AC Insights

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AC Insights provides audit committee members with a summary of financial reporting developments for public companies using IFRS, 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 IASB completed its work on a narrow scope amendment on transfers of investment property, and its latest cycle of annual improvements. The Interpretations Committee also finalized its interpretation related to foreign currency transactions. This edition outlines the key provisions of these changes. The IASB is also finalizing its new standard on insurance contracts and expects to issue a final standard in March 2017. Work continues on other projects, in particular, the disclosure initiative, primary financial statements, financial instruments with characteristics of equity, rate regulated activities, and the conceptual framework.

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 provide a link to the CAQ website.

Contents

IFRS developments

Transfers of investment property

In December, the IASB amended IAS 40: *Investment property* to clarify the principle that transfers property to or from investment property is limited to situations resulting in a change in use of the property. The amendments reflect that a change in use involves both (a) an assessment of whether a property meets or ceases to meet the definition of any investment property; and (b) evidence supporting a change in use. The list of conditions included in IAS 40 has been recharacterized as a non-exhaustive list of examples.

These changes clarify that (a) a change in intention, in isolation, is not sufficient to support a transfer; and (b) assets under construction or development may be transferred to or from investment property before the projects are completed.

These amendments are effective for annual periods beginning on or after January 1, 2018. Earlier adoption is permitted. These amendments may be adopted prospectively with a cumulative adjustment to opening retained earnings, or retrospectively without the use of hindsight.

Annual improvements approved

The IASB made two improvements to its standards in December 2016. These are minor amendments arising from issues identified from 2014 to 2016.

Disclosures about entities classified as held for sale

This amendment clarifies that the disclosures required by IFRS 12: *Disclosures of interests in other entities* are applicable to interests in entities classified as held for sale, except for the summarized financial information of the entity held for sale. Previously, it was unclear whether all other IFRS 12 requirements were applicable for these interests.

IFRS 12 will require information about nature of interests in other entities held for sale, risks associated with these interests, and the effect of these interests on financial statements.

These amendments are to be applied retrospectively for annual periods beginning on or after 1 January 2017.

Measurement of investments by entities using fair value

Under IAS 28: *Investments in associates and joint ventures,* venture capital organizations, mutual funds, unit trusts, and similar entities may elect to measure their investments in associates or joint ventures at fair value through profit or loss. This amendment clarifies that this election should be made separately for each associate or joint venture when the investment is initially recognized.

These amendments are to be applied retrospectively for annual periods beginning on or after 1 January 2018. Early application is permitted.

Foreign currency transactions

IFRIC 22: *Foreign currency transactions and advance consideration* addresses the issue of what exchange rate to use to measure foreign currency transactions, under IAS 21: *The effects of changes in foreign currency rates*, when an entity pays or receives advances before the transaction date. The question asked of the Interpretations Committee is whether the exchange rate used to measure a foreign currency transaction in this situation should be the rate when the transaction is initially recognized as an asset, expense or income, or the rate when the advance is originally paid or received.

The Interpretations Committee concluded that the exchange rate should be the rate used to initially measure the non-monetary asset (prepaid asset) or liability (deferred credit) when the advance was made. If there were multiple advances, each receipt or payment would be measured at the date the non-monetary asset or liability is recognized.

This interpretation is effective for annual periods beginning on or after January 1, 2018. Earlier adoption is permitted. The interpretation can be applied retrospectively for all periods presented, prospectively for transactions recognized after the beginning of the reporting period that the interpretation first applies, or the beginning of a prior period presented for comparative purposes in which the entity first applies the interpretation.

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.

Financial reporting issues (FASB)

The SEC staff noted that the areas of focus and comments received by registrants using IFRSs are generally consistent with those received by registrants using US GAAP. The key areas of focus are revenue recognition, income taxes, fair value measurement, segment reporting, intangibles and goodwill, acquisitions and business combinations, and commitments and contingencies.

Some SEC staff observations made at the Conference relevant to these areas of focus include:

- 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.

- Income tax disclosures
  - Improvements are still necessary in the presentation of the income tax 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.
  - MD&A disclosures should also cover changes in the statutory and effective tax 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.
- 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 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.