually involve any correspondence with the issuer. Generally, these files remain open for a very short period of time.
Prospectuses – a screening review is completed and the file is selected for full, issue-oriented or basic review. Basic review is largely limited to an administrative processing of the file.

d) *Real Time Reviews* - these are specific to the CD review process and are carried out for issuers identified as higher-risk based on our review criteria. Real time review files remain open until our assessment of the risk profile changes, and encompass ongoing monitoring and review of SEDAR filings, news articles, trading patterns, press releases, website, and analyst calls. This approach facilitates prompt identification and resolution of issues as they occur, and may identify patterns of behaviour not as readily evident when looking at an issuer at a specific point in time.

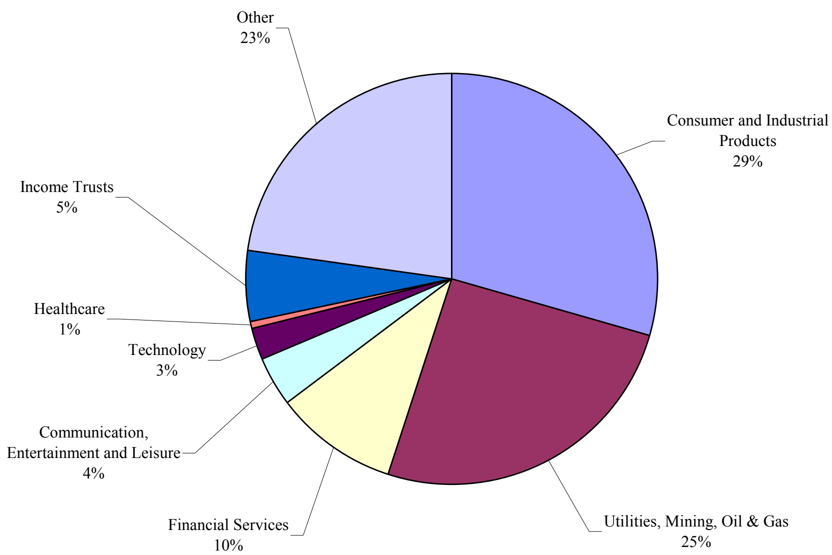
Some issuers will be selected for a CD Review and some prospectuses will be selected for a full review on a random basis.

3. Overview of Corporate Finance Activities

Between April 1, 2003 and March 31, 2004, we completed 274 full or issue-oriented reviews of preliminary prospectuses and rights offering documents, 100 of which included an element of CD review. We also completed 361 full, issue-oriented, screening or real-time CD reviews that were not related to a prospectus or a rights offering. We completed 635 reviews in all, including 461 CD reviews.

Breakdown of CD Reviews
The 461 CD Reviews represent 36% of active Ontario-based reporting issuers.

Our CD reviews were drawn from the following industries:



We carried out more CD reviews this year than last, because lower-risk issuers are increasingly likely to be subject only to a screening review, which involves less time and other resources. Overall, 46% of the companies reviewed were listed on the TSX, 31% of the companies were listed on the TSXV, and the remainder were either not listed or listed on other exchanges.

Of the 361 CD reviews not connected with a prospectus (some files are included in more than one of the following categories):

- 47 were part of a targeted review of companies' Management Discussion & Analysis. We report on this initiative in section 7 of this Notice.

- 25 companies were part of the real-time review approach described above.

- 17 were part of a targeted review of income funds. We reported on the outcomes of these reviews in CSA Multilateral Staff Notice 51-310 *Report on Staff's Continuous Disclosure Review of Income Trust Issuers* (27 O.S.C.B. 1847).

- 37 were part of a targeted follow-up review of executive compensation practices. We originally reported on this area in November 2002, in CSA Staff Notice 51-304 *Report on Staff's Review of Executive Compensation Disclosure* (25 O.S.C.B. 7277). We will report the results of the follow-up review later in the year.

- 32 were part of a targeted review of asset-backed securities issuers. We will report on this initiative later in the year.

- 94 were full reviews.

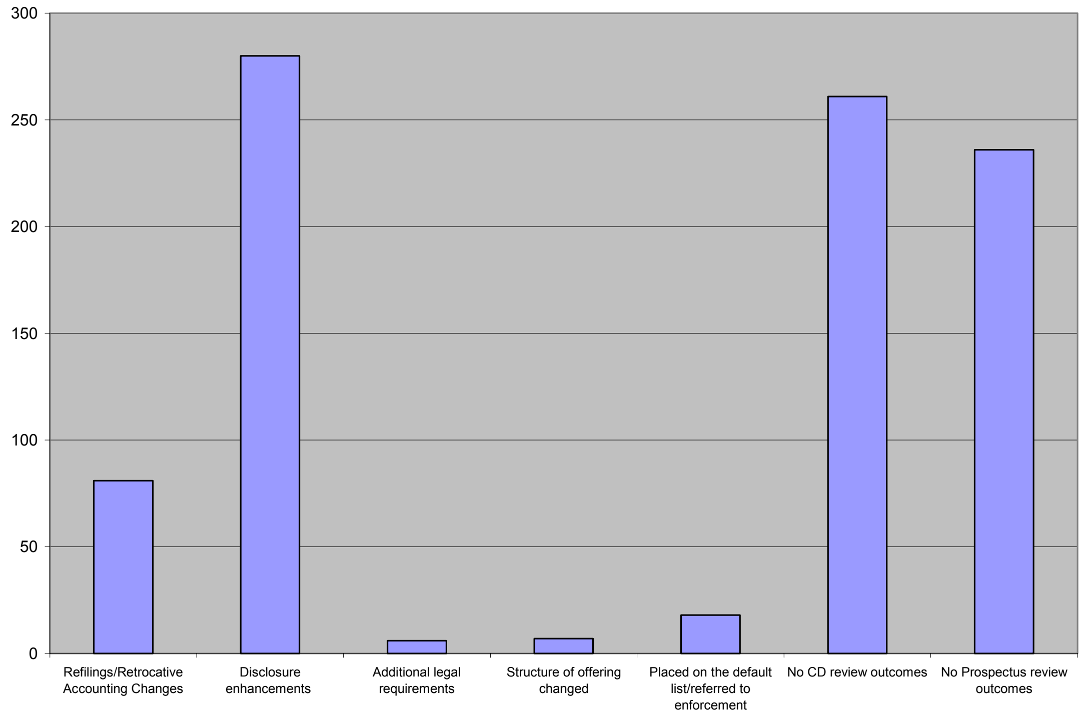
- 175 were screening reviews.

- 49 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.

Breakdown of Prospectus Reviews
The 274 reviews of prospectuses and rights offering documents were made up of 202 long form prospectus reviews, 52 short form prospectus reviews, and 20 rights offering circular reviews. In 2002/2003 we reviewed 217 prospectuses and rights offering documents.

4. Outcomes of Corporate Finance Activities – Continuous Disclosure and Prospectus Reviews

The outcomes of our 635 completed reviews are summarized below. More than one outcome could be reported for each file.



Legal outcomes included prospectus qualification of warrants and stock purchase contracts and activities of "finders" in the context of prospectus offerings. See sections 5 and 6 respectively for details regarding these outcomes.

The majority of the files with no outcomes are CD screening reviews, which do not generally involve any correspondence with the issuer. Excluding screening reviews, 37% of our CD reviews and 57% of our prospectus reviews resulted in no significant changes.

- For CD reviews, the 37% of reviews that resulted in no significant changes is lower than last year, when the equivalent number was 39%. As we continually reassess our risk-based approach to our reviews, we believe that we are spending a greater proportion of our time focusing on the companies that have potential disclosure problems.

- The percentage of prospectus reviews that resulted in no significant changes is again greater than that for CD reviews. We think that this is due to the high degree of involvement and review by issuers, underwriters, counsel and auditors involved in offering documents.

In 18% of our CD reviews, primarily relating to smaller issuers, we identified filings that were so deficient that the issuers were required to refile continuous disclosure materials, to make retroactive changes or to file materials that had not previously been filed. Our approach to this area is described in OSC Staff Notice 51-711 *Refilings and Corrections of Errors as a Result of Regulatory Reviews* (26 O.S.C.B. 4).

49% of our reviews represented commitments by issuers to enhance some aspect of their disclosure in future filings. A significant number of these commitments related to enhanced MD&A discussion, executive compensation and non-GAAP earnings measures.

Some of the issues that led either to some of the above outcomes such as a refiling, a retroactive accounting change or a change resulting from a prospectus review comment are as follows:

- *Management Discussion and Analysis (MD&A)* – restatement of annual and interim MD&A due to failure to meet the requirements of Ontario Securities Commission Rule 51-501 *AIF and MD&A*, including insufficient analysis and discussion of results of operations and financial condition, risks and uncertainties, and liquidity and capital resources (see section 7);

- *Purchase Price Allocation* - over-allocation of purchase price to goodwill, and failure to recognize intangible assets;

- *Discontinued Operations* – disposal of a business incorrectly accounted for as a discontinued operation;

- *Consolidation* – failing to provide consolidated financial statements when the parent continued to exercise financial control over a subsidiary;

- *Dilution Gains* –incorrectly deferring a dilution gain over 5 years instead of recognizing it at the time of the transaction; recording a dilution gain in share capital instead of on the income statement;

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

- *Reverse Takeover* – continuing to file financial statements of the predecessor company subsequent to the effective date of a reverse takeover;

- *Share Purchase Loan* - setting up an excess provision even though the issuer had negotiated repayment terms and had adequate collateral for the loan;

- *Cash flow statement* - failing to include a cash flow statement in the financial statements;

- *Interim Financial Statements* – failing to provide notes to the financial statements and/or the correct comparative periods for the income and cash flow statements;

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

- *Financial Reorganization* - failing to account for a financial reorganization in accordance with section 1625 – Comprehensive Revaluation of Assets and Liabilities of the CICA Handbook;

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

- *Revenue recognition* – inadequate disclosure of revenue recognition policies;

- *Segments* – failing to identify reportable business segments;

- *Business acquisitions* – inadequate disclosure with respect to business acquisitions and significant corporate investments;

- *Tax* – inadequate disclosure in the preliminary prospectus relating to complex structures and/or transactions - for example, regarding the tax treatment on distributions by income trusts;

- *Financial Instruments* – failing to disclose unrealized gains/losses for derivatives and interest rate swaps; and

- *Resource properties: technical report information updates* – inadequate updating of production information in the preliminary prospectus, which was extracted from previously filed technical reports, to reflect current market conditions for the minerals discussed.

5. Prospectus qualification of Warrants and Stock Purchase Contracts

Corporate Finance staff have recently had the opportunity to review a number of base shelf prospectuses that qualify, among other things, warrants (i.e., “stand-alone” warrants or “long-term” warrants) and share purchase contracts (also known as stock purchase contracts).

Where an issuer proposes to distribute “stand-alone” warrants or stock purchase contracts under a prospectus, in keeping with longstanding staff practice, we will generally raise a comment as part of the prospectus review process relating to certain policy concerns associated with these types of securities.

It should be noted that the reference to stand-alone warrants or long-term warrants is intended to refer to warrants and other forms of exchangeable or convertible securities that are offered under a prospectus as a separate and independent form of investment. The following discussion in relation to warrants would not apply to an offering of warrants where the warrants may reasonably be regarded as incidental to the offering as a whole. For example, in the case of a typical special warrant offering, the special warrant converts into i) a common share, and ii) a common share purchase warrant (or a fraction thereof). In such cases, we have generally accepted that the common share purchase warrant component merely represents a "sweetener", and that the primary investment decision relates to the common share underlying the special warrant. This would also generally be the case with a unit offering where the unit consists of a common share, and a common share purchase warrant.

Where an issuer proposes to distribute under a prospectus an exchangeable or convertible security, such as a warrant, option, right, subscription receipt or share purchase contract, we will generally consider whether the prospectus should also qualify the distribution of the underlying security. If the underlying security is not qualified, we may be prepared to accept some other form of protection for investors, such as a contractual right of action, in certain circumstances.

The policy concern with respect to exchangeable or convertible securities relates to the potential impact of the exchange or conversion feature on a purchaser’s statutory rights under s. 130 of the *Securities Act* (Ontario). For example, an investor may pay part of the purchase price at the time of the purchase of the convertible and part of the purchase price at the time of the conversion. To the extent that an investor makes a further “investment decision” at the time of conversion, we would want to consider whether the investor should continue to enjoy the benefits of statutory rights or comparable contractual rights in relation to this further investment.

Similarly, a security that is distributed under prospectus may convert into or be exchanged for a security that is distributed under an exemption. In this case, we would be concerned that the statutory rights described in s. 130 may be "stripped away" since the statutory rights arise where a security is purchased *under a prospectus*.

In the case of certain types of offerings, such as a prospectus offering of “subscription receipts,”[1] or an offering of convertible preference shares,[2] we will generally be prepared to recommend that a receipt be issued if appropriate disclosure relating to the impact of the conversion or exchange feature is contained in the prospectus, and the purchaser under the prospectus is provided with an appropriate contractual right of action (similar to that contained in s. 131 of the *Securities Act* (Ontario)).

Similarly, in the case of a preliminary short form base shelf prospectus that purports to qualify so-called “stand-alone” or “long-term” warrants, it is established staff practice to request an undertaking, and disclosure of the undertaking in the prospectus, that the issuer will not distribute such securities unless the prospectus supplement containing the specific terms of the securities is first approved for filing by the securities commissions or similar regulatory authorities in each of the provinces and territories of Canada where the securities will be offered for sale.[3] The purpose of this undertaking is to provide staff with an opportunity to consider whether there is an appropriate level of disclosure to the investor at the time of the exercise of the warrant.

We also request an undertaking where the base shelf prospectus purports to qualify share purchase contracts. Share purchase contracts are similar to a forward contract in that they typically require the holder to purchase from or sell to the issuer, and the issuer to purchase from or sell to the holder, a specified number of the issuer’s common shares at a future date or dates. The price per common share may be fixed at the time the share purchase contract is issued or may be determined by reference to a specific formula contained in the share purchase contract.

1 See, for example, the final prospectuses filed by Rogers Sugar Income Fund., dated January 23, 2002.

2 See, for example, the final prospectus filed by Fortis Inc., dated January 20, 2004.

3 See, for example, the final prospectus filed by Fairfax Financial Holdings Limited, dated April 20, 2004.

In our view, share purchase contracts may raise similar concerns to those described above. In our experience, there has been limited disclosure in the base shelf prospectus relating to share purchase contracts. Accordingly, rather than delay the processing of the base shelf prospectus or make a determination based on inadequate information, we will generally request an undertaking that the issuer pre-clear the supplement relating to the share purchase contracts, and disclosure of the undertaking in the prospectus.

6. Activities of "finders" in the context of prospectus offerings

Recently, we had the opportunity to consider a prospectus which raised a number of issues relating to the activities of a "finder" in connection with a prospectus offering.

The facts were essentially as follows. An issuer (the Issuer) filed a preliminary prospectus to qualify, among other things, the distribution of securities underlying two tranches of special warrants that had previously been privately placed: the Series A Special Warrants and the Series B Special Warrants.

The preliminary prospectus stated that a full service dealer (the Dealer) had acted as "agent" on a best efforts basis in connection with the sale of the Series A Special Warrants. The preliminary prospectus further stated that no underwriter or agent had acted in connection with the offering of the Series B Special Warrants but that the Dealer had acted as a "finder" in connection with the offering of the Series B Special Warrants.

On the Series A Special Warrants, the Issuer paid the Dealer a fee equal to a percentage of the gross proceeds plus certain compensation options. On the Series B Special Warrants, the Issuer paid a finder's fee equal to the same percentage of the gross proceeds, plus certain compensation options.

In the course of our review, we raised a number of comments relating to whether the Dealer should be considered as having acted as agent in connection with the private placement of the Series B Special Warrants. We took the position that there were several factors that suggested that the Dealer had also acted as agent on the Series B Special Warrants, including the following:

- The Dealer is a full-service dealer;
- The activities of the Dealer in the private placement of the Series A Special Warrants were not clearly different from the activities of the Dealer in the private placement of the Series B Special Warrants;
- The Dealer received the same consideration on the Series B Special Warrants as on the Series A Special Warrants; and
- The fact that no other party acted as agent in connection with the Series B Special Warrants.

The purchasers of the Series A Special Warrants have a statutory right of action against the Dealer under s. 130 of the Act for any misrepresentation in the prospectus as a consequence of the Dealer having acted as agent.

However, we were concerned that purchasers of the Series B special warrants may not have had such a right (or that such rights might be adversely affected). We were concerned that the limitation contained in s. 130(6) of the Act could potentially operate to limit the Dealer's liability to purchasers of the Series B Special Warrants. (Subsection 130(6) limits the liability of an underwriter to the portion of the distribution underwritten by the underwriter.)

The final prospectus included disclosure stating that, in the event of a misrepresentation in the prospectus, the Dealer would not limit its liability as provided for under section 130(6) of the Act. The statement that there was no agent or underwriter in connection with the offering of the Series B Special Warrants was also removed.

7. Management Discussion & Analysis (MD&A)

On March 5, 2003, the Canadian Securities Administrators (the CSA) announced it had launched a review to assess how well publicly-traded companies comply with their MD&A disclosure obligations. Under this initiative, a number of CSA jurisdictions reviewed a sample of MD&A of companies in their local jurisdictions. Concurrent with the reviews in the other jurisdictions, we reviewed the MD&A of forty-seven companies, primarily with head offices in Ontario. Of the forty-seven companies reviewed, thirty-four (72%) filed their MD&A with one or more deficiencies. The most common deficiency was a failure to provide explanations of material variances or to analyze material variances, followed by failure to adequately analyze identified risks and to disclose selected quarterly financial information.

Of these thirty-four companies, three restated and refiled their MD&A and have been recorded on the Refilings and Errors list. Thirty-one committed to make prospective improvements to their MD&A. We recently published OSC Staff

Notice 51-713 *Report on Staff's Review of MD&A*, which reports our findings and comments arising from these reviews. Subsequent to the publication of the Notice, we continue to review and comment on issuers' MD&A. Since March 31, 2004, nine additional reporting issuers were required to restate and refile their MD&A.

Subsequent to issuing Staff Notice 51-713, we have identified an additional area of concern. Some issuers aggregate the cost of goods sold and major operating expenses and present this figure as a one line item on their income statement. Companies taking this approach generally provide no further analysis or discussion of the components of this item in their MD&A and focus the discussion on the aggregate number. While CICA 1520 lists the amount of cost of goods sold and other major operating expenses as desirable rather than prescribed disclosure, we believe that separate disclosure of these amounts is generally necessary to provide a fair presentation of an issuer's results of operations. Form F2 of National Instrument 44-101 *Short Form Prospectus Distributions* requires that an issuer "disclose any significant components of revenue or expense necessary to understand the results of operations." We are of the view that regardless of the presentation of the expenses in the income statement, separate identification and discussion of cost of goods sold, gross margins and the material components of major operating expenses would generally be necessary to comply with the MD&A requirements.

8. Revenue Recognition

On March 9, 2001, we issued Staff Notice 52-701 – *Initial Report on Staff's Review of Revenue Recognition*. We are continuing to review the revenue recognition practices of reporting issuers, while incorporating the additional guidance provided by the recent issuance of two Emerging Issues Committee Abstracts (the EICs) issued by the Canadian Institute for Chartered Accountants in December 2003. EIC 141- *Revenue Recognition* and EIC 142 – *Revenue Arrangements with Multiple Deliverables,* provide guidance on a number of revenue recognition issues including determining whether delivery has occurred in various situations and determining sales price. We discuss below three recent examples of revenue-related matters raised in our reviews.

Non-Refundable up-front fees
The first issue was a non-refundable up-front fee received at the time of signing a contract, in exchange for the conveyance of a right. The right, effective for the duration of the contract and transferable only upon approval by both parties, allowed the purchaser to assist in future promotion of the product. In turn, the purchaser would receive a portion of future sales, providing it met the future commitments required under the contract. The contract also required significant continuing involvement on the part of the seller of the right, including providing the product for future sales.

The seller recognized the up-front fee as received; however, we believe that the fee should have been deferred and amortized over the term of the contract, based on the guidance provided in section 2(d) of EIC 141. We reached this conclusion because we did not believe that the granting of the right represented a separate culmination of the earnings process.

In determining whether a culmination of the earnings process had occurred, we considered if a separate value could be measured and assigned to the grant of the right. In this case, a separate value for the right could not be reliably identified, since the value of the contract to the purchaser depends on the receipt of a portion of future sales, which in turn depends on supply of the product by the seller. Without the continuing involvement of the seller, through the future supply of the product, the contract (and therefore the right), would have little value and thus, a culmination of the earnings process did not occur. Furthermore, the continuing involvement of the seller represents a significant portion of the contract, indicating that the seller had not substantially completed all of its obligations when granting the right. Therefore, a culmination of the earnings process did not occur at the time the right was granted.

The facts differ from the facts presented in example eight of the EIC, as that example addresses a product in the development stage, whereas the situation we addressed involved a fully developed product currently being marketed and sold. When an example in an EIC Abstract differs in the detail from a real-life example, it is not sufficient to assume, on this basis alone, that the Abstract is not relevant. Rather, the significance of the difference in the fact pattern must be carefully considered with regard to the basic principles of the Abstract.

Revenue Recognition in an Emerging Market
The second issue centered on recognition of revenue related to the sale of software in an emerging market. The company did not alter its pre-existing sales practices in entering this market, and the customers were therefore subject to the same contract and terms as the customers in the company's existing markets. Following the revenue recognition by the company, several customers in the new market subsequently notified the company that they were unwilling to pay for the software because it had not been satisfactorily deployed. Customers in this new market appear to consider 'acceptance' of the software a pre-condition for payment, even though the written contract did not have a formal written acceptability clause. It is necessary when entering a new market to assess the unique challenges of the new market and adjust the revenue recognition practices appropriately. If collectibility is not reasonably assured, then revenue must be recognized on the basis of the cash received.

Sale of an Asset in an Emerging Market
The third issue involved the sale of an asset in an emerging market. The amount receivable as a result of the sale was fully recognized at the time the agreement was finalized, due to the fact that collectibility appeared to be reasonably assured. Subsequently, the issuer had difficulty collecting the receivable, which remained outstanding several years later. Similar to the example above, due to the fact that business practices in the emerging market differ significantly, the amount owing as a result of the sale has become uncollectible, and must be written off. Once again, it is necessary for an issuer to complete further analysis of the emerging market and exercise caution when recognizing revenue from sales in these markets.

To adequately determine when to recognize revenue when selling assets or goods or services in emerging markets, issuers should have an understanding of the business practices of the market and of the legal options available to them that will assist in enforcing collection. Issuers should also consider their own past experiences, as well as experiences of others in emerging markets, when determining the timing for revenue recognition.

9. Income Trusts

The income trust structure has become a popular vehicle for public offerings. In an effort to further understand and evaluate the financial disclosure practices of income trusts, we conducted a coordinated project among certain CSA jurisdictions to review the continuous disclosure records of 40 income trusts. We reported the findings from our review in CSA Multilateral Staff Notice 51-310 - *Report on Staff's Continuous Disclosure Review of Income Trust Issuers* dated February, 2004 (27 O.S.C.B. 1847).

Our findings suggest that income trust issuers need to improve on the quality of their continuous disclosure records. Overall, 29 of the 40 income trust issuers reviewed committed to improve disclosure in future filings of MD&A, press releases, and annual and interim financial statements. Staff Notice 51-310 comments on and illustrates the types of issues we encountered.

We encourage income trust issuers to review Staff Notice 51-310 in conjunction with proposed National Policy 41-201 *Income Trusts and Other Indirect Offerings* (NP 41-201 or the Policy). NP 41-201 provides guidance and clarification to market participants about income trusts and other indirect offering structures. The Policy focuses upon prospectus disclosure, continuous disclosure, liability, and sales and marketing materials. It will apply to public offerings, continuous disclosure filings, and other contexts such as applications for exemptive relief.

We are currently revising the Policy, taking into account comments received. We intend to publish the revised Policy with a summary of comments and responses to comments within the next several months.

10. Non-GAAP Financial Measures

On November 14, 2003 we issued CSA Staff Notice 52-306 *Non-GAAP Financial Measures* (Revised Notice) which supersedes Staff Notice 52-303 *Non-GAAP Earnings Measures*. The Revised Notice was issued to clarify our expectations for issuers using non-GAAP measures, and to expand the scope of the original notice from non-GAAP earnings measures to all non-GAAP financial measures. Although we have noted that there appears to be a reduction in the number of issuers using non-GAAP financial measures, we expect issuers that continue to use non-GAAP financial measures to refer to our Revised Notice for guidance. The most common deficiency that we continue to see is that issuers do not explain why the non-GAAP financial measure provides useful information to investors and how management uses the non-GAAP financial measure. We will continue to monitor practices in this area and will actively follow up with issuers that have not followed the expectations contained in the Revised Notice.

11. Business Combinations

We continue to encounter issues relating to the implementation of CICA 1581 *Business Combinations* (CICA 1581) and CICA 3062 *Goodwill and Other Intangible Assets* (CICA 3062), and the application of EIC 14 *Adjustments to the Purchase Equation Subsequent to the Acquisition Date* (EIC 14) and EIC 137 *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination* (EIC 137).

Goodwill Impairment
In the absence of any triggering events, goodwill is required to be tested for impairment annually using a two-step approach. We remind issuers that as part of our CD and prospectus reviews, we may request copies of documentation that management used to support this testing. Based on our reviews of such documentation, we think that some issuers have been overly optimistic in establishing assumptions used to determine the fair value of their reporting units. Signs of potential problems included cash flow forecasts prepared without sufficient consideration for working capital and capital expenditure requirements; or sales forecasts based on unrealistic growth rates or unproven sales trends.

Subsequent Adjustments to the Purchase Price Equation
As discussed in EIC 14, adjustments to the allocation of the purchase price should only be made in unusual circumstances. In our view, such circumstances usually involve complex acquisitions that occur close to the end of a reporting period, where the issuer is unable to finalize the purchase price allocation because of specific circumstances. For example, there may be a delay in receiving necessary information from a third party, such as a valuation report. In such cases, the issuer is required to provide detailed and specific disclosures in the financial statements and in the MD&A of the reasons for not having finalized the purchase price allocation, and the expected timeframe for finalization. Subsequently, issuers should aim to complete the allocation as promptly as possible.

Recognizing Customer Relationship Intangible Assets
We have encountered situations in the past where issuers are reluctant to ascribe any value to customer relationships based on existing or prior contractual relationships. Issuers have also argued that cancellable or short-term contracts represent little or no value despite the existence of renewal terms. It has always been our view that customer contracts and related customer relationships should be recognized as intangible assets. Factors such as the duration of the contracts, and whether they are cancellable by the customer will have a bearing on the measurement of that intangible asset. EIC 137, consistent with paragraph B174 of the Basis for Conclusion for FASB Statement 141 *Business Combinations*, explicitly states that future contract renewals and other benefits related to the intangible assets should be considered in the estimate of its fair value.

We continue to encourage issuers to consult with independent valuation experts in identifying and determining the fair value of intangible assets. In our CD and Prospectus reviews, we will continue to challenge issuers and their auditors if we are not satisfied that qualified personnel have been sufficiently involved in preparing and/or auditing the financial statements. On some occasions, we have requested that more audit work be carried out, and in a number of instances we have requested that issuers engage an independent valuation expert at their expense to review the identification and valuation of intangible assets and goodwill.

12. Ratings

During the year we reviewed the continuous disclosure record of 32 issuers of asset-backed securities. A number of these issuers used the short-form system to distribute securities. The prospectus included a rating by an "approved rating" organization at the time of the offering. If an issuer receives a rating, it must be disclosed in accordance with part 7.3 of NI 51-102F2 *Annual Information Form.* In a number of cases, there was no disclosure of the issuer's rating subsequent to the offering. We are of the view that a downgrade to an issuer's credit rating constitutes a material change in most circumstances. Moreover, National Policy 51-201 *Disclosure Standards* notes that a change in a credit rating may constitute a material change under section 75 of the Act. Even if the issuer's rating has not changed, the passage of time creates uncertainty regarding the ongoing applicability of information disclosed in a prospectus and ongoing ratings, and so even if the credit rating has not changed we think it is good practice to disclose the credit rating in the annual filing.

13. Asset-Backed Securities (ABS)

The Director has recently granted several discretionary exemptions from Multilateral Instrument 52-109 – *Certification of Disclosure in Issuers' Annual and Interim Filings* (MI 52-109) to issuers of asset backed securities (ABS issuers).[4] The exemptions recognize that these issuers typically file distribution date statements instead of conventional financial statements under previously granted exemptions from some of the continuous disclosure requirements in Canadian securities legislation. Consequently, the form of certificate required under MI 52-109 does not fit all of the filings made by these issuers. The Director granted the exemptions in connection with the interim certificates required for the 2004 financial year only. Before the filing date of the annual certificate required under 52-109, we intend to review this issue to determine what form of modified certificate is appropriate for ABS issuers' unique circumstances.

14. Review of Executive Compensation Disclosure

As a follow-up to our 2002 review of executive compensation disclosure included in CSA Staff Notice 51-304 *Report on Staff's Review of Executive Compensation Disclosure*, we reviewed the same group of Ontario based reporting issuers to ensure the issuers had addressed any prospective changes they had agreed to make. Thirty-seven Ontario based reporting issuers were reviewed for the purposes of this targeted project. In general, the reporting issuers in the original sample addressed the comments raised by us during our first review, and improved the disclosure on executive compensation in their most recent information circular. However, we continue to see poor disclosure of issuers' *Statement of Executive Compensation* (Item 9 of Form 51-102F6). The disclosure in this area tends to be vague and the use of boilerplate language is common. We are planning to publish a notice shortly that will provide further guidance.

[4] See for example *In the Matter of Mansfield Trust*, dated May 12, 2004 and *In the Matter of Schooner Trust*, dated May 31, 2004.

15. Websites

Introduction
As websites have become an accepted source of information for the public, the quality of disclosure provided through them has become a critical issue. Currently, all full CD and prospectus reviews include a review of an issuer's website. This allows us to assess the quality of electronic communications disclosure for issuers for a broad spectrum of industries. In reviewing websites, we focus primarily on whether all financial information is presented clearly, is consistent with the information presented in an issuer's continuous disclosure filings and is consistent with disclosure in the prospectus. In addition, we look at whether the issuer has met the expectations of National Policy 51-201 *Disclosure Standards* and the TSX guidelines on electronic communications disclosure. The TSX strongly recommends that all listed companies maintain a corporate website in order to make investor relations information available electronically; however there is no obligation to do so. For approximately 30% of the issuers reviewed, we found that no website existed.

Findings
Due to the types of guidelines which exist for websites and the nature of website reviews, an element of subjectivity or judgment exists in performing such a review. For the most part, we have not found many fundamental problems with issuer websites. Our specific findings are as follows:

- Three of the issuers we reviewed had no financial information available on their websites, although one of the three issuers did provide a link to SEDAR. The link was not prominent and was therefore not easy to find. One of these issuers has now agreed to include all material financial information on a forward looking basis.

- Two issuers had hyperlinks on their website but did not use disclaimers to state that they are not responsible for the third party information.

- Several issuers used testimonials on their websites; however these were not clearly labelled as such.

- In a few cases, outdated information was not moved to an archive.

Recommendations
Our specific suggestions on websites include:

- all refiled, amended or restated financial information should be clearly labeled as such.

- Supplemental information such as presentations or information distributed to analysts and institutional clients should be posted, and should be clearly identified.

- Promotional, sales and marketing information should not be included on the same web pages as investor relations information. This includes the use of testimonials.

- Issuers should not post any investor relations information on their website that is authored by a third party unless the information is prepared on behalf of the issuer, or is general in nature and not specific to the issuer.

In addition, we continue to encourage issuers to establish a clear written policy on electronic communications as part of their existing policies governing corporate disclosure.

16. Mergers & Acquisitions

Rule 61-501 – *Insider Bids, Issuer Bids, Business Combinations and Related Party Transactions*
Commission Rule 61-501 provides security holders of issuers involved in specified types of transactions with the benefits of enhanced disclosure requirements and, in certain cases, independent valuations and majority of minority security holder approval. Amendments to Rule 61-501 and Companion Policy 61-501CP came into force on June 29, 2004. The amendments were primarily intended to clarify grey areas, reduce the necessity for applications for exemptive relief and generally make the Rule more user friendly.

Among the amendments was the introduction of a definition of "collateral benefit". Previously, the concept of a collateral benefit was included in the definition of "going private transaction" (which in the amended Rule is referred to as a "business combination") and elsewhere in the Rule, but was not a defined term. In the amended Rule, the main implication of the existence of a collateral benefit in connection with a proposed business combination is that the votes of the recipient of the collateral benefit must not be counted in the security holder vote on the business combination. If the collateral benefit was derived as a consequence of a take-over bid, the votes attaching to the securities tendered by the recipient of the benefit must not be counted by the bidder in a security holder vote on a subsequent "second step" business combination.

In preparing take-over bid circulars, or information circulars in connection with business combinations, care should be taken to ensure that the disclosure properly reflects the amendments to the Rule. For example, the votes attaching to certain securities may be precluded from being counted as votes in favour of a "subsequent acquisition transaction" in a minority approval vote following a take-over bid, because of a collateral benefit received by the person who tendered those securities to the bid. If this is the case or is a possibility, the disclosure in the take-over bid circular should not indicate, without qualification, that all securities acquired in the bid will be voted in favour of the subsequent acquisition transaction. For business combinations and related party transactions, the amended Rule requires disclosure in the information circular of the number of securities that, to the knowledge of the issuer after reasonable inquiry, will be excluded in a minority approval vote.

17. National Instrument 43-101 Standards of Disclosure for Mineral Projects

We have seen a significant improvement in the scientific and technical disclosure by issuers and in the filing of technical reports when triggered under NI43-101 *Standards of Disclosure for Mineral Projects*. The Canadian Institute of Mining, Metallurgy and Petroleum (CIM) continues to prepare best practice guidelines for the industry. This year, CIM prepared Best Practice guidelines for the Reporting of Diamond Exploration Results and for Estimation of Mineral Resources and Mineral Reserves. These are available at www.cim.org.

Issuers should continue to consult with us prior to disclosing estimates, if needed. Our reviews of scientific and technical disclosure continue to identify the following issues:

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

- Disclosure of Inferred Resources - *We continue to see inferred mineral resources totalled with other categories of mineral resources. As there is a low confidence level in inferred resources, these must not be totalled with indicated and measured resources.*

- *Disclosure of 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:

  a) the source, relevance and reliability of the historical estimate;

  b) whether CIM definitions have been used and if not, an explanation of the differences; and

  c) 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 discloses its own estimate of mineral resources and reserves on the property or adopts the historical reserves and resources as their own estimate. The report must be filed within 30 days of the acquisition.

A resource estimate prepared by another company after February 1, 2001 but before an issuer acquired the property is not a historical resource under NI43-101. This is a particular problem with projects in Russia and China, as these countries use different resource classification codes that are not recognized by NI43-101. We are of the view that qualified individual(s) should visit the site and complete the necessary work to upgrade the estimates to Canadian standards prior to any disclosure of mineral resources and mineral reserves.

Problems with gross metal values - The conversion of *insitu* metal grades into equivalent dollar values may imply value that does not exist. We have seen this disclosure both in terms of 'per tonne' and 'per deposit' value. In many instances the disclosure is meaningless as costs and recoveries incurred in extracting the metals are not taken into account in computing value. Even if all factors are taken into account, issuers are encouraged to include a clear cautionary statement that the values have no economic significance and do not in any way imply current or future value to the company.

Disclosure of mineral resources and mineral reserves – While disclosure in this area has improved significantly we continue to see the following problems:

- *Totalling of Resource Data* - If an issuer has properties with both historical and current resources, they cannot be added together. In our view, estimates of historical resources often do not have the same level of reliability as current resource estimates prepared under the CIM standards. Until historical resources have been prepared using CIM standard definitions, the two should be separately disclosed.

- *Realistic metal prices* – Metal prices should be consistent with prices used by other issuers in the industry. Price estimates should reflect the expected average metal price over the life of the mine, and not sudden changes in metal prices.

- *Multiple Resource Scenarios* – If multiple resource scenarios are disclosed, the qualified person should highlight the most realistic resource scenario so investors are clear which set of numbers to rely on.

- *Cut-off Grade* – Occasionally companies disclose resource scenarios based on a zero cut-off grade or a cut-off grade below what is typically used for similar deposits. Under CIM definitions, zero or very low cut-off grade scenarios do not qualify as mineral resources, because they include material that does not have a reasonable prospect of economic recovery.

18. Insider Reporting

The System for Electronic Disclosure by Insiders (SEDI) was successfully launched in May 2003. SEDI now contains close to 25,000 insider profiles and 4,300 issuer profile supplements. With a year's transactions now on SEDI we will further direct our resources to monitoring insider reporting compliance over the upcoming months.

SEDI Issuer Profile Supplements
National Instrument 55-102 - SEDI (NI 55-102) requires issuers to file an issuer profile supplement. Issuers are reminded of the importance of defining their outstanding securities in their issuer profile supplements to allow insiders to file complete and accurate insider reports. New reporting issuers, other than mutual funds, are also reminded that an issuer profile supplement must be filed within 3 business days of becoming a reporting issuer.

Frequently Occurring Issues
In March 2004 we sent out a mass e-mail to insiders which included the "Top Ten Errors in SEDI Filings". Frequently occurring filing errors include inaccurate reporting of options, failure to certify insider reports and inappropriate use of insider-defined security designations and insider calculated balances. For our complete top-ten list you can refer to the CSA website: www.csa-acvm.ca.

Late Fees
In August 2003 we began charging fees for late insider reports filed on SEDI. Insiders who file late are subject to a $50 per day fee up to an annual maximum of $1,000. Experience since August suggests that late filings are approximately 10% of total SEDI filings. While we did not track the percentage of paper insider reports filed late before SEDI, we believe that the late fees introduced have reduced the number of insider reports filed late. With the accumulation of data on late filings we have also begun to track "chronic late filers" who have reached their $1,000 cap for further follow-up. Recent analysis indicates that many of the late insider reports relate to the inaccurate reporting of options rather than open market transactions. Insiders are reminded to use the notification date as the "date of the transaction" in completing insider reports if they are not made aware of the grant of options until sometime after the grant date.

Insider Reporting and Equity Monetization Reviews
Multilateral Instrument 55-103 Insider Reporting for Certain Derivative Transactions (Equity Monetization) came into force in Ontario on February 28, 2004. Related Staff Notice 55-312 Insider Reporting Guidelines for Certain Derivative Transactions (Equity Monetization) contains our recommendations as to how certain derivative-based transactions should be reported on SEDI. This year we will do a targeted review of insider reports which will include reviewing: SEDI transactions for completeness and accuracy; issuer's corporate disclosure policies and monitoring procedures related to insider trading; and compliance with our requirements and recommendations for reporting equity monetization transactions.

19. System for Electronic Document Analysis and Retrieval (SEDAR) Filings

Profiles
We 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). This is especially important as information contained in SEDAR profiles is automatically transferred over to SEDI.

Changing the status of documents filed
We remind issuers to carefully check their SEDAR filings before they are filed. Once a document has been made public, we only make it "private" again in very limited circumstances. The system for the dissemination of SEDAR information to subscribers exists in real time. The SEDAR-SCRIBE system allows third party information redistributors to electronically receive documents from the SEDAR system the moment filed documents are marked "public". SEDAR-SCRIBE disseminators may include news service providers. 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. Please note that the original document will generally not be removed from the public record.

National Instrument 51-102 Continuous Disclosure Obligations
SEDAR has been updated to reflect the requirements of NI 51-102 Continuous Disclosure Obligations. Changes include new filing deadlines and delivery requirements, the content of some disclosure requirements, and new continuous disclosure reporting requirements.

Frequently Occurring Issues
We have noted that issuers sometimes file blacklined documents under the filing subtype/document type "amended filings". The correct procedure is to file blacklined documents as "other correspondence". Issuers are reminded that a refiling should be described as amended only when required under National Instrument 41-501 General Prospectus Requirements. In such a case, the actual refiling itself should be labelled as amended on the cover page.

The SEDAR Filer Manual 7.0 requires, among other things, that the issuer include the name (in English and French), mailing address, telephone number and fax number of the auditor, including foreign auditors. A significant number of issuers are not complying with these requirements. We are of the view that an issuer’s SEDAR profile should always be complete and accurate and should include all the requirements of the Filer Manual. We consider this information particularly important when an issuer’s auditor is based in a jurisdiction outside Canada.

In addition, sometimes an issuer has an audit completed by a foreign auditor. For example, an Ontario based reporting issuer may have a U.S. parent which may engage a U.S. auditing firm to complete the audit for the parent and all subsidiaries. Currently the SEDAR profile of the issuer only indicates that an accounting firm is the auditor without specifying the jurisdiction of the accounting firm. We are of the view that the issuer’s SEDAR profile should also include the jurisdiction of the accounting firm who performed the audit function (U.S., U.K. etc) following the name of the auditor.

Contact Information:

Questions on any of the foregoing may be referred to:

John Hughes
Manager, Corporate Finance
Ontario Securities Commission
e-mail: jhughes@osc.gov.on.ca
416-593-3695

Cameron McInnis
Manager, Corporate Finance
Ontario Securities Commission
e-mail: cmcinnis@osc.gov.on.ca
416-593-3675

Paul Hayward
Senior Legal Counsel, Corporate Finance
Ontario Securities Commission
e-mail: phayward@osc.gov.on.ca
416-593-3657

Neeti Varma
Accountant, Corporate Finance
Ontario Securities Commission
e-mail: nvarma@osc.gov.on.ca
416-593-8067

Kelly Gorman
Asst. Manager, Corporate Finance
Ontario Securities Commission
e-mail: kgorman@osc.gov.on.ca
416-593-8251

Erin O’Donovan
Sr. Legal Counsel, Corp. Finance
Ontario Securities Commission
e-mail: eodonovan@osc.gov.on.ca
416-593-8973