

ALBERTA SECURITIES COMMISSION

DECISION

Citation: Bears paw Opportunity Company Inc., Re, 2010 ABASC 266

Date: 20100616

Bears paw Opportunity Company Inc.

Panel:

Stephen Murison
Roderick McKay, FCA

Representation:

Tracy Clark
for Commission Staff

Rick Skauge
for the Applicant

Submissions Completed:

21 May 2010

Date of Decision:

16 June 2010

I. INTRODUCTION

[1] Bearspaw Opportunity Company Inc. ("Bearspaw") requested that a panel of the Alberta Securities Commission (the "Commission") consider Bearspaw's application for an exemption from the requirement to include audited financial statements in an offering memorandum. The request followed the communication by Commission staff ("Staff") to Bearspaw, in a 19 March 2010 e-mail, of Staff's determination not to recommend the requested exemption. This, therefore, constituted a Commission hearing – based on written submissions – of Bearspaw's application, as contemplated by section 4.7 of Commission Policy 12-601 *Applications to the ASC*.

[2] Bearspaw's 3 May 2010 written submission to the panel – made through its President, Rick Skauge – reiterated the points it made in its 8 March 2010 application to Staff, supplemented with additional argument and documentation. We also received Staff's 10 May 2010 written submission and Bearspaw's 21 May 2010 written reply submission.

II. FACTUAL BACKGROUND AND SUBMISSIONS

[3] Bearspaw is an Alberta corporation incorporated on 3 December 2009. Bearspaw stated – and Staff did not dispute – that it has not yet commenced any operations (apart from preparing an offering memorandum with a view to raising capital) and, as set out in its draft 3 February 2010 unaudited financial statements before us, has as its sole asset cash of \$1000. Bearspaw "was created to raise capital in order to acquire certain residential real estate properties" in Alberta with a view to earning rental income and, if and when it becomes profitable to do so, reselling the properties. Bearspaw wishes to raise up to \$5 million by issuing common shares in reliance on the prospectus exemption under section 2.9(2) of National Instrument 45-106 *Prospectus and Registration Exemptions* ("NI 45-106"). A key condition of this exemption is that the issuer relying on the exemption provide investors with an offering memorandum. For convenience, we will refer to that document as an "OM" and to the exemption as the "OM Exemption".

[4] The required contents of an OM for an issuer such as Bearspaw are prescribed by Form 45-106F2 *Offering Memorandum for Non-Qualifying Issuers* (the "OM Form"). Instruction B.3 to the OM Form states that an issuer whose first financial year is not yet completed, or ends less than 120 days from the date of the OM, must include in the OM financial statements consisting of: statements of income, retained earnings and cash flows for the period from the issuer's inception to a date not more than 90 days before the OM date; a balance sheet as at the end of that period; and notes to the financial statements. Instruction B.9 states that these financial statements must be audited. It follows – as prescribed by section 3.2 of National Instrument 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currency* – that the financial statements in the OM must be accompanied by an unreserved auditor's report on the financial statements.

[5] Bearspaw seeks an exemption, under section 7.1 of NI 45-106, from this audit requirement. The essence of Bearspaw's submissions was that an audit, given its current financial circumstances (according to Bearspaw, it has no liabilities and only the mentioned \$1000 in assets) would be of "no benefit to any party", and that the cost of an audit (which, Bearspaw suggested, would approximate \$3000) would be "prejudicial to investors and contrary

to public policy", being "an additional cost ultimately borne by the investors without any benefit". In support of its application, Bearspaw pointed to two orders granting other applicants exemptions from financial statement requirements. It argued that the granting of those two orders suggested an acceptance of "the premise that audit requirements can be waived if investors are provided with other relevant information and other safeguards are in place". Bearspaw proposed to the panel that, in lieu of an audit, the mandatory OM certificate (certifying the absence of a misrepresentation in the OM) could be expanded to state also that "[Bearspaw] has no liabilities and all costs and expenses relating to the preparation of incorporation documents and this [OM] were donated by the sole shareholder". Bearspaw further proposed that a deferral of the requirement for an audit would be a more meaningful way to protect investors. Bearspaw also presented to the panel letters from two firms of auditors – a 19 April 2010 letter from PricewaterhouseCoopers LLP (the "PWC Letter") and a 30 April 2010 letter from Collins Barrow Calgary LLP (the "CB Letter"). The PWC and CB Letters, Bearspaw claimed, are supportive of its positions on the benefit and cost of an audit in this case and that an expanded OM certificate could suffice in lieu of an audit.

[6] Staff submitted, in response, that the audit requirement for the OM Exemption is "protective of the public interest". To this end, they argued that "[a]n audit is necessary even where an issuer is inactive, has little or no assets, and has only recently been incorporated" because "an audit includes procedures to determine whether an issuer has material future commitments or contingencies that may be potentially detrimental to the financial position and results of operations of the issuer and, as such, may pose potential risk to an investor's investment". Staff also argued that audit costs are not excessive when balanced against the benefits to investors. Staff submitted that the two precedent exemption orders cited by Bearspaw involved the provision of sufficient and more relevant alternative financial disclosure to investors, justifying the relief sought therein – something not offered under Bearspaw's proposals. Staff also submitted that the PWC and CB Letters do not assist Bearspaw.

III. ANALYSIS

[7] In our view, Bearspaw's submissions failed to address the essential function of an audit in the context of securities-offering-related financial disclosure: the audit involves the testing by an independent professional of the information set out in the financial statements, the underlying facts and the procedures followed by whomever prepared the statements. The auditor's report thus provides a measure of independent expert assurance as to the veracity and reliability of the financial statements. In considering whether the exemption sought by Bearspaw would be consistent with the public interest, we therefore focus on the relative benefit and cost of this independent professional testing and reporting.

[8] In so doing, we pay heed to all prescribed components of the requisite financial statements. These include statements of income, retained earnings and cash flows and, in the balance sheet, reports of assets, liabilities and equity. Finally, the financial statements include notes; pursuant to Canadian generally accepted accounting principles ("Canadian GAAP"), these provide the reader with additional information, explanation or commentary on various items set out in the statements, as well as on events occurring between the end date of the period covered and the statements' completion date. The notes may include information about securities

transactions, commercial contracts and other developments material to an understanding of a company's financial position and results of its operations.

[9] We note, further, that Canadian generally accepted auditing standards require an auditor not only to report on the fairness of the financial statement presentation for the period covered, but also to consider events up to the date of the auditor's report. The auditor's report will therefore express an opinion on the fairness of the financial statement presentation in accordance with Canadian GAAP to the end date of the period covered, incorporating material matters affecting the reported financial position and results of operations to a different, more current date, the date of the auditor's report.

[10] In short, the audit requirement for the OM Exemption offers prospective investors a *post facto* independent professional opinion on the fairness with which the tested financial statements present the company's financial position and results of its operations. The significance of the audit requirement lies, in our view, in a combination of factors: the scope of the audit; the currency of the audit and auditor's report; and the independence, objectivity and expertise of the auditor.

[11] These three factors – individually or collectively – are not addressed satisfactorily by Bearspaw's emphasis on its start-up status or its claimed minimal assets and nil liabilities. In our view, the notes to the financial statements contain important information for investors in issuers, whatever their status or substance. For example, subsequent event disclosure could be critical in deciding on the merits of investment in a start-up venture. More to the point, here, we are not persuaded that independent professional testing and assessment of financial statements (including the notes thereto) is necessarily less valuable, from an investor's perspective, for a start-up venture with no "track record" – especially an entity seeking money from investors while it is still, in financial terms, essentially a shell – than for a more established and substantial enterprise.

[12] The public interest in this case does not turn on the mere assurance of prospective investors, by audit or other means, that Bearspaw actually has, as stated, only \$1000 in assets. Indeed, independent or other verification of the existence of Bearspaw's stated minimal assets may well be immaterial to most, if not all, prospective investors. Rather, we see the public interest here in the independent and current assessment of all components of Bearspaw's financial statements and in the independent and current report thereon (potentially addressing, among other things, subsequently-arising material commercial contracts or securities transactions) that would be provided by adherence to the audit requirement.

[13] We do not ignore Bearspaw's proposal of an expanded OM certificate in lieu of an audit. We simply do not perceive such an approach as providing, in the circumstances, benefits equivalent to those provided by the audit requirement, discussed above. First, the standard mandatory OM certificate already requires a statement that the OM contains no misrepresentation, as at the OM date. We note that the particular expansion proposed by Bearspaw adds little of substance to the information found elsewhere in the draft OM (including the incorporated unaudited financial statements) before us. Ultimately – and this we consider

fatal to Bearspaw's position – even the most elaborate imaginable OM certificate cannot provide the independent professional opinion reflected in an auditor's report.

[14] We also note Bearspaw's suggestion that, for issuers raising in excess of \$1 million (at least those "with a small balance sheet"), a more meaningful way to protect investors would be to defer the requirement for an audit until after the completion of an offering. However, as acknowledged by Bearspaw, "this proposal . . . does not protect or deter investors from making the initial investment". And it is obviously those investors, and that initial investment decision, that the OM and the audit and other requirements of the OM Form are designed to inform.

[15] We are not unmindful of the merits, and the importance, of sensibly weighing the costs and benefits of securities regulatory requirements. Clearly, the maintenance of the audit requirement in this case would impose on Bearspaw a cost (approximately \$3000, apparently) significantly in excess of its stated \$1000 in assets. However, we note that the anticipated audit cost would represent a negligible percentage of the money – up to \$5 million – that Bearspaw seeks to raise. We disagree that, "[a]t best, the maximum benefit to be gained by the audit is equal to the amount of the assets and or liabilities", as was contended by Bearspaw. Rather, in our view, the value to prospective investors – who will be invited to hand over millions of dollars – of the assurance they might reasonably be expected to gain from an auditor's report on all aspects of Bearspaw's current financial position and any associated material developments – including reportable subsequent events – could reasonably far exceed the anticipated audit cost.

[16] Our views are not altered by our consideration of the PWC and CB Letters. The PWC Letter noted the value of an audit – "while the financial statements may not be complex, an audit can enhance the degree of confidence that intended users have in the financial statements and . . . can also assist the users in their due diligence process"; and, consistent with our discussion above, the particular expanded OM proposed by Bearspaw "would not replace the value that the users potentially place on an independent audit opinion". The PWC Letter also noted that "[c]ertain users may conclude that the cost of completing these audit procedures on a very simple opening balance sheet . . . outweigh[s] the benefits" and that "[t]he value of . . . independent verification versus having management represent directly to the shareholders in the [OM] for these opening balance sheet audits is based on the user's perspective which will likely vary between users and vary depending on the complexity of the transaction". In other words, while certain prospective investors may question the benefits of an audit in these circumstances, others may reasonably be expected to perceive value; this, then, does not assist Bearspaw.

[17] The CB Letter commented, in respect of liabilities, that an audit of a start-up venture like Bearspaw "is limited to discussing with management as to whether there have been any transactions subsequent to the financial statement reporting date". While we question whether this comment fully describes the required audit process, it does correctly acknowledge the concept of an independent review into subsequent events. The CB Letter also stated: "An audit ensures that the nominal cash raised through share subscriptions exists. As this amount is clearly inconsequential to the overall plan of [Bearspaw] to raise capital, this could be viewed as overkill." This comment is unpersuasive given that, as discussed above, the public interest in this case goes beyond the mere assurance that Bearspaw in fact has the stated \$1000 in assets. The CB Letter went on to suggest that Bearspaw's "financial statements are fairly simple and if

[it] prepares the financial statements with proper care, the risk to investors is low". This comment, too, is unpersuasive. Obviously, any issuer – whatever its substance – that prepares its financial statements "with proper care" diminishes the risk of an investor being misled. The imposition of an audit requirement is not an indication or implication that any particular issuer was or is careless or deceitful, but rather, simply, a means of obtaining assurance that it did indeed apply "proper care" in preparing its financial statements. Finally, the CB Letter suggested an expanded OM certificate as an alternative to an audit, but, as we discussed above, this would not be equally beneficial.

[18] As for the two exemption order precedents cited by Bears paw, we do not consider them to be of assistance to it. Our task in deciding an exemption application is to assess the public interest in light of the facts of each case, and the burden of demonstrating that it is appropriate to depart from prevailing securities laws rests with the applicant in each case. The facts underlying the cited exemption orders differ clearly and materially from those before us. There, alternative approaches to providing equally (or more) relevant financial information were identified. Here, we conclude, for the reasons given, that an audit would provide value and that the two alternative approaches put forward would fail to deliver equivalent benefits.

IV. CONCLUSION

[19] Bears paw's application is therefore denied.

16 June 2010

For the Commission:

"original signed by"
Stephen Murison

"original signed by"
Roderick McKay, FCA