AC Insights

Spring 2017 – Issue C2017-2

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

There were no new IFRS standards or amendments or interpretations to IFRSs issued during the first quarter of 2017. We have provided a summary of amendments to standards that are effective for years beginning after January 1, 2017. The changes are limited and provide companies with ample opportunity to work on the implementation of some major new standards effective for 2018.

In this edition, we report on several CSA developments resulting from reviews of continuous disclosure documents, enforcement actions, and staff notices. The findings on a review of disclosures of investment entities, cyber security risks and incidents, and disclosures through social media were released during the quarter. In addition, the CSA *2016 Enforcement Report* was published. In addition, a staff notice was issued to outline voluntary protocols to improve the tabulation of vote proxies.

In SEC developments, we provide the annual list of highly inflationary companies that was discussed with the SEC staff late last year. On the technology front, the SEC has published the XBRL taxonomy for IFRS, which will require foreign private issuers to provide XBRL data, and hyperlinks to exhibits will be required in many filings. These developments are summarized in this edition.

CPAB has been working with several companies on a pilot project on audit quality indicators. Their interim report on this project is summarized under Auditing developments.

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IFRS developments

Changes affecting 2017

Changes to standards affecting financial statements for years beginning on or after January 1, 2017 are minimal. Two changes relate to disclosures for annual financial statements. The other change that amends the income taxes standard will affect a limited number of companies.

While these changes for 2017 are minimal, companies should be preparing for the adoption of some significant changes that are effective for 2018. Virtually all companies will be affected by the new revenue standard, IFRS 15: *Revenue from contracts with customers*. In addition, the final standard for recognizing and measuring financial instruments, IFRS 9: *Financial instruments,* will require changes by many companies that hold investments or apply hedge accounting.

The following table summarizes the three changes that are effective for 2017.

Standard	Amendments	Summary of changes
IAS 7: *Statement of cash flows*	Changes in liabilities arising from financing activities	New disclosures are required about the changes in debt and similar liabilities arising from financing activities, including those resulting from cash flows, changes of control, changes in foreign exchange rates, changes in fair value, and other changes. Disclosures are required in annual financial statements only. Comparative disclosures are not required in the first year of application.
IAS 12: *Incomes taxes*	Recognition of deferred taxes for unrealized losses	The amendment clarifies the guidance on recognizing deferred tax assets when there is an unrealized loss due to fair value changes for assets measured at fair value. The amendment is to be applied retrospectively.
IFRS 12: *Disclosure of interests in other entities*	Disclosure about entities held for disposal	The amendment clarifies that disclosures under IFRS 12 are required for subsidiaries, joint ventures and associates held for disposal and discontinued operations, except for certain summarized financial information for such entities. These disclosures will initially be required in the annual financial statements, with comparative information for the prior year.

CSA developments

Investment entities asked to improve financial disclosures

In March 2017, the Ontario Securities Commission (OSC), the Alberta Securities Commission (ASC) and the Saskatchewan Securities Commission (SSC) released their report on key findings of a review of continuous disclosures by reporting issuers that are identified as investment entities under IFRS 10: *Consolidated financial statements*. The review applied to investment entities that are not investment funds under NI 81-106: *Investment fund continuous disclosure*.

The review was initiated by the OSC staff in response to the increase in the number of reporting issuers that have determined they are investment entities. Investment entities, generally, measure their investments at fair value through profit or loss, including their investments in subsidiaries.

Five of the 12 reporting issuers reviewed were found to have material disclosure non-compliance issues. The deficiencies included insufficient discussion of the entity's operations, investments, and risks; undue prominence of non-GAAP measures; lack of information about significantly concentrated investments or investments in emerging markets; failure to disclose and/or file material contracts; and lack of governance disclosures. These companies were placed on the OSC Refilings and Error List.

The review also resulted in some issuers agreeing to prospective disclosure enhancements.

Financial statements

The OSC staff reviewed some of the issuers' assessments of whether an issuer was an investment entity as defined in IFRS 10. The OSC staff did not object to any issuer's determination. However, the reviews highlighted the need for additional disclosures to understand the operations and risk profile of the entity and how those items affected the judgment made by the issuer.

The majority of investment entities provided disclosures about their specific investments, costs and fair values. Where such information was aggregated by industry, geography or another categorization, the OSC staff requested further disclosure by investment in the MD&A.

The OSC staff requested some entities to disaggregate fair value gains and losses to segregate realized and unrealized amounts, as well as reversals of previous unrealized fair value changes.

Questions were also raised about the fair value measurements used, particularly when non-independent transaction prices or outdated independent transaction prices were used. The OSC staff also encourages the use of independent valuation experts for significant investments with fair value measurements based on Level 3 of the fair value hierarchy (that is, when some inputs are unobservable).

IFRS 13: *Fair value measurement* specifies certain disclosures. The OSC staff found that some investment entities provided detailed information while others provided generic or vague information. Improvements were needed to provide more information about the valuation techniques used, the inputs used in certain cases, and the sensitivity of the fair value measurement in certain cases.

MD&A

Comments for improved disclosures were raised when the discussion of an entity's performance did not disclose material changes to the composition of the investment portfolio and the key drivers of significant changes to fair value by investment. The staff expects a complete analysis of the financial and operational trends considered in the determination of the fair value for a material investment.

Several of the investment entities reviewed had a single investment that represented 40% or more of the fair value of their portfolios. The OSC staff expects sufficient disclosure about such investments. This might include

summarized financial information for significant investments along with a discussion of those results.

The report states that many investment entities have complex management fee structures and these structures and the amounts paid or accrued should be disclosed in detail in the MD&A, including any impact of these fee structures on distributions made to investors.

Other continuous disclosure documents

The OSC staff also asked companies to provide more detailed disclosure in the Annual Information Form about investment selection and criteria, related party transactions, corporate structure, investee specific risk factors, and material contracts.

Some investment companies use an external management company to manage the activities of the investment entity. In addition, some of the functions delegated to an external investment manager may include substantive management functions. The report highlights the need for enhanced disclosures for such management contracts and compensation paid to executives at these types of companies.

Considerations and illustrative examples

The report includes points for investment companies to consider when preparing their disclosures, as well as, illustrative examples of enhanced disclosures. Management at investment companies will likely want to carefully read the report and consider what enhancements to make to their disclosures in their future filings.

Cyber security a material risk for many reporting issuers

The CSA has identified cyber security as a priority area for its 2016-2019 Business Plan. In 2016, the staff of the British Columbia Securities Commission (BCSC), the Ontario Securities Commission (OSC), and the Autorité des marchés financiers (AMF) conducted a review of disclosures about cyber security risks published by certain reporting issuers. The findings of this review were published in January 2017 in Multilateral Staff Notice 51-347: *Disclosure of cyber security risks and incidents.*

The review focused on disclosures of reporting issuers included in the S&P/TSX Composite Index. This review included the respective reporting issuers' annual information forms, MD&A, management information circulars, material changes reports, and news releases.

Risk factor disclosures

Sixty-one percent of the issuers reviewed addressed cyber security issues in their disclosures, particularly their dependence on information technology systems. Many acknowledged that cyber security risks was a material business risk. Some companies disclosed their businesses may be targets of cyber surveillance or cyber-attacks and the risks from reliance on third party service providers.

The disclosures by these companies indicated disruptions due to cyber security incidents could adversely affect their business, results of operations, or financial condition. This may result from, among other things, the release of confidential, proprietary or sensitive information; the destruction or corruption of data; the failure to comply with privacy and information security laws; higher insurance costs; reputational harm; and/or ineffective internal control over financial reporting. A cyber security incident may also have a number of operational impacts.

Some issuers addressed who was responsible for the issuer's cyber security strategy. Parties identified as being responsible for overseeing and managing this risk included the audit committee, a risk committee, the board of directors and management as a whole, the chief financial officer, or the chief information technology officer.

Some issuers disclosed mitigating factors such as a disaster recovery plan and controls over unauthorized access. Few companies mentioned insurance coverage.

The CSA expects issuers to provide detailed and entity specific disclosures when cyber security risk is a material risk, considering the probability of a breach occurring and the anticipated magnitude of the breach. The disclosures should be tailored to the individual issuer's circumstances.

The staffs expect issuers to consider factors identified by IOSCO report on cyber security coordination efforts: *Cyber Security in Securities Markets – An International Perspective* (April 2016). Factors to consider include:

- the source and nature of the risks,
- potential consequences of a breach,
- adequacy of preventative measures,
- the impact of prior breaches,

- how the risks are mitigated, including insurance coverage,
- use of third party experts as part of their strategy,
- remediation plans for prior or future attacks, and
- the committees or persons responsible for the cyber security and risk mitigation.

Issuers were also reminded to establish and maintain disclosure controls and procedures to include cyber security incidents.

Cyber security incidents

None of the issuers reviewed reported a material cyber security incident.

Issuers were reminded to report a cyber security incident if it is a material fact or a material change. The report includes guidance on assessing whether one or more incidents are material. The CSA expects any cyber-attack remediation plan to address how materiality of the incident should be assessed for purposes of determining if, when, how and what disclosures should be made if an attack has occurred.

Next steps

With the increased concerns over hacking and its consequences, reporting issuers should be reviewing their own internal practices, procedures and controls to ensure information is disclosed about the issuer's exposure to such risks, how the issuer mitigates the risks, and any material cyber incidents that have occurred and their consequences.

Use of social media raises concerns over quality of disclosures

Social media disclosures made by 111 reporting issuers in Alberta, Ontario and Quebec were reviewed by the staffs of the Alberta Securities Commission (ASC), OSC, and AMF during 2017. Seventy-two percent of these issuers actively used a social media platform for disclosures. These disclosures included information posted on Facebook, Twitter, YouTube, LinkedIn, Instagram, Google Plus and other platforms. In addition, issuer websites, message boards and blogs were considered. This information was assessed against the requirements of NP 51-201: *Disclosure standards* and NI 51-102: *Continuous disclosure obligations.*

The staffs uncovered deficient disclosures for about 25% of the issuers reviewed, which might have resulted in material stock price movements. In those cases, the issuers provided clarifying disclosure on SEDAR and/or removed the social media disclosure or committed to improve prospective social media disclosures and/or their internal controls and policies.

Selective or early disclosures

The report notes that selective or early disclosure of material information may have been made to some investors through social media when the information was not disclosed generally. This included:

- Disclosure of forward looking information, such as revenue, earnings per share and cash flow targets, only on social media.
- Lack of coordination of timing about social media announcements and general disclosures.
- Information provided by third party posts on social media which indicated a material event had occurred, but the issuer had not disclosed the event through continuous disclosures or otherwise.

Misleading or unbalanced disclosures

It was noted that certain disclosures on social media were misleading or unbalanced as the information was not sufficient to present a complete picture or the information was inconsistent with information already disclosed on SEDAR. Instances mentioned in the report include:

- Disclosures were untrue or promotional. In some cases, the information was inconsistent with information provided on SEDAR, such as the use of non-GAAP financial measures not disclosed in continuous disclosure documents.
- Constraints on social media content often limits the amount of text in a single post. Some issuers have provided links to analysts' reports and other commentary without prominent disclosure of relationships with the writers or providing the names and/or recommendations of all independent analysts covering the issuer.

Insufficient governance policies over social media disclosures

A significant number of issuers did not have policies, procedures, or controls in place to ensure the integrity of their social media disclosures.

The report recommends a social media governance policy consider who can post information; what types of sites can be used; what types of information can be posted; what approvals, if any, are required; who is responsible for monitoring social media accounts; and other relevant best practices to ensure the principles of disclosure are met.

Next steps

The prominence of social media as a communication tool is clearly evident and far-reaching. We have all seen or heard of the consequences of a poorly planned posting. Companies should ensure any disclosures that relate to material facts or material changes and information important to investors are provided through all the appropriate outlets and subject to the same scrutiny as news releases and other filings.

Enforcement actions highlighted in CSA 2016 Enforcement Report

In January 2016, the CSA released it *2016 Enforcement Report,* which highlights the type of actions taken by the CSA members, the nature of the wrongdoings, and the fines and penalties imposed on market participants.

The enforcement actions of the CSA members resulted in several significant jail terms for some individuals; fines, administrative penalties and other payments totaling over $62 million; and restitution, compensation, or disgorgement amounts of approximately $350 million. The CSA also works with other law enforcement agencies, resulting in 13 individuals being found guilty by the courts under the *Criminal Code.*

The *Report* also includes further details on the outcomes of enforcement action and several examples of specific cases undertaken by the enforcement teams.

Improving tabulations of proxy votes

The CSA has published a set of voluntary protocols to improve the tabulation of proxy votes and the reconciliation of votes at a meeting. These protocols deal with vote entitlement information, sending of proxy information, tabulation and recording of proxy votes, and responding to owners about rejected or pro-rated votes. These protocols are published in CSA Staff Notice 54-305: *Meeting vote reconciliation protocols.*

The CSA will monitor the implementation of the protocols and assess the need for enhanced regulatory measures.

SEC developments

Monitoring inflation rates

Each year, the International Practices Task Force of the SEC Regulations Committee of the Center of Audit Quality discuss inflation rates with the SEC staff to assess which economies may be highly inflationary under US GAAP. A highly inflationary economy is one that has cumulative inflation of approximately 100% or more over a 3-year period. US GAAP requires that the functional currency of a foreign entity be changed to the reporting currency of its parent when an economy becomes highly inflationary.

IFRS has a similar approach to assessing whether an economy is hyper-inflationary, but does not specify an absolute rate.

As of January 1, 2017, the following countries were considered highly inflationary:

- Malawi,
- South Sudan,
- Sudan,
- Ukraine (New for 2017 – the cumulative rate was determined to be 101% and there are indications the cumulative rate may fall below 100% later in 2017. If this occurs, Ukraine would no longer be considered highly inflationary. Ukraine is not considered to be hyper-inflationary under IFRS.), and
- Venezuela.

Argentina is no longer on the list as being highly inflationary. The analysis indicated a cumulative inflation rate of less than 100% for Argentina. However, the SEC staff indicated companies should closely monitor the economic environment in Argentina.

Other countries on the watch list include Suriname and Angola.

Companies should actively monitor the inflation rates in the countries they operate to ensure compliance with the accounting requirements related to highly inflationary or hyper-inflationary economies.

XBRL available for foreign private issuers

In March 2017, the SEC published a taxonomy so that foreign private issuers (FPIs) that prepare their financial statements using IFRS may submit those reports using XBRL. XBRL is a machine readable data format that allows investors and other data users to more easily access, analyze and compare financial information across reporting periods and across companies.

All FPIs using IFRS must submit their financial statements in XBRL for fiscal periods ending on or after December 15, 2017. FPIs may begin immediately to submit their financial statements in XBRL.

The IFRS taxonomy is available on the SEC website.

Exhibits a click away

Soon it should be easier for investors and other market participants to find and access exhibits in registration statements and periodic reports that were originally provided in previous filings. Amendments to the rules and forms, approved in March 2017, will require hyperlinks to each exhibit listed in the exhibit index, unless the exhibit is filed in paper form under a temporary hardship exemption. There are exceptions for exhibits that are filed with Form ABS-EE: *Form for submission of electronic exhibits for asset-backed securities* and exhibits filed in XBRL.

Companies will have to format their registration statements and periodic reports in HTML. These requirements will also apply to all registration statements (including those of Form F-10) and Annual Reports on Form 20F filed by foreign private issuers. Hyperlinks will not be required in other forms used by Canadian issuers such as registration statements on Forms F-7, F-8, F-80 and Annual Reports on Form 40F.

Accelerated filers will have to comply with the changes starting September 1, 2017. The effective date for non-accelerated filers and smaller reporting companies is September 1, 2018.

Auditing developments

Audit quality indicators research

In 2016, CPAB began exploring the usefulness of audit quality indicators (AQIs) for audit committees. A pilot project was started which involved six Canadian audit committees and their external auditors. In the pilot project, the pilot participants selected AQIs and the method and frequency of reporting AQIs. CPAB did not set any specific requirements for AQIs and encouraged participants to select AQIs best suited to their goals and areas of interest.

In February 2017, CPAB provided its preliminary observations on the pilot project in its interim report: *2016 Audit Quality Indicators Pilot Project – Interim Report*.

Process

In the process of considering AQIs, certain objectives of the audit committee were identified by pilot participants, including:

- General oversight of the audit, including project management and monitoring of key audit risk;
- External auditor evaluation on audit quality and client service; and
- Monitoring and managing the added value provided by the auditor.

The objectives considered by each participant were used to select specific AQIs for the project. It was noted that other tools in addition to AQIs would be used to meet the objectives of the respective committee. Management was actively involved in the process of discussing and selecting AQIs.

The formats and frequency of reporting AQIs varied by participant.

Specific AQIs

Participants selected between six and 10 AQIs, which were influenced by the nature of the business, significant audit risks, areas of concern to the audit committee, factors for evaluating the auditor, the auditor's own AQIs, concerns raised by the CPAB in their inspections, and the ability of the auditor to provide the information. The process resulted in a significant variety in types of AQIs selected by the participants. The table below identifies some of the specific AQIs used in the pilot project by participants.

Category	Examples
Audit execution	***Audit hours by phase***
	Audit hours by risk
	Amount of audit work performed by centralized service centres
	Achievement of significant milestones in the audit
	Frequency and areas of challenges
Firm level metrics	Internal and/or external audit firm quality review results
	Training and professional development
	Independence
Management indicators	Timely achievement of agreed upon deliverables to the auditor
	Timely reporting of internal control deficiencies identified by management to the audit committee and/or the auditor

Category	Examples
Engagement team	***Staffing leverage*** ***Experience of engagement team*** Workload ***Use of specialists*** Turnover
Client service indicators	Survey of audit committee members Sharing of thought leadership, ideas, and best practices

Key benefits and challenges

In a November 2016 roundtable of participants, the key benefits of AQIs noted were more efficient and effective interactions between the audit committee and the auditor, as well, being beneficial in the evaluation of the auditor. A number of other benefits were noted.

The most significant challenge noted was the development of evaluation criteria. The report also reported on other challenges identified at the roundtable.

Some key insights

Project management

Project management was found to be important to audit quality. Tracking milestones, phases of the audit, or the completion of significant tasks were considered helpful in keeping the engagement team focused on project management and management in providing auditors with supporting working papers on a timely basis.

Management's role

Some participants included AQIs for management which highlighted that management's contribution is beneficial to the successful completion of a high quality audit. This may involve AQIs to measure the timeliness of providing deliverables to the auditor.

Definitions and evaluation

Many of the AQIs listed in the Audit execution category were selected by the participants. However, the definition, reporting, and evaluation of the AQIs often differed. These difference resulted from the ability of the auditor to provide the information and the specific needs of the respective audit committee.

Some participants evaluated AQIs using prior years' information, budgets, objective targets, benchmarks, and industry standards. Evaluation of AQIs was challenging due to lack of industry or objective standards.

Perceived usefulness

Each participant in the roundtable were asked to rank each of the indicators in the list on a five point scale. While five of the indicators had an average score higher than four (highlighted in table in this ***text***), there were diverse views on other indicators.

Next steps

CPAB will continue the AQI Pilot Project in 2017. CPAB has encouraged other Canadian reporting issuers to participate.

A full copy of the report can be obtained from the CPAB website at cpab-ccrc.ca.

CPAB releases 2016 Inspections Report

In March 2017, the Canadian Public Accountability Board (CPAB) released its *2016 Annual Inspections Report,* which summarizes common findings from the inspections conducted during 2016 and provides questions for audit committees to consider in their discussions among management and the auditor.

The report includes good news on the quality of auditors' work in the audit of public companies' financial statements. Files inspected with significant findings in 2016 decreased to 24 from 43 in 2015. The majority of the significant findings required audit firms to carry out additional audit procedures to support the conclusion there were no material errors in the financial statements audited. In

some cases, the firms were required to add audit evidence to their files to support their audit opinion. The 2016 inspections resulted in four restatements as of the date of the report.

CPAB stated those firms have sound audit methodologies and quality systems, which are applied by most engagement teams in their audits; however, there are still exceptions where firms do not perform consistently. CPAB believes there needs to be more effort to embed quality improvements into every audit engagement. CPAB is working with firms with larger numbers of findings to achieve improvements in quality.

For the big four firms (Deloitte, EY, KPMG, and PwC), 11 files out of 87 inspected had significant findings. Remediation work did not result in any restatements. In addition to continuing efforts to improve quality for medium to smaller market client capitalizations, CPAB has asked the big four firms to focus on:

- Firm guidance and methodologies to address systemic risks;
- Key quality controls and metrics to monitor and measure audit effectiveness; and
- Escalation processes to management to mitigate firm risk.

CPAB also inspected 80 files prepared by national, regional and independent firms (41 firms). These inspections identified 32 significant findings and resulted in four restatements. While many of these firms have made improvements in audit quality, more needs to be done to ensure their quality initiatives are effective in supporting consistent execution of audit procedures.

The *2016 Inspections Report* identified the following audit quality themes that were common in the significant findings:

- Significant professional judgment and objective analysis is still required when determining audit procedures for material balance sheet items or transaction streams, even if the audit risk is assessed as low. Further, auditors should corroborate the reliability of management's evidence and challenge that evidence when conflicting evidence exists.

- Basic audit procedures, such as selecting sample sizes and accounting-specific testing, need improvement. Appropriate staff training and supervision should reduce these types of deficiencies.

- Auditing accounting estimates can be one of the most challenging aspect of an audit when there are large dollar amounts involved, sophisticated models to determine amounts, or amounts are subject to management bias. While management may use experts to prepare reports to support the accounting estimates, auditors still need to independently assess the appropriateness of financial inputs used and the reasonableness of assumptions and models used.

- An understanding of the business and accounting processes relevant to a transaction or series of transactions is necessary to identify and respond to audit risks. Testing may not be appropriate or the evaluation of the evidence received may be incorrect if there is a lack of understanding about these processes.

- Internal controls, particularly for management review controls, that are relied upon by the auditor must be evaluated to assess whether such controls are performed in a way to identify or prevent material errors. In addition, CPAB noted that auditing around computer systems might be difficult to do effectively if the auditor is relying on system-generated information in the audit.

Under the CPAB Protocol, we will be providing the *2016 Inspections Report* to audit committees. The report includes questions that audit committees may consider in their discussions with the auditors about the audit and audit quality.

CPAB forum for financial institutions

CPAB hosted its first financial institutions industry forum on January 20, 2017. Audit committee chairs from boards of directors of banks and insurance companies in Canada were invited to have a discussion on matters relevant to audit committees of financial institutions. The event covered issues facing audit committees of banks and financial institutions, developments in audit quality, and auditor perspectives on areas of audit focus. The highlights of the forum have been summarized in *CPAB exchange: Industry forum series – Financial institutions*. This summary is available at www.cpab-ccrc.ca.

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