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Keeping your head above water

Recent issues in financial reporting

Financial Reporting Release

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In this issue

But here, cleverly disguised as a bomb, is a bomb.
– The Bullwinkle Show

Do you remember those cartoons you used to watch on TV? Occasionally some character, usually a mouse, would light a long fuse connected to a bomb, and another character, usually a cat, would say, “Bomb, what bomb?” just before the explosion. Those cartoons remind us of what’s happening in financial reporting these days. Major new accounting standards on revenue, financial instruments and leases soon will be taking effect. How are companies faring with their implementation? Is it possible that some will find themselves sailing through the air with singed hair and a surprised look on their faces? Those are some of the questions we’re focusing on in this edition of the *Financial Reporting Release*.

A fundamental public policy question that’s receiving significant attention these days is why the number of public companies in North America has halved over the last 20 years. Both Canadian and US securities regulators are floating proposals intended to help reverse this trend, generally by trying to identify what’s truly material and pruning regulatory requirements accordingly. We examine their efforts in some detail, contrasting the different strategies the two countries are taking. Recent accounting and disclosure developments are, of course, among the other matters we consider. Some are momentous. Did you know, for example, that the world’s longest running accounting project in history has finally come to an end? That the IFRS Interpretations Committee has roused itself to issue an interpretation, one addressing accounting for income tax uncertainties? That the IASB is proposing to take down traditional borders that separate financial statements from the other parts of an interim or annual report? Or that pressures are building on companies to significantly expand their disclosures about the impact of climate change? What can we say? If you thought that you’d be getting a break from having to worry about accounting changes once revenue, financial instruments, etc. are safely put to bed, you thought wrong.

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The Future of Regulatory Reporting in the US

Sometimes I lie awake at night, and ask, 'Where have I gone wrong?' Then a voice says to me, 'This is going to take more than one night.'
– Charlie Brown

In July the newly appointed Chair of the SEC, Jay Clayton, gave a speech outlining his priorities and vision for the Commission. The speech addressed fundamental philosophical issues about the burdens that regulations should be imposing on public companies and the attitudes that regulators should be taking in enforcing them, issues that are subject of debate in Canada as well (see the next page).

Here are the key points:

- The number of public companies in the US has dropped by roughly half over twenty years as the result of a rise of private equity markets.
- Public markets are important because they provide opportunities for Main Street investors to participate in the growth of companies and the economy.
- Regulators have slowly but significantly expanded the scope of required disclosures above the core concept of materiality, often based on evaluations that the discrete, direct and indirect benefits to specific shareholders or other constituencies, outweigh the marginal costs to companies of providing it. However, that analysis needs to take into account the cumulative, as well as the incremental, impact.
- The Commission should be reviewing its rules retrospectively to determine which are functioning as intended, and which are not.
- The SEC should be following the Supreme Court definition of materiality to ensure that investors have access to a well-crafted package of information that facilitates informed decision-making.
- It's incumbent on the Commission to write rules so that those subject to them can ascertain how to comply with them and demonstrate compliance. As such, the Commission needs to have a realistic vision of how regulations will be implemented and the practical costs of demonstrating compliance in setting them.
- The SEC welcomes and encourages companies to exercise their existing right to appeal for relief from reporting requirements that are burdensome but may not be material.

PwC observation. Clayton's speech is both a reflection on the issues seen to be adversely affecting regulatory reporting in the US in the past and a prescription for addressing them in the future. A key element of his solution is that the SEC should be adhering to the US Supreme Court definition of materiality in developing reporting requirements. Under that definition something is material only if there's a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information made available. Some have argued that applying this definition rigorously would allow too many potential disclosures to be dismissed as being immaterial for at least some aspects of reporting to investors, in particular, financial statement reporting. It was therefore not surprising that a FASB proposal last year to abandon the "could influence an investor's decision" definition of materiality it now shares with the IASB in its concept statements in favour of the legal definition has provoked much debate. At a public roundtable the FASB convened this year to hear views on the matter, some investors and investor groups maintained that doing this would unduly raise the materiality bar for financial statement disclosure, allow companies much more discretion in deciding what not to disclose to investors, and, ultimately, hand the decision as to what's material over to the lawyers. The FASB hasn't made any decisions yet, so stay tuned. Having materially different definitions of materiality between IFRS and US GAAP for financial statement reporting purposes could have profound implications.

The Future of Regulatory Reporting in Canada

"I'd agree with you but then we'd both be wrong."
– Russell Lynes

The SEC isn't alone in considering regulatory burdens on public companies. Canadian Securities Administrators announced earlier this year a project to reconsider and rationalize Canadian regulatory reporting requirements with a view to reducing the burden on public companies. Whereas the SEC has set out a general framework for regulation without providing any details, the CSA has gone in the opposite direction, issuing a Consultation Paper asking for comments on an array of possible changes to specific existing requirements. These include:

- Permitting semi-annual instead of quarterly reporting.
- Consolidating the MDA, Annual Information Form and the financial statements into a single document, similar in style to the US Form 10K.
- Providing smaller companies listed on the TSX with the regulatory relief from continuous disclosure requirements that "venture issuers" currently enjoy.
- Streamlining or eliminating certain prospectus and continuous disclosure requirements; for example, substituting the interim MDA with a quarterly highlights package, eliminating or increasing thresholds for business acquisition reports, pro forma statements and auditor involvement in certain prospectus situations.
- Eliminating overlap in requirements.
- Enhancing the ability of companies to deliver information electronically.

The paper asks for feedback on which of these options would provide meaningful relief, which measures should be prioritized, the feasibility of addressing them in the short or medium term, and whether there are any other actions that might be worthwhile.

PwC observation. We expect everyone would agree with eliminating outdated, overlapping or demonstrably ineffective requirements and streamlining others. That's the easy part. The other options the Paper identifies will be much more controversial, not only because they involve upsetting the usual order of things, but also because certain options involve depriving investors of information that they receive now. Among the most contentious ones are eliminating mandatory quarterly reporting and combining the MDA, AIF and financial statements. We agree with the latter, but not the former. We also think that the CSA should be cautious about importing regulatory reporting solutions from other jurisdictions such as Europe or Australia (e.g. semi-annual rather than quarterly reporting), if that could jeopardize the simplified MJDS basis of reporting to the SEC that Canadian SEC registrants now enjoy. Will there be substantial agreement among stakeholders about which options to pursue? We're not optimistic.

Revenue

"I'm writing a book, I've got the page numbers done."
– Steven Wright

It's ironic that even as the first steps are being taken to lighten the load of regulatory reporting requirements, companies are having to shoulder new ones; that is, complying with the major new accounting standards on revenue, financial instruments, and leases. For many companies, the revenue standard, effective in 2018, is uppermost in their minds. How are they coping with the stresses, strains and tribulations? What are those stresses, strains and tribulations?

Here's what we're seeing:

- Only a handful of companies have adopted the standard early.

- A poll in June of more than 400 US companies showed that 20% of the respondents still hadn't started evaluating the new requirements yet, 50% have started but were not finished, and only about 30% were in the active implementation phase. Those findings, and others like it, have provoked some rather sensational headlines in the US financial press – "70% of Companies May Miss New Revenue Recognition Deadlines", "Study Says Companies Not Ready for New Recognition Rules", "Revenue Recognition 'Doomsday Clock' is Ticking", and so on. There aren't any equivalent Canadian surveys, but based on our experience, the Canadian situation is similar. Without the frantic headlines, of course.

- It appears that companies beginning implementation only in 2017 often are resorting to spreadsheets to accumulate transition adjustments and other data, presumably either because there's not sufficient time left to make the necessary changes to IT systems, processes and related internal controls, or they believe the changes aren't significant enough to worry about.

- Analysis of recent SEC filings shows that relatively few companies (only about 10% so far) have decided to restate comparatives in adopting the standard. That percentage may change because lots of companies have yet to make up their minds, but we're betting it won't change much.

- The quality of disclosures in 2017 regulatory filings about the status of a companies' implementation and the impact of the standard has been, well, mixed. Some companies are still disclosing only that they're "evaluating the impact of the standard", a communication that makes up in brevity what it lacks in specificity. Recall the OSC's view that companies should be providing entity specific qualitative and quantitative disclosures, with disclosure growing progressively more detailed in later periods as the company gets further into its implementation. The objective, says the OSC, is that there shouldn't be any surprises for investors when the companies report the details of their transition in 2018. What can we say? Regulators love anti-climaxes.

- Surveys regularly show that up to 50% of companies don't expect the effects of adoption of the standard to be material. While disclosures of this kind haven't been uncommon, tread carefully before making any such blanket representations. The SEC, ever the bellwether for Canadian regulators, is telling anyone who'll listen that the standard's new disclosures can be material all on their own. Companies that haven't considered this angle before might want to revisit what they've been saying.

And there you have it.

PwC observation. We suspect a major reason for the survey results is that a relatively high percentage of companies don't expect the new revenue standard to be material to their income statement or balance sheet. However, no matter what the expectation, every company needs to have completed and documented an in depth diagnosis of the standard's effects, citing chapter and verse. If you're staring at nothing but blank pages right now, it's time to get busy. Make sure you consider the new disclosure requirements as part of the process. We're already hearing "Oh damn" reactions from those that are only now discovering that their accounting systems don't provide the data necessary to comply with them. Finally, a message for those that haven't been especially forthcoming about the impact of adopting the standard (or lack thereof) so far in 2017 filings. You may want to consider being more expansive in your third quarter or annual reports. You're risking raising the ire of investors and regulators if you don't.

Financial Instruments

"One learns to itch where one can scratch."
– Ernest Bramah

Like revenue, IFRS 9, the new standard on financial instruments is effective in 2018. As almost everybody must surely know by now (and shame on you if you don't), IFRS 9 changes the basic principles to be used for classifying and measuring financial instruments and liberalizes what can be hedged. Like revenue, its effect will be felt unevenly, with some companies, especially banks, having to deal with once in a lifetime changes to systems and processes (see the next page), and others having to address only relatively self-contained modifications. Everyone will have something to worry about, though. Are companies other than banks preparing for their transition to this standard on a different timetable than what we just saw for revenue (see prior page)? Not especially. Our sense is that, like revenue, many companies have begun implementation in earnest only relatively recently.

Sadly, implementation has just become a little more difficult – the IASB issued a directive a few months ago about the application of IFRS 9 to debt modifications (e.g., the maturity date of the debt or the interest rate changed). This might seem like an arcane topic of limited application, but it's not. Debt modifications are like the chicken pox – they're hard to avoid and itch like the dickens when you get them.

Predominate practice today for debt modifications is that their effects are recognized prospectively over the remaining term of the debt, as an adjustment of interest expense. No one was expecting any different answer under IFRS 9. No one except the Board (and its subsidiary, the IFRS Interpretations Committee), that is. Its view is that reflecting the effect in profit and loss when the modification occurs (by adjusting the carrying value of the debt) is the only right answer, even under existing IFRS. The Board will be amending its Basis of Conclusions to IFRS 9 to clarify this, but declined to provide any special transition relief to make life easier for IFRS 9 adopters. As a result, you'll have to determine whether any debt that's sitting on your balance sheet when you transition to IFRS 9 has been modified sometime in the past and if it has, recalculate the carrying value from that date forward.

Starting to scratch yet?

PwC observation. Needless to say (but we will anyway), many of the observations we made about the new revenue standard on the preceding page also apply to financial instruments. As to the debt modification stuff, some might wonder whether the necessary adjustments to reflect the IASB's views should be reflected in 2017 financial statements instead of as a 2018 IFRS 9 transition adjustment. The Board chose to remain tactfully silent on this question. We don't expect this will be required.

Common Impacts of IFRS 9

- Having to apply new criteria for determining whether to classify and measure financial assets at cost or fair value.
- Potentially, more financial assets measured at a fair value and more changes in fair value recognized immediately in profit or loss.
- Adjusting the allowances for bad debts on allowances for trade receivables and loans to recognize "expected credit losses" rather than waiting until they are incurred.
- Recognizing changes in fair value of equity investments not held for trading immediately in profit or loss or permanently in OCI.
- More liberal rules as to what can be hedged.
- Re-measuring debt liabilities whose terms have been modified with changes recognized in profit or loss.
- Enhanced disclosures.

Loan Impairment – Banks

"Time flies like an arrow, fruit flies like a banana."
– Groucho Marx

When it comes to adopting IFRS 9 banks are different than everybody else – chalk to everybody else's cheese. What makes them unique, of course, is the magnitude of the impact of the new "expected credit loss" model for recognizing impairments in loans, investments in debt securities and receivables. To calculate expected credit losses, a bank has to estimate the loss it would incur if a loan were to default under various scenarios about the future, weight them by the probability of occurrence and discount them. Voila!

The purpose of the calculation is to approximate the risk premium a bank would charge for a loan had it been made at the balance sheet date – as the credit risk of the borrower goes up, loan loss provisions go up too. Non-banks also have to use the expected credit loss model for their receivables, too, but special short-cut approaches and the relative size of receivables usually mean that for most companies the requirements are an annoyance; for banks, the systems, data gathering, credit modelling and internal control issues make them among the most complex and difficult they've ever had to implement.

Banks' audit committees are facing challenges getting on top of this stuff too. In an effort to help, the Global Public Policy Committee (a forum of the six major accounting firms otherwise known as the GPPC) recently issued a paper on how committees should be evaluating the work of the auditor on a bank's implementation. The fact that the paper is over 40 pages testifies not only to the complexity of the issues, but also to the expectations of regulators and others that audit committees will be deeply involved in overseeing their resolution. We're starting to see some audit committees scheduling separate IFRS 9 meetings in response.

One issue the GPPC paper highlights is the need for getting comfort on the reasonableness of management's policies, assumptions and estimates – key drivers in the calculation of expected credit losses. Others are concerned about this matter as well. For example, the European Systemic Risk Board has just issued a report that concludes that expected credit loss models could be open to manipulation and over-optimism. It recommends that European banking regulators provide more guidance on rating the credit status of their borrowers. There's also a growing realization in the financial community that the expected credit loss model is so entity specific in its focus that it may adversely affect inter-bank comparability. One aggrieved letter writer to the *Financial Times* went so far as to call for roving bands of auditors to travel from bank to bank to inject more consistency in banks' reporting. On that, no comment.

PwC observation. There's little doubt that implementation has been, and will continue to be, challenging, especially now that time is flying by. As often is the case with complex new accounting standards, we expect that banks will continue to improve their systems, processes and controls as they gain more experience with the requirements. Issues over the use of assumptions and judgments and the implications for inter-bank comparability are another matter entirely. Provisions for expected credit loss aren't supposed to represent estimates of market values, but rather a bank's own perspectives on the riskiness of its loans. As such, the reasonableness of provisions can be assessed only by considering the reasonableness of the assumptions and judgments that underlie them. This may be one standard where fulsome disclosure about the key inputs may be as, or more, important than the provisions themselves. Getting the balance right between too much and too little disclosure will be tricky indeed.

Leases

"I have a new philosophy. I'm only going to dread one day at a time."
– Charlie Brown

The leasing standard's effective date is a year later than revenue and financial instruments, 2019 versus 2018. That difference creates an interesting tactical issue for management – is implementation of the standard something you should be worrying about only after you finish revenue and financial instruments? Or should you swallow hard, bend your back and adopt the leasing standard in 2018 too, in one unholy big bang to get the lot of them behind you? Or take the middle path by getting ready for leases now, even as you work towards completing revenue and financial instruments? The results of our US May 2017 lease accounting survey may help your deliberations.

The findings show that:

- There's next to no appetite for early adoption.
- About 20% of companies admit to not having flipped open the standard yet, around 50% are still evaluating its impact (how far along they've gotten varies substantially), and nearly 25% have actually started the nuts and bolts of implementation. A few (a very few) have even claimed that they're done.
- The biggest implementation challenges relate to systems, data collection and resources, with 25% ranking these issues as being the most difficult.
- About 40% are addressing systems issues by acquiring a new lease management system. The second most popular solution, at 20%, is modifying existing systems. 34% of companies aren't planning any changes to what they're doing now. (This implies, we suspect, that we haven't seen the last of using spreadsheets to keep track of leases, but you can expect a lot more rows and columns.)
- Leveraging existing internal resources is the predominant implementation weapon of choice, with 70% planning to collect the data necessary to transition to the standard manually, using in house resources.

PwC observation. Leasing appears to be at approximately the same stage of implementation as revenue is at now, though it's effective a year later. Of course, many aren't at all happy with the thought of having to put more debt on the balance sheet and are anxious to see the impacts, with a view to taking remedial action as early as possible.

Common Impacts of the New IFRS on Leases – Lessees

- All leases are recognized on the balance sheet as assets and liabilities, other than small ticket items and short-term leases.
- Lease assets are amortized to expense over the lease term.
- Interest expense is accrued on lease liabilities.
- New definition of a lease.
- Possible impact on debt covenants, compensation plans, etc.

Insurance

"Reality continues to ruin my life."
– Calvin and Hobbes

It says something, we're not sure quite what, that children have been borne, raised and have had children of their own in the time the IASB took to develop a comprehensive standard on accounting for insurance contracts by insurers. Still, it's out now; the begetting is done. What can you expect to see? Thankfully, no major surprises. The basic provisions of the final standard are pretty much in line with what the Board had previously announced they were going to be.

To recap:

- Companies will have to present a new income statement format that highlights revenues earned from insurance services. Reporting revenue as earned doesn't sound so very revolutionary, but it seems to be in the insurance industry.

- Insurance contracts have to be recognized on the balance sheet and measured at a current value at each balance sheet date (there's a simplified approach for qualifying short-term contracts and special relief for so-called participating contracts).

- Current value as defined isn't fair value or market value. Instead, it's calculated by forecasting future cash flows under various scenarios, weighting them by the probability of their occurrence, and discounting them. It's more or less the same process we described on the preceding page for accruing expected credit losses on loans.

- All changes in the value of contracts from period to period are recognized in profit and loss in the period of the change, except for those attributable to future services, which are recognized over the service period, and changes attributable to movements in discount rates, where companies have the option of presenting them in other comprehensive income. A compromise? You bet.

- There will be lots and lots of new disclosure. Of course.

The standard is effective for years beginning on or after 2021, with earlier adoption permitted. There are special options relating to the presentation of qualifying financial assets under IFRS 9 to deal with its interaction with insurance, and, for pure insurance companies, to defer adopting of IFRS 9 until adoption of the insurance standard. Deferral is mandatory for Canadian lifeco's as the result of new regulatory requirements.

PwC observation. As a general rule, life insurance companies will be significantly affected by the new measurement model for insurance contracts, property and casualty companies, not so much. Some worry the model might not paint a picture of reality that's always conducive to prudence and financial stability. In recent speeches, Hans Hoogervorst, the Chair of the IASB, has been arguing that it does. He likens the model to being the canary in the coal mine – it signals that trouble lies ahead. This may be rather an unfortunate choice of metaphor. Canaries are always the first to die when the air starts getting toxic.

Uncertainty over Income Tax Treatments

***"The only difference between a tax man and a taxidermist is that the taxidermist leaves the skin."* – Mark Twain**

Bet you thought you just had leases to worry about for 2019, didn't you…

The IFRS Interpretations Committee has just released guidance addressing uncertainties in income tax treatments. It addresses two basic questions. The first is, when do you have to set up a provision to recognize the risk of being reassessed? The second is, how do you calculate the provision? The Interpretation applies to the uncertainties relating to current and deferred income taxes, tax bases, and tax rates, etc. It's effective for years beginning on or after January 1, 2019, with retrospective application permitted provided you can do it without hindsight. You can adopt it earlier if you like.

Here's what the interpretation would have you do:

- Identify any significant income tax treatments where there's uncertainty about whether they'll be accepted.
- Determine whether to evaluate each uncertain tax treatment separately or lump them together with one or more others because they're interconnected.
- Assess whether it's probable that the tax authority will accept the treatment as filed. Probable means "more likely than not", i.e., more than 50%. You've got to assume that the tax authority will look at everything it has the right to examine, and will have the full knowledge of all the relevant information. The argument that "they'll never find it" holds no water here.
- If, and only if, acceptance isn't probable, set up a provision using either the most likely amount or the expected value method, depending on which is the better predictor of the outcome. As you might have already guessed from our write up on expected credit losses, applying the expected value method involves identifying possible settlement amounts and weighting them by the probability of their occurrence. The Interpretation says that the first approach may be better if outcomes are binary or concentrated around one value, and the second is better when outcomes aren't binary or there's a broad range of possible outcomes with different probabilities of occurrence. How many possible outcomes are you supposed to consider? That's a matter of judgment.
- Apply the provision to the tax liability or asset, including deferred taxes, to which it relates.
- Reassess estimates in light of any changes in relevant facts and circumstances, accounting for any changes through income as a change in estimate.

There aren't any new disclosure requirements, just a sharp reminder of the need to comply with existing ones relating to the disclosure of key uncertainties and judgments and income tax contingencies.

PwC observation. The Interpretation reflects much of existing practice, but the requirement to assess whether the expected value method provides a better estimate than the most likely amount may be the trigger for some changes in the basis of calculations.

Reporting through Social Media (or not)

"Pool rules: You're not allowed to do anything that begins with the words, Hey everyone, watch this."
– Anonymous

How good are your controls against the inadvertent leaking of material information on your companies' social media sites (e.g., Facebook, Twitter, YouTube, LinkedIn goodness knows what else)? That's a question that you might want to consider asking yourself in light of a recent CSA investigation.

The investigation found that 77% of the 111 reporting issuers reviewed didn't have sufficient controls, policies and procedures in place to prevent leaks. It also found, not surprisingly, that many companies were leaking like sieves – 30% had problems of some sort or the other and were required to take remedial action, ranging from providing clarifying disclosure on the SEDAR website (the CSA's home for material information), removing disclosure from social media sites, and undertaking to improve social media practices in the future. The CSA's considering taking further disciplinary action in a few cases where either the original posting or the corrective action triggered material changes to share prices.

Specific problems the CSA highlighted included:

- Posting forward looking information only on social media.
- Social media disclosures being made in advance of the issuance of news releases.
- Posts that were unbalanced, misleading or untrue. An example is linking to favourable analyst reports without also identifying the names and/or recommendations of all independent analysts covering the issuer.

The CSA rejected permitting the SEC's alternative of permitting posting of material information on social media so long as companies alert investors which platform will be used. It's not opposed to reconsidering its policy sometime in the future, but for now you're stuck.

PwC observation. Canadian securities legislation requires that material information be "disclosed generally" to market participants so that no one group or person gets privileged access. Notwithstanding the growth and prevalence of social media, the CSA's view is that this test can be met only through the traditional route of press releases, press conferences or conference calls, etc. In other words, you can't make quite the social media splash that your US counterparts can.

Climate Change Reporting

"Change is inevitable… except from vending machines."
– Steven Wright

Climate change disclosure is the latest hot topic these days (no pun intended), made more so by recent controversy over the US's withdrawal from the Paris Accord on the one hand, and the issuance of a Financial Stability Board Task Force report about the impact of climate change on business on the other. Our focus is on the latter. Enough, says the report, of companies disclosing only information designed to show that they're good corporate citizens. Instead, disclosure should allow stakeholders to better understand the business risks and opportunities of climate change. That disclosure should cover a company's:

- Governance – the extent of management's involvement and the board's oversight.
- Strategies – for the short, medium and long term.
- Risks – the processes for identifying, assessing and managing.
- Metrics and targets – how companies are keeping score for their initiatives and reporting results.

A key recommendation is for disclosure of the impact on an organization's businesses, strategies, and financial planning under different potential future scenarios, including a change of 2 degrees Celsius.

There's a Canadian angle to this, too. The CSA has announced that it'll be reviewing whether Canadian companies are making climate change disclosure that assists investors in making informed investment decisions. The project will include examining the risk disclosure requirements of other countries, and the Financial Stability Board's and other voluntary frameworks.

PwC observation. Historically climate change reporting hasn't been viewed as being necessarily relevant to investment decisions, on the basis that climate change is so far distant that it's beyond most investment horizons. The Financial Stability Board Task Force report challenges this assumption. Compliance is voluntary, but the report has received the support of a significant cross section of companies and investors. It's fair to say that it's not unanimous, though. In a few highly publicized cases shareholders have voted in support of this reporting despite management's strong opposition. Should be considering expanding your reporting?

Principles of Financial Statement Disclosure (and Integrated Reporting?)

"You can lead a horse to water, but a pencil must be lead."
– Stan Laurel

We're sure you'll recall that the IASB has undertaken a series of discrete projects, collectively called the "Disclosure Initiative", whose objective is to improve disclosure in financial statements. Notice the very careful wording here. To the dismay of some, the Board isn't committing to reduce the volume of its disclosure requirements – that would be impossible, considering the new ones being introduced as the result of the new revenue, financial instruments and leases standards. Rather, the goal is to get companies to add more relevant information, eliminate what's irrelevant, and better the way they communicate. The Board acknowledges that this is a tall order because compliance will require fundamental behavioural changes by management, regulators, auditors, and yes, even standard setters. After all, you can lead a horse to water…

The Board's latest step has been to issue a Discussion Memorandum addressing how to improve the effectiveness of communications. The DM proposes a number of basic principles for achieving this. Disclosures, it says, should be entity specific, clear and simple, highlight the important matters, appropriately cross-referenced, free from unnecessary duplication, comparable among entities and across reporting periods, and in an appropriate format. Those "principles" might seem obvious, but their implications are perhaps greater than they first appear. The Board is relying on them to recommend two fundamental changes affecting the information content of financial statements. Those are:

- Certain disclosures necessary to comply with IFRS standards shouldn't have to be reported within the financial statements themselves, but rather can be put in some other location in the annual or interim report provided certain conditions are met.
- An entity should be able to include certain types of non-IFRS information in its financial statements; e.g. qualifying non-GAAP measures. This would have to come with certain warning labels and reconciliations to the nearest GAAP measure. (Generally, these would be consistent with existing requirements in Canada for the disclosure of non-GAAP measures in press releases and the MDA.)

PwC observation. Historically the principle governing the preparation of financial statements is that they're stand-alone documents that exist independently of the interim or annual report in which they happen to be included. By proposing to allow information that otherwise appears in the statements to be located elsewhere in the report, and certain non-IFRS information to be included in the statements, the Board appears to be moving away from this principle in favour of a more integrated form of reporting, one that potentially would blur distinctions between GAAP and non-GAAP information. (Would anyone really care whether or not EBITDA is a GAAP or non-GAAP measure so long as it's included in the financial statements?) The Board seems to be very attracted to integrated reporting and the role it possibly might play in its development. Says Hans Hoogervorst, "We are especially well placed to make sure there is a good fit and connectivity between financial reports and non-financial information". As a result, the Board is considering reviving its non-authoritative MDA style guidance it issued some years ago ("the Management Commentary"), which no one ever looks at now and which, quite frankly, didn't get all that much attention when it was fresh. Should the Board be refocusing on a project that's so foreign to its usual remit and bound to eat lots of time? As Hoogervorst himself admits, the Board has shown a propensity to bite off more than it can chew. It's tough to disagree with that.

Auditor Reporting – Key Audit Matters

"When you come to a fork in the road, take it."
– Yogi Berra

This is an update on the status of the Canadian Auditing and Assurance Standards Board's long-standing efforts to align their requirements on auditor reporting with international auditing standards. For listed companies, one of the key differences between the two is that international standards oblige the auditor to expand its opinion on the annual financial statements (yes, the one that gets included in your annual report) to include a discussion of key audit matters (KAMs). Key audit matters have been described as being those issues that kept the auditor awake at night, but we reckon that explanation overestimates the capacity of auditors to sleep –auditors worry a lot. A better description is that they're the most significant matters the auditor reviewed with the audit committee.

In the spring, the Board finally issued a revised Canadian standard, but – and this is an important but – KAMs reporting is optional unless a law or regulation requires it. The new standard does incorporate all of the other features of the international requirements (e.g., changing the format of the opinion, reporting on other information, emphasizing auditors' responsibilities and independence and going concern matters, and providing the name of the audit partner). It's effective for audits for years beginning on or after December 15, 2018 although earlier application is possible.

Why require KAMs reporting? It's a compromise of sorts. On the one hand, the Board was persuaded it wasn't appropriate to make this reporting mandatory until the US does. On the other hand, it didn't want to prevent companies from following it if they want to. Given that mandatory reporting in Canada now depends on when the US introduces it, the question arises as to when this will happen. A few months ago, the audit regulator in the US, the Public Company Accounting Oversight Board, approved their version of a KAMs reporting standard – except that KAMs are called critical audit matters. The standard is supposed to be effective for 2019 audits of larger SEC registrants and 2020 for smaller ones, but the SEC still has to endorse it. When might that be? In a recent speech, a representative from the Office of the Investor Advocate of the SEC observed that the office was happy the PCAOB had finished the project. Some might take this as a positive sign that the SEC will be moving swiftly to approve it. On the other hand, the US Chamber of Commerce and a group of 27 major corporations and business trade associations issued a letter in August urging the SEC to not enact the standard based on cost-benefit considerations. There's also a new SEC Chair in town. It's never over till it's over.

PwC observation. The question arises whether a Canadian public company should consider adopting KAMs reporting voluntarily. This issue requires careful consideration. It may have broader implications than just your audit opinion. For example, the audit committee might wish to expand its reporting to shareholders, and protocols with auditors almost certainly will be affected. Some jurisdictions, such as the UK, have issued regulatory guidance addressing these matters. Although the OSC had announced it would be considering providing similar guidance, the odds that it will are slim now. Of course, the decision whether to adopt KAMs reporting may not be entirely in your own hands. Your friendly neighbourhood industry regulator may have something to say about it too.

For more information

This newsletter has been prepared for the clients and friends of PwC by National Accounting Consulting Services. For further information on any of the matters discussed, please feel free to contact any member of ACS, or your PwC engagement leader. This newsletter is available from the PwC Canada web site, which is located at www.pwc.com/ca/financialreportingrelease.

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- Assistance with financial statements, prospectus and other documents
- Assistance with due diligence process
- Advice on alternatives

Complex Mergers and Acquisitions

- Carve-out financial statements
- Pro-forma financial information
- Accounting function integration

Regulatory Issues and Restatements

- Assistance with offering documents
- Support in responding to regulatory comments and requests
- Advice on alternatives

GAAP / IFRS Interpretation and Conversions

- Diagnostic summary of key impacts on transition
- Evaluation and development of accounting policies
- Training development
- Support in analyzing and documenting technical accounting issues

Accounting Standard Adoption

- Adoption of new standards under IFRS, U.S. GAAP and Canadian GAAP for Private Enterprises
- Diagnostic summary of key impacts on adoption
- Evaluation and development of accounting policies
- Training development and implementation
- Support in analyzing and documenting technical accounting issues

Other Services and Products

- On-site assistance / expert secondment
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- Tax Accounting Services
- Comperio
- Automated Disclosure Checklists
- PwC IFRS Manual of Accounting

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