

**ONTARIO SECURITIES COMMISSION  
STAFF NOTICE 52-713**

**REPORT ON STAFF'S REVIEW OF  
INTERIM FINANCIAL STATEMENTS  
AND INTERIM MANAGEMENT'S DISCUSSION  
AND ANALYSIS - FEBRUARY 2002**

**1. PURPOSE OF NOTICE**

This notice reports the findings and comments of staff of the Continuous Disclosure Team of the Corporate Finance Branch arising from our review of a sample of interim financial statements and interim management's discussion and analysis (MD&A) for the three month period ended March 31, 2001.

**2. OBJECTIVE AND SCOPE OF REVIEW**

The objective of our review was to assess compliance by reporting issuers with the requirements, as they relate to interim financial statements, of:

- ! Ontario Securities Commission (OSC) Rule 51-501 - AIF and MD&A (Rule 51-501);
- ! OSC Rule 52-501 - Financial Statements (Rule 52-501); and of
- ! Section 1751, the standard on Interim Financial Statements as set out in the Handbook of the Canadian Institute of Chartered Accountants (Handbook).

These rules and standard apply to issuers with fiscal years beginning on or after January 1, 2001.

Historically, the quality of interim financial statement reporting in Ontario has been poor. To address this problem, on January 1, 2001, the OSC brought into force Rules 51-501 and 52-501. At the same time, the OSC issued supporting companion policies. These rules and companion policies provide guidance on, among various things, the type of financial and other disclosure that should be included in interim financial statements and interim MD&A. Shortly after the rules were issued, we commenced this review to determine if the guidance provided by the OSC was being followed.

We selected, at random, 150 issuers representing various industries for our review. Approximately 120 of these issuers are eligible to file a short form prospectus under National Instrument 44-101, with the remainder not being eligible to file a short form prospectus. We corresponded with 77 of the 150 issuers chosen for this review. It was not necessary to issue letters to the other 73 issuers.

Our review focussed on interim financial statements and interim MD&A filed for the first quarter ended March 31, 2001, along with a review of material change reports and news releases issued during that quarter and shortly thereafter.

We also review interim financial statements and interim MD&A as part of our full reviews of issuers' continuous disclosure records, as described in OSC Staff Notice 51-703. Some of the observations in parts 5, 6 and 7 of this notice arose from those reviews.

**3. EXECUTIVE SUMMARY**

Our findings suggest that issuers and their advisors were not as well informed about Rules 51-501 and 52-501, and Handbook section 1751, as we might have expected.

We corresponded with 77 of the 150 issuers chosen for this review. The 77 letters were issued for the following reasons:

- ! 17 (or approximately 22%) as a result of issuers failing to include the minimum components of interim financial statements, or failing to include the minimum components for the appropriate periods.
- ! 32 (or approximately 42%) as a result of other issues related to generally accepted accounting principles (GAAP), be it recognition, measurement or disclosure.
- ! 23 (or approximately 30%) for insufficient or inadequate information in the MD&A.

! 5 (or approximately 6%) for a perceived failure to file material change reports.

Our letters had the following outcome:

- ! 17 (or approximately 22%) of the issuers re-filed their interim financial statements, generally within four business days of us issuing the letter.
- ! 40 (or approximately 52%) of the issuers committed to improve disclosure in interim MD&A and notes to the financial statements, in future filings.
- ! 20 (or approximately 26%) of the issuers provided sufficient information in their response to our questions and did not generate any follow-up comments.

Also, as a result of our continuing full reviews of issuers' continuous disclosure records, as described in OSC Staff Notice 51-703, 8 issuers to date have re-filed their interim financial statements.

We identified the following issues as a result of our review which, for ease of reference, have been broken down under three broad headings:

Non-compliance with Rule 52-501 and GAAP - see Part 4 for details

Some issuers had to re-file their interim financial statements as a result of:

- ! not including an interim balance sheet
- ! not including notes to the interim financial statements
- ! failing to include a balance sheet as at the end of the immediately preceding fiscal year.

As the review progressed, we also noted that some issuers failed to include both current and year to date income statements and cash flow statements, with comparative statements for the immediately preceding fiscal year.

Other GAAP-related issues - see Part 5 for details

- ! omission of basic disclosures required in interim financial statements by Handbook sections 1751.14 (a) and (b)
- ! failure to include a description of any seasonality or cyclicity of interim period operations
- ! failure to provide information about reportable segments
- ! failure to disclose changes in accounting policy or adoption of new accounting policies
- ! failure to follow Handbook guidance on income taxes, especially with respect to the reassessment of tax assets and liabilities

Interim MD&A (Rule 51-501) issues - see Part 6 for details

Some issuers did not comply with certain requirements of Part 4.2 of Rule 51-501. In particular, the following requirements were not met:

- ! an update of the analysis of the issuers' financial condition in the annual MD&A for the most recently completed financial year
- ! an analysis of the issuers' cash flows for the most recently completed interim period
- ! a comparison of the issuers' financial condition and cash flows for the current quarter and the year to date period with the corresponding periods in the previous year.

In our view, the requirements of Rules 51-501 and 52-501 and Handbook section 1751 are clearly set out. We are concerned that the lack of compliance demonstrated by our review suggests a failure by management to meet its obligations to maintain a current level of knowledge of financial reporting requirements. Our findings also raise questions about how boards of directors and audit committees carry out their responsibility to monitor and challenge management

on financial reporting matters.

#### **4. NON-COMPLIANCE WITH RULE 52-501 and GAAP**

Approximately 22% of the sample of issuers re-filed their interim financial statements as a result of them not complying with the requirements of Rule 52-501 and Handbook section 1751. In particular, some issuers did not include:

- ! an interim balance sheet
- ! a comparative balance sheet as at the end of the preceding fiscal year
- ! notes to the interim financial statements

As the review progressed, we also noted that some issuers failed to include both current and year to date income statements and cash flow statements, with comparative statements for the immediately preceding fiscal year.

The most common deficiency was that issuers did not include a comparative balance sheet as at the end of the immediately preceding fiscal year (December 2000), as required by Rule 52-501 and Handbook section 1751. Instead, some issuers included a comparative balance sheet for the comparable period (March 2000).

In our view, not providing the minimum components of, or the relevant periods for, interim financial statements clearly results in issuers failing to file financial statements in accordance with Rule 52-501 and GAAP. Accordingly, for the purposes of this review, we required these issuers to re-file their interim financial statements within four business days from issuing our letter.

#### **5. OTHER GAAP-RELATED ISSUES**

##### **5.1 Basic information required in interim financial statements**

Issuers frequently omitted the disclosure required by Handbook sections 1751.14 (a) and (b). Handbook section 1751.14 (a) requires, when applicable, a statement that the disclosures in the interim financial statements may not conform in all respects to GAAP for annual financial statements. The section also requires a statement that indicates that interim financial statements should be read in conjunction with the most recent annual financial statements. Handbook section 1751.14 (b) requires a statement that the interim financial statements follow the same accounting policies and methods of their application as the most recent annual financial statements, except in limited circumstances.

Issuers occasionally failed to include a description of any seasonality or cyclicity of interim period operations, as required by Handbook section 1751.14 (c), and certain disclosures required in annual financial statements; for example for discontinued operations, as required by Handbook section 1751.14 (g).

We remind issuers that interim financial statements should disclose, when applicable, at least the minimum disclosures as specified in Handbook section 1751.14.

##### **5.2 Reportable Operating Segments**

Some issuers included unclear or insufficient information with respect to reportable segments. We also found that where changes occurred in reportable operating segments, there was a tendency not to explain those changes from the previous annual financial statements.

We remind issuers about the requirement in Handbook section 1751.14 (e), which seeks information about each reportable segment, and requires, among other things, a description of differences from the most recent annual financial statements in the basis of segmentation, or in the basis of measuring segment profit or loss.

We also remind issuers to clearly state the factors used to identify the enterprise's reportable segments, as well as the types of products and services from which each reportable segment derives its revenues, in accordance with Handbook section 1701.29.

Examples:

- 5.2.1 Company A, in the real estate industry, did not disclose a break down of revenue from external customers for its reportable segments, as required by Handbook section 1751.14(e)(i) and section 1701.39. Instead, it disclosed only the gross profit (revenue less property operating expenses) for the operating segments.

Company A's rationale was that, for companies in the real estate industry, gross profit or, (as Company A referred to it) Funds from Operations (FFO), is the most important measure of performance. Accordingly, FFO is the focus of a reader of the interim financial statements in assessing the value of the company, and that is what Company A chose to disclose in its note on operating segments.

While we acknowledge that FFO may be a key measure of performance in the real estate industry, GAAP requires the disclosure of revenue by segment. In order to ensure consistency on this point within the real estate industry, we reviewed the segmented disclosure of a sample of five other real estate issuers. All five disclosed revenue by segments.

Company A concurred with our view and agreed to disclose segmented revenues in its future filings of interim and annual financial statements. Company A's subsequent interim financial statements disclosed revenue by segment.

- 5.2.2 Company B, an investment holding company, did not disclose or describe a change (an addition) in reportable operating segments, as required by Handbook section 1751.14 (e). Its rationale was that disclosure about the impending change in segments had been made in the annual MD&A for the year ended December 31, 2000, and disclosure about the business of the segment had been included in the interim financial statements.

Company B concurred with our view that these other disclosures did not compensate for the deficiencies in its interim financial statement disclosures and that a description of differences in segmented reporting should be included in interim financial statements. Company B agreed to include a description of this change in future interim filings, in accordance with Handbook section 1751.14(e)(v). Company B's subsequent interim financial statements included a description of the change.

### 5.3 Changes in accounting policy or adoption of new accounting policies

Some issuers did not disclose a change in accounting policy for the adoption of Handbook section 3500 - Earnings Per Share. All of these issuers committed to including the disclosure in future filings.

We expect that changes in accounting policies would be disclosed in accordance with Handbook section 1751.14 (b). We remind issuers that where a changed accounting policy or method has been adopted, the interim financial statements should provide the same information and disclosures concerning the change as required in the annual financial statements. Similar disclosure is also required when issuers adopt new accounting policies or methods.

### 5.4 Handbook guidance on income taxes

Some issuers did not follow the Handbook Application guidance on income taxes, especially with respect to reassessments of tax assets and liabilities, and to material variances in future income tax rates, from quarter to quarter. Appendix B (paragraphs B12 to B25) to section 1751 of the Handbook discusses and illustrates the application of Handbook section 3465 - Income Taxes - to interim financial statements.

Examples:

- 5.4.1 An issuer, Company C, in the manufacturing industry, did not include a tax provision in its first quarter interim financial statements, on the basis that it had a large tax loss carried forward that would be sufficient to eliminate taxable income for the first two quarters.

Handbook section 1751 Appendix B (paragraph B13) requires that Company C should have calculated its income tax expense by applying the estimated average annual effective income tax rate (estimated tax rate) to its first quarter pre-tax income. Further, Appendix B (paragraph B21) requires that tax losses carried forward should only be reflected in the computation of the estimated tax rate to the extent that the losses carried forward have not previously been recognized as a tax asset. Consequently, Company C should have recorded a tax provision using the estimated tax rate, and correspondingly drawn-down the income tax asset.

Company C concurred with our view and consequently re-stated its interim financial statements for the first quarter. The restatement represented 34% of net income and correspondingly decreased earnings per share by the same amount.

- 5.4.2 Another issuer, Company D, in the real-estate industry, did not adequately apply the estimated tax rate for the March 31, 2001 interim period.

Company D acknowledged that it had not followed the guidance in Handbook section 1751 Appendix B (paragraph B13) for its first quarter. However, it addressed this in its interim financial statements for the second quarter, by increasing its provision by more than the estimated tax rate. Company D's six month cumulative provision was, as a result, correctly made at the estimated tax rate. Consequently, staff did not pursue the issue further. Company D committed to disclose, as required by Handbook section 1751 Appendix B (paragraph B13), any changes in its estimated tax rate that may have a material effect on the interim financial statements. We reviewed Company D's subsequent interim financial statements and determined that the tax rate had not changed materially from the previous interim period. Consequently, no further disclosure was required to be made by Company D during that quarter.

## 6. INTERIM MD&A

Approximately 30% of letters issued by us were as a result of insufficient, or poor quality information in the interim MD&A. Several issuers did not comply with Part 4.2 of OSC Rule 51-501. In particular, the following requirements were not generally met:

- ! an update of the analysis of the issuers' financial condition in the annual MD&A for the most recently completed financial year;
- ! an analysis of the issuers' cash flows for the most recently completed interim period; and
- ! a comparison of the issuers' financial condition and cash flows for the current quarter and the year to date period with the corresponding periods in the previous year.

The most common deficiency was the lack of analysis and discussion of aspects of the financial condition, including a comprehensive discussion of the balance sheet.

While a discussion and analysis of every line item on the balance sheet may not be warranted, Rule 51-501 requires that material or significant changes in financial condition from the previous fiscal year end should be discussed in the interim MD&A.

For example, Company E, in the mining industry, did not discuss or explain material reductions in accounts receivable of approximately 36% and accounts payable of approximately 21% between the December fiscal year end and the end of March 31, 2001. Upon questioning, the rationale provided by Company E was that it was going through a transition stage. In Company E's view, since information about the transition had been provided in various press releases issued by it previously, such comparisons were unnecessary.

We sought and received a commitment that Company E's future filings would include discussions and comparisons as required by Rule 51-501. Company E's subsequent interim MD&A included a more comprehensive and significantly improved discussion and analysis of its operations.

In our view, a press release issued by a company is not sufficient, in and of itself, to provide meaningful and complete disclosure about matters affecting the company. Material changes that occur during the course of the interim period should be discussed in the interim MD&A.

Another common deficiency was a lack of analysis and comparison of issuers' cash flows. Some issuers did discuss items for the current quarter, however, numbers were very seldom compared to the comparative quarter, even on a high-level basis.

We also found that some issuers tended to provide a discussion of changes in working capital as a whole, without breaking down and providing an explanation of the component parts. Issuers tried to meet the requirements of Rule 51-501 by combining the requirements to discuss and analyse the issuers' financial condition and cash flows under the heading "Liquidity and Capital Resources". However, generally, this section of the interim MD&A simply reiterated the numbers as they appeared on the face of the balance sheet and cash flow statement, without any accompanying explanation, discussion or analysis. Combining a discussion of the balance sheet and cash flow statement is acceptable, but only to the extent that the discussion and analysis provided reflects the interaction in the issuers' business as reported by the two financial statements. For example, an issuer's increase in debt may be off-set by a reduction in accounts payable. This may be discussed as part of an issuer's combined section on liquidity and capital resources.

We found limited discussion of how the changes occurring in the quarter would affect the issuer on a prospective basis. For example, only a few companies discussed the expected effect of the changing economic climate on their business. Where appropriate, we would have expected to see, under the liquidity section, a discussion about issuers' ability to

generate adequate amounts of cash in the short term, and an explanation of the major demands placed on issuers' liquidity and how (for example, with a new line of credit) the issuer expects to meet those demands in the short term.

We encourage issuers to provide a complete and meaningful discussion in their interim MD&A. For example, a statement that the issuer has sufficient capital resources to meet its liquidity requirements for the next twelve months is of limited use to readers of the MD&A. Issuers should consider continuing the discussion by describing the sources of funds and capital resources, and the circumstances likely to affect those sources, in the short term.

Issuers could also provide more complete and meaningful information on their reportable operating segments. Where issuers disclose such segments in their financial statements, issuers should provide an analysis and comparison on that basis, as well as on the issuer as a whole.

In our view, MD&A is intended to provide readers the ability to look at issuers through the eyes of management. It provides management the opportunity to discuss the dynamics of the business, thereby giving investors, both current and prospective, the ability to better assess the issuers' historical performance and position, as well as future prospects. Consequently, in our view, the interim MD&A should discuss any significant changes from the annual or the previous interim MD&A, and disclose any significant adjustments to its outlook going forward.

We remind issuers that the companion policy to Rule 51-501 provides guidance with respect to interim MD&A, and that Form 44-101F2 - MD&A to National Instrument 44-101 sets out the information an MD&A should contain. Both, the companion policy and Form 44-101F2, can be found on the OSC web-site located at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

#### Interim MD&A - specific matters

We found that the vast majority of mining companies that were reviewed tended to include a discussion on operational statistics like "mine throughput" and "price per carat", with only minimal discussion, if any, of the financial results as reported in the financial statements. We recognise that some of these operational statistics provide valuable information, however, it is important that they be related directly to the results of operations as represented in the financial statements.

Some issuers filed their interim MD&A later than the interim financial statements. We remind issuers that Rule 51-501 requires the filing of the interim MD&A concurrently with the interim financial statements. Some issuers incorrectly filed their interim MD&A under the "other" category on SEDAR. There is a separate filing type on SEDAR under which the interim MD&A should be filed.

## **7. OTHER MATTERS**

### **7.1 National Instrument 62-102 (NI) - Disclosure of Outstanding Share Data**

This little known NI, which came into force on March 15, 2000, requires issuers to include data with respect to the company's outstanding shares, within, or supplementing, the interim financial statements.

Part 2.1(1) of the NI allows this disclosure to be made in a "supplement" to the interim financial statements, if the supplement is filed and sent to issuers' security holders with the applicable interim financial statements. For the purpose of this NI, there is no technical definition of the word "supplement". Our interpretation of "supplement" is anything (a sheet of paper with the relevant information would be adequate) that is filed along with (supplements) the interim financial statements. Interim MD&A is one example of where such information may be included.

Part 2.1(2) requires the relevant disclosure as of the latest practicable date. Our interpretation of "latest practicable date" is that the information should be current as close as possible to the date of filing of the interim financial statements. Disclosing the number of shares outstanding at quarter-end is generally not sufficient to meet the requirements of Part 2.1(2), given that issuers have up to 60 days subsequent to their quarter-end to file their interim financial statements.

### **7.2 Material Change Reports**

We found that some issuers were not filing reports of material changes, as required by section 75 of the Securities Act. Sometimes the material information was included as a note to the financial statements and/or in a press release. Examples of where such reports were not filed include the suspension of payments of dividends by an issuer, and the detailing of a transaction that led to an issuer going private.

In the examples mentioned above a press release had been filed. In such cases, a report of material change

should have been filed with the OSC, together with the press release.

7.3 Handbook section 3870 - Stock Based Compensation and Other Stock Based Payments

We remind issuers that Handbook section 3870 applies to companies with fiscal years beginning on or after January 1, 2002. Consequently, we expect to see the guidance in Handbook section 3870 being applied by companies (with a December 31 fiscal year end) during the interim period to March 31, 2002.

7.4 Handbook sections 1581 - Business Combinations and 3062 - Goodwill and Other Intangible Assets

We remind issuers that, for issuers with a December 31 fiscal year end, the full impact of these two new standards will be in effect for the interim period ended March 31, 2002. The application of these standards requires that issuers focus on all aspects of their existing accounting for goodwill and intangible assets in business combinations. These standards contain important transition rules to which issuers should pay close attention while preparing their March 31, 2002 interim financial statements. In addition, we expect issuers to provide clear and complete disclosures of the impact of the transition to the new standards. We expect to focus on the application of these new standards, and particularly the application of the transition provisions.

7.5 Corporate governance

We remind issuers that Rule 52-501 requires that the board of directors of an issuer review the interim financial statements prior to them being filed with the Commission and delivered to security holders. The rule contemplates that the board of directors, in fulfilling that responsibility, may delegate the review of the interim financial statements to an audit committee of the board.

We also remind issuers that the companion policy to Rule 52-501 suggests that, in the Commission's view, the board of directors of an issuer, in discharging its responsibilities for ensuring the reliability of interim financial statements, should consider engaging an external auditor to carry out a review of those financial statements. Further, the companion policy to Rule 51-501 suggests that, in the Commission's view, if an issuer has an audit committee, the MD&A should be carefully reviewed and considered by that committee.

## 8. CONCLUSION

In our view, the requirements of Rules 51-501 and 52-501 and Handbook section 1751 are clearly set out. We are concerned that the lack of compliance demonstrated by our review suggests a failure by management to meet its obligations to maintain a current level of knowledge of financial reporting requirements. Our findings also raise questions about how boards of directors and audit committees carry out their responsibility to monitor and challenge management on financial reporting matters.

We have however, observed what appears to be a gradually increasing awareness of Rules 51-501 and 52-501, and Handbook section 1751, during the period following the review. We encourage issuers to consult with their advisors, particularly where unusual transactions that need to be reported in a timely fashion occur, during the course of the interim period.

We remind issuers that failing to comply with GAAP and securities law may result in us initiating administrative procedures against issuers, including, but not limited to, placing issuers on the list of defaulting issuers. Recurring failures to comply with GAAP and securities law could also provide a basis for enforcement action.

We are planning targeted reviews to assess compliance of the disclosure on Executive Compensation as required by Form 40 and of Handbook section 3870. These reviews are part of our shift towards the review of more continuous disclosure documents. In addition to targeted reviews, we carry out a range of other reviews described in OSC Staff Notice 51-703.

OSC Rules 51-501 and 52-501, along with their respective companion policies can be found on the OSC website located at [www.osc.gov.on.ca](http://www.osc.gov.on.ca).

Questions may be referred to:

### **Continuous Disclosure Team**

#### **John Hughes**

Manager, Continuous Disclosure  
416-593-3695  
[jhughes@osc.gov.on.ca](mailto:jhughes@osc.gov.on.ca)

#### **Viraf Nania**

Senior Accountant, Continuous Disclosure  
416-593-8267  
[vnania@osc.gov.on.ca](mailto:vnania@osc.gov.on.ca)