

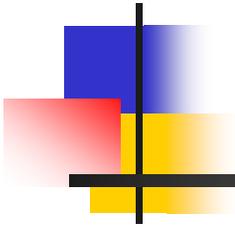
# SOLVING DIFFICULT DISCLOSURE ISSUES

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Brian Ludmer, B.Comm., LLB.

Presentation to LSUC *"12 Minute Securities Lawyer"*  
May 31, 2006

# New Certification Requirement: Robust Processes Required

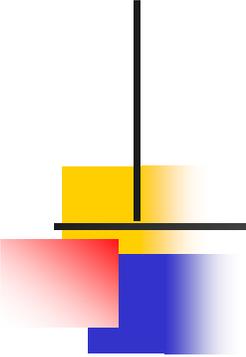


# Definitions

- **"annual filings"** means the issuer's AIF, if any, and annual financial statements and annual MD&A filed under provincial and territorial securities legislation for the most recently completed financial year, including for greater certainty all documents and information that are incorporated by reference in the AIF;
- **"interim filings"** means the issuer's interim financial statements and interim MD&A filed under provincial and territorial securities legislation for the most recently completed interim period;

# Disclosure Controls and Procedures

- **"disclosure controls and procedures"** means **controls and other procedures of an issuer** that are designed to provide reasonable assurance that information required to be disclosed by the issuer in its annual filings, interim filings or other reports filed or submitted by it under provincial and territorial securities legislation is recorded, processed, summarized and reported within the time periods specified in the provincial and territorial securities legislation and include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its annual filings, interim filings or other reports filed or submitted under provincial and territorial securities legislation is accumulated and communicated to the issuer's management, including its chief executive officers and chief financial officers (or persons who perform similar functions to a chief executive officer or a chief financial officer), as appropriate to allow timely decisions regarding required disclosure;



# Disclosure Risks (Deloitte & Touche)

- Entity Level

- Quality of corporate governance practices; tone at the top; disclosure culture; overall control environment; CEO/CFO involvement; global, multinational, decentralized operations; level of skill and experience in public company reporting; nature of the industry; complexity of the business; significant acquisitions; prior disclosure deficiencies; recent restatements; rapid growth; earnings guidance; management bias (compensation linkage)

- Business Unit / Process Risks

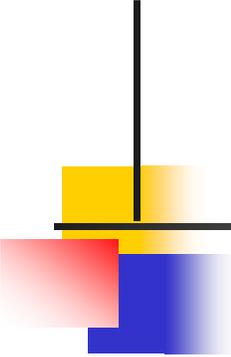
- Changes to key staff; new systems and processes (or significant modifications); reliance on technology solutions with limited documentation, change controls, security, etc.; complex transactions; prior disclosure deficiencies; lack of awareness of disclosure obligations; lack of documented policies; coordination of regulatory filings; lack of oversight over the disclosure process; lack of knowledge of GAAP; significant reliance on ad-hoc prepared information; reliance on one or few individuals

# Evaluation of MD&A Preparation Process

- Identify key MD&A elements (material financial and non-financial disclosures and analysis)
- Identify the source of each of these disclosures
- Determine who prepares, summarizes and reviews the information and analysis
  - Determine their competence, training and resources
- Determine controls ensuring completeness, timeliness and accuracy
- Determine controls re consistency re prior periods
- Determine process used to identify and communicate changes in regulatory requirements
- Review role of CEO/CFO/AC/Board legal counsel, auditor in review and approval
  - Are reviews performed on a timely basis to allow time for suggested changes to be incorporated?

# High level Issues

- Importance of Credibility
  - Dreamworks (Katzenberg) teething pains re “promotion”, sales of *Shrek 2* in the quarter, disclosure of *Shark Tale* cost, analyst meeting that they were “disinvited” from when it turned into a “road show” meeting
- Poor quality of disclosure
- Poor Investor Relations and Media Relations practices
- Poor document creation/retention/destruction practices
- Use of experts (OSA and OBCA defences not always available)
  - Shell reserves scandal 2004 (5 successive reductions knocked 25% off market cap)
    - Reserves auditor was semi-retired employee described as “financially independent” by outside auditor but proven to be poorly trained and not independent enough in hindsight
  - M&A context – multiple fairness opinions now solicited
    - Hollinger and Enron – outside advisor issues



# High Level Issues

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- Crisis Control
- Research, scripting, dry-runs of Processes
  - (in financial control terms: determination of material assertions, mapping and documenting controls and processes, walk-throughs, assessing design effectiveness, testing operating effectiveness)
  - Disclosure Committee charter, but also operations in practice



# MATERIALITY

# Materiality

## ■ *Standard Trustco Ltd. et al OSC 1992*

- Accumulating loan arrears in real estate portfolio
- Balancing act between making disclosure and frightening shareholders and depositors
- OSFI concerns presented to board and materials distributed
- Breach of Act relating to material press release regardless of lack of motive or intent
- Directors should not rely on management unquestioningly where they have reason to be concerned about the integrity or ability of management or where they have notice of a particular issue
- In the circumstances it was incumbent on the board to make further inquiries
  - Given the seriousness of the issues, could not rely on outside counsel and auditor advice to management without meeting directly with them and considering advice

# Materiality

- *Standard Trustco, cont'd*
  - Audit committee members held to bear more responsibility, not due to higher duties, but rather due to circumstances – had a greater opportunity to obtain knowledge about and to examine the affairs of the company
  - In some cases it is appropriate for outside directors to make inquiries and to have discussions in the absence of management where they have concern about something which management has done

# Materiality

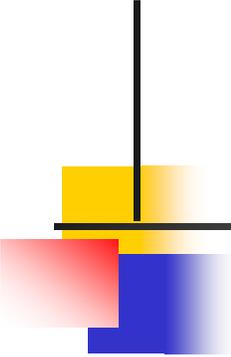
- *YBM Magnex International Inc. (OSC June 27, 2003)*
  - Canvasses limited previous decisions on “materiality” in the context of a prospectus offering (special committee investigation) and continuous disclosure (auditors demand for additional verification)
    - Risk disclosure held insufficient as general description of concerns re Eastern Europe companies failed to highlight YBM-specific concerns
    - Press release should have been issued when Auditors refused to complete audit without in depth forensic investigation that dealt with their concerns (released 18 days later)
  - Confirms that too much disclosure can be counterproductive – the concept of “material change” acts as a brake on premature and undesirable disclosure
  - Assessing materiality requires consideration within the broader factual context, or “total mix”

# Materiality

- *YBM Magnex International Inc. (OSC June 27, 2003)*
  - Separate analysis of each director or officer's role, experience, training and skills and access to information
  - The concept of "material change", like that of "material fact", requires an exercise of judgment
    - *"If the decision is borderline, then the information should be considered material and disclosed. In our opinion, a supercritical interpretation of the meaning of "material change" does not support the goal of promoting disclosure or protecting the general public"*

# Materiality

- *YBM Magnex International Inc. (OSC June 27, 2003)*
  - If a respondent has knowledge of facts, but is mistakenly of the view that they are not material, i.e. if he or she was diligent in ascertaining their materiality but was nonetheless honestly and reasonably mistaken in this respect, the due diligence defence is available – though staff feels this is remote
  - Special Committee report had highlighted deficiencies in financial control systems and reporting – raising duty to investigate further
  - Consider the “reasonable investigation” defence in OSA 138.4(6): *“conducted or caused to be conducted a reasonable investigation” ; “no reasonable grounds to believe ... a misrepresentation”*



# Materiality – Analysis

- OSC Decision *In the Matter of Piergiorgio Donnini*, June-Sept. 2002
  - Analysis of Cdn and US law in the context of insider trading allegations relating to a pending private placement financing
  - Divisional Court decision reduced OSC penalty and costs, but is being appealed by OSC on those points
- See also *Kerr v. Danier Leather Inc. (Ont. CA Dec. 2005)*
  - *Discussed in another paper*

# Materiality - Guidance

- *National Policy 51-201 Disclosure Standards*
  - “material change” defined in most Provinces in relation to “significant effect on the market price or value of any of the issuer’s securities”
    - Quebec has a similar concept regarding when a press release is required but a “reasonable investor” test for purposes of tipping prohibitions
    - BC legislation differed for purposes of the Pezim case decided by the SCC
    - Most recent OSC statements and recommendations in the Crawford Five Year Review Committee confirm that there may not be a change to the US concept of “information which would be important to a reasonable investor” – US reporting rules differ
      - But the two standards usually converge, for practical purposes, in most cases
  - Stock Exchange timely disclosure policies include many examples of material information

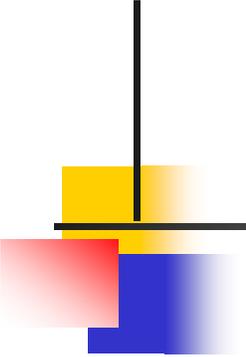
# Materiality - Guidance

- *National Policy 51-201 Disclosure Standards*
  - Avoid using an overly technical approach to determine materiality
    - The nature of the information itself, the volatility of the company's shares and prevailing market conditions are also relevant
      - E.g. actual vs. analyst consensus earnings results can have differing effects depending on market volatility
      - Monitor market reaction to announcements and reassess decisions on materiality in the future (the fact that market reaction to a disclosure may serve as a post hoc test for materiality has been recognized in US cases such as *Burlington Coat Factory Securities Litigation* and *Oran v. Stafford*)
  - If there is any doubt: disclose
    - CIRI and NIRI support this view in their model disclosure policies and standards and guidance for disclosure

# Materiality – US Guidance

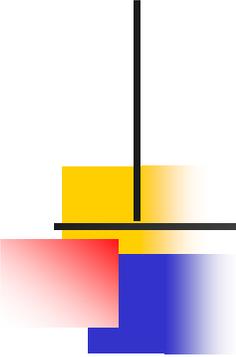
## ■ US Law and Jurisprudence

- Must examine all surrounding circumstances: There must be a substantial likelihood that the disclosure of an omitted fact would have been viewed by a reasonable investor as having altered the “total mix” of information made available (*USSC in TSC Industries, Inc. v. Northway, Inc.*)
- No “bright line test” for what a reasonable investor would consider significant in making an investment decision (USSC in *Basic, Inc. v. Levinson* – merger negotiations)
- For contingent or speculative information, the analysis requires a balancing of: (1) the probability that the event will occur; and (2) the magnitude of the event in light of the company’s total activity (*Basic* and *SEC v. Texas Gulf Sulphur Co.* – first drill core assay results)
  - Contrast *Pezim* and *Cartaway*
- *Ganino et. al v. Citizens Utilities Company et al* (CA 2<sup>nd</sup> Cir. Sept. 2000) and *Gebhardt v. ConAgra Foods, Inc.* (CA 8<sup>th</sup> Cir. 2003)
  - No single numerical benchmark for immateriality at law



# Materiality – US Guidance

- SEC limited guidance in Reg FD release (2000)
  - Acknowledges difficult judgments
  - Still wants to avoid deterministic factors, which would result in over inclusion or under inclusion
  - Did identify certain types of events that are potentially material:
    - Earnings information
    - Mergers, acquisitions, tender offers, joint ventures, changes in assets
    - New products or discoveries or developments regarding customers or suppliers (new contract)
    - Changes in control or management
    - Changes in auditor or withdrawal of audit report
    - Events regarding company securities (default, redemption, new issues, splits, changes in dividends, etc.)
    - Bankruptcy or receivership



# Materiality – Accounting Guidance

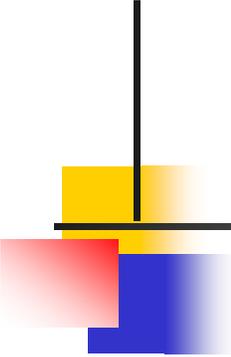
- Accounting and Auditing standards
  - CICA Handbook
  - FASB SFAS No.2
  - SEC SAB 99
  - All focus on the effect of a statement or omission on the actions of a reasonable person who relies on the information. All require consideration of surrounding circumstances (including expected volatility of the shares) and not just the statement or omission itself
  - SAB 99 confirms that misstatements below 5% could be material due to qualitative factors, including whether management had knowledge, such as whether the misstatement:
    - Arises from an item capable of precise measurement or an estimate
    - Masks a change in earnings
    - Hides a failure to meet analysts' consensus estimates
    - Changes a loss into income or vice versa
    - Concerns a significant segment
    - Affects the company's regulatory compliance or loan covenants
    - Results in an increase in management compensation
    - Involves concealment of an unlawful transaction



# SELECTIVE DISCLOSURE

# Selective Disclosure

- Disclosure of material, non-public information must be non-selective:
  - Cannot favor certain analysts or institutional investors without making the information public
  - US SRO rules (NYSE, AMEX, NASD) had always prohibited this, but abuses led SEC to enact Regn. FD in 2000:
    - If disclosure of material non-public information by a company or person acting on its behalf to a securities professional or to shareholders who are likely to trade on the information, public disclosure required
    - If “intentional”: simultaneous release required
    - If “inadvertent”: “prompt” (24hr) disclosure is required
    - Four exclusions: (1) communications under a duty of trust; (2) express (verbal or written) confidentiality undertaking; (3) credit rating agency disclosures; and (4) registered securities offerings
  - SEC Reg. FD enforcement: Flowserve, Siebel Systems



# Selective Disclosure

- Implications of Reg. FD:
  - Changed landscape for dissemination of info
  - Improved access for press and retail investor
  - Improved disclosure practices
    - Investor relations now a policy function; not just facilitative
    - 97% of companies in NIRI survey still hold one-on-one or group analyst/institutional meetings
    - 71% of NIRI surveyed comps. Still provide guidance (2001: 79%)
  - Allows superior analysts to distinguish themselves
  - 2000 – 2005 SEC only brought seven cases (Flowserve reaffirmed guidance in a private meeting 42 days before y/e); lost Siebel Systems appeal (essentially repeated public statements – Court to SEC: “don’t nitpick”)

# Selective Disclosure

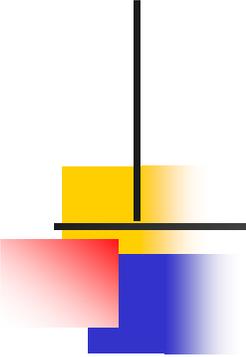
- Canadian jurisdictions generally prohibit “tipping” by persons in a “special relationship” with the issuer
  - Tipping and insider trading prohibitions apply to both “material facts” and “material changes”
  - Insiders, directors, officers, employees, professional or business service providers and other tippers are included
  - Exception for trades “in the necessary course of business” include: vendors, suppliers, employees, directors, lenders, professional and financial advisors, parties to negotiations, labour unions and industry associations, governments and other regulators, credit rating agencies for that purpose
    - Does not include research analysts, institutional investors or other market professionals, even if they sign a confidentiality agreement (unlike Reg. FD)
  - Note OSC sanction in connection with Air Canada



# DUTY TO UPDATE

# Duty to Update

- Unlike Ontario laws, U.S. federal securities laws impose no duty to disclose material developments as they occur, except where Form 8K applies, where some other filing is made or:
  - It is necessary to correct a previous untrue statement that has become materially misleading and on which the market is still relying (a “duty to correct”)
  - It is necessary to update forward-looking statements or projections on which the market continues to rely (“live”) that were true when made, but later become materially false and misleading in the context of subsequent events (a “duty to update”)
    - This is an unsettled area of law with conflicting federal circuit court decisions
    - The recent 9<sup>th</sup> Circuit Court of Appeal decision in *Winnick v. Pacific Gateway Exchange* reinforces the value of disclaiming a duty to update forward-looking statements
  - The issuer is in the process of buying or selling its own securities and wishes to facilitate such transactions by insiders
- The CSA in NP 51-201 infer an obligation to update forward-looking information where that information, in the light of subsequent events and absent further explanation, becomes misleading.



# Duty to Update in Relation to Earnings Pre-Announcements

- No US or Canadian requirements to pre-announce generally – company practices vary widely
  - Issues: management/governance process; when are prospective results “known”?; What size of deviation from consensus estimates or from previous guidance merits disclosure? *Ad hoc* vs scheduled updates?; role for external auditors?; Audit Committee pre-approval – timing issues
- However in light of strong rules and enforcement concerning selective disclosure and insider trading, there is merit
  - Analysts estimates can vary widely, hurting trading
  - Outstanding guidance is generally considered a “live” statement
  - Avoid apologetic statements such as “the company will apply extra caution to future revenue and earnings projections”
  - Do use oral “bespeaks caution” disclaimer and disclaim duty to update further
- TSX positive obligation to report early if anticipated that actual results will fall materially below previous period (not related to analyst consensus estimates)



# DEALING WITH STOCK ANALYSTS

# Dealing with Stock Analysts

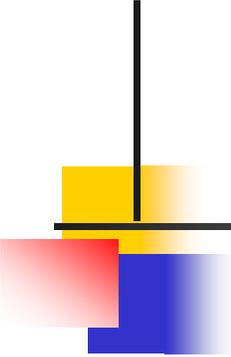
- Analysts serve an important role in collecting, evaluating and disseminating information
- Tense relationship with management
  - “fencing match conducted on a tightrope”
    - *SEC v. Bauch & Lomb (1977)*
- Selective disclosure vs. mosaic theory
- Corporate liability for analyst statements
  - Direct statements
  - Pre-publication entanglement
    - Commenting on reports
  - Post-publication ratification or adoption
    - Hyperlinks or distribution
- Best practices for investor calls: NP 51-201 s.6.5

# Regulation of Research Analysts

- IDA Policy 11
- NYSE Rule 472/NASD Rule 2711
  - Took effect May 10, 2002
  - Three versions of subsequent amendments approved by SEC in June 2003 and took effect in stages
  - Latest changes incorporate certain structural reform elements from SEC Global industry settlement
- New requirements:
  - Enhanced disclosure in public appearances and reports of business relationships of dealer and analyst with issuer; positions held in the subject company's securities; policies re dissemination; conflict disclosure; rules regarding distribution of third party reports; restrictions on analyst compensation tied to Investment Banking; prohibition on offering rating or target price as inducement for business; standards for analysts; restrictions on investments and trading; regulation of inter-department contacts; supervisory obligations; ratings terminology rules; coverage blackout rules

# Guidance

- NIRI 2005 survey:
  - 71% of surveyed companies give guidance (but moving to annual only and 1/3 considering dropping)
  - Small to mid-caps feel they will lose analyst coverage if they don't
  - In 2001-2002 Gillette, AT&T, Coca-Cola and McDonald's stopped giving quarterly guidance – Coke now back to giving guidance
  - Google doesn't give sales or page-views guidance
  - Sears Holdings: followed by 12 analysts before Kmart acquisition, then only 3 after guidance ceased
- Google March 2006 disclosure control weaknesses and surprises exasperated analysts:
  - Abnormally high tax rate undercut Q4 earnings
  - Spectre of slowing growth raised in unscripted remarks by CFO
  - Inadvertent posting of internal financial planning documents that discussed profit margin compression



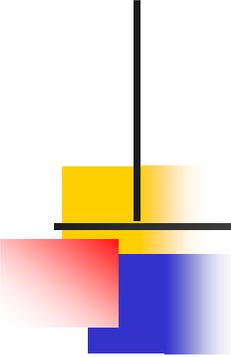
# Guidance Issues

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- Manage for the long term yet guide for the short term
- How to control analyst outliers
- Peer Group practices
- Complex business model
- Manage down expectations and then outperform
- Manage volatility without blowing guidance
- Avoiding selective disclosure
- Help vs hindrance regarding civil liability for continuous disclosure
- PROVIDING GUIDANCE IS A GOOD THING IF YOU ARE GOOD AT IT

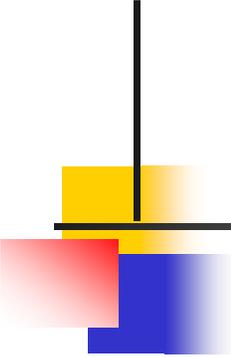


# FINANCIAL DISCLOSURE



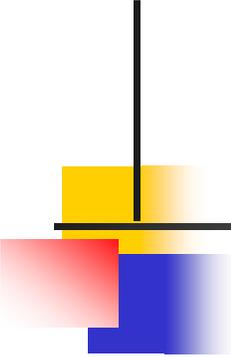
## Delay in Releasing Financial Statements

- Adecco (2004) re additional audit work resulting from control deficiencies
- Cognos (may 2006) re SEC review of allocation of revenue from multi-element contracts
- Nortel – during restatement work followed “alternative information guidelines” of the OSC
  - Bi-weekly updates, with target date for filing
  - Senior exec. Cease trade Order (15 days rolling; up to two months)
  - Repeated delays in announced filing date for 200-2003 restatement; finally filed January 2005
  - Must keep negotiating with lenders as failure to file on time is usually an event of default
- MDC (accounting change), Alderwoods (new computer system) and Royal Group (restatement) are current examples



# Delay in Releasing Financial Statements

- New requirements (60/90 day filing deadline and increased disclosure and certification requirements)
- Increasing trend in US as well:
  - *"Companies are filing late", WSJ, April 11, 2005, C3*
  - *"Big Board Proposes Crackdown on Late Filers", WSJ, Feb. 11, 2005, C3*
- *June 2004, OSC cautions CP Ships for failing to give prompt notice of decision to restate financial results*
  - *Insiders knew that Q2 2004 results would be changed, but not by how much- that is itself a material change*
  - *Company didn't have enough resources for move to a new accounting system*

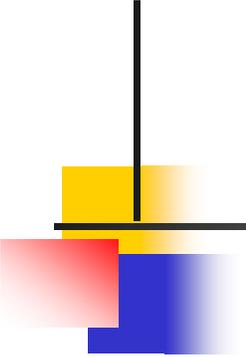


# Leaks

- CN forced to release Q3 2003 a day early due to US filing mistakenly including headline for Q3 release
- Bank of Montreal forced to release Q1 2004 early after inadvertent release to employees
- Bayer AG released its financial results early at the same time after results were leaked to the media
- Petrocan (July 2005) released its results two days early after the newswire service inadvertently sent the Q2 2005 results
- American College of Cardiology study of Plavix drug was improperly leaked (March 2006) to financial analysts and published online in New England Journal of Medicine before its formal presentation



# INCOME TAX DISCLOSURE

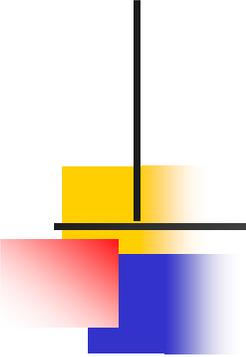


# Income Tax Disclosure Beyond Financial Statements

- Sometimes appropriate to highlight major components and significance of reconciling item
- What is the effective tax rate - Highlight items that are non-recurring and availability of unutilized balances
- Restrictions on carrying value of tax loss carry forwards
- WorldCom aggressive tax shelter program shifted income to Delaware (no tax on out-of-state corporations)
- Enron dealers sold it “tax structures”
- CIBC tax refund for fiscal 2003 re Global Crossing \$689 million
- Hudson’s Bay spreading of costs between merchandise and credit card segments to maximize tax position obscured segmented results
- Freddie Mac’s use of linked swaps to “smooth” and defer income possibly leads to tax liability
- CICA 3465/FAS 109 don’t address initial recognition (though CICA 3290/FAS 5 re contingencies) – FASB Uncertain Tax Positions Exposure Draft; SEC speeches
- KPMG shelters and SEC investigation



# FORWARD-LOOKING INFORMATION



# FORWARD-LOOKING INFORMATION

- OSC MD&A Guide:

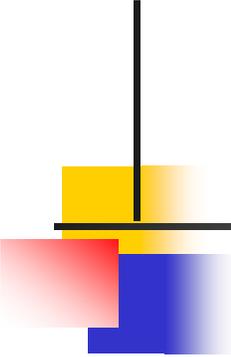
“A disclosure duty exists where a trend, commitment, event or uncertainty is both presently known to management and reasonably expected to have a material impact on the issuer’s business, financial condition or results of operations”

- Contrast “optional forward-looking information”:

Anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty

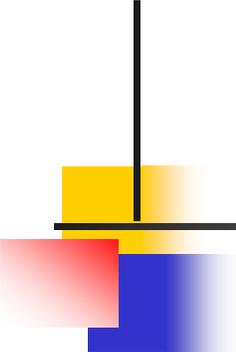
- Concerns about liability misplaced:

Not mandating a prediction or guarantee, merely identification of key factors for management decisions



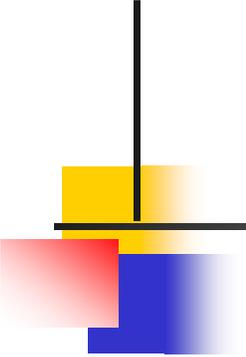
# FORWARD-LOOKING INFORMATION

- Four requirements of Reg X Item 303:
  1. Known trends or known demands, commitments, events or uncertainties that will result in or are reasonably likely to result in material effect on liquidity
  2. Known material trends (+ve/-ve) in capital resources and any expected material changes in mix/relative cost of resources
  3. Known trends/uncertainties that have had/reasonably expected to have a material impact (+ve/-ve) on net sales/revenues/income from continuing operations
  4. Material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating results or future financial condition



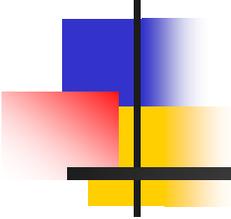
# FORWARD-LOOKING INFORMATION

- SEC definition of “voluntary”:
  - Similar to OSC
- Safe Harbours
  - Rule 175 of the 1933 Act and Rule 3b-6 of the 1934 Act
    - Criteria 1: FLI contained in an SEC filing
    - Criteria 2: Reasonable basis exists for the information
    - Criteria 3: Disclosure made in good faith
  - Private Securities Litigation Reform Act of 1995
    - Extends to written documents (even if not filed) and oral statements if accompanied by meaningful cautionary statements and made in good faith
  - OSA 138.4(9)(9.1)(9.2)(10) contains a similar provision, which applies to continuous disclosure and prospectuses (other than IPO or financial statements)



# Forward-Looking Information

- Protection if have a reasonable basis for drawing the conclusion or making the forecast/projection and provided the FLI is accompanied by:
  - Reasonable cautionary language identifying the FLI and identifying material factors that could cause actual results to differ materially from a conclusion, forecast or projection in the FLI; and
  - A statement of the material factors or assumptions that were applied in drawing a conclusion or making a forecast or projection set out in the FLI
  - Oral statements can incorporate filings of cautionary language by reference
- Question: effect on MD&A and related requirement for disclosure of known events, trends and uncertainties and analysis of results with a view to the future

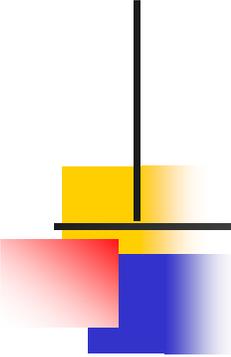


# Non-Financial Metrics

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# Issues in Non-Financial Metrics

- NOT: Non-GAAP Financial Measures – CSA Staff Notice 52-306
- Non-Financial Metrics considered highly important by analysts and investors (CIRI/NIRI studies):
  - RIM, Telco's and cable companies: # of subscribers
  - AMD/Intel and Lucent/Cisco/Nortel/Alcatel: market share in various categories of product
  - Apple sales of iPod units
  - Media: # of viewers/subscribers/circulation
    - *"Making marketing measure up"*, BusinessWeek Dec. 13, 2004
    - Hollinger Oct. 2004 reserve of \$27 million set up for reimbursement to advertisers
    - SEC 2004 whole industry review re practices
    - May 2006, six people pled guilty to charges they inflated circulation figures at Newsday – owner reserved US\$90 million for reimbursements to advertisers
  - Income Funds distributions: sustainability, return of capital portion, maintenance CapX, R&D, marketing, tax effectiveness, distribution history
  - **Oil and gas reserve replacements (life and type: proven, probable), refinery throughput, utilization of refinery capacity (Shell scandal of 2004)**
  - Peoplesoft CEO re Oracle's FUD campaign
  - Dexit: stores, customers, float, average spend
  - Airlines: revenue passenger miles, available seat miles, passenger load factor
  - Advertising agencies: net new business
  - Real Estate: occupancy rate, weighted average remaining lease term, lease expiry details/yr
  - Retail: same store sales, system sales (franchise), sales per square foot
  - AOL and not every subscriber is a "true" subscriber



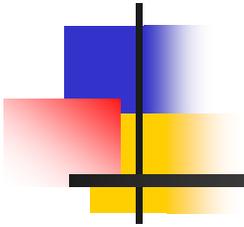
## Charter Communications – July 2004 SEC

- From the first through the fourth quarters of 2001, Charter inflated the number of customers who subscribed to its services in an attempt to meet analysts' expectations for subscriber growth and depict itself as a growing company. To inflate its subscriber numbers, Charter employees stopped its usual practice of disconnecting the services of delinquent paying customers and customers who had requested the termination of their services. As a result of this conduct, Charter artificially inflated its number of subscribers and subscriber growth that it reported to the Commission and to the public from the first through the fourth quarters of 2001 in its Forms 8-K, Forms 10-Q and Form 10-K.

# Issues in Non-Financial Metrics

- 3<sup>rd</sup> party validation (Audit Bureau of Circulation, JD Power)
- Soft statements: Product safety/efficacy (police vest manufacturer)
- Issues to consider:
  - Is the measure based on a generally accepted industry standard?
  - Is the measure unique to the company?
  - Is the measure prepared primarily for inclusion in the MD&A or is it part of the regular management reporting process?
  - Is the measure used in other public disclosures?
  - Does the measure involve the use of significant estimates and judgments?
  - Have there been any changes to the systems, people and processes used to prepare the measure?
  - Has there been a change in the methodology used to determine the measure?
  - Are there any changes in the business, such as rapid growth, acquisitions, structure that need to be included in the measure?
  - Who prepares, reviews and approves the measure?
  - Are senior management compensated based on the performance measure?

# Non-GAAP Earnings Measures

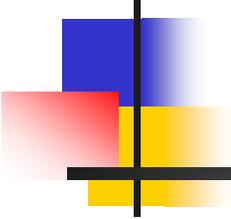


# Non-GAAP Earnings Measures

- CSA Staff Notice 52-306 and Reg G (US)
- Deals with “pro forma” puffery
  - Had its root properly in real estate industry’s “operating earnings” or “funds from operations”
  - Taken to an extreme by tech industry where no real earnings at all
- Requirements:
  - Explicit statement that non-GAAP financial measure employed does not have a standard meaning and differs between companies (e.g. “free cash flow”)
  - The related GAAP measure displayed at least as prominently
  - An explanation of why the NGFM is relevant
  - A clear reconciliation to the comparable GAAP measure
  - An explanation of any changes in the NGFM
  - Must discuss the NGFM in the MD&A
- E.g. railway “operating ratio” requires understanding of whether special charges are included and whether the definitions of operating/non-operating have been stable
- Are expenses related to Hurricane Katrina “normal”?
- S&P 500 “operating earnings” vs. GAAP earnings gap was 13.7% in Q4 2004

# Non-GAAP Earnings Measures

- Income Trusts and “Distributable Cash”
- Al Rosen’s numerous columns about whether enough being reinvested to maintain the cash flows and to what extent they represent a return “of” capital rather than a return “on” capital
- Expansion vs. maintenance Cap X
- Advertising, R&D, equipment replacement cycle etc.
- CSA 2005 Staff Notice 41-304 – *Income trusts: prospectus disclosure of distributable cash*
  - Requires description of work done to ensure completeness and reasonable ness
  - Description of and support for all assumptions and adjustments
  - Specific risks and uncertainties that may affect each individual assumption
  - See also Staff Notice 51-310 re CD Review of income trusts
- S&P papers by Ron Charbon (Part 1 Jan 16, 2006; Part 2 march 9, 2006)

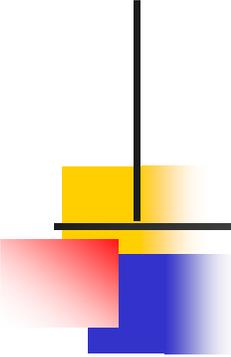


# Loss of a Material Contract

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# Loss of a Material Contract

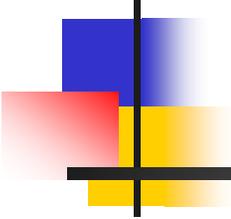
- Historically considered something requiring immediate disclosure by TSX and CSA
- 2004 announcement by Bennett Environmental Inc. stunned analysts by disclosing New Jersey contamination cleanup contract had been cancelled and replaced by a less profitable deal almost a year before
- CoolBrands International Inc. July 2004 announcement that its contract with Weight Watchers re Smart Ones brand ice cream would expire Sept 2004 hurt mgt credibility due to recent guidance that company's main licensing agreements were long-term
- CAE 2003 bought deal – prior to closing of the deal an analyst disclosed, and CAE confirmed, missing out on a major US Army contract
- Tesco Corp. (oilfield services) 2003 announcement at a brokerage-sponsored conference that a Mexican contract with Pemex had been called off – disclosure two weeks late and possibly “selective”



# Material Contracts

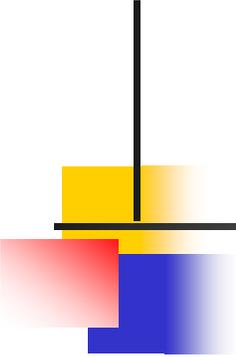
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- August 2005 Cryptologic possible loss of Betfair (UK)
- Molson-Coors
  - Undisclosed terms of profit-sharing and marketing/production agreement for Coors Light an issue in takeover battle
  - Redacted document released after shareholders complained



# Key Employee Illness/Departure/Baggage

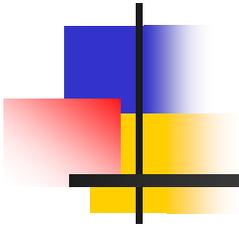
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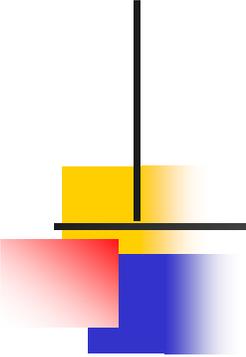


## Key Employee Illness/Departure/Baggage

- *"Kraft's Silence About Sick CEO Poses Dilemma", April 12, 2004*
  - *Duty to inform vs. right of privacy*
  - *Length of time in hospital*
  - *Employees need to know - risk of leaks, selective disclosure*
- *When the CEO/CFO Jumps Ship Investors Want to Know & Why*
- *Sprint sued by New Jersey pension fund over 2001 statements that contracts designed to ensure CEO and COO retention while internally mulling over cause for dismissal*
- *Quebecor 2002 Bought Deal*
  - *Lead manager didn't consider pending departure of CEO and CFO to be material, but when disclosed to syndicate company forced to press release*
- *CEO tenure shrinking*
- *Generally need to disclose reasons for departure and timeline for search for replacement, as well as interim management*
- *Criminal and regulatory and securities litigation background*

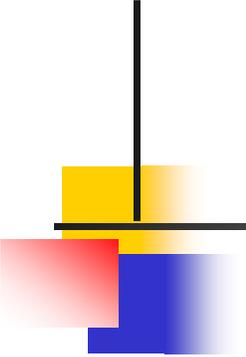
# Key Employee Compensation





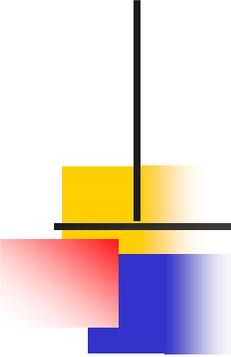
# Issues in Compensation Disclosure

- Google IPO and pre-IPO option and share grant disclosure – blew s.701 exemption
- SEC settlement with GE 2004 re failure to provide sufficient granular specificity re Jack Welch retirement arrangements concerning ongoing access to perks
- December 2004 SEC settled enforcement proceedings against The Walt Disney Company for failing to disclose certain related party transactions between Disney and its directors, and for failing to disclose certain compensation paid to a Disney director
- April 2005 SEC settlement with Tyson foods for failing to disclose over US\$1 million of perks to Donald Tyson
- SEC 2005 probing Shell's compensation plans to see if bonus awards could have influenced incentive to overstate reserves (2006 Fannie Mae investigation)
- Nortel 2003 reserves issue and compensation plan



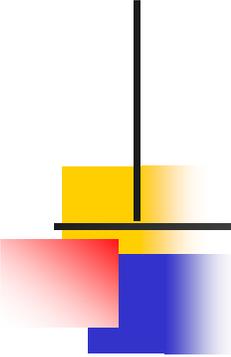
# Issues in Compensation Disclosure

- SEC proposal to update compensation disclosure rules (from 1992, 2002 equity plans update; Canada 1994) for 2007 proxy season to increase transparency and ensure “clear, concise and understandable” disclosure and help shareholders police alignment re:
  - Deferred compensation (75 of largest 96 US cos offered, but only 10 allowed deferral of stk option gains – Analogue Devices interest rate for 2005 was 6.48% on the pre-tax deferral)
  - SERPs and Options valuations in summary comp table (see BofA 2006)
  - Change of control provisions – a big issue in M&A and GPT
  - Lower threshold for perks disclosure and prevent “business use” excesses
  - Extending beyond top 5 highest paid officers to include CEO/CFO, three highly paid officers and up to three other employees who would hit top 5 (the “Katie Couric rule”)
  - Details on personal use of corp. assets (such as entertainment budgets and private jets)
  - Compensation Committee report to be “filed” rather than furnished – disclosure control context and must provide analysis and address specifics of pay for performance (e.g. what targets)
  - Compensation committee independence and governance provisions to eliminate cronyism (Disney and NYSE cases)



# Issues in Compensation Disclosure

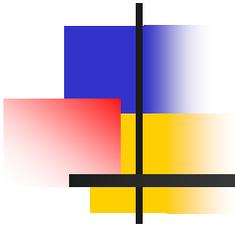
- ***“I have a feeling that when people are forced to undress in public, they’ll pay more attention to their figures”*** (SEC Chairman Cox in a speech to the Council of Institutional Investors)
- CSA study on executive compensation disclosure practices (Staff Notice 51-304 Nov. 2002) found lack of specifics re how compensation determined and how it relates to performance
- OSC proposing to release guidance on disclosure for SERPs
- May 2006 David Wilson speech re compensation disclosure review
- Institutional investors proxy guidelines and sample proxy circulars being updates (see Council of Institutional Investors 2005 revision and Canadian Coalition for Good Governance 2004-2005 revision)
- See [www.CompensationStandards.com](http://www.CompensationStandards.com) for Comp Comm. Advice
- Revised 8-K items include material agreements/amendments to senior exec compensation
- Loans, security, debt forgiveness and governance (WorldCom, Tyco)



# Issues in Compensation Disclosure

- *"Executive Pay Irks Major Investors"*, WSJ, Dec. 20, 2005, B9
- "Executive Pay Faces New Tactics", WSJ, Feb. 27, 2006, B3
  - Previous shareholder proposals calling for limitations on pay, caps on grants of restricted stock received on average less than 15% of votes
    - *"Mutual Funds Back Executive Pay Plans"*, Globe and Mail Mar. 28, 2006, B8
      - *Management proposals supported 75% of the time by US mutual funds*
  - New strategies less prescriptive and more directed at ensuring alignment with corporate performance and requiring more granular disclosure
  - Golden parachutes still targeted

# DISCLOSURE ISSUES FOR INTERNAL AND GOVERNMENTAL INVESTIGATIONS AND LITIGATION

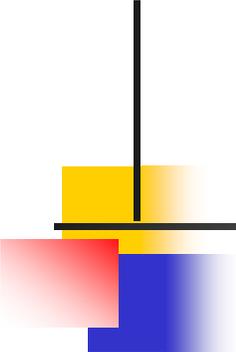


# Internal Investigations – Managing Disclosures

- Conflicting Goals:
  - Avoid liability in Courts or re Regulators
  - Protect the brand (“Court of Public Opinion”)
- Management may want to publicly release information about findings of investigation:
  - to reassure shareholders, customers and others that it is serious about remedial steps and punishing those responsible
  - to government to head off investigation or to limit scope and severity of remedial or punitive measures
  - to satisfy securities law disclosure obligations
- Decisions needed about executives/employees testifying before grand juries, regulatory or legislative bodies
- Private plaintiffs (class action counsel and institutional shareholders), prosecutors and regulators will watch closely for a basis to assert waiver of privilege to gain access to the underlying factual materials which are used for the internal investigation, as well as the report

# Internal Investigations – Managing Disclosures

- Securities law duties - triggers
  - Timely disclosure of material events
  - Periodic disclosure line items; MD&A; contingent liabilities on fin stmts
  - Prospectus disclosure
  - Contemplating an acquisition/financing (Pantheon)
- Disclosure by regulators?
  - OSC 2004 re Royal Group and Black/Hollinger and Biovail
    - See OSC Staff Notice 15-703 (Oct. 15, 2004) *"Guidelines for Staff Disclosure of Investigations"*
- Stages of a securities law investigation:
  - Industry-wide or issue-oriented review and request for documents
  - Informal company-specific inquiry ("subject" / "target" of investigation)
  - Formal company-specific investigation (allows subpoena power re documents and testimony) usually where not full cooperation
  - Pending/Actual Decision to prosecute (*"Wells Notice"* in US; OSC "letter soliciting submissions to avoid enforcement – Bennett Environmental 2005)
  - Formal Hearing or Prosecution
    - Civil (SEC/OSC) or criminal (Dept. of Justice or Crown)



# Internal Investigations and Litigation – Managing Disclosures

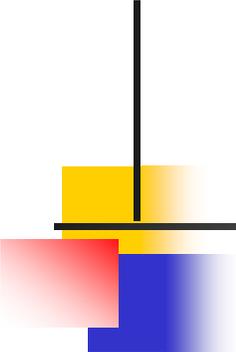
- Issues:
  - Gauging and disclosing extent of investigation and potential litigation and extent of exposure and ancillary effects and updating the market as these change
    - AIG (SEC Litigation Release No. 18985 Nov. 2004 alleged false press releases limiting scope of activities under investigation)
    - Merck – Vioxx
    - IBM – cash balance pension conversion
    - Tobacco industry
    - Marsh & McLennan (stock falls 38% due to material impact to current business model)
    - The Titan Corp.
      - Wells Notice received June 2004 re allegations of improper payments to foreign officials
      - Minor market impact but led to loss of Lockheed merger and significant government contracts

# Internal Investigations and Litigation – Managing Disclosures

- Fairfax Financial trips on March 2006 disclosure of SEC and US attorney's office in SDNY subpoena re finite risk insurance without much detail
- SECInsight (an independent research firm) uses FOFI request to see what companies are under investigation – will force earlier disclosures
- Need to disclose cost and timing of investigation and defence expenses as well
- Need to update market on termination of the investigation – results and final costs
- After securities settlement agreement with regulators must comply with disclosure/non denial provisions
  - Deloitte statement about Adelphia audit raised SEC's ire April 2005

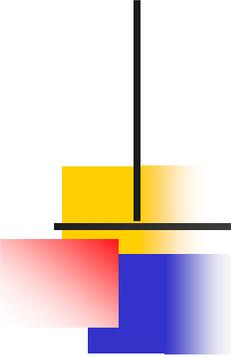
# Managing Litigation Disclosure

- Timely and periodic disclosure of nature and quantum of claim and chance of success, as well as accounting and cash reserves set aside
  - E.g. Ronald Perelman litigation against Morgan Stanley re sale of Coleman to Sunbeam
    - Award of compensatory and punitive damages of US\$1.45 billion from a Florida jury exceeded MS reserve of US\$360 million
  - CIBC settlement re Enron litigation was 10X what it had reserved – question effect on other banks reserves
  - Mosaid patent litigation: (1) stock jumps 20% Oct. 2004 with win against Samsung; (2) stock drops 30% after terms of settlement agreed to with Samsung Jan. 2005; (3) stock jumps 10% on announcement Jan 2005 of Hynix Semiconductor intent to license patents; and (4) stock drops 24% in April 2005 when most of same patents ruled in valid against Infineon Technologies
- Risk factor disclosure (internet gaming companies)
  - See: *"Looks Like a Sure Thing, But ..."*, BusinessWeek, July 4, 2005, p.41



# Recent Significant IP Litigation

- Mosaid suit against Samsung Sept. 2001
  - Stock rises 37% after July 2004 rulings re evidence
  - Stock rises 19% in last 90 minutes of trading on a Friday in Oct. 2004 prior to announcement of rulings upheld on appeal
  - Suit settled Jan. 2005
- Issues:
  - Valuation of effects of a win, a partial win, a partial loss, a complete loss
  - Valuation of effect on parallel lawsuits
  - Confidentiality provisions of settlement and business considerations mean little guidance on full financial effect of settlement
    - Mostly inferred from short term guidance of revenue pickup over next two quarters
    - Implied royalty rate half of what market expected and stock falls on digestion of settlement details
    - Implications for capturing license fees from other DRAM manufacturers – hard to value

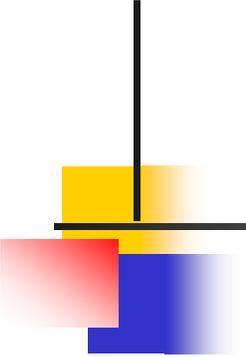


# RIM – NTP IP Litigation

- Case could have been settled for US\$10 million before 2002 trial
  - RIM lost and damages to that point assessed at US\$50 million
  - Fought for 5 years in expectation that patents would ultimately not be upheld but ran out of time facing an injunction on US sales and confusion/fear affecting US sales in February 2006
    - USSC had denied leave to appeal in January 2006
  - All along RIM kept winning the reviews of the NTP patents accelerated by US Patent and Trade Office – with all 5 patents at issue ultimately the subject of final (subject to appeal) rejections based on prior art not examined in the 2002 trial
- March 2005 announced US\$450 million settlement as if it was final yet NTP walked and RIM lost June 2005 action to enforce settlement (NB Court file sealed – to avoid litigation)
  - Issues included whether money was refundable if patents not upheld and whether RIM could sub-license the technology to its partners and corporate clients
- March 2006 settlement for US\$612,5 million final settlement also covers all future NTP patents and all RIM past and future products, as well as all RIM's suppliers and channel partners

# RIM – NTP IP Litigation

- NTP had been holding out for US\$1 billion or to enforce its Court-ordered 8.5% royalty through expiry of patents in 2012
- RIM had already accrued the US\$450 million from 2005 and recorded the additional US\$162.5 million in its Q4
- RIM had 1.8 billion in cash and cash equivalents as of Nov 2005.
- Stock price jumped at the time of each settlement
- RIM was lucky on the facts – disclosure was terrible regarding finality of march 2005 settlement
- RIM disclosure of status of ongoing litigation and PTO proceedings over the years was exemplary however
- Next challenge: MD&A regarding Visto litigation and competing phones/PDA's
  - Sales growth now to come from retail channel rather than corporate accounts and retail purchasers looking for MP3, camera, etc.



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# MERGERS AND ACQUISITIONS ISSUES

# Mergers and Acquisitions Issues in the News

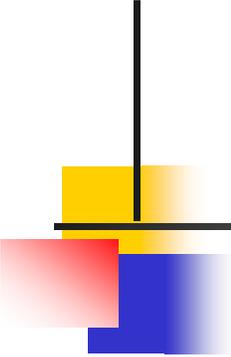
- *"Onex said to be Hiring Credit Suisse to Eye Sale"*, March 3, 2004
- *"Hollinger Hires Adviser to Seek Buyer of Media Stake"*, September 3, 2004
- *"A Market for Gossip"*, Financial Post editorial September 30, 2003 re Manulife-John Hancock
- *"E\*Trade, Toronto Dominion Unit End Merger Talks"*, January 19, 2004
- *"CGI to use credit facilities to fuel acquisitions"*
- *"Investor Says He Made an Offer for Minacs"*, March 26, 2004
- *"RBC Could Swing \$10 billion Buy: CEO; but Nixon 'prepared to be patient' in U.S."*, two weeks before announcing purchase of Florida bank

# Mergers and Acquisitions Disclosure Issues

- Northrup entered into deal to buy Lockheed in 1997, but transaction didn't proceed in 1998 due to competition issues
  - SEC investigated whether the company should have updated its joint proxy statement and prospectus to reflect DOJ antitrust concerns before a shareholder vote to approve the merger
- RJR Nabisco in 1992 paid US\$72.5 million to stock-option holders who alleged that company failed to disclose takeover talks in months before Oct. 1988 LBO
- What is unsaid in many announcements is how the deal is to be financed
- SEC sued E.ON AG (Germany's third largest industrial company) in 2000 for falsely denying merger talks (after confidentiality agreements, signed and IB and lawyers retained)

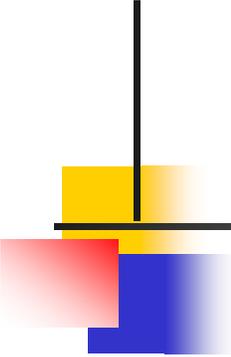
# Disclosure of Preliminary Negotiations

- Generally not required to disclose existence of M&A negotiations, even if material, until closing
  - USSC in *Basic v. Levinson* (1988):
    - “no comment” statements are acceptable and appropriate to protect the confidentiality of ongoing business negotiations; are the functional equivalent of silence and are not misleading under Rule 10b-5 absent an affirmative duty to disclose
    - Must assess probability of completion against materiality of transaction to determine when disclosure required
  - 2000 SEC enforcement action against E.ON AG, Germany’s third-largest holding company, alleging deliberately false statement – denied press reports that it was in merger negotiations
  - Contrast *Phillips v. LCI International, Inc.* (CA 4<sup>th</sup> Cir. 1999) where “company not for sale” statement held not to conflict with fact of active negotiations
    - In context of “total mix” of information available to shareholders, including knowledge that industry was consolidating, company had done previous acquisitions and analysts were recommending further deals



# Disclosure of Preliminary Negotiations

- General Principles (in addition to trading blackout):
  - Can't deny merger talks if in fact taking place
  - "Duty to correct" statements made by the company after you learn they were misleading or inaccurate when made
  - Possible "duty to update" if subsequent events overtake previous statements so that total mix of information is now inaccurate, misleading or incomplete
  - "No comment" policy is the functional equivalent of silence
  - Must balance duty to disclose material events to the market against risks of premature disclosure
    - Misleading if no deal
    - May lead to competitive/disruptive bids
    - May lead to run-up in stock price
    - May lead to business disruptions re employees/customers
  - Forced early disclosure if offering securities, if line item disclosure in a period filing (e.g. business acquisition reports or MD&A), if necessary to respond to market rumours attributable to the company or where "duty to update"



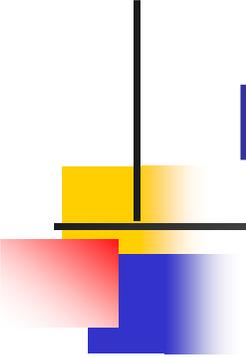
# Disclosure of Preliminary Negotiations

- General Principles:

- Must consistently and rigorously enforce a “no comment” policy
  - If respond to some inquiries, marketplace may interpret “no comment” to be an indication of ongoing M&A developments
    - Defeats purpose and creates liability risk
  - Caution must be taken to avoid selective disclosure in response to inquiries
- All market inquiries should be funnelled through head of Investor Relations, who tracks information in the public domain and who is privy to the current state of negotiations.
- Keep the group of people “in the know” as small as possible

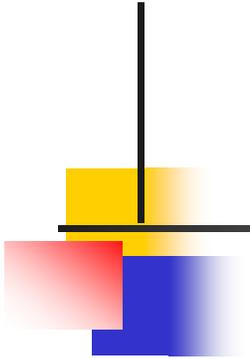
# M&A Disclosure Issues

- Timing of announcement of transaction vs when equity financing is sought
  - Use of subscription receipts equity financing deals either before or after the acquisition agreement is announced
  - Consider how broadly to solicit funding – may impact trading liquidity due to “deemed insider” status
  - BCE 2002 hybrid involved a pre-arranged lead PP investor for about 45% of the offering
- Post transaction market updates re cost reduction progress
- Announcement of “putting out the sale sign” (Royal Group 2005-2006, Intrawest Feb. 2006, Imax March 2006) vs GSW Inc. lack of prior disclosure of hiring of advisors, receipt of fairness opinion, expiry of exclusive negotiation period etc. – all cleared up only when circular mailed (see Barry Critchley columns Feb.-Mar. 2006) and Dofasco circular (Dec. 2005) which revealed a year-long process during directors had turned down offers with no announcement and many stock options granted over the period (Ira Gluskin editorial)
- TSX forced CP Ships to disclose preliminary discussions due to a Financial Times article (July 2005)



# M&A Disclosure Issues

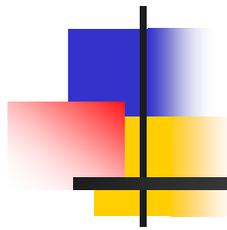
- Encana denies takeover discussions with Shell and affirms “continued independence” (Oct. 2005)
- Oracle’s investor relations website has a page devoted to “Strategic Acquisitions, which explains all the deals done 2005 – 2006 (including PeopleSoft and Siebel)
- Retirement Residences REIT discloses unsolicited offer (Jan. 2006), then Kuhl letter and hiring of financial advisers (Feb. 2006)
- Vocal institutional shareholders informing market and players whether they intend to sell: Vincor, Molson and Royster-Clark (2005)
- Tyco rises on split-up rumours (Jan. 2006)
- How to deal with typical price drop on announcement of proposed acquisition
- Updating of market as bids process continues re values received (First Cdn. Petroleums fell 10% on speculation; HBC sale process dragged on amid much speculation of other bidders, who underbid original bid)



# Private Placements

# Private Placements – Disclosure Issues

- Marketing requires managing material information
  - Will inquiries be interpreted as “just a feeler” or as a tip-off that a financing is planned
  - Financing often at a discount to market due to 4 month hold period
  - Call to brokers soliciting interest runs risk of trading:
    - Short sales which are covered by the PP purchases
    - General selling in advance of the offering
    - Common for dealer to warn re “putting you offside” and then require a written confidentiality agreement and no-trade commitment with a planned outside date for the deal announcement
  - See OSC settlements with Pollitt re tips to clients and with Paradigm Capital re “gypsy swaps”
  - Conversely Alimentation Couche-Tard private placement financing of equity portion for Circle K purchase (Aug 2003) was selectively marketed and other institutions complained after the transaction was announced and stock had run up



# Resource Industries

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# Oil and Gas and Mining Reserves

- US law from 1975 (2 years after OPEC embargo) required publicly traded energy companies to publish disclosures detailing production activities, estimates of proved oil & gas reserves and estimates of the present value of future cash flow streams
- FASB set current disclosure rules in 1982 – “supplementary information” not audited
  - No requirement for third party review
  - Only two of the nine major integrated oil companies had reserves reviewed by external petroleum engineers as of 2004
  - Wide scope of services provided by third parties in any event
  - Arbitrary rules such as 10% discount rate, Dec. 31 commodity price and no transparency re aging of reserves
  - Bears no relation to investment decisions being made today – offshore, high tech, third world
  - See, *“Big Oil Differs With SEC on methods to Calculate the Industry’s Reserves”*, *WSJ*, Feb. 24, 2005, C1
- Tiny SEC Staff of two petroleum engineers police resource companies (2004)

# Resource Reserves Issues

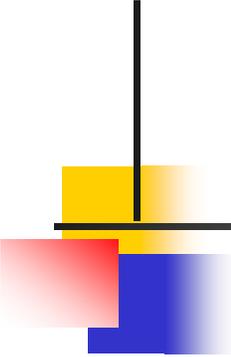
- Alberta Sec. Comm. Investigation of Blue Range Resource Corp. (2004) for fraudulent reserve calculations and failure to disclose extent of forward sales – couldn't capitalize on price run-up
- 67% of Canada's 1,200 listed mining companies (850 are TSXV) resident in British Columbia – BCSC initiating enforcement and supervision programs
- Shell 2004 reserves debacle
  - Poor governance and capability; lack of controls
  - Reserves not replaced over previous 5 years and Shell projected to spend US\$12 billion on exploration and production in 2005
  - By February 2005, reserves had been cut 5 times (cumulative 1/3 reduction); five year earnings impact of US\$700 million (1% of profit)
  - 2004 reserve replacement ratio estimated at 50%
  - Combined Royal Dutch and Shell companies to simplify governance
- Timely disclosure obligations as reserves become more clear (PlacerDome cut reserves at its South Deep mine in South Africa)
- OSC settlement with Agnico-Eagle in 2005 re lack of timely disclosure of production shortfalls caused by a rockfall at Quebec goldmine

# NI 43-101 and NI 51-101

- B.C. took the lead in enacting national instrument 43-101 *Standards of Disclosure for Mineral Projects* in 2001
  - Goal was to rein in the as many as 50 different terms used, from “prospective geological reserve” to “indicated mineral resource”
  - Today there are just 5 categories, three for resources and two for reserves
  - All else has to be called an exploration target
  - Far more disclosure required about the assay laboratories used to test core samples and the security of those sample
  - Requirement to employ a qualified geologist who belongs to the professional org.
    - In some cases “junior miners” required to hire a third party expert
- NI 51-101 enacted July 2003 *Standards of Disclosure for Oil and Gas Activities* (CSA with Alberta leading) mandates a higher confidence factor regarding recoverability than US rules (senior cos. can still use the SEC rules)
  - Under prior NP 2B, proven reserves based on 80% probability of being extracted within a year – now 90%
  - Probable (50% likelihood); possible (10% likelihood)
  - Governance and timely disclosure obligations and future cost calculations  
When instituted effective 2004 y/e up to 10% of industry reserves wiped out, some companies hit up to 30% of previous reserves

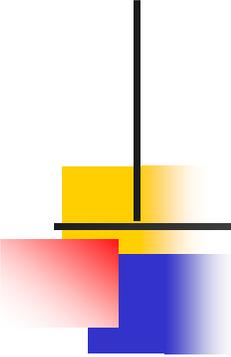
# Reliance on Experts

- Many Cdn cos. Avoid requirement of independent expert in NI 510101 by using the US rules
  - Imperial Oil wrote: *“the company believes that the reliability of its internally generated reserves data is of equal or better quality than would be afforded by it involving independent qualified reserves evaluators or independent qualified reserves auditors”.*
- El Paso Corp. (2004) hired an outside engineer but went with reserves 5% higher than the recommendation
- CALPERS pressures oil companies for independent reserves audits (2004)
- Shell, in response to scandal, now relies on outside contractors to help review its tally, but not a full-blown external reserves audit
- First Calgary Petroleum released an outside expert report in January 2005 substantiating doubled reserves using the broadest category and received a 10% boost to its stock price



# Clarity re Hedging

- In 2005, Nexen Inc., Petro Canada, Encana and many other companies announced that their profits had been hit by their hedging programs given the rising price of oil.
- Husky Energy Inc. announced in January 2005 that the company's hedging program for crude oil, which ended in 2004, had hedges wiping out \$203 million in pre-tax profit in Q4 2004 (up from \$11 million in 2003). For all of 2004, it lost \$561 million on hedges, up from \$26 million in 2003
- Barrick had a similar problem with its gold hedging in 2003-2004
- Conversely, several airline cos. announced major profits from the fuel purchase hedges in 2005 – 2006
- MD&A best practices require much detail about the extent of the hedging program: prices, timing of contracts and long term hedging strategy

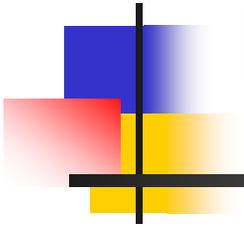


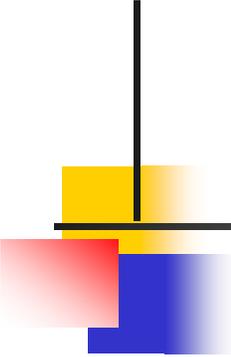
# Capital Expenditures

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- This is historically a problematic area in MD&A disclosure
- Particularly difficult for offshore drillers and oil sands plays due to significant cost overruns, labour and input shortages, insufficient infrastructure, hurricanes, etc.

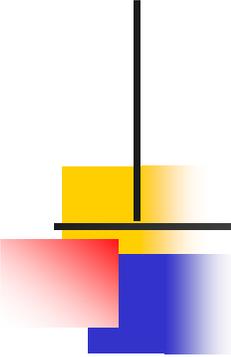
# The Drug and Medical Devices Industries





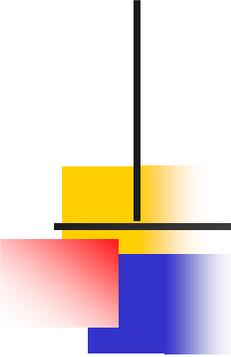
## Drug and Medical Device Disclosure Issues

- New drugs are risky, even if proven effective
- Drug companies have huge sales and marketing overhead and have to “feed the pipeline”, given patent expirations and competition from generic drug companies and patent litigation
- Most drugs never get commercialized and very bright people spend their entire careers researching compounds that will not prove out
- Drugs get pulled from the market at various trial stages and even after final approval (FDA/Health Canada)
- The FDA’s monitoring system relies on drug companies to report side effects and injuries, but they mostly rely on doctors, who have no obligation to report side effects and often lack the time. The FDA receives about 400,00 reports a year of possible bad reactions (est. 10% of the actual events)



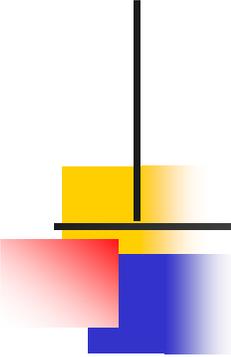
## Drug and Medical Device Disclosure Issues

- Industry website [www.patientinform.org](http://www.patientinform.org) aims to bring medical journal and other information to consumers re cancer, heart disease and diabetes
- Merck withdrew Vioxx from the market in 2004, after 5 years of sales and an aggressive multi-million marketing campaign in 80 countries
  - 2003 worldwide sales were US\$2.5 billion (11% of revenue)
  - Estimated income loss of 20%: initial market reaction cost US\$28 billion of market cap
  - An independent panel had found that the painkiller doubled heart attack and stroke risk if taken for more than 18 months
  - Merck decided additional warning labels weren't sufficient
  - Warnings had mounted over the 5 years due to various studies
  - Over 11,500 lawsuits estimated to cost US\$10 billion–US\$50 billion
- Wyeth has spent \$15 billion since 1998 re fenphen diet drug combination



## Drug and Medical Device Disclosure Issues

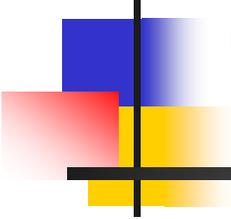
- Guidant internal review committee report (2005) concerning late recall of defective heart defibrillators
  - May provide a roadmap to product liability and securities class actions and SEC, DOJ and FDA investigations
  - Identified flaw was so serious that company had stopped producing/selling older model
  - New model allowed to be shipped to doctors
  - Panel held that decision to ship while withholding information from doctors
  - Panel found that governance was driven by engineers rather than doctors was wrong
  - Plaintiff lawyers likely to argue for punitive damages
  - Nonetheless, Boston Scientific proceeded with its US\$27 billion takeover in January 2006
  - Feb 2006 regulatory filing indicated potential suits by 2,500 patients after 2005 recall of 109,000 devices linked to at least seven deaths. 1,700 claims in addition to 211 individual and class action lawsuits) so far and more expected. So far only US\$113 million charge on financial statements to replace units



## Drug and Medical Device Disclosure Issues

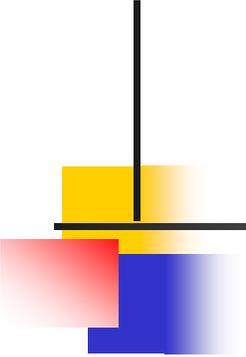
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1. Achievements and failures in clinical trials
2. Risks associated with clinical trial design/supervision
3. Prospects and timing for FDA approval
4. Extent of unapproved uses
5. Scientific literature from third parties
6. Differing opinions
7. Serious adverse effects – litigation and insurance
8. Warnings of regulatory action
9. Benefits and limits of patents
10. Freedom to operate issues
11. Patent litigation with generic drug companies
12. MD&A disclosure re remaining life of current products (patent extensions, captive generic production)
13. Comparisons to competitors products (all Cox2 implicated)



# OTHER ISSUES

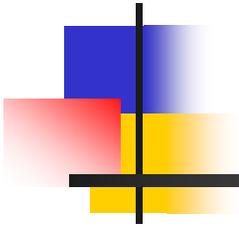
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# Other Issues

- Stock exchange listing, delisting, joining or leaving indexes
- Responding to rumours
- Related party transactions
- Insider trading
- Market manipulation
- Credit and insurance ratings
- Blogs
- Corporate Governance Disclosure
- Crisis management
- Environmental
- Internet
- Sales channel and end of quarter cut-offs/information flow
- Quiet Periods

# “Soft Controls Over Accounting Subjectivity”



# Selected Hot Topics

## Financial Closing and Reporting Process

- Taxes
- Estimates
- Non-routine and non-systematic transactions
- Unreconciled balances
- Disclosures
- Contracts
- Journal entries
- Related party transactions
- Outsourced processes, controls and/or IT environments
- Preventive vs. Detective
- Safeguarding of Assets
- Segregation of Duties

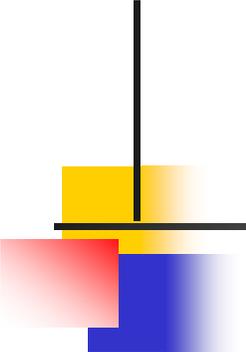
# What Are Important Accounts

## **Factors to consider in determining key financial reporting elements:**

- Materiality of financial statement items
- Degree of volatility of the recorded amount over time
- Degree of subjectivity used in determining account balance
- Susceptibility to error or omission as well as loss or fraud
- Complexity of calculation

## **Additional factors to consider might include the following:**

- Velocity of account - the speed of transactions through the account
- Nature and types of errors and omissions that could occur, i.e., “what can go wrong” (for example suspense accounts warrant greater attention)
- Volume, size, complexity, and homogeneity of the individual transactions processed through a given account or group of accounts
- Disclosures / footnotes in financial statements
- Prior year external auditor management letter comments
- Restatements



# Accounting is Getting More Complex and More Subjective

- Audit committees and finance executives need to understand the subjective judgements, estimations, assumptions, valuations and other methodologies adopted by those reporting to them
- A study released in January 2004 by Huron Consulting Group highlights accounting errors for balance-sheet reserves and contingencies as the leading cause of 2003 restatements
  - Revenue recognition fell to second
  - Bad debt, restructuring and other reserves highly influenced by estimates and judgements of management
  - Restatements reflect flawed judgements due to oversight or misuse of facts, fraud or misapplication of accounting rules
- Nortel restatements a sign of the times?
- Alliance Atlantis results delayed (May 2004) to “get it right”
  - Estimating multi-jurisdictional and multi-entity exit costs and reserves for production activities

# 2003/2004 “Soft Accounting” Issues

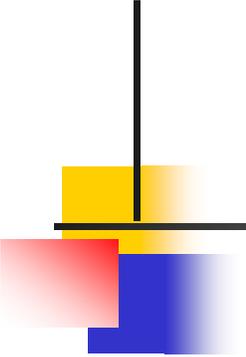
- Auditing fair value measurements and disclosures, estimates, judgment
- Krispy Kreme investigated for accounting (amortization period) for franchise buy-backs
- AT&T restated 2001, 2002 results due to two mid-level employees circumventing controls and incorrectly recording network access charges
  - Employees and supervisors terminated
- SEC industry-review of supplier rebates in foodservice industry as a result of Ahold’s U.S. Foodservice unit scandal
  - Minimal disclosure requirements for over U.S.\$100 billion industry issue in 2003
  - Recent EITF (FASB) guidance states that generally should deduct rebate from COGS, but in some cases can be booked as revenue, other income or as a reduction of some other cost
  - Determining when to book the rebate is left open – “probable and reasonably estimable” that rebate will be received
- Travelers merger with St. Paul Insurance highlighted different methodologies used by the two companies for loss reserves – led to increased reserve for St. Paul business post-closing
- Alstom US subsidiary significantly understated losses on rail-car contract

# 2003/2004 "Soft Accounting" Issues

- Pensions:
  - assumed rates of return on assets
  - Discount rates re future cost
  - See, *"Pumped-Up Pension Plays?"*, BusinessWeek, October 25, 2004, p. 92
  - SEC requested details of pension accounting from Ford and GM, October 2004
- Post retirement healthcare:
  - Healthcare inflation typically exceeds assumptions
- Tax rates/deferred taxes
  - Assumptions re rates and timing of taxes on foreign income (*"Unexploded Ordnance"*, Forbes, October 4, 2004)
  - Lack of clarity on overall tax rate – Texas Instruments 2004
- Gaming the "matching" principle:
  - Delayed recognition of a variety of operating expenses including development costs, acquisition costs for new ventures, start-up costs, financing costs
- Revenue games:
  - Vendor financing, rolling receivables into investments in customers, artificially low allowance for doubtful accounts
- Abuse of "one time gains"
  - Asset sales, currency translation, changes in valuations, allowances and reserves

## Freddie Mac (2003) & Fannie Mae (2004-2006)

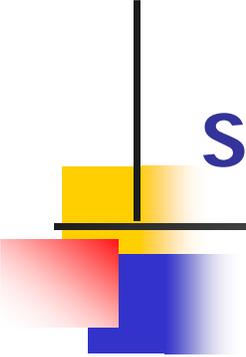
- Among the largest financial institutions in the US; own or guarantee close to half of the U.S.\$7.8 trillion residential mortgage debt outstanding
- Regulated by OFHEO and SEC
- Each alleged to have improperly “smoothed” earnings to avoid impact of FAS 133 and other accounting rules and to meet executive bonus targets
- Concerns about corporate cultures, capital adequacy and response of market to their securities, as well as impact on mortgage market
- Investigative reports (<http://www.ofheo.gov>) charge: departure from GAAP re derivatives transactions and hedging, use of “cookie-jar” reserves, tolerating internal control deficiencies, deferring expenses to achieve compensation targets and “maintaining a corporate culture that emphasized stable earnings at the expense of accurate disclosures”



# Soft Issues Are Prevalent

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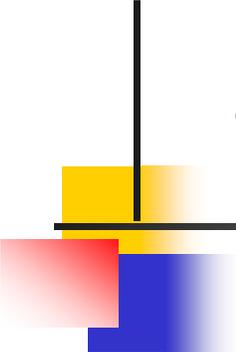
- **Contract Accounting**
- **Telecom Revenue Recognition**
- **Percentage Rent**
- **Bad Debts**
- **Inventory Obsolescence**
- **Legal Accruals**
- **Warranty Accruals**
- **Depreciation and Amortization**



## **Soft Issues Are Increasingly Complex**

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- **Valuation of Financial Instruments and Stock Options**
- **Impairment of Capital Assets and Goodwill**
- **Oil and Gas Reserve Estimates**
- **Accruals for Insurance and Pensions**
- **Residual Values in Leases**
- **Going Concern**
- **Future Income Tax Assets**

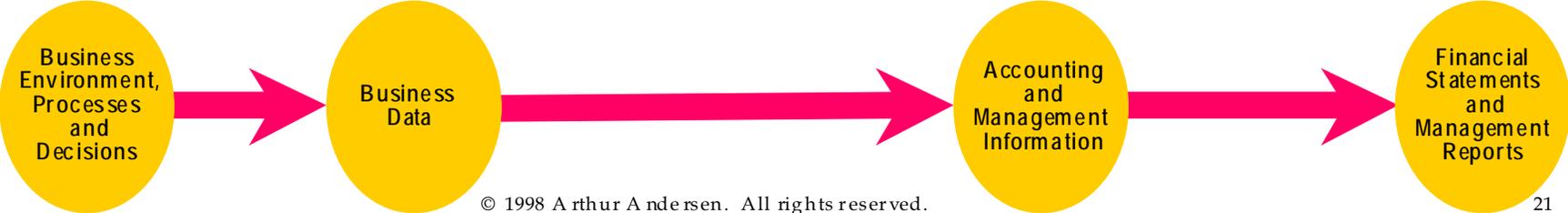
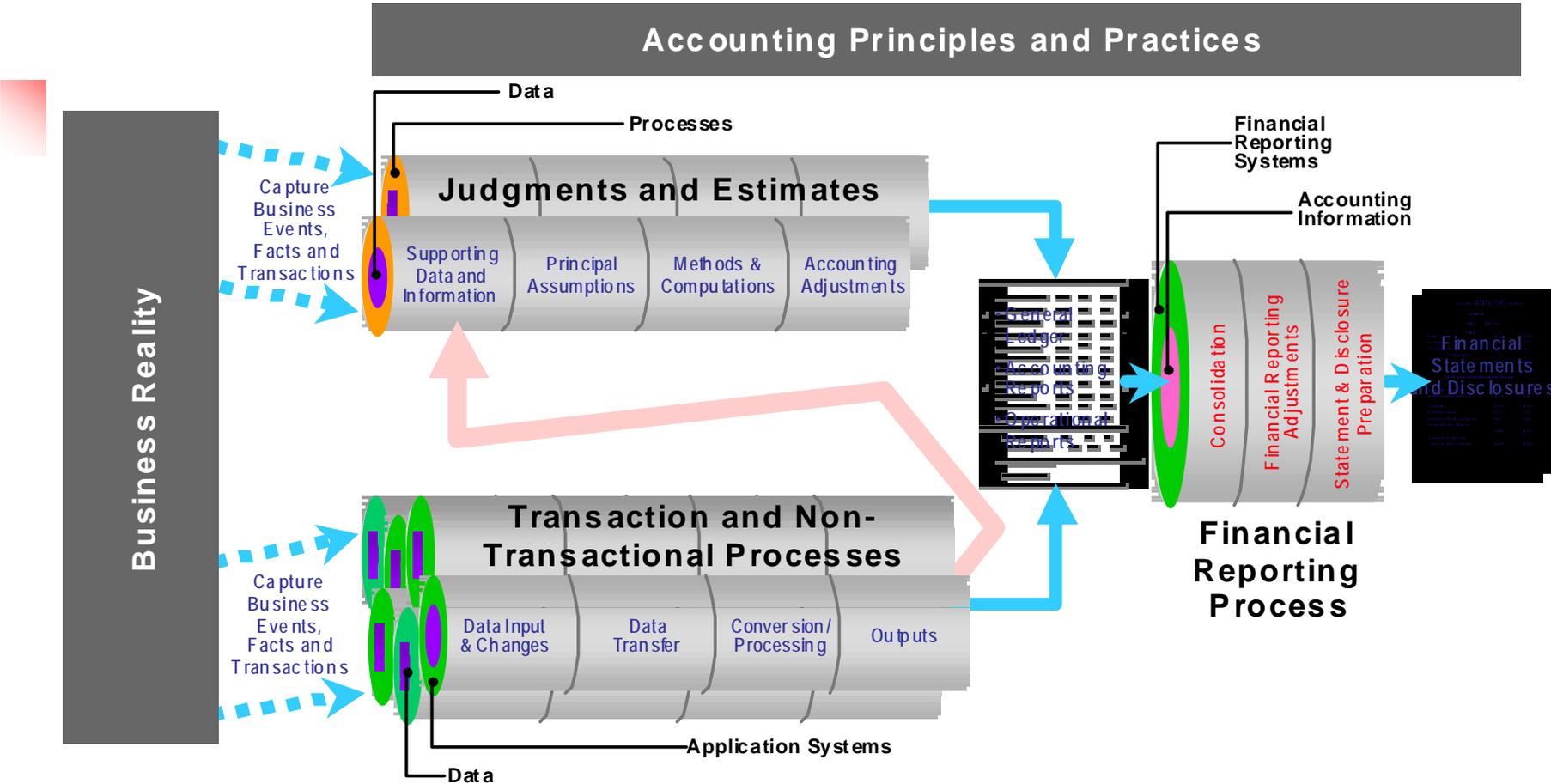


# HAVE YOU PAID SUFFICIENT ATTENTION TO THE FINANCIAL REPORTING PROCESS?

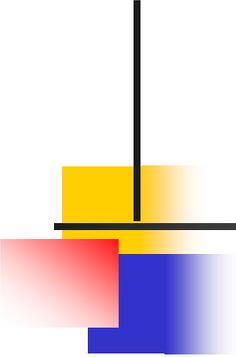
- Sox / Certification Is A Reality Primarily As A Result Of Management Override
- Consider The Specific Risks In The Financial Reporting Processes
  - Estimates Have Served Purposes Other Than Accurate Reporting
  - Control Environment
  - Entity Level Detective Controls
  - Fraud Including Management Override
  - Decentralized Environments
  - Audit Committee Effectiveness

# Business Information Framework™

## Objectives and Key Activities



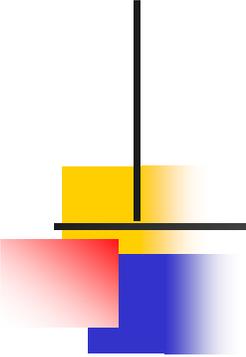
May 31, 2006



## Have You Defined Your Business Information Needs and Framework?

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- Consider the nature of the business
- Consider the sources of economic events
- Consider disclosure control requirements
- Consider underlying business drivers
- Identify non-routine and non-recurring transactions
- Identify relevant accounting principles and specific risks



## Integrate Your Business Information and Control Framework

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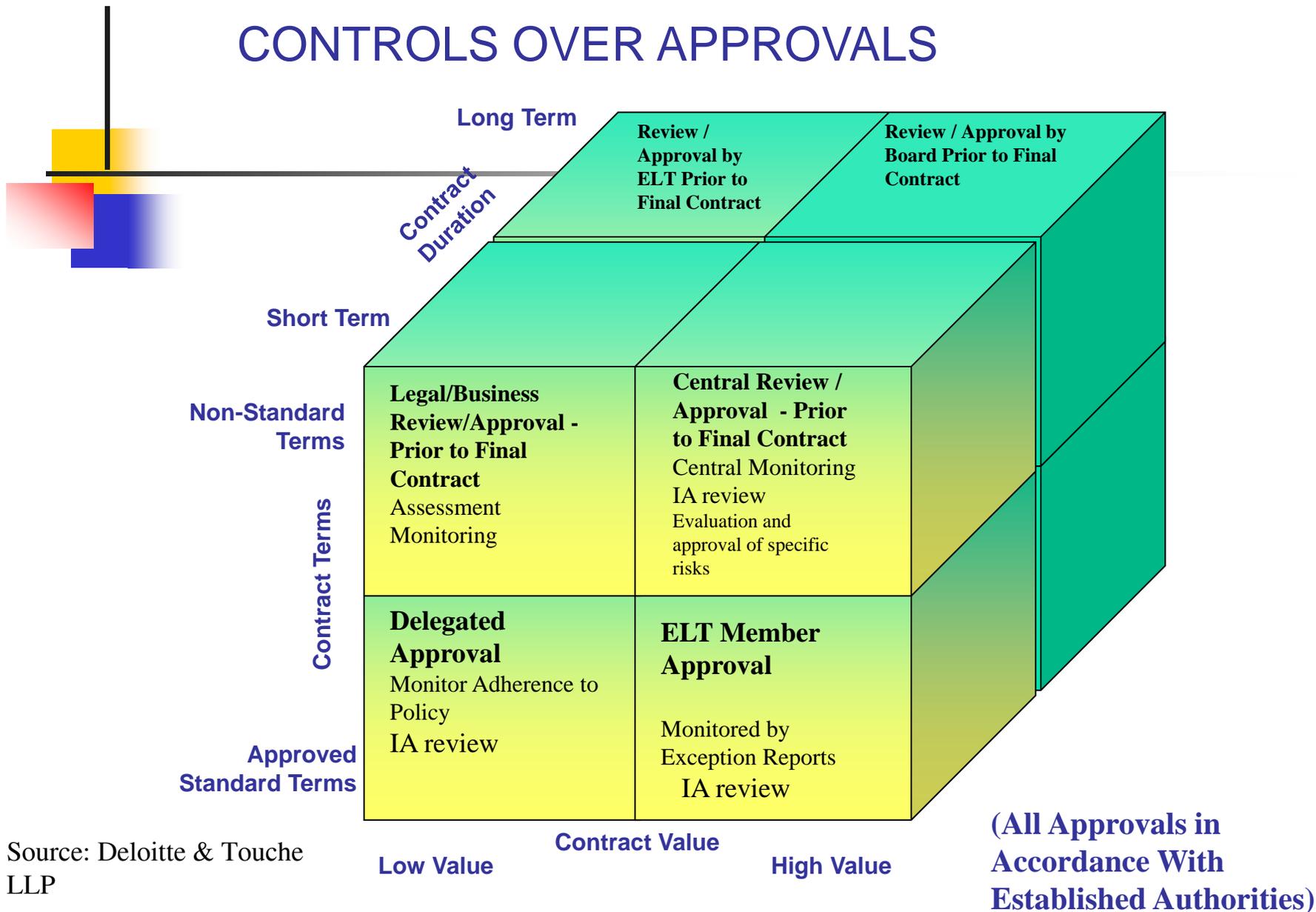
- Establish and Communicate Discretionary Authority
- Define Authority Structure to support defined information requirements
- Include enabling and constraining authorities
- Consider segregation of duties
- Consider “detective” competencies needed “at the rock face”
- Monitor compliance with policies / authorities
- Establish communication framework that supports appropriate “control environment”

# Capture all Major Classes of Transactions

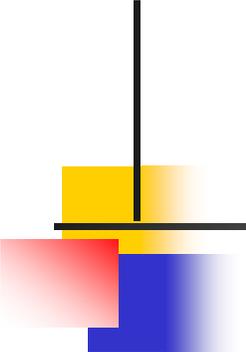
Major Classes of Transactions can be categorized into three different types: routine, nonroutine, and estimation (see paragraph 72 of the Standard)

- May be processed either systematically or nonsystematically.
- May be processed by one or multiple significant processes.

# CONTROLS OVER APPROVALS

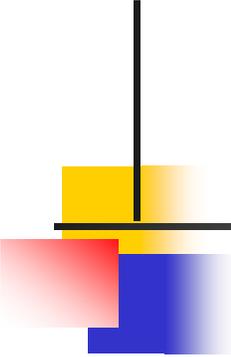


Source: Deloitte & Touche LLP



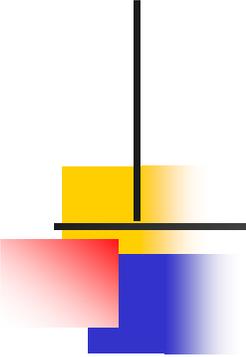
## Have You Considered Segregation of Duties/Safeguarding of Assets?

- Disclosure Control and Internal Control Certification applies to Related Party Transactions
  - Tyco, Adelphia, Hollinger
- Entity Level Policies and Monitoring
- Communication Needs
- Management's response to identified issues
- IT across departments and across applications
- Procedures to assign manual duties
- Process Level (initiate/record, authorize, reconcile/review of reports, handling/custody)



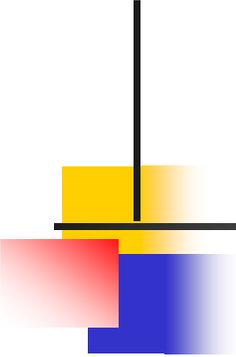
## The “Soft” Side is Harder Than You Think Are You Prepared?

- Some MD&A Requirements are forward-looking
- Judgments and Estimates Generally Forward Looking
- A “forecast” is FOFI prepared using assumptions all of which reflect the entity’s planned courses of action for the period covered given management’s judgment as to the most probable set of economic conditions (4250.03)
- Forecast dependant on assumptions and translation of assumptions into forecast (quality of data and model)
- Outcome based on intent and ability to execute
- Often sensitive to changes in assumptions
- Traditional evidence gathering techniques may not work



# Soft Issues Often Require Reconsideration of Talent

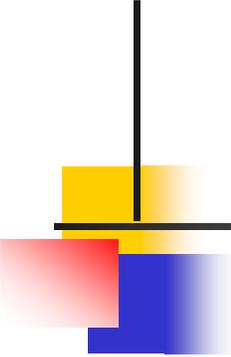
- **Necessary competence and training for assigned duties**
- **Cross-training**
- **Broad functional experience of management**
- **Appropriate consultation with internal and external professionals**
- **Training on new accounting and financial reporting issues and bright lines**
- **Formal job descriptions should consider the exercise of judgment and supervision**
- **Errors and deficiencies are evaluated and remediated**
- **Business changes should initiate a reconsideration of competence of accounting and financial reporting personnel**



## Consider Recognition and Measurement Risks Related to Assumptions

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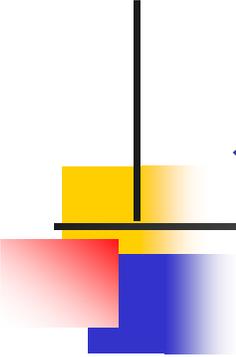
- Difficult to avoid unconscious bias (self-awareness needed)
- Denial is common – confidence is high – technological change and competitor strategies will fail – success is around the corner Reasonable in the circumstances
- No hypothetical assumptions
- Internally consistent
- Consistent with intent, past practices (both prospective and retrospective)
- Suitable external/ internal support exists
- Sufficiently comprehensive to reduce volatility of error when tested retrospectively
- Significant changes in assumptions constitute recognizable “events”



## Consider Measurement Risk Related to the Model

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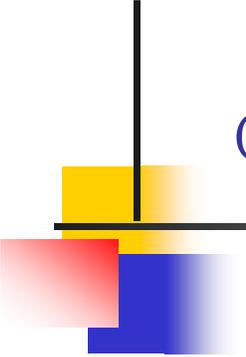
- “All Models are wrong, but some are useful”
- Range of results is plausible when model is stress tested using alternative assumptions
- Hindsight and retrospective assessment does not reflect a bias in results
- Reflective of all assumptions
- Translation of assumptions into the model is appropriate and complete
- Model does not imply other assumptions
- Model changes are reviewed and approved



## Consider Disclosure Risk Related to the Judgment

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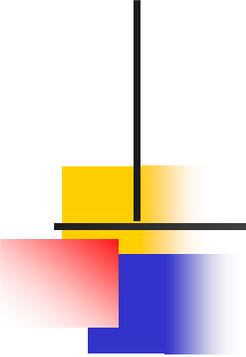
- The degree of volatility or uncertainty should be disclosed if significant – required by GAAP
- Consider the linkage to Disclosure Controls and the MD&A (critical accounting estimates and policies) and Management's and the Board's new responsibilities vis a vis the Certification of Disclosure Controls in 2005



## Consider Measurement Risk Related to Data Quality

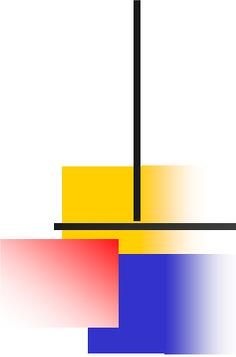
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- Utilize actual data wherever possible
- Minimize the use of proxies
- Statistical characteristics appropriately considered (stratified, seasonal adjustments etc)
- Source is reliable / tested elsewhere



## Is Your Business Information and Control Framework Adequately Documented?

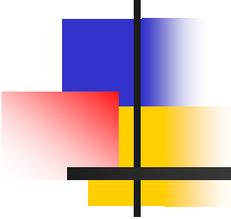
- Prepare templates identifying the required controls
- Document the execution of the control procedures
- Track changes in your assumptions about the future – they may be events requiring recognition
- Collect control related information on actual versus expected business results
  - Reconsider modeling, estimating, judgment processes and quality of personnel/training after comparing actual to expected results



# Documentation Standard

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- Audit Standard
  - If it is not documented it did not happen
- Document
  - Date of Procedure
  - Data, model and assumptions
  - Conclusion
  - Approval in accordance with discretionary authority requirements
  - Evidence of monitoring to ensure the controls were performed



# SOLVING DIFFICULT DISCLOSURE ISSUES

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Brian Ludmer, B.Comm., LLB.

Presentation to LSUC *"12 Minute Securities Lawyer"*  
May 31, 2006