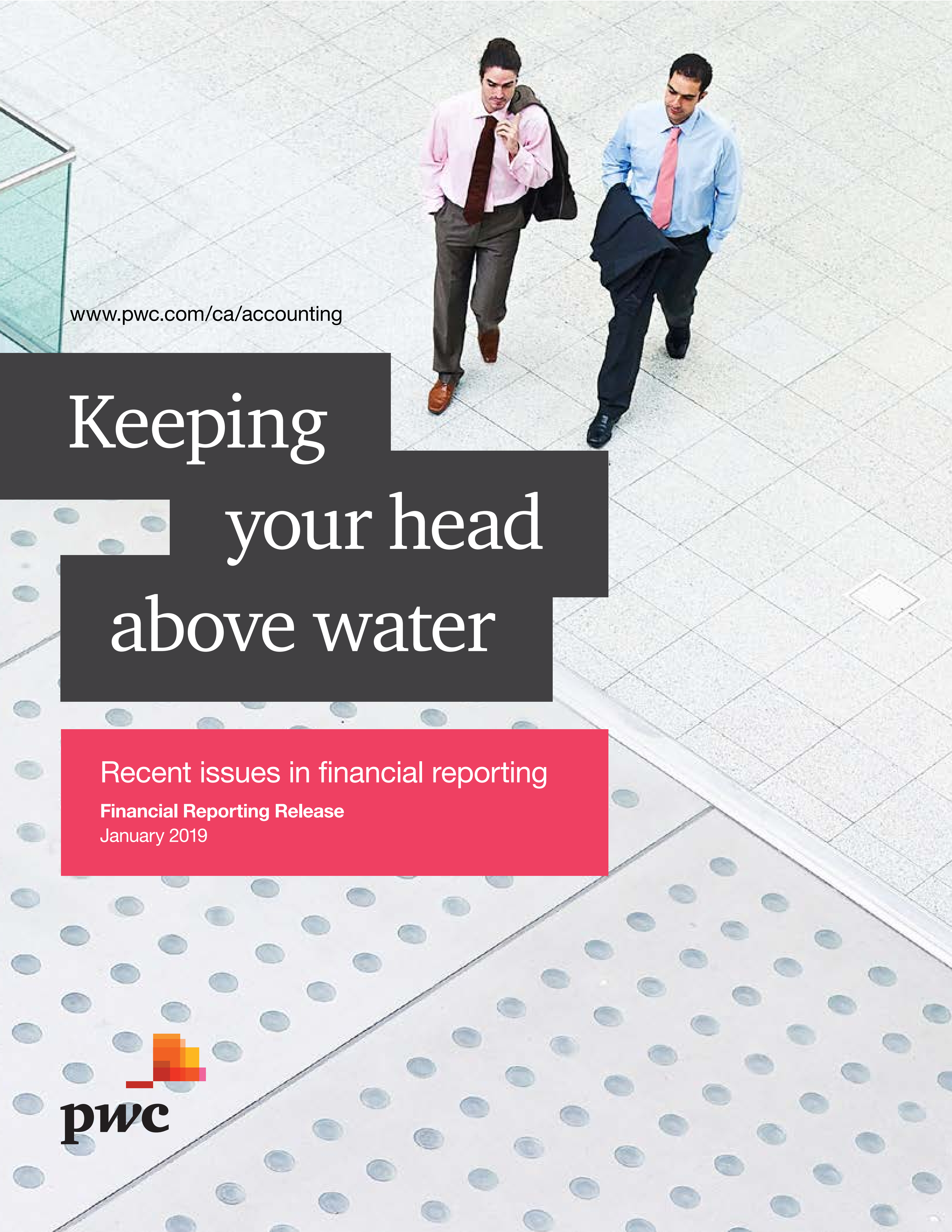

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Keeping your head above water

Recent issues in financial reporting

Financial Reporting Release

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In this issue

Sometimes, it's never over even after it's over. Just ask the IASB and FASB, both of whom are now struggling to deal with pushback, dare we say uprisings, against recently completed standards. In the IASB's case, it's the new standard on insurance, and in the FASB's, it's its version of the new global standard on expected credit losses – you know, the one you had the pleasure of adopting last year. The push back against the standards they're getting now, a few years after their issuance, far surpasses what they heard when they were under development. Demands in both cases are that implementation needs to be delayed pending a remorseful reconsideration of their requirements and, in the case of the US standard, a study of its economic impact. Even politicians in the US are getting involved, never a good sign. Ultimately, these challenges may prove to be a tempest in a teapot, but they may not. Considering their possible implications to future standard-setting you need to be reading about this stuff, even if your only association with the standards is limited to the occasional fleeting thought of thankfulness you don't have to apply them.

Contention seems to be the defining characteristic of developments in the financial reporting world over the past few months. For example, we've got proposals from the Canadian Securities Administrators to upgrade and substantially expand its guidance on non-GAAP financial measures that's drawing the ire of Canadian public companies. We've got the SEC moving ahead on its Trump inspired project to consider the elimination of mandatory quarterly reporting, which is sure to raise the decibel level of debates on this issue in the US that sprung up as soon as the fateful tweet came out last summer announcing the project's creation. We've got most public companies listed on the TSX being told that, yes, their auditors soon will have to start telling the world about the most significant issues they had to address during their audits. That's come coupled with a warning to other Canadian public companies that their turn might be coming soon too. We've got Canadian auditors deciding that, as a result of new Canadian auditor reporting standards, they can't provide Canadian-style audit opinions to Canadian SEC registrants any longer. We've got a number of clarifications and amendments to existing IFRS that are sure to tick somebody off. The only development that's not controversial is, ironically enough, the new leasing standard which went live on January 1. A few years ago, critics were arguing that the world as we know it would end if operating leases had to be on the balance sheet. Now no one seems to care – yet.

And there you have it. A summary of the major financial reporting developments in Canada and around the world at your fingertips. Could you ask for anything more? Wait. Don't answer that.

Non-GAAP reporting

"I dream of a better tomorrow, where chickens can cross the road and not be questioned about their motives."
– Anonymous

Beware. A new era for reporting of non-GAAP financial measures is coming. Maybe not tomorrow, but soon and for the rest of your lives. (Apologies to Casablanca fans.)

The change likely to have the most immediate effect comes courtesy of the Canadian Securities Administrators. Disappointed with how companies have been blowing off their guidance for selecting and reporting non-GAAP measures, it's proposing to upgrade the authority of the guidance by converting it into a National Instrument, which would enhance the CSA's ability to pursue enforcement actions. Recall that, among other things, this guidance specifies that companies should give no greater prominence to non-GAAP measures than they do to GAAP ones, and reconcile non-GAAP measures to their nearest GAAP equivalent.

The CSA's also proposing major changes to the guidance, including updating and significantly expanding the definition of a non-GAAP financial measure, and setting new requirements for the disclosure of financial ratios, and segment and capital management measures financial outlook information. Some companies haven't been shy in voicing their opposition. Among their arguments is that the changes would make reporting so onerous that companies might stop disclosing important data altogether.

The CSA isn't the only one taking action in this area. Last December, the Canadian Accounting Standards Board issued a voluntary Framework to help establish best practices for the reporting of non-GAAP performance measures and related internal controls and governance practices. Farther afield, the IASB is considering a new IFRS relating to financial statement presentation that, among other things, would require companies to include new subtotals in the income statement, such as operating profit, income from investments and earnings before interest and taxes that disaggregate the entity's performance. The Board's even considering allowing companies to present a subtotal of operating income before depreciation and interest – aka EBITDA – and requiring companies to include key non-GAAP measures in their IFRS financial statements, together with appropriate explanations and reconciliations.

PwC observation. Fear and suspicion about the motives for and potential misuse of non-GAAP reporting run so deep and wide that any notion that securities regulators possibly would relax existing constraints over its use is a dream for a future day. We support the CSA's effort to improve the quality and consistency of non-GAAP reporting, including upgrading the authority of its guidance, but think that some proposals need to be clarified, simplified and rationalized. As to the Accounting Standards Board's initiative, we applaud the Board's effort to raise the profile of non-GAAP reporting, but have concerns about some aspects of its Framework. The IASB's project surely is the most audacious. Two goals lie at its heart. The first is to erode acceptance and tolerance of specialized performance measures that companies provide now by developing and requiring the presentation of more standardized performance subtotals on the face of the IFRS income statement. The second is to encourage a more targeted and disciplined process for the oversight, evaluation, explanation and reconciliation of any key non-GAAP measures that survive by requiring their inclusion in the GAAP financial statements, as counter-intuitive as that might sound. It's not been lost on the Board that including non-GAAP measures in the IFRS statements would usually subject them to audit. Not that the Board doesn't trust you or anything.

Quarterly reporting

"There are three side effects of acid: enhanced long-term memory, decreased short-term memory, and I forget the third."
– Timothy Leary

The plot thickens.

Last summer Donald Trump asked the SEC to study abolishing mandatory quarterly reporting in the US in favour of a semi-annual reporting regime. That initiative took a major step forward late last December, when the SEC issued a Request for Public Comments seeking views on how it could reduce the administrative and other burdens associated with quarterly reporting while at the same time maintaining appropriate investor protection. In particular, it's seeking views on three main issues:

- The nature and timing of disclosures in quarterly reports and earnings releases and the role of earnings releases as a key quarterly disclosure. A key question here is the duplicative nature and inefficiencies caused by mandatory quarterly regulatory reporting and voluntary earnings releases and what can be done about it.
- Whether its rules should provide all or some companies with flexibility as to the frequency of their periodic reporting.
- How the existing reporting system may affect corporate decision-making and strategic thinking, including whether it contains factors that promote "short-termism".

The Chair of the SEC dropped a hint a few months ago about the direction the SEC might be heading in, warning that quarterly reporting wasn't going to disappear anytime soon for the US's top companies. He did contemplate, however, that there might be some sort of relief for smaller companies.

One of the more contentious issues the Request raises is whether the SEC's current reporting system contributes to "short-termism". This question became the subject of impassioned, if not always illuminating, debate in the US financial reporting world the moment Trump broadcasted the tweet announcing his request. Some believe that there's no question that quarterly reporting is a major contributor, perhaps "the" contributor (though often without explaining why behavior would change any if reporting were to move to a semi-annual basis). Others, usually investors, pin the problem on different factors, such as the pressure of meeting quarterly forecasts (e.g., see the recent article in the Wall Street Journal by Warren Buffet and Jaimie Dimon), the structure of compensation arrangements, the short shelf life of CEOs, the pernicious influence of activist hedge funds, and fiduciary responsibilities of directors. Even Milton Friedman, the economist, is being identified as a cause, or would if he were still alive, because of the pervasive influence his 1970s theory has had over Corporate America that the main goal of the corporation is to maximize profits.

PwC observation. If the SEC provides significant relief from quarterly reporting in the US, we expect that Canada will probably revisit the issue too. While the CSA decided last year not to pursue quarterly reporting as part of its initiative to reduce the regulatory reporting burden in Canada, it did this on the basis it was looking for quick solutions for which there was a high degree of consensus among stakeholders. There may be a topic less likely to meet this criteria than quarterly reporting, but we can't think of what it might be. Or perhaps we've just forgotten.

Key audit matters reporting

"In theory there is no difference between theory and practice. In practice there is."
– Yogi Berra

And now to reporting of a very different kind…

Late last year white smoke poured forth from the chimneys of 277 Wellington Street West, the headquarters of the Canadian Auditing and Assurance Standards Board, a sign to the anxious crowds gathered in the square below that the Board had finally approved a standard making the reporting of key audit matters in Canadian audit opinions mandatory. As you're probably already aware, that standard is a photocopy of the international one that's been in play in capital markets in the UK, Europe and other jurisdictions for some years now. Is it in the US? Of course, not. The US, being the US, has developed its own new auditor reporting model, known as "critical audit matters". The good news is that critical audit matters are sufficiently close in concept to key audit matters that often the same issues will be identified and reported on under both standards. The bad news is that there can be significant differences, particularly with respect to the reporting of weaknesses in internal controls, so you shouldn't be presuming there's always a one-to-one correspondence.

The introduction of key audit matters reporting in Canada hasn't been without controversy. Adding to it that the Board still has yet to fully resolve which public companies have to apply it. As the standard stands now, only those listed on the TSX, other than investment funds, fall within its scope. However, the Board has announced it will be publishing an Exposure Draft early in 2019 addressing whether auditors of companies listed on other Canadian exchanges and investment funds, and their management and audit committees, also should have the pleasure of dealing with the consequences that the standard brings.

As to timing, the standard affirms what was already widely expected – key audit matters reporting will be mandatory for opinions on financial statements for years ending on or after December 15, 2020. In a happy coincidence, this is also when critical audit matters reporting under US auditor reporting standards begins, except for SEC registrants that qualify as large accelerated filers. Reporting for these behemoths, including Canadian SEC registrants, begins for years ending on or after June 15, 2019. In effect, these become the guinea pigs for everybody else.

PwC observation. Practice makes perfect. Starting in 2018, auditors of SEC registrants, including Canadian SEC registrants, have been conducting dry runs of the critical audit matter requirements. This involves identifying and drafting the matters that would have been reported in opinions for 2018 had the new reporting requirements been effective then, and engaging with management and the audit committee to develop appropriate protocols and procedures. A key issue (no pun intended) for the latter is how the new auditor reporting will influence management's and the audit committee's own reporting to stakeholders. We encourage those subject to the new requirements in 2020 to begin dry runs with their auditors this year. The US Center for Audit Quality has issued a related publication, *Critical Audit Matters: Lessons Learned, Questions to Consider, and an Illustrative Example.* This provides early observations emerging from dry runs, lists key questions that audit committees should be considering and in an appendix lists the important differences between key and critical audit matters. While the primary focus of the publication is on critical audit matters, many of its observations apply equally to key audit matters.

Auditor reporting on 2018 financial statements

"No good fish goes anywhere without a porpoise."
– Lewis Carroll

It seems almost cruel and unusual punishment to throw in yet another article discussing audit opinions, but, hey, you can take it. It's only a quick reminder that opinions for December 31, 2018 year ends are going to look a lot different than they used too – the result of an effort to more closely align Canadian opinions to international auditing standards. Major changes include putting the "presents fairly" paragraph first (lest anyone have any trouble finding it), expanding the descriptions of auditors', management's and the audit committee's responsibilities as well as going concern matters, addressing other information in the annual report, and providing the name of the engagement partner.

Audit opinions of Canadian SEC registrants will be something altogether different. That's because most registrants are electing to use only US audit opinions for Canadian reporting purposes. The reason isn't because they've suddenly taken violent and irrational dislike to the new Canadian reporting format. Rather, it's because the form and content of the new Canadian opinion is now significantly different than the US PCAOB audit opinion a Canadian SEC registrant will have to include in its US filing (see table). In the event that the Canadian opinion has to be in the US filing too, companies will end up having two different opinions covering the same set of financial statements. Whereas in the past, differences between Canadian and PCAOB auditor reporting requirements were sufficiently narrow that it was usually possible to prepare a single audit opinion simultaneously meeting both countries' requirements, the differences are now so significant that this no longer appears to be feasible. Furthermore, even if a single combined opinion was possible, it wouldn't solve concerns over providing the name of the engagement partner in a Canadian opinion that makes its way into certain US filings. Because the PCAOB decided to use a Form AP database, this approach settled the debate of including the engagement partner name in PCAOB audit opinions… problem solved. Is it possible for a Canadian SEC registrant to provide only a PCAOB auditor report for its Canadian reporting? For the most part, yes, because Canadian securities regulations specifically allow this. However, the governing acts of some SEC registrants, such as banks and other financial institutions, continue to require "Made in Canada" audit opinions.

PwC observation. We understand and generally agree with the objective of aligning Canadian audit reports with international standards, but it's not apparent to us what purpose is served by establishing requirements for Canadian audit opinions that don't adequately consider US reporting implications.

Canadian and US Audit Opinions – Differences

In the US opinion, there's:

- A less detailed description of the responsibilities of the auditor, management and the audit committee.
- No affirmative statement that the auditor is independent and fulfilled its ethical responsibilities.
- No requirement to disclose the name of the engagement partner provided the name is filed separately on Form AP.
- No discussion of other information in the annual report.
- Disclosure of the auditor's tenure.
- In future years, reporting of "critical audit matters" rather than "key audit matters", which can be different (see the previous page).

Leases

***"If you think nobody cares about you, trying missing a couple of payments."* – Steven Wright**

And now, finally, to some accounting. Well, sort of.

For a new IFRS standard that will be adding trillions in assets and liabilities to the world's balance sheets, you'd have thought that there would be more angst over the fact that it went live on January 1, but not so. The markets appear positively indifferent to the prospect of lessees capitalizing operating leases. Unlike revenue and expected credit losses last year, there's been no emphasis on this standard in quarterly investor calls or anything else. Or special announcements as to their impact. Oh sure, there've been the ritual "the sky is falling, the sky is falling" articles in the financial press that companies aren't nearly as ready for the transition as they should be, but even these seem kind of half-hearted. Of course, equity analysts and credit rating agencies have been treating operating leases as liabilities in their analyses for years now. The idea that operating leases are liabilities just isn't news.

If the markets seem indifferent to the standard, those having to apply it aren't. Our latest US survey, taken at the end of last October, provides a glimpse of how implementation is going. Not particularly well, apparently.

- Only 4% of participants had finished.
- 80% were still implementing with only about the same percentage more than half way done.
- The remaining 16% of participants had yet to begin the process. Not all of them can say it's because they have only a few leases.
- Participants were still ranking completeness as the number one implementation issue, such as determining whether service and other contracts that aren't leases in legal form meet the accounting definition of a lease, or contain embedded leases. Tricky one, that.
- Fully a quarter of companies didn't expect that the system changes necessary to implement the standard would be ready by the effective date, causing some to stress over their internal controls over financial reporting.

One major consequence of the leasing standard that's become increasingly apparent has nothing to do with GAAP reporting but its implications for non-GAAP reporting of EBITDA. Recall that under the IFRS version of the standard, you recognize interest expense on the lease liability and depreciation on the lease liability. Under US GAAP, you charge rental expense on operating leases the same way you always have. As a result of this difference in the models, we expect that we'll be seeing the proliferation of more adjustments to non-GAAP measures to compensate for this.

PwC observation. It's not that the markets don't care about operating leases, it's just that existing GAAP already provides what many sophisticated financial users think is the most important information about them – the amount and timing of future payments. Recognizing their discounted value on the balance sheet as liabilities is the cherry on top of the cake – nice to have but not essential. As to companies' implementation, our survey confirms facts of life that became evident last year with the standards on financial instruments and revenue – that implementation of any major new accounting standard is almost always back end loaded, and will often go right up to the date when reporting begins, and even beyond. Nevertheless, audit committees need to be aware of the leasing standard's 2018-year end reporting implications. The most obvious one is addressing regulatory expectations that you'll disclose a reasonable estimate of the standard's quantitative impact. Then there's the delicate issue of your footnote disclosure for operating leases in the December 31, 2018 annual financial statements. Remember, you have to reconcile the amounts that appear in this footnote to the liability you recognize on the balance sheet at January 1, 2019 and include this in your transition disclosures (unless you're restating). Nailing down the leases that are going to be recognized as liabilities on transition by the time you have to publish the footnote will avoid those awkward "Well, you know" public explanations of how contracts that weren't included in the footnote somehow managed to turn themselves into leases overnight.

Insurance contracts

"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

If we put subtitles under our headings, we would have used "The Politics of Standard Setting", or the "Anatomy of a Deferral", or something like that.

Our story begins a few years ago…

May 2017. After 17 years, the IASB finally completes its insurance contracts standard. Insurers have until January 1, 2021 to adopt it. They can defer adoption of the new financial instruments standard until then too. As a result insurers can continue to apply the "incurred loss" model for recognizing loan impairments, which was roundly damned as being too little too late when the financial crisis hit, for four years after everybody else had to apply it.

Spring and summer, 2018. Insurers start muttering dark things about the standard. Talk about the need for deferring the standard's effective date fills the air.

September 2018. The European Financial Reporting Advisory Group (EFRAG) writes to the IASB. EFRAG is the agency responsible for advising the EU on whether new IFRSs are fit for European consumption and is a very big cheese. EFRAG lists a variety of fundamental issues about the standard that it says merits the Board's further consideration.

October 2018. European securities, banking and insurance regulators publish a joint letter to EFRAG. They're not happy with what EFRAG did, saying that they would have expected a more transparent decision-making process around the EFRAG letter, and stressing the importance of the standard's timely adoption. EFRAG responds with a wounded innocence that it was only trying to clarify whether the standard is a stable platform.

A few days later. A worldwide coalition of insurance associations writes to the IASB, emphasizing that important issues have to be resolved to ensure the standard's quality and operational practicality. It also says that there are serious constraints on insurers' ability to meet timelines and asks for a two year delay in the standard's effective date.

Sometime later in October. IASB staff present the Board with a list of 25 possible amendments to the standard that insurers and others have proposed. The Board receives the list with approximately the same level of enthusiasm you'd show if the cat were to drag a dead bird into the house and lay it at your feet. Nevertheless, it decides to consider the proposals. It attaches a qualifier, though. The Board will entertain only those proposals that won't result in a significant loss of information, or unduly compromise companies' implementation activities or the standard's effective date. Hans Hoogervorst, the Chair, stresses the importance of having both the insurance and financial instruments standards in place before the next financial crisis. If everybody viewed this matter with the same urgency, he said, the Board wouldn't be having this discussion.

November 2018. The IASB votes to defer the standard's effective date by a year, on the basis that by agreeing to consider the amendments at all, it's creating uncertainties that may disrupt companies' implementation. It defers the financial instruments standard on the same basis.

December 2018. The Board discusses the first 13 of the 25 proposed amendments. It agrees to relax the requirements for the presentation of insurance assets and liabilities because of unanticipated systems consequences. It rejects all the other proposals out of hand, except for part of one it wants to think further about. The other 12 possible amendments are scheduled for future meetings as well.

An Exposure Draft of proposed amendments is now expect toward the middle of this year.

PwC observation. In responding to the insurance industry, the Board has drawn a very clear line in the sand – it's not about to "re-litigate" (as one Board member described it) the standard's main principles, though it will consider issues at the edges and, to some degree, timelines. Regulators, investors and other financial statement users, says the Board, have waited long enough for the new standard. Implicit in this response is the proposition that however bad you might think the standard is, it's got to be better than the chaos that's existing IFRS. We'll see how this plays out. A key test for the Board is whether the EU will endorse the standard for European companies, which in turn will be based on EFRAG's recommendation. The fact that European regulators are concerned about delaying the standard's adoption is a major plus from the Board's perspective.

Expected credit losses

"This isn't life in the fast lane, it's life in the oncoming traffic."
– Terry Pratchett

We rarely venture into the world of US GAAP but this issue is so significant and so interconnected with IFRS reporting that we're making an exception.

You'd have thought that all controversies over the new "expected credit loss" loan impairment standard would have died down by now. After all, IFRS banks and other companies, including non-financial institutions, have been following this model for a year now and the world hasn't exploded or anything. In the US, however, they're only just now fully sinking their teeth into their own version of the standard (which they've dubbed the CECL model), which isn't effective for SEC registrants until 2020. Before we get into the controversies, though, a quick recap.

Under both the IASB and IFRS versions of the expected credit loss model, companies have to recognize an allowance for expected credit losses on a loan from the moment they acquire it, by charging earnings. As we never tire of saying, expected losses aren't the losses you actually expect to happen; rather, they're an average of the losses that might occur under management's forecasts under different future economic scenarios, weighted by the probability that they'll happen. In effect, loan losses should go up as the credit risk of the loan goes up (i.e., the probability of loss increases). (Damn all accountants for using "expected" in a way that nobody but geeks understand.)

A key difference between the IASB and FASB versions of the model is that under the IASB's you forecast expected credit losses only for the next 12 months unless there's a significant increase in a loan's credit risk. It's only then that you switch into estimating losses expected over the loan's remaining life. Under the FASB version, there's no such staging; rather, expected losses over the remaining life of a loan are recognized from the get go. The FASB decided on this approach at least partly on the grounds that applying the IASB approach would cause banks to reduce, not increase, loan loss allowances, which would kind of defeat the purpose of the whole thing. There are other differences between IFRS and US GAAP, too, but this would take us deep into corners where few dare tread.

And now to the controversies. Last fall the banking industry in the US started a campaign against the standard, arguing that the banks' studies show that it will increase pro-cyclicality and so exacerbate economic downturns (not everyone agrees with this), adversely affect the cost and availability of credit, and significantly burden smaller community banks. They've been calling for the FASB to at least delay its effective date pending the completion of a quantitative impact study of its economic and behavioural impacts. Politicians are now entering the fray too, with some members of Congress penning letters to the SEC, the FASB and the Treasury supporting the banking industry's position, and damning the FASB's due process. A bill has now been introduced into Congress that would require the FASB to delay implementation at least until the study is complete.

How has the FASB responded? It's announced a special roundtable to discuss the CECL model with banks and other stakeholders, including possible alternatives. That meeting is to be held sometime in January.

PwC observation. In the hothouse that is US politics it's never easy to predict how initiatives like this will play out. A key issue is whether the SEC will continue to support the FASB's standard as is.

Classifying liabilities as short- or long-term

"Who are you going to believe, me or your eyes?"
– Groucho Marx

Some accounting wounds never truly heal over but remain painful for years after they're inflicted. There's no better example of this, perhaps, than the existing IFRS principle for classifying liabilities as current or non-current. They're definitely still a sore point for companies. And so it's with some trepidation that we report that the Board has decided, tentatively, to clarify how the principle should be interpreted and applied.

As this IFRS stands right now, in order to classify a debt or other liability with a fixed maturity date as long-term, you have to have the right to defer its settlement for at least 12 months from the reporting date. The changes the Board has agreed to are supposed to make it clear that:

- The right to defer settlement has to exist at the reporting date. Period. If you acquire the right later, tough, even if it happens before the financial statements are issued. This merely reiterates what had been broadly understood in practice.
- Deferral rights have to be substantive. But what does this mean? At the Board meeting, IASB staff observed that a right isn't substantive if at its inception its exercise is so unlikely that both the borrower and the lender know it will never be exercised. On the other hand, rights that are substantive on day one, but become uneconomic later so that no one in their right mind would exercise them, are still substantive and have to be taken into account in classifying a debt.
- An unused long-term financing commitment that the company has acquired by the reporting date that's available to fund a short-term borrowing doesn't turn it into a non-current liability. Ever.
- Rights of lenders to call a debt after a periodic review of the borrower's financial condition have to be taken into account in classification determinations.
- If a breach in a covenant on a debt happens and the lender grants a grace period before the reporting date allowing the borrower to cure the breach, the liability is long-term only if the cure happens by the reporting date, or the grace period extends beyond 12 months (fat chance of that happening).
- If you expect to pay a liability off in the short-term that you have a right to defer settlement for 12 months from the reporting date, don't even think about classifying it as short-term.
- Breaches of debt covenants after the reporting date, expected or actual, don't affect classifications of liabilities at the reporting date.
- Provisions for warranties that last for more than 12 months may have to be split between current and non-current.

PwC observation. Companies usually have a beef with IFRS requirements for classifying liabilities because they believe that expectations as to when a liability will be settled can be as important, or even more important, than the right of the borrower to settle it. The IASB has acknowledged that expectations might be relevant and appropriate for disclosure purposes, but for the balance sheet? Never!

Onerous contracts

"A verbal contract isn't worth the paper it's written on."
– Sam Goldwyn

If you're standing right on the edge of a cliff, an inch here or there can make all the difference. That explains, we think, why the IASB has issued an Exposure Draft on an expedited basis proposing to clarify when construction, service or other executory contracts are such losers that you've got to recognize a loss on them.

Existing IFRS establishes the basic principle that the trigger for booking a loss is whether the costs the company expects to incur to fulfil the contract are higher than the economic benefits the company expects to receive from it (presuming that the net cost is lower than any compensation or penalties arising from walking away from it). The Exposure Draft proposes that the cost of fulfilling the contract should include not only the incremental costs of completing it, such as the direct cost of material and labour, but also an allocation of other costs that are "directly related", such as the depreciation charge for equipment the company uses to meet contracts, insurance, and contract supervisors. By loading directly related costs into the calculation, of course, you're increasing the probability that a loss will be required to be recognized sooner rather than later.

This requirement would apply to all executory contracts, other than those subject to the financial instrument rules, on hand at whatever the Board decides the date of initial application of the change should be.

PwC observation. IFRS used to require directly related costs to be factored into loss determinations in its standard on construction costs. However, that standard was eliminated when the new revenue standard came out, and with it the requirement. Oops. The Board is concerned that its elimination will lead to inconsistent practice in accounting for construction contracts. However, the Exposure Draft proposes to extend the principle to all contracts, including the manufacturing and service industries. This may be a significant issue for companies that have been considering only incremental costs in their assessments, and indeed, may not have established reporting systems that allocate "directly related" overhead costs to individual contracts. If you fall into this category, you may want to consider responding to the Exposure Draft. We should also note that the IASB decided not to address the potentially even more troublesome issue of identifying and measuring the benefits the company expects to receive under the contract. The change it is making thus might narrow divergent practice, but it won't eliminate it.

Materiality

"Awkward is my specialty."
– Charles Brown

Just what you always wanted – more guidance on what's material for IFRS financial statement reporting purposes.

This time the new guidance from the IASB represents amendments to its existing definition of the term. The Board has emphasized that the purpose of the changes is to clarify the existing concept of materiality to be, not to fundamentally alter it. The revised definition emphasizes that:

- Information is material only if it could reasonably be expected to influence a user's decision. Before any information was material if it "could" influence a decision – much broader test that was honoured more in its breach than its application.
- The only users' decisions you have to worry about are those of the primary users of the financial statements – present and potential investors, lenders and other creditors.
- Obscuring financial information in the financial statements is as mortal a sin as misstating or not providing it (see the accompanying table).

The new definition is effective for years beginning on or after January 1, 2020.

In a related move, the Board also has tentatively agreed to change existing IFRS requirements for the disclosure of accounting policies. Whereas this is now mandatory for all significant policies, the Board is going to substitute "material" for "significant". The thinking here is that because the concept of what's material is defined and what's significant isn't, the change will allow financial statement preparers to make better judgments about what policies should be disclosed.

PwC observation. As a practical matter, many companies disclose all financial information that standards specifically require, other than information that's clearly immaterial. After all, the consequences of being wrong in materiality assessments can be, well, material. While the definition still allows you to do this, now it also will be necessary to decide which pieces of that information are material, and which aren't, so as to be able to assess whether the latter obscures the former. That's the principle, in any event, awkward as its application might appear to be.

Ways in Which Material Information may be Obscured

According to the IASB:

- The language regarding a material item, transaction or other event is vague or unclear.
- Information regarding a material item, transaction or other event is scattered in different places in the financial statements.
- Dissimilar items, transactions or other events are inappropriately aggregated.
- Similar items, transactions or other events are inappropriately disaggregated.
- Material information is hidden by immaterial information to the extent that it becomes unclear what information is material.

Cannabis reporting

"I was eating at a Chinese restaurant. There was a dish called the Mother and Child Reunion. It was chicken and eggs. And I said, I gotta use that."
– Paul Simon

It's a fledgling industry, of course, one that's hardly taken wings, so you might expect that the outcome of reviews by Canadian Securities Administrators of their initial financial reporting might be a trifle harsher than might ordinarily be the case. You'd be right. Much more disclosure and transparency needed pretty well sums up the findings.

Here's a summary of the major points:

- Companies need to disclose all fair value adjustments affecting profit and loss. A particular concern is the absence of specifics about how fair value adjustments relating to growing plants affect cost of sales, since these don't relate to product actually sold. Among other things, the CSA is encouraging disclosure of the split of fair value adjustments between those that have been realized and those that are unrealized.
- There needs to be better disclosure of accounting policies for costs that are directly or indirectly attributable to biological assets and inventory sold. Disclosing a policy in some cases would be a start, says the CSA. Those policies need to address whether these costs are being capitalized or expensed, what costs are included and, if costs are expensed, where they go to in the income statement. The CSA isn't at all thrilled about expensing of these costs and is encouraging companies to consider whether this policy meets the information needs of investors, and to provide supplementary information in MD&A as to what the results would have been had the costs been capitalized.
- Using the term "gross profit" may be misleading if it doesn't include all direct and indirect costs of production (e.g., depreciation on related production assets).
- Disclosures about fair value determinations were found to be deficient in 100% of the cases examined, which must surely be a record of some kind. Companies are being exhorted to beef up descriptions of valuation techniques and processes, the inputs used in fair value measurements, including quantitative information about unobservable inputs, the level of hierarchy into which valuations fall (i.e., Level 1, 2 or 3), the sensitivity of fair value changes to changes in inputs and their interrelationship.
- There's no uniformity in how companies calculate cost per gram of cannabis – a key measure for investors if ever there was one. Issues include lack of clarity over what costs get included, and the basis used for the denominator – grams harvested versus grams sold. Also deficient are reconciliations to the related GAAP costs and disclosures about significant judgments.
- Other points of contention include the quality of production forecasts, misleading or unbalanced disclosures about new opportunities/contingencies, impairment testing, material contracts and risk factors, including those relating to US marijuana activities.

PwC observation. For most industries, increases (or decreases) in fair value of assets during their production process are reflected only upon the sale of the asset, as part of the revenue from the sale, and direct and indirect costs of production are always capitalized. In its recommendations to the cannabis industry the CSA appears to be viewing this accounting as a benchmark, and encouraging the industry to provide sufficient information to allow investors to see what the results would be had these principles been applied. In effect, the recommendations are a grand attempt at reuniting the fair value world to its historical cost predecessor.

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 https://www.pwc.com/ca/en/services/accounting-advisory-services.html.

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Capital Markets Accounting Advisory Services

At PwC, our Capital Markets Accounting Advisory Services team offers a wide range of experience and expertise in technical accounting issues. We provide a wide variety of services to both audit and non-audit clients, **tailored to accommodate each client's unique circumstances and needs.**

Our team of highly experienced accounting professionals, subject matter specialists and local resources across Canada are **ready to help you address your most pressing business issues.**

IPOs and Capital Market Transactions

- Readiness assessments for public reporting
- Advice on regulatory and exchange requirements
- 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
- Quantitative analysis and model development
- Tax Accounting Services
- Comperio
- Automated Disclosure Checklists
- PwC IFRS Manual of Accounting

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