

AC Insights

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

In this edition

During the summer, the FASB released its update to accounting for hedging activities. The ASU introduces amendments that will more closely align the accounting for hedging relationships with a company's hedging strategies. The ASU also reduces some of the complexity of the existing standard.

In addition, the FASB issued an ASU to reduce the complexity of accounting for certain financial instruments with down round features, which permit adjustments to the strike price of conversion or similar options and rights.

In September, the staff of the AMF and OSC Corporate Finance Branches each released a report on various matters

including findings from their reviews of continuous disclosure documents and prospectuses. We have summarized these findings for you, along with a CSA Staff Notice on cryptocurrency offerings.

The summer saw the SEC issuing a statement on cybersecurity, updating its revenue recognition guidance in line with the new revenue standard, and providing some disclosure relief for certain registration statements.

In auditing developments, the PCAOB has laid out some key areas of focus for its 2017 inspections. Also, COSO has updated its framework for enterprise risk management. These developments are highlighted this quarter.



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US GAAP developments

Aligning hedge accounting and risk management

In August 2017, the FASB issued major amendments to its standard on derivatives and hedge accounting. ASU 2017-12: *Targeted improvements to accounting for hedging activities* improves the financial reporting of hedging activities to reflect the economic results of a company's risk management activities. In addition, the ASU simplifies the application of hedge accounting.

These amendments can be adopted immediately if companies wish to do so.

What's changed?

New hedging strategies

The FASB's new guidance will make more financial and nonfinancial hedging strategies eligible for hedge accounting. It is intended to more closely align hedge accounting with a company's risk management strategies.

The ASU will allow hedge accounting for risk components of nonfinancial items and interest rate risks. Entities will now be able to hedge a specific price component in a hedge of forecasted purchase or sales of nonfinancial assets and a contractually specified interest rate in a hedge of variable rate financial instruments.

Fair value hedging of interest rate risk has been expanded to allow:

- Hedges of the benchmark rate component of the contractual coupon cash flows of fixed-rate assets or liabilities;
- Hedges of the portion of a closed portfolio of prepayable assets not expected to prepay; and
- Partial-term hedges of fixed-rate assets or liabilities (e.g., the first and second years of a five-year bond).

These changes will allow more hedging strategies to be eligible for accounting purposes and result in the economics of these hedging strategies to be reflected in the financial statements.

Recognition of hedging gains and losses

For cash flow hedges, if the hedge is highly effective, all changes in the fair value of the hedging instrument will be recorded in other comprehensive income. These changes will be reclassified to earnings when the hedged item affects earnings. The ineffective component will no longer be recognized currently in earnings.

On the other hand, for fair value hedges, the change in fair value of the hedged item and the hedging instrument will be recorded in current earnings. If the hedge is not perfectly effective, there will be an income statement impact.

In addition to the time value of options or forward points in a forward contract, the cross-currency basis spread in a currency swap will be excluded from effectiveness testing. Changes in the fair value of these excluded components will be recognized immediately in income or may be deferred in other comprehensive income and amortized to earnings. The initial value of the time value of options, the forward points or the currency basis spread continue to be amortized to income.

Presentation of hedging gains and losses

The ASU requires the total fair value change in a hedging instrument be represented on the same line as the earnings effect of the hedged item. An exception is provided for hedging gains and losses on transactions no longer expected to occur, which can be reported in other lines.

Effectiveness assessments

Hedge designation and effectiveness testing is still required. However, the initial prospective hedge effectiveness testing may now be performed after

hedge designation. Public business entities, public not-for-profit entities, and financial institutions will have until the end of the first quarter in which a hedge is designated to perform an initial assessment of a hedge's effectiveness.

Subsequent effectiveness testing may now be performed qualitatively provided the company can reasonably support an expectation that the hedge is highly effective currently and in subsequent periods. This assertion must be supported by facts and circumstances and documented.

Both the shortcut method and the critical-terms-match method for assessing hedge effectiveness have been retained. Updates have been made to application guidance to facilitate use of these methods on a reasonable basis.

Disclosure

Additional disclosures include cumulative basis adjustments for fair value hedges and the effect of hedging on individual income statement line items.

When is the ASU applicable?

The ASU may be adopted immediately in any interim or annual period after the ASU is issued. The ASU will be applicable for fiscal years beginning after December 15, 2018.

The ASU is to be adopted using a modified retrospective method to existing hedging relationships at the adoption date. Cumulative adjustments will be made to opening accumulated other comprehensive income or opening retained earnings, as applicable. Several transition elections are provided to facilitate the transition.

What's next?

The changes made to hedge accounting provide opportunities to reflect the economics of hedging strategies in the financial statements and simplifies several aspects of hedge accounting. Companies will want to consider whether they wish to apply the ASU early to take advantage of any changes that will be beneficial.

Down round features in certain transactions

In July 2017, ASU 2017-11 was issued by the FASB to address narrow issues relating to the classification of certain financial instruments. Part I: *Accounting for certain financial instruments with down round features* addresses the complexity of the accounting for financial instruments with down round features.

Down round features are most often found in warrants and conversion options embedded in debt or preferred equity instruments issued by private entities, but may be found in financial instruments issued by public companies. These features reduce the strike price of the warrant or conversion option when an issuer sells shares of its stock (or issues equity-linked instruments) for amounts less than the current strike price (or with strike prices less than the current strike).

A down round feature will no longer cause a freestanding equity-linked financial instrument (or an embedded conversion option) to be accounted for as a derivative liability at fair value with changes in fair value recognized in current earnings.

When a down round feature is triggered on an equity-classified freestanding financial instrument, entities that present earnings per share must recognize the value of the effect of the down round feature as a dividend. This deemed dividend should be reflected as a reduction of income available to common stockholders in the computation of basic earnings per share.

The new guidance also provides for additional disclosures, including the existence of the down round features and the financial statement impact upon its trigger.

The changes are effective for public business entities in 2019. Early adoption is permitted for all entities, including in an interim period. Entities may use the retrospective or modified retrospective transition method.

CSA developments

Need for disclosure improvements

In September 2017, the Corporate Finance Branches of both the AMF and the OSC issued their respective branch reports on their activities. The reports covered, among other things, the branches' statistics, the continuous disclosure review programs, and the reviews of public and exempt offering documents. In this edition, we outline the findings from the review of continuous disclosure documents and prospectuses. Further details about the Corporate Finance Branches' activities and commentary can be found in the following reports on the respective agency's website:

- AMF – *Summary of Oversight and Regulatory Activities*
- OSC – OSC Staff Notice 51-728: *Corporate Finance Branch 2016-2017 Annual Report*

Continuous disclosure review programs

A substantial number of the reviews of continuous disclosure documents by the staffs flagged deficiencies (OSC – 95% of issuers reviewed and AMF – 84% of issuers reviewed). The outcomes included (a) prospective disclosure enhancements (OSC – 72% and AMF – 40%); (b) refile of disclosure documents (OSC – 16% and AMF – 11%); (c) additional guidance to assist in disclosures (OSC – 2% and AMF – 28%); or (d) referrals to enforcement or placement on the default list (OSC – 5% and AMF – 5%).

The two reports highlight some common concerns as well as other key areas for improvements. Illustrative examples have been provided of improved disclosures.

Non-GAAP financial measures

Both reports raised concerns over the prominence given to non-GAAP financial measures (NGFM), the lack of visibility and clarity of adjustments made in

NGFM, the appropriateness of adjustments made, and the descriptions of adjustments as “one-time”. The staffs stressed that it is important that NGFM not mislead investors or obscure GAAP measures. In the MD&A, NGFM must be presented with the most directly comparable GAAP measure determined using the applicable GAAP.

The OSC staff mentioned certain specific NGFM that warrant further attention:

- Production costs and free cash flow used by mining issuers;
- Pay-out ratios, which are distributions as a percentage of funds from operations or adjusted funds from operations, used by real estate reporting issuers; and
- EBITDA, adjusted EBITDA, and adjusted EPS used by many industries.

Issuers are encouraged to refer to CSA Staff Notice 52-306: *Non-GAAP Financial Measures* for further guidance on presenting NGFM.

The securities administrators will continue to look at disclosures about NGFM in filings, news releases and on company websites to ensure the guidance in the CSA Staff Notice is followed and to ensure the presentation of NGFM is not misleading to investors.

MD&A

The OSC Report expressed overall disappointment that many issuers continue to struggle to provide meaningful disclosures in their MD&A. Specific areas of concern include:

- Disclosures about changes in accounting policy including initial adoption, which require discussion and analysis of the nature of the changes and the effect or potential effect.
- Discussion and analysis of results of operations, which need more detailed, analytical and quantified discussion of factors affecting revenue and expenses.

- Disclosures of risks and uncertainties, which require more specific information about material risks and uncertainties, including the anticipated significance and the impact of the risks and uncertainties on financial position, operations and cash flows. If circumstances change for any risks and uncertainties, the disclosures should be updated.
- Discussion and analysis of liquidity and capital resources, which needs to be more specific including disclosures about material cash requirements to settle obligations, quantification of working capital needs, and funding requirements for future business plans and milestones.

The AMF staff has indicated that during the 2017-2018 review cycle, they will monitor disclosures about new IFRSs and the risks of climate change.

Operating segments

The AMF staff noted certain deficiencies in the disclosure of operating segments in both the financial statements and the MD&A. The financial statement concerns related to the aggregation of operating segments without disclosure of the fact and without support for the aggregation. In the MD&A, the segment results presented and discussed were not always consistent with those in the financial statements. In some cases, there was no discussion of the operating segment results. Issuers were also reminded that adjustments to segment results are NGFM, which requires disclosures as outlined in CSA Staff Notice 52-306.

Forward-looking information

Companies often provide forward-looking information (FLI) in various disclosures. To understand FLI, specific and relevant material factors and assumptions used in preparing the information should be disclosed. The OSC staff often found the disclosure of factors and assumptions to be generic without any quantification of assumptions and explanation of the risks associated with the information. The staff has also questioned the reasonableness of the time period used when the FLI goes beyond the issuer's next fiscal year. If reasonable

quantifiable and qualitative assumptions are not provided, the time period of the FLI may need to be shortened. Reporting issuers are also reminded to update FLI if key assumptions and factors change and to compare FLI to actual results.

Social media disclosures

The OSC staff found the quality of social media disclosures needs improvement to prevent unbalanced, misleading or selective disclosures. Social media disclosures must provide a complete picture. Similar disclosures should be made simultaneously through SEDAR so all investors have the ability to obtain the disclosures at the same time. The disclosures on social media should also be consistent with disclosures made on SEDAR.

Mining disclosures

Both the AMF and the OSC raised concerns over disclosures about mineral projects.

Mining issuers' preliminary economic assessment of an advanced property containing mineral reserves are to be presented in a prescribed manner. The OSC staff continues to see noncompliant disclosures, some of which required refileing.

The AMF comments focused on the presentation of the reasonable prospect for eventual economic extraction. Concerns were raised over the use of overly aggressive or unreasonable assumptions in the assessment of the economic potential of the mineralization.

Investment entities

The OSC staff's review of disclosures by investment entities indicated a disappointing trend and broad concern with the issuers' understanding of their disclosure obligation. Disclosures about the entity's operations, investments and risks were not entity specific and insufficient. Some entities omitted fair value disclosures in their financial statements. The lack of disclosures made it difficult to understand the composition of the investment portfolio, its performance, the investment strategies and oversight, and the related risks.

Venture issuers

The OSC and AMF staffs' reviews included the quarterly highlights of venture issuers. Quarterly highlights replaces the requirement for full MD&A for venture issuers. The staff observed that many venture issuers have not fully applied the revised requirements. The results indicated that, while companies did exclude information not required by the quarterly highlights, the commentary was highly similar to previously issued MD&A with no real change in quality.

The disclosures of executive compensation under the new venture issuer requirements were generally adequate. However, improvements are required for the discussion of oversight and description of director and named executive officer compensation. In some cases, all information required about stock options and other compensation securities was not provided.

Disclosure of policies about women on boards and in executive officer positions

Non-venture issuers need to have policies about the inclusion of women on their boards and in executive officer positions. If issuers do not have such policies, they are reminded to disclose the reasons why they do not have such policies.

Cybersecurity risks and incidents

Cybersecurity risks were highlighted in the OSC Report. If cybersecurity risks are a material risk, the disclosure of these risks should be detailed and entity specific. If a material cybersecurity incident has occurred, disclosure may be required as a material fact or a material change.

Prospectus reviews

The review of prospectuses and information circulars for significant acquisitions or restructuring transactions by both the AMF and OSC staffs highlighted some common deficiencies. The OSC staff noted that many matters could have been resolved early through pre-filing discussions with the staff. The key takeaways from the review are:

- **Disclosure improvements** – Material disclosure changes are often required to provide a comprehensive description of the

business and its regulatory environment, specific risks related to the business and the offering, relevant and sufficient information in the MD&A, and sufficient and comprehensive details about the use of proceeds.

- **Acquisitions** – The OSC encourages issuers to use pre-filing consultations to confirm the nature of the acquisition and any disclosure requirements in the following situations:
 - Assessing whether the acquisition is an asset acquisition or a business combination.
 - If the proceeds being raised are to be used to finance a significant acquisition, any additional disclosures that may be required.
 - When there have been or will be multiple acquisitions in an IPO, the extent of information required for some or all of the acquisitions.
- **Financial condition of the issuer** – A critical part of a review of a prospectus by both the AMF and OSC staffs is the issuer's financial condition and whether the issuer has or will have sufficient funds to continue operations for a reasonable period of time. A company may be required to demonstrate its ability to continue as a going concern, make representations about this conclusion to the regulatory authority and in the prospectus, and include disclosures to allow investors to assess the reasonableness of assumptions made. In certain extenuating circumstances, a prospectus may not proceed if the staff believe there will not be sufficient cash resources to continue operations for the next 12 months or meet the developmental milestones for the next 12 months.
- **Audit committees** – The OSC staff reminded issuers that an audit committee is required when an issuer files an IPO prospectus.

- **Third party information in a prospectus** – The AMF stated that issuers cannot limit their liability for third party information included in a prospectus. Disclosures can be made about the source of the information and the extent of verification of the information made by the issuer.
- **Review of unaudited interim financial reports** – The AMF report reminds issuers that interim financial reports included or incorporated by reference in a prospectus must be reviewed in accordance with the relevant auditing and assurance standards.

What's next?

The two reports provide a number of insights on key issues of concern to the securities administrators, advice on resolving issues, illustrative guidance on how to comply with disclosure requirements, and solutions the administrators use to facilitate compliance with securities requirements. These two reports are an important read for management and your advisors.

Cryptocurrency cautions

The CSA staff has observed a number of offerings in cryptocurrency. These include initial coin offerings (ICO), initial token offerings (ITO), and sales of securities of cryptocurrency investment funds. The CSA staff recognizes that these offerings facilitate capital raising, but also noted that it is important to ensure the capital markets are fair and efficient and

investors are protected from high-risk or fraudulent activities.

In response, the CSA staff has issued CSA Staff Notice 46-307: *Cryptocurrency Offerings* to assist issuers in assessing whether the coins and tokens are securities and whether the offerings of these coins and tokens are subject to securities laws.

The CSA staff has indicated they will consider the substance of the coin or token over its form in applying the analysis. In reviews of potential offerings, the staff has concluded that in many instances the coins or tokens are investment contracts because they involve an investment of money in a common enterprise with the expectation of profit coming significantly from the efforts of others.

Offerings of coins or tokens that are securities would be subject to securities law and may require a prospectus unless a prospectus exemption exists. Companies or persons facilitating offerings of coins or tokens that are securities may also need to register as dealers.

The Notice also asks companies establishing investment funds investing in cryptocurrencies to consider a number of factors including prospectus requirements; the impact of using cryptocurrency exchanges; the registration of dealers, advisors, and investment fund managers; valuation of the fund's portfolio; and the custody of portfolio assets.

The CSA staff encourages businesses that are proposing cryptocurrency offerings to discuss approaches with the staff.

SEC developments

Cybersecurity

In recent testimony to the US Congress, the Chair of the SEC, Jay Clayton, revealed that the SEC data systems had been hacked. In response to these events and other cybersecurity breaches, the Chair issued a statement on cybersecurity and the SEC has launched two initiatives to focus on the ever increasing risks of cyber threats.

SEC Chair's statement

The Chair of the SEC, Jay Clayton, issued a statement on cybersecurity which stressed the importance of identifying and managing cybersecurity risks. The Chair acknowledged that “the most diligent cybersecurity efforts will not address all cyber risks that an enterprise faces”. However, he made it clear that adequate disclosure is critically important.

In the statement, the Chair outlined the SEC’s own initiatives to manage cybersecurity risks, the governance of its programs, and its policies and procedures to protect data held by the SEC, the audit and review of its cybersecurity program, and its reporting on its cybersecurity performance.

The SEC Chair reminded public company issuers of the importance of disclosures about cybersecurity risks in the company’s risk factors, the MD&A, the description of the business, the discussion of legal proceedings, the financial statements, and disclosure controls and procedures. Companies should disclose information about their risk management governance and cybersecurity risks, including any evolving cyber threats.

Considering the high profile cybersecurity breaches that have occurred, companies should closely examine their practices and procedures for mitigating cyber risks, as well as review their disclosures of these risks.

SEC initiatives

The SEC has also launched two initiatives to address cyber-based threats and protect retail investors. A cyber unit will be established in the Enforcement Branch of the SEC to deal with market manipulation, hacking to obtain non-public information, violations involving cryptocurrency offerings, dark web misconduct, intrusions into retail brokerage accounts, and cyber threats on trading platforms and critical market infrastructure. The retail strategy will involve proactive, targeted initiatives to identify misconduct affecting retail investors.

SEC revenue guidance updated

As the adoption date for the new revenue standard approaches, the SEC has updated its interpretative guidance on revenue recognition.

The SEC guidance on bill-and-hold arrangements included in Staff Accounting Bulletin Topic 13 will no longer apply when the new standard is adopted. In addition, the SEC guidance on the sale of specific vaccines and bioterror countermeasures to the federal government has been updated to require revenue recognition when the vaccines are placed in the government stockpiles, as this is the point of transfer of control to the customer.

The SEC staff has issued Staff Accounting Bulletin 116, which effectively eliminates all of the revenue guidance in Topic 13: *Revenue recognition* and Topic 8: *Retail companies*. Topic 11.A: *Operating-differential subsidies* has been modified to require these subsidies to be presented as a separate line in the statement of comprehensive income, either under a revenue caption separately from revenue from contracts with customers or as a credit in the costs and expenses section. These changes are effective upon the adoption of the new revenue standard.

In a separate announcement, the SEC staff announced that it would allow certain entities to use the private company effective dates for the new revenue and leases standards. Entities that are private companies but are required to include their financial statements or financial information in a registrant's filing will be able to continue to use the private company effective dates for those filings. This announcement will be beneficial to equity method investees who do not wish to adopt the revenue standard early.

Relief from providing interim financial statements in certain registration statements

On August 17, 2017, the SEC's Division of Corporation Finance issued two new Compliance and Disclosure Interpretations (CDIs) that expand the scope of interim financial information that may be omitted from a draft registration statement

submitted for confidential/non-public review. Under the new guidance:

- An Emerging Growth Company (EGC) may omit interim financial information it reasonably believes will not be required to be separately presented at the time of the contemplated offering.
- An issuer that is not an EGC, but that is permitted to submit draft registration statements for non-public review, may omit from its draft registration statements interim financial information it reasonably believes will not be required to be separately presented at the time it publicly files its registration statement.

The CDIs provide examples of when these provisions can be applied.

The new guidance is part of the SEC's ongoing efforts to facilitate capital formation while maintaining important investor protections.

The new guidance is effective immediately.

Auditing developments

PCAOB Inspection Brief

In August 2017, the PCAOB issued a *Staff Inspection Brief* outlining key areas of inspection focus for its 2017 PCAOB inspections. Several areas deal with auditing procedures and audit risk assessment. The PCAOB also outlined economic factors and other financial reporting areas it believes may be significant for 2017. In this edition of *AC Insights*, we outline some of these factors and areas.

Current important economic developments considered by the PCAOB include:

- Brexit and its effect on entities with operations in the UK and Europe;
- Business combinations and the risks associated with the identification of intangible assets, the valuation of assets and liabilities, the measurement of contingent consideration, and the assignment of goodwill to reporting units;
- Use of higher yield investments which may have higher risk due to the complexity of terms and conditions and valuation issues; and
- Fluctuating oil and gas prices and the impact on debt defaults, impairments, valuation risks, and the assessment of the ability to continue as a going concern.

The PCAOB has identified three emerging financial reporting developments that have been added as focus areas for 2017:

- The impact of current economic factors on a company's ability to continue as a going concern, such as fluctuating oil and gas prices, and increase in debt defaults;
- The evaluation of income tax accounting including management's assertion that cash held in foreign subsidiaries will be held for indefinite reinvestment. In addition, the PCAOB plans to focus on internal control over income tax accounting, particularly the use of prospective financial information in judgments used for tax accounting; and

- Cybersecurity risks affecting financial statements.

These insights of key risk areas may be helpful to auditors and the audit committee when reviewing the audit plan for the current year.

COSO ERM update

In September 2017, COSO released an update to its Enterprise Risk Management Framework. The updated publication: *Enterprise Risk Management – Integrating with Strategy and Performance* addresses current and evolving concepts and applications of ERM. The publication focuses on the need for organizations to improve their approach to managing risk.

The update was developed by PwC (US Firm) under the direction of the COSO Board. The Framework outlines the benefits that can be achieved through ERM. The update focuses on how ERM integrates from strategy through implementation and performance.

The publication provides a focused framework and 20 principles to be used in developing and management of ERM. The key elements are as follows:

- Governance and culture covering:
 - Establishing the Board's oversight of the risk management strategy;
 - Establishing operating structures and reporting lines;
 - Defining the entity's desired culture and its spectrum of risk;
 - Reflecting the entity's core values; and
 - Attracting, developing and retaining capable individuals to carry out the strategy.
- Strategy and objective setting covering:
 - Analyzing the business environment;

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- Defining the entity’s risk appetite in the context of creating, preserving and realizing value;
 - Evaluating alternative strategies and the potential impact on the risk profile; and
 - Formulating business objectives that consider the risks and aligns with the risk management strategy.
- Practices that support the organization in making decisions and achieving their strategy and business objectives including:
 - Identifying risks that impact performance;
 - Assessing the severity of risk;
 - Prioritizing risks for selecting responses to risks;
 - Identifying and selecting risk responses; and
 - Developing and evaluating a portfolio view of risk on an entity-wide basis.
 - Review and revision of practices and capabilities as the business context changes including:
 - Identifying and assessing changes that may affect strategy and business objectives;
- Reviewing the entity’s performance and considering how risks and the risk management strategy affected performance; and
 - Improving the enterprise risk management strategy.
- Structuring data and information to communicate relevant information to identify enterprise risks, including:
 - Leveraging the entity’s information and technology systems to support ERM;
 - Communicating with stakeholders to provide relevant information for decision making; and
 - Reporting on risk, culture, and performance at multiple levels and across the entity to improve decision making.

The publication is available in printed form, e-book, on-line subscription, and pdf licensing through www.coso.org. COSO also expects to translate the publication into French.

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