AC Insights

Summer 2017 – Issue US2017-3

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

The summer quarter has been fairly quiet on the accounting front with the FASB issuing two narrow scope amendments to its accounting guidance to deal with modifications of share-based awards and the determination of the customer in service concession arrangements. We expect to see an update to the hedge accounting standard and some other narrow scope amendments in Q3, 2017.

On the auditing front, the PCAOB issued its final rule to update the auditor's report. The key feature of the new auditor's report is the reporting of critical audit matters. The PCAOB final rule has been submitted to the SEC for approval.

During the most recent quarter, there were no CSA developments. The SEC will be implementing procedures to expand non-public reviews of registration statements to all IPOs and offerings of new classes of securities, subject to providing sufficient timing for the public to evaluate those offerings. This change is expected to facilitate security offerings without the glare of the public until the offerings are ready to go to market.

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US GAAP developments

When is a change to a share-based award a modification?

Modifications can be made to share-based payments for a variety of reasons. In response to diversity in practice and the complexity of accounting for modifications to share-based payments, the FASB issued ASU 2017-09: *Scope of modification accounting*. The amendments made to ASC Topic 718: *Compensation – Stock Compensation* clarify when a change in terms and conditions of a share-based payment is subject to modification accounting.

All changes to terms and conditions will qualify for modification accounting unless all of the following criteria are met:

1. The measurement value (fair value, calculated value or intrinsic value, as applicable) of the modified award is the same as the measurement value of the original award immediately before the changes were made to the original award. As a practical expedient, an entity need not calculate the values, but can compare the inputs used in a valuation.

2. The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the modification.

3. The classification of the modified award as an equity or a liability instrument is the same as the classification of the original award.

These amendments, applied prospectively to modified awards, will be effective for annual periods (and the related interim periods) beginning after December 15, 2017. Earlier adoption is permitted for reporting periods for which financial statements have not been issued.

Who is the customer?

The Emerging Issues Task Force (EITF) addressed the question of who is the customer when an operating entity is operating under a service concession agreement. Is the customer the grantor of the concession (e.g., the government) or the third-party users of the infrastructure being operated?

The EITF concluded that the granter (the government) that enters into the arrangement with the concession operator is the customer in all cases.

This consensus was issued in ASU 2017-10: *Determining the customer of the operation services.*

For entities that have not adopted ASC Topic 606: *Revenue from contracts with customers,* the ASU is effective at the same time as ASC Topic 606 is effective, which is for years beginning on or after December 15, 2017. The ASU can be adopted earlier. The Update can be applied using a modified retrospective approach with a cumulative effect adjustment; or a full retrospective method. There are alternative effective dates for entities that have already adopted ASC Topic 606.

SEC developments

Expansion for non-public reviews

On June 29, 2017, the SEC announced that it would allow companies in addition to Emerging Growth Companies to voluntarily submit draft registration statements for non-public review. These non-public reviews are consistent with the provisions of the Jumpstart Our Business Startups (JOBS) Act. The intention is to facilitate capital formation. These process revisions come into effect on July 10, 2017.

Submissions of registration statements and related revisions for non-public reviews will be accepted for the following:

- An initial public offering if the registrant confirms it will publicly file its registration statement at least 15 days prior to any road show, or if no road show is planned, at least 15 days prior to the requested effective date of the registration statement.

- Subsequent offerings within 12 months of the effective date of the IPO registration statement if the registrant confirms it will publicly file its registration statement so it is available on EDGAR at least 48 hours prior to any required effective time and date. In this case, the initial submission will be subject to non-public review, but further reviews will be subject to normal procedures.

- An offering of a new class of securities under the Exchange Act if the registrant confirms that it will publicly file its registration statement at least 15 days prior to the anticipated effective date of the registration statement for its listing on a national securities exchange.

Foreign private issuers may use these provisions as well as those available for Emerging Growth Companies. The SEC has traditionally accepted submissions for non-public review of initial registration statements of foreign private issuers.

These provisions are expected to provide companies with more flexibility in planning their offerings and reduce the exposure to market fluctuations that can adversely affect the offering process and harm existing shareholders. The conditions placed on the use of the non-public review also ensure the public has an opportunity to evaluate the offerings.

Auditing developments

PCAOB auditor's report

On June 1, 2017, the PCAOB adopted a new standard to enhance the auditor's report. AS 3101: *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion* will communicate critical audit matters and disclose the tenure of the auditors. Conforming and related amendments were also made to other standards.

The objective of the new auditor's report is to make the auditor's report more relevant for investors by requiring the auditor to communicate more information about the audit. The key piece of new information is Critical Audit Matters (CAM), which will be included in all PCAOB auditor's reports on audits of all SEC registrants except for emerging growth companies. Certain Canadian issuers are not required to submit PCAOB auditor's reports and may continue to use the Canadian auditor's reports.

In addition, auditors will be required to disclose the length of their tenure and clarify their role and responsibilities.

Critical Audit Matters

CAM are any matters arising from the audit of the financial statements communicated, or required to be communicated, to the audit committee and that:

- Relate to accounts or disclosures that are material to the financial statements; and
- Involve especially challenging, subjective, or complex auditor judgment.

In determining CAM, the auditor will be required to take into account specific factors such as:

- the auditor's risk assessment;
- areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;
- significant unusual transactions;
- degree of subjectivity in applying audit procedures in addressing a matter or in evaluating the results of procedures;
- the nature and extent of audit effort, including the use of specialized skill or knowledge; and
- the nature of audit evidence necessary to address the matter.

The auditor's report will be required to (1) identify the CAM; (2) describe the principal considerations that led the auditor to determine the matter is a CAM; (3) describe how it was addressed in the audit; and refer to the relevant financial statement accounts and disclosures. If the auditor determines there are no CAM, the auditor must state so in the auditor's report.

Subject to approval by the SEC, provisions related to CAM will take effect for audits for fiscal years ending on or after June 30, 2019 for large accelerated filers; and for audits for fiscal years ending on or after December 15, 2020 for all other companies to which the requirements apply.

Other changes

The auditor's report will be required to include a statement disclosing the year in which the auditor began serving consecutively as the company's auditor ("auditor tenure").

Other changes to existing requirements are intended to clarify the auditor's role and responsibilities and make the auditor's report easier to read. These requirements include:

- addressing the auditor's report to the company's shareholders and the board of directors;
- standardizing the language in and reformatting the auditor's report;

- disclosing that the auditor is required to be independent; and
- adding the phrase "whether due to error or fraud" when describing the auditor's responsibilities under PCAOB standards to disclosing that the auditor is required to be independent; and
- adding the phrase "whether due to error or fraud" when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The other changes to the auditor's report will take effect for audits for fiscal years ending on or after December 15, 2017.

An illustrative example of the new PCAOB auditor's report is included in Appendix A to this edition of *AC Insights*.

Comparison to international standards

International Standards on Auditing (ISAs) updated the requirements for auditor's reports in 2015. The Canadian Auditing Standards (CASs) for audit reports were also updated in 2017. There are several differences between the ISAs and the CASs as follows:

- The PCAOB changes to the description of management's and auditor's responsibilities are not as comprehensive as those made to the ISAs and CASs.

- The ISAs and CASs require the auditor's report to explain the responsibilities of the auditor related to Other Information that includes or accompanies the financial statements and the auditor's report. These requirements are not included in the PCAOB final rule.

- The ISAs and CASs require the name of the engagement partner to be disclosed in the auditor's report. There is no requirement to disclose the name of the engagement partner in the PCAOB auditor's report; however, the PCAOB does have a requirement that the name of the engagement partner be reported and included in a PCAOB database available to the public. The new PCAOB rule does permit the auditor to include this information in the auditor's report as well as in the database.

- The tenure of the auditor is not required in an auditor's report under ISAs and CASs.

- The disclosure of Key Audit Matters as required under ISAs for listed companies and CAM as required by the PCAOB for most SEC registrants is currently optional under CASs.

- PCAOB rules and the SEC require clear language in the auditor's report that there is substantial doubt about an entity's ability to continue as a going concern. The ISAs and CASs use different language which requires the report to state that significant doubt may exist about an entity's ability to continue as a going concern.

While these three sets of standards are highly similar, the reports will look different as the ISAs and CASs are much more detailed.

Appendix A

Illustrative example of PCAOB Auditor's Report

We have included the following example of an unqualified auditor's report under the PCAOB's new auditor reporting rule.

The example covers the financial statements and internal control over financial reporting.

The example does not show an Explanatory Paragraph required when substantial doubt exists about an entity's ability to continue as a going concern or in other circumstances, or a matter of emphasis that may be require when there is an important matter that the auditor wishes to draw to the attention of the reader.

The report as shown is based on the style published by the PCAOB. PwC Canada's style of reporting has not be finalized and may be different.

Report of Independent Registered Accounting Firm

To the shareholders and Board of Directors of Public Limited Company

Opinions on the consolidated financial statements and internal control over financial reporting

We have audited the accompanying consolidated statements of financial position of Public Limited Company (the Company) as of December 31, 2018 and 2019, the related consolidated statements of net income, comprehensive income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2019, and the related notes (collectively referred to as the consolidated financial statements). We have also audited the Company's internal control over financial reporting as of December 31, 2019, based on the criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2018 and 2019, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019, in conformity with International Financial Reporting Standards, as issued by the International Accounting Standards Board. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on the criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Basis for opinion

The Company's management is responsible for these consolidated financial statement, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, including in the accompanying Management Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the US federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of the internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and limitations of internal control over financial reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical audit matters

The critical audit matters communicated below are matters arising from the current period audit of the consolidated financial statements that were communicated or required to be communicated to the Audit Committee and that: (1) relate to accounts or disclosures that are material to the consolidated financial statements; and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Critical audit matters

Goodwill and intangible assets impairment assessment

Critical audit matter

The Company has significant amounts of goodwill and intangible assets at December 31, 2018, as disclosed in Note 7 to the consolidated financial statements.

During the year ended December 31, 2018, the Company recorded a goodwill impairment loss of $10.1 million.

We focused on this area because of the amount of the goodwill and intangible assets, the existence of indicators of potential impairment, and because the assessment of whether an impairment loss is necessary involves significant estimates and judgments by management including:

- Estimates of future cash flows and key assumptions based on management's expectations;
- Long-term growth rates; and
- Discount rates applied to discount future cash flows.

Refer to Notes 7 and 12 in the consolidated financial statements.

How our audit addressed the critical audit matter

Our audit procedures included assessing the Company's impairment model. We monitored the process of identifying impairment indicators and the process for impairment testing at the cash generating unit level.

In addition, we obtained impairment tests prepared by management and evaluated the reasonableness of estimates and judgments made by management in preparing these tests.

We challenged management on the suitability of the impairment models and the reasonableness of the Company's key assumptions, with particular attention paid to its Unit A CGU, through performing the following:

- Benchmarking management's key assumptions with industry comparators and with assumptions made in prior years including revenue and margin growth trends, capital expenditures, changes in working capital, discount rates and long-term growth rates applied;
- Testing the mathematical accuracy of the cash flow models and agreeing relevant data to the Company's budgets approved by the Board of Directors;
- Assessed the reliability of management's forecasts through a review of actual performance against previous forecasts;
- Stress-testing the key assumptions used by analyzing the impact on results from using other reasonably possible growth rates and discount rates which were within a reasonably foreseeable range.

Furthermore, we assessed the appropriateness of disclosures in the financial statements.

Recognition of deferred tax assets and uncertain tax positions

Critical audit matter

The Company has recognized deferred tax assets in the amount of $400 million on the balance sheet.

We focused on the recognition of deferred tax assets because the recognition of these assets involves judgment by management as to the likelihood of realization of the deferred tax assets, which is based on a number of factors including whether there will be sufficient taxable profits in future periods.

The Company has recognized provisions against uncertain tax positions. We focused on this area because the assessment and estimate of provisions for uncertain tax positions involves significant judgment.

Refer to Note 10 of the consolidated financial statements.

How our audit addressed this critical audit matter

We evaluated the management's assessment as to whether there will be sufficient taxable profits in future periods to support the recognition of deferred tax assets by comparing the management's forecasts of future profits to historical results, and evaluating the assumptions used in those forecasts.

We discussed with management the known uncertain tax positions and read communications from taxation authorities to identify uncertain tax positions. We considered the status of current and recent tax audits, judgmental positions taken in tax returns, and developments in the tax environment. We assessed the adequacy of management's key assumptions and methods to recognize provisions for uncertain tax positions.

PricewaterhouseCoopers LLP

We have served as the Company's auditor since 1995.

Anycity, Canada

March 15, 2019