AC Insights

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AC Insights provides audit committee members with a summary of financial reporting developments for public companies using US GAAP, how those developments might affect your company and things you may want to think about when reviewing financial reports.

In this edition

During the fall of 2016, the FASB issued four Accounting Standards Updates consisting of a standard simplification, a narrow scope amendment, an EITF interpretation, and technical corrections to the new revenue standard. This edition outlines the key provisions of these changes. Work continued on two major projects: hedging and accounting for long-duration insurance contracts, as well as several narrow scope amendments, improvements, and simplifications. Certain of these narrow scope projects are expected to be completed by the end of the first quarter of 2017.

In CSA developments, the Alberta Securities Commission has adopted the disclosure requirements about the representation of women on boards and in senior management and expanded the crowdfunding provisions available in Alberta.

The American Institute of Certified Public Accountants (AICPA) hosted their annual conference on Current SEC and PCAOB developments. We have provided the key views of SEC staff and other participants on accounting developments, common issues in financial reporting, non-GAAP measures and internal control over financial reporting. During the fall of 2016, the SEC also made amendments to Regulation D to update some of its requirements for offerings not requiring a registration statement.

CPAB issued its report on its inspection findings of the Big Four public accounting firms. We have summarized those findings in this edition of *AC Insights*. In addition, CPAB published its *Industry Insights* for the oil and gas industry, which provides some questions for audit committees to ask auditors on areas of audit focus.

The Center for Audit Quality (CAQ) in the US has developed a tool to assist audit committees in assessing management's implementation of the new revenue standard. We outline a summary of the tool and a link to the CAQ website.

Contents

US GAAP developments

Income tax consequences of intra-entity transfers

The FASB issued ASU 2016-16: *Intra-entity transfers of assets other than inventory* in October 2016, which simplifies the accounting for tax consequences of intra-entity transfers of assets other than inventory. For transfers of intangibles and property, plant and equipment, income tax consequences will now be recognized when the transfer occurs generally in current income tax expense in the income statement. Previously, the tax consequences were only recognized when the asset was sold to a third party.

The amendments are effective for public business entities for annual reporting periods beginning after December 15, 2017, including the related interim reporting periods. Earlier adoption is permitted at the beginning of an annual reporting period. The amendments are to be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption.

Indirect interests impact on VIE consolidation

In October 2016, the FASB issued a narrow scope amendment to its guidance on consolidation. ASU 2016-17: *Interests held through related parties that are under common control* changes how a decision maker that holds an indirect interest in a variable interest entity (VIE) through a party that is under common control with the decision maker assesses the consolidation consequences.

Currently, a single decision maker may be required to consider all indirect interests in a variable interest entity held through related parties under common control when determining whether it is the primary beneficiary of the VIE. If the related parties are not under common control, the single decision maker only needs to consider indirect interests held through related parties on a proportionate basis. The common control guidance may result in the single decision maker consolidating a VIE even if it has little to no variable interests in the VIE.

Now, indirect interests held by related parties under common control will only be considered on a proportionate basis in assessing whether the single decision maker has the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

If the single decision maker does not have the characteristics of a primary beneficiary of the VIE, the reporting entity would have to evaluate whether it and one or more of its related parties under common control, as a group, have the characteristics of a primary beneficiary. If so, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary.

These changes will make it less likely that a decision maker will consolidate a VIE when it holds a minor indirect interest in the VIE through a non-consolidated common control affiliate.

The provisions are effective for public business entities for fiscal years beginning on or after December 16, 2016, including interim periods within those fiscal years. Earlier adoption is permitted, including in interim periods. Transition provisions will depend on whether the company has adopted ASU 2016-02: *Amendments to the consolidation analysis*, which was issued in February 2015.

Restricted cash in cash

On November 17, 2016, the FASB issued ASU 2016-18: *Restricted cash,* a consensus of the Emerging Issues Task Force. The Update will require companies to explain in the statement of cash flows the change during the period in total cash, cash equivalents, and amounts generally described as restricted cash and restricted cash equivalents. This change has been made to eliminate the diversity in practice in classifying restricted cash in the statement of cash flows.

The new provisions will require restricted cash and cash equivalents to be combined with unrestricted cash and cash equivalents when reconciling the beginning and ending balances in the statement of cash flows. The Update does not define restricted cash, but requires disclosures of information about the nature of restrictions on cash balances and how the amounts in the statement of cash flows reconciles to the balance sheet when the balance sheet includes more than one line for cash, cash equivalents and restricted cash.

As restricted cash will be included with unrestricted cash, transfers between restricted and unrestricted cash will no longer be reported as cash flows within operating, investing, and financing activities. However, the receipts from or payments to third parties will be classified as operating, investing or financing cash flows.

For public business entities, the Update is effective for fiscal years beginning on or after December 15, 2017, and the related interim periods. Early adoption is permitted, including in an interim period. The amendments are to be applied retrospectively.

Technical corrections for new revenue standard

The FASB has adopted several technical amendments to clarify the new revenue standard and other standards or to correct unintended consequences in the application guidance. These changes, presented in ASU 2016-20: *Technical corrections and improvements to Topic 606, Revenue from contracts with customers,* are narrow and not expected to have a widespread impact on current accounting practice.

The resolution of several issues identified through the FASB processes are outlined in the ASU as follows:

- Guarantee fees within the scope of Topic 460: *Guarantees* are not within the scope of Topic 606. Guarantees accounted for as derivatives are subject to guidance in Topic 815: *Derivatives.*

- Testing for impairment of contract costs related to revenue contracts should (a) consider expected contract renewals and extensions, and (b) include both the amount of consideration already received but not recognized as revenue and the amount expected to be received in the future.

- Impairment tests should be performed in the following order: (1) assets within the scope of Topic 350: *Intangibles – Goodwill and other* or Topic 360: *Property, plant and equipment*; (2) assets within the scope of Topic 340: *Other assets and deferred costs – Contracts with customers;* and (3) asset groups and reporting units within the scope of Topic 360 and Topic 350.

- The provision for losses on onerous contracts should be determined at least at the contract level; however, companies may elect to determine the provision at the performance obligation level.

- All contracts within the scope of Topic 944: *Financial services – insurance* are excluded from the scope of Topic 606.

- Optional exemptions from the disclosure requirement for remaining performance obligations have been provided for specific situations in which an entity need not estimate variable consideration to recognize revenue. Additional disclosures are required when one of these optional exemptions are used.

- Disclosure of revenue recognized in a reporting period from performance obligations satisfied or partially satisfied in previous periods applies to all performance obligations, not only those with corresponding contract balances.

- Certain examples illustrating various principles have been revised to eliminate concerns raised by some stakeholders (Example 7 of Topic 606 illustrating contract modifications; Example 38, Case B illustrating the presentation guidance on contract assets and receivables; and Example 40 illustrating the recognition of a receivable and a refund liability).

- The guidance on accruing advertising costs previously included in Topic 340: *Other assets and deferred costs* and removed when the revenue standard was issued has been reinstated and included in Topic 720: *Other expenses.*

- Fixed odds wagering contracts are excluded from the scope of Topic 924: *Entertainment – Casinos* and Topic 815: *Derivatives* and are within the scope of Topic 606.

- Cost capitalization for advisors to private funds and public funds has been aligned with guidance in Topic 946: *Financial services – Investment companies.*

These amendments have the same effective date and transitional requirements as the new revenue standard.

CSA developments

Alberta adopts disclosure about women on boards and in senior management

The Alberta Securities Commission announced on December 15, 2016 that it would adopt the provisions to NI 58-101: *Disclosure of Corporate Governance Practices* related to disclosures about the representation of women on boards and in senior management of reporting issuers. These amendments will require reporting issuers in Alberta to provide annual disclosures about:

- Any policies regarding the representation of women on the board of directors;
- The consideration of the representation of women in the director identification and selection process;
- The consideration of the representation of women in executive officer positions when making such appointments;
- Targets for the representation of women, if any;
- The number of women on the board or in executive officer positions; and
- Any director term limits or other mechanisms of board renewal.

These amendments are effective as of December 31, 2016.

Crowdfunding availability expanded in Alberta

The crowdfunding prospectus exemptions were expanded in Alberta on October 31, 2016 by the adoption of Multilateral Instrument 45-108: *Crowdfunding*. This instrument is viewed as being complementary to ASC Rule 45-517: *Prospectus exemption for start-up businesses* and will allow moderate financings to be raised through an online funding portal across multiple jurisdictions in Canada.

The Instrument permits:

- Individual investments by investors of $2,500 per distribution, unless the investor is an accredited investor for which the limit is $25,000; and
- Offerings of up to $1,500,000 during a 12-month period.

These offerings must be made using a registered funding portal.

The two sets of rules will provide attractive financing opportunities for companies to raise funds in Alberta and across Canada.

SEC developments

Current SEC developments

The Annual AICPA National Conference on Current SEC and PCAOB Developments was held in early December 2016 in Washington. At the Conference, representatives from the SEC, the FASB, the IASB, and the PCAOB shared their views on various accounting, financial reporting, and audit issues.

The SEC staff continued to stress the importance of the role of audit committees in the financial reporting process, including having effective communications with the auditors. The SEC Chief Accountant recommended that audit committees should ensure that cost-cutting initiatives do not adversely affect the audit scope, staffing, or compensation.

Some key messages from the Conference

The IASB and FASB outlined the implementation efforts related to *significant new accounting standards* on revenue, leases, and financial instruments. The SEC staff indicated they are working with companies on pre-filing submissions on accounting positions and encouraged preparers to implement the new standards in a timely manner, in accordance with the objectives of those standards. The SEC staff also emphasized the importance of robust disclosures about the qualitative and quantitative impact of the new standards on a company's financial reporting and the status of its implementation efforts.

Non-GAAP measures were addressed by regulators, standard setters, investors, and preparers. The SEC staff noted improvements in compliance with its staff interpretations, but observed that some companies still need to address the appropriateness of and prominence given to non-GAAP measures. The SEC staff also noted concerns about non-GAAP measures that are shared internationally with standard setters and other securities regulators. The SEC staff has indicated they would likely not object to certain adjustments made in non-GAAP measures for share-based compensation, discrete restructuring charges, and the elimination of the effects of recording inventory or deferred revenue at fair value in a business combination.

Registrants were reminded of the importance identifying, evaluating, and disclosing material weaknesses on a timely basis. This requires an appropriate assessment of *internal control over financial reporting* by management and an effective audit by the independent auditor, if applicable. In reference to recent enforcement action, the SEC staff emphasized management's responsibility to (a) carefully identify the severity of identified deficiencies, and (b) maintain competent and adequate accounting staff. In addition, preparers were reminded of the importance to update and maintain effective internal controls as significant new accounting standards on revenue, leases and financial instruments are implemented.

New standards

Revenue

The SEC staff reminded registrants to disclose the effects of adopting new accounting standards in accordance with the SEC Staff Accounting Bulletin Topic 11.M. Qualitative disclosures should include a description of the new standard's effect on the company's accounting policies and a comparison to the company's current account policies. Reasonable estimates of the quantitative impact should be provided, even if only available for some of the company's product lines or revenue streams. If reasonable estimates are not available, this fact should be disclosed. If the information provided may subsequently change, this fact should also be disclosed.

The SEC staff discussed some matters that have been raised by registrants with the Office of the Chief Accountant. Their observations are outlined below.

- The SEC observed that the definition of a contract is based on enforceable rights and obligations in an existing contract. Future or anticipated contracts are not included in the definition and should not be accounted for as a revenue contract. Further, contracts with different customers cannot be combined as a single contract.

- The accounting for payments made to customers will depend on the specific facts and circumstances. First, a company needs to determine the nature and substance of the payments. Companies should consider why the payment is being made, how the payment is described to investors, the terms and conditions of the payment, the nature of the relationship with the customer, and the rationale for the accounting conclusions made.

- The determination of whether a company is the principal or agent in a revenue transaction can be challenging and the conclusions under the new standard may be different from existing GAAP conclusions. Companies will have to revisit their current assessments considering the specific facts and circumstances of the arrangement. The SEC staff reminded registrants that disclosures of the determination are important to provide an understanding to investors.

- Registrants were also cautioned that the SEC staff will look to information outside the financial statements to determine the adequacy of disclosures of disaggregated revenue (by type of goods or services, geographic region, customer).

Credit losses

The new standard on credit losses will apply to a wide range of financial assets and the SEC staff encourages registrants to start the implementation process early.

The SEC staff expects its Financial Reporting Release 28 and SAB 102 will continue to be relevant when applying the standard as companies will need to consider reasonable and supportable forecasts.

Financial instruments recognition and measurement

For hybrid financial liability instruments (for example, a debt obligation indexed to the price of gold and requiring a cash settlement), an entity can irrevocably elect to measure the entire instrument at fair value through earnings. The SEC staff believes that the impact of a change in instrument-specific credit risk should be presented in accordance with the new guidance, which requires such changes to be presented separately in OCI.

Recast financial statements in registration statements

If a company selects or is required to use a full retrospective transition method to adopt a new standard, it must provide retrospectively recast financial statements for the most recent annual periods required to be included or incorporated by reference in a registration statement. For the revenue standard, if the modified retrospective method is used, financial statements will not have to be recast before the date of adoption. For the leases standard, the modified retrospective method requires the prior comparative year to be restated which will require financial statements for a registration statement to be recast.

The SEC staff also indicated that they will not object if companies and their securities counsel conclude that the adoption of new accounting standards are not "fundamental changes" for purposes of drawing on an effective shelf registration.

Current financial reporting issues

The SEC staff in the Office of the Chief Accountant and the Division of Corporate Finance made several comments on some issues noted in pre-filing consultations and financial statement reviews.

Accounting policies

A change in accounting principle is only permitted if the alternative accounting principle is allowed and preferable to the current policy that is applied. The SEC staff has indicated that judgment is required when determining whether transactions or events are clearly different in substance from those occurring in the past and could warrant adoption of a new accounting principle. A well-documented analysis is required about the existing accounting policy and the transactions and events it is applied to, and the differences warranting the adoption of a new accounting policy.

Equity method accounting and definition of a "public business entity"

Certain SEC rules require financial statements or summarized financial information to be provided for equity method investees. When such information is required, the equity method investee is subject to accounting standards for public business entities, including the applicable effective dates. This would not be the case for equity method investees for which financial statements or summarized financial information is not required to be filed or included in SEC filings.

Joint ventures, strategic alliances and other collaborative type arrangements

Registrants are encouraged to identify the applicable accounting guidance consistent with the facts and circumstances of the arrangement. This may include guidance on consolidation, equity method investees, industry specific joint ventures, collaborative arrangements, and revenue.

Income tax disclosures

Improvements are still necessary in the presentation of the income tax rate reconciliation and disclosures about changes to valuation allowances, unrecognized tax benefits, and the indefinite reinvestment in foreign entities assertion. Often these disclosures are boilerplate and not meaningful. The SEC also continues to question management's assertion that remittances to the parent company will be postponed indefinitely, particularly, when other disclosures contradict the assertion.

The quality of MD&A disclosures also needs improvement to tell the complete story about the company's tax positions, related trends, and uncertainties. MD&A disclosures should cover changes in the statutory and effective tax rates, changes in reconciling items between the effective and statutory rates, the extent to which the effective tax rate is indicative of the future tax rate, the effect of taxes on liquidity, and uncertainties related to tax positions taken.

Discount rates for defined benefit pension plans

The SEC staff has concluded that the measurement of the pension benefit obligation (PBO) and the determination of interest cost are integrated concepts. Accordingly, companies should measure the PBO first and then attribute the change in the PBO to various components of net pension cost, including interest expense. The interest expense should be based on the same information used to measure the PBO.

Share-based payments grant date

Some share-based payment awards may include key terms or conditions subject to the discretion of the compensation committee or board of directors. The SEC staff noted that when determining whether a mutual understanding has been reached and a grant date established, a registrant would have to assess past practices of the compensation committee or board and how those practices evolved over time.

Operating segments

Some registrants have asserted that a component is not an operating segment because no operating costs are allocated to the component. The SEC staff has noted that gross margins provided for a component may indicate that discrete financial information is available and the component may be an operating segment.

When considering aggregation of operating segments into reportable segments, registrants need to critically examine all of the aggregation criteria and all of the economic characteristics (quantitative, qualitative, and consistency with the overall principle), rather than only looking at quantitative characteristics.

Acquisitions and business combinations

Measurement period adjustments must be reflected as adjustments to the provisional amounts when new information is obtained during the measurement period about facts and circumstances that existed as of the acquisition date. The SEC staff reminded registrants that the measurement period is not one year, but only the period during which the additional information becomes available, which should not exceed one year.

Carve-out and proforma financial statements

The SEC staff noted that a lack of authoritative guidance for the preparation of carve-out financial statements has resulted in significant diversity in practice and can delay offerings. Questions can arise on the definition of a business, the treatment of shared assets and liabilities, the bifurcation of assets, liabilities, revenues, and expenses, goodwill identification and impairment, allocation of corporate costs, and treatment of intercompany transactions. The SEC staff has indicated that authoritative guidance in this area would be beneficial.

Modernizing Regulation D offerings

Regulation D of the *Securities Act* (USA) provides exemptions from the registration requirements of the *Securities Act* for certain offerings; however, registration is still required in each state in which the securities are offered or sold under the exemption. Regulation D is available to foreign issuers, except for investment companies, *Exchange Act* reporting companies, and development stage companies. During the period from 2009 to 2015, 2% of offerings were initiated by foreign incorporated issuers.

To streamline and modernize capital-raising options for start-ups and small businesses, the SEC has amended Rules 504 and 505 of Regulation D by:

- Raising the aggregate amount of securities an issuer may offer and sell under Rule 504 in any 12-month period from US$1 million to US$5 million;

- Introducing a "bad actors" provision which will disqualify certain issuers from issuing securities under Rule 504, similar to other current provisions in Regulation D, Regulation A and Regulation Crowdfunding; and

- Repealing Rule 505, which allowed exempt offerings in the range from US$1 million to US$5 million.

While these changes will reduce certain requirements for start-ups and small businesses, these companies have various alternative methods of raising financing under the *Securities Act*. They will have to carefully consider which method best suits their needs.

Auditing developments

Findings of 2016 CPAB inspections

In November 2016, CPAB released its *2016 Big Four Inspections Report* outlining its findings of its inspection of Canada's four largest public accounting firms – Deloitte LLP, EY LLP, KPMG LLP, and PwC LLP.

Overall, CPAB found that initiatives by the Big Four have enhanced audit quality and most public company audits in Canada are well done. However, CPAB's inspections found some exceptions to the execution of audits in accordance with the audit methodologies and quality systems of the firms.

In 2016, CPAB focused their inspections of the Big Four on audits of smaller reporting issuers. These inspections resulted in significant findings in 11 files out of 87 examined. This is a reduction from 24 deficient files out of 93 inspected in 2015. A significant inspection finding is a deficiency in the application of generally accepted auditing standards that could result in a restatement of the financial statements.

The CPAB report identifies five key areas of concern:

- Auditing of significant accounting estimates, particularly complex estimates where the auditor may use the work of management's experts.

- Execution of basic audit procedures, such as selecting samples for testing and executing account-specific testing (for example, physical inventory counts, and testing existence of additions to property, plant, and equipment).

- Assessment of the risk of material misstatement when applying professional judgment and scepticism. Professional judgment and scepticism are necessary to design and execute adequate testing to match the risk, particularly to (a) corroborate management's evidence to ensure it is reliable, and (b) to challenge information provided by management when there is conflicting evidence.

- Testing of internal control, particularly for management review controls and controls over computer systems when relying on system-generated information.

- Failure to obtain an accurate or complete understanding of the underlying business and accounting processes resulting in insufficient or ineffective audit procedures or reliance on audit evidence of limited value.

Further details on the inspection findings, CPAB's concerns, and points for audit committees can be found in the report as well as in *CPAB 2016 Big Four Public Report: Highlights for Audit Committees*. PwC provides a full copy of the CPAB report to audit committees as part of our protocol with CPAB.

CPAB oil and gas industry insights

In October 2016, CPAB published *Industry Insights – Oil and Gas,* which discusses certain areas of focus for audits of companies in the oil and gas industry. The publication includes several questions audit committees may consider in carrying out their oversight role of the auditors.

The publication identifies six areas of focus for possible discussion by audit committees. Discussions of these topics may depend on the risks and materiality in the particular business.

The areas of audit focus include:

- The impact of economic uncertainty on the going concern assumption and maintenance of debt covenants. In these situations, CPAB notes that the auditor may need to assess management's evaluation of future cash flows and the impact of current and expected economic conditions on the future operation of the company; the classification of debt on the balance sheet; and disclosures about uncertainties. CPAB also observed that internal controls may be impacted by staff reductions and cost cutting. These types of initiatives may affect management's judgment and estimates in complex areas such as impairment, recoverability of deferred income taxes, unusual transactions, and going concern disclosures.

- Financial statement estimates may be supported by evaluation reports on estimates of oil and gas reserves, resources other than reserves and unproved properties. CPAB indicated that the auditor may need to assess the objectivity, competency, and capabilities of experts used to prepare evaluation reports, to test the operating effectiveness of internal controls over the development of evaluation reports, and to assess the reasonability of significant judgments and assumptions made by management.

- The appropriate classification of costs as assets or expenses often requires judgment and established accounting policies and procedures to assist a company's staff in appropriately classifying costs. CPAB's insights noted that the auditor may need to test the operating effectiveness of controls over cost classifications, and perform tests of details to assess the classification of costs.

- Projects in foreign jurisdictions may create additional challenges for auditors and audit committees. The auditor of the parent company (the group auditor) may use the work of a local auditor and is responsible for the overall audit strategy and audit plan, including effective supervision of the local auditor's work. To identify audit risks and develop an appropriate audit strategy, CPAB highlighted that the group auditor needs to be aware of business practices, legal structures, customs, and cultural norms in the foreign jurisdictions.

- Companies may adopt income tax strategies to optimize taxation across multiple jurisdictions. These strategies may involve complex arrangements, including intercompany financing arrangements, transfer pricing and uncertain tax positions. CPAB observed that the auditor may need to involve tax specialists to evaluate the income, commodity, or other tax consequences of these strategies.

- Companies may have legal or constructive obligations to decommission or clean-up sites, which are recognized as liabilities before the costs may be funded. Auditors may rely on internal and external experts to assess management's estimates of future decommissioning and environment remediation costs. CPAB noted that the auditors will need to assess the extent of reliance on these experts and whether the auditor needs to involve its own specialists.

A copy of the publication can be found on the CPAB website (www.cpab-ccrc.ca) or from a member of your engagement team.

Center for Audit Quality Tool

The Center for Audit Quality (CAQ) has released a tool to help audit committees assess a company's implementation of the new revenue recognition standard. The CAQ tool provides audit committees with information that may be helpful in understanding a company's implementation of the new standard including:

- Understanding the core principles of the new revenue standard;
- Evaluating how revenue will change for the company;
- Evaluating the company's implementation plan; and
- Considering other implementation matters, such as the transition provisions and the new disclosure requirements.

The tool also provides a list of resources on revenue recognition developed by various parties to assist companies with implementation.

While the tool is developed based on the US GAAP standard, the tool may be beneficial for companies using IFRSs as the US GAAP and IFRS standards are virtually identical.

The tool can be accessed through the CAQ website at www.thecaq.org.