AC Insights

Insights for reviewing financial reports

Insights on financial reporting using US GAAP

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Stay the course

"That's all I hear about now. … COVID, COVID, COVID, COVID, COVID, COVID."

As we head into 2021, all of us are likely feeling the same sentiment as expressed by one national leader in October 2020. COVID-19 is still here and strong. We wonder, how much longer? Will the vaccine work on the new strains? When will we recover? There are many unknowns. However, we do know we should not let up our guard until we cross the finish line. This same message rings true as issuers prepare their annual financial reports; we must stay the course.

Over the last quarter of 2020, standard-setters, accounting organizations, and regulatory agencies have been thinking about how the consequences of COVID-19 affect financial reporting. These groups have provided tips and best practices for companies to consider when preparing their annual financial reporting for 2020 and 2021. We have reviewed the various materials and summarized the various observations by topic for your review. For each topic, the source of the comments has been indicated at the beginning of each set of paragraphs. The references for these comments are outlined at the end of this article.

COVID-19 affects financial reporting under US GAAP

During the last quarter of 2020, there has been much discussion about the challenges of COVID-19 in preparing annual financial statements. At the AICPA Annual Conference on SEC and PCAOB Developments, speakers highlighted forecasting and valuation issues, people and time constraints, and the rapidly changing environment. The pandemic's consequences have affected the accounting for revenue contracts, leases, compensation arrangements, financing arrangements, and hedging relationships.

During 2020, the FASB has delayed the effective dates of specific new standards and provided educational materials through the COVID-19 web portal at www.fasb.org (see "FASB update" in this edition of *AC Insights* for recent amendments and educational materials). FASB Chair Richard Jones has stated that the FASB continues to monitor emerging issues and will address issues as needed. He invited companies to raise questions with the Technical Inquiry Service using the FASB website. These questions alert the FASB to potential emerging issues.

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In previous editions of *AC Insights,* we provided our observations about accounting and disclosures to consider when preparing financial reports. These comments are still relevant for 2020 financial reports.

- "COVID-19: Businesses are not immune." *AC Insights,* US2020-2, (Spring 2020): 1-8.
- "COVID-19 uncertainties affect your financial reporting." *AC Insights,* US2020-3, (Summer 2020): 1-9.
- "Being vigilant through the continuing pandemic." *AC Insights,* US2020-4, (Fall 2020): 1-3.

Click on the issue number of the publications to obtain a copy.

Making estimates amid uncertainties and incorporating changing expectations

Financial Accounting Standards Board (FASB): The FASB staff has observed that one of the possible effects of COVID-19 may be increased modifications and exchanges of outstanding debt arrangements. The FASB staff has issued the FASB Staff Educational Paper: Topic 470: *Borrower's accounting for debt modifications* to assist entities in evaluating the nature of any debt modifications. Modifications to a debt arrangement may include a reduction in the stated interest rate for the remaining term of the debt, an extension of the term of the debt at the existing stated interest rate, a reduction in the face amount or maturity amount, or a reduction in the accrued unpaid interest.

The educational material provides an overview of the accounting guidance for common modifications or exchanges of debt arrangements. Illustrative examples are included in the paper. The paper does not deal with debt settled by equity, convertible debt, embedded conversion features in debt instruments, or certain fees and costs incurred by the borrower. Issuers modifying the terms of their debt will find this paper helpful in assessing the accounting that would be applicable.

Canadian Securities Administrators (CSA): COVID-19 affects judgments and estimates in many areas, including going concern assessments, impairment assessments, fair value measurements, recognition and presentation of government assistance, revenue recognition, and assessing the recoverability of deferred taxes. Management needs to use the best available information and make well-reasoned judgments and estimates when preparing financial statements. Judgments and estimates should be updated as new information becomes available. Disclosures about judgments, estimates, events, and transactions that are significant to understanding the issuer's financial condition and operating performance should be included in the notes to the financial statements. Subsequent events may require disclosure and may factor into the assessment of going concern.

Canadian Public Accountability Board (CPAB): CPAB's discussions with audit committee chairs revealed committees are focused on judgments, estimates, and valuations. Audit committees are aware that inputs and assumptions could have wide ranges. CPAB believes audit committees can set the tone for a robust challenge process by encouraging management teams and auditors to dialogue about subjective areas of the audit. Direct conversations between the auditor's valuation specialists and the audit committee can be beneficial in assessing the reasonableness of valuations. Audit committees could ask whether valuation reviews are qualified in any respects and how estimates compare to industry peers, market information, and other external evidence.

Audit committees should probe the underlying assumptions and sufficiency of disclosures related to accounting estimates and going concern assessments. Members may want to consider the range of critical estimates, how the estimates compare to other companies, and if any contradictory evidence was identified by the auditor, how the auditor has assessed that evidence.

Liquidity

CPAB: CPAB noted that management at many companies affected by COVID-19 provide more information and analysis to audit committees and auditors on their companies' long-term prospects and their companies' ability to continue as a going concern. Reverse stress tests—bottom-up scenario analyses—have helped identify issues that could give rise to adverse outcomes, such as covenant breaches, and how these risks and events could be prevented or mitigated. Audit committees should ensure auditors have access to the information for their assessment of going concern and exercise sufficient skepticism in challenging management's analysis.

Non-GAAP financial measures may be adjusted for COVID-19, but…

Companies may wish to isolate the impact of COVID-19 using non-GAAP financial measures with a variety of adjustments. Companies will want to carefully consider what adjustments are COVID-19-related and not used the pandemic as an excuse for other factors affecting their businesses. While securities regulators have acknowledged the benefits of non-GAAP financial measures, they remain ready to curtail any bad practices that result in misleading information about operating performance.

CSA: Issuers are reminded to assess whether any adjustments made to calculate non-GAAP financial measures are non-recurring, infrequent, or unusual. Some COVID-19 consequences may not meet these criteria to be shown as adjustments. For any COVID-19 identified adjustments, management will need to clearly explain how the adjustment was specifically associated with the pandemic. Management will also want to consider the language used to describe adjustments and whether a breakdown of expenses will help understand the nature of the adjustments. The CSA Staff Notice included an example illustrating both inadequate and improved disclosures to show how COVID-19 adjustments to non-GAAP financial measures can be explained.

Securities and Exchange Commission – US (SEC): COVID-19 adjustments included in non-GAAP financial measures need to be carefully considered to assess whether the adjustment is: (1) due to COVID-19 or general economic downturn, (2) incremental to normal operations, and (3) objectively quantifiable, as opposed to an estimate. Examples of incremental costs may be increased sanitation (but registrants will need to consider whether the new procedures will be ongoing) or risk pay to employees (if not previously provided). Examples of costs not considered incremental are payments to employees idled on compassionate grounds, costs incurred for temporarily closed facilities, and lost revenue, as the amounts would be hypothetical. If certain costs are excluded, registrants will need to be consistent and exclude any subsidies, grants, or concessions received.

Preparing your MD&A

MD&A is an essential vehicle for explaining material changes and known trends and uncertainties resulting from the pandemic. The securities regulators have provided some best practices companies should consider for their annual reports to explain what happened in their businesses. The focus is on giving entity-specific information. Issuers are cautioned to use care to assess all the factors affecting the company, making estimates about lost revenue, and use of forward-looking information without reasonable support for that information.

Discussion of material changes and known trends and uncertainties

CSA: The MD&A should discuss the impact COVID-19 has had on the issuer's operations and how that impact was determined. Issuers are exposed to different risks and uncertainties from COVID-19 depending on their business structure, their industries, the locations of their operations, their dependence on personnel, and other factors. The disclosures about the consequences of COVID-19 should be entity-specific and transparent and not generic or boilerplate.

Issuers are cautioned not to attribute the period-over-period changes solely to COVID-19 or other negative news. Other factors that have contributed to material variances should not be overlooked. If differences are attributed to COVID-19, the MD&A should explain how the issuer determined the impact and describe other factors that have affected the revenues and expenses. Any actions or mitigations taken in response to COVID-19 should be explained. It may be challenging to explain the impact, and issuers should provide information about the judgments and estimates used to ensure that the information does not become misleading.

Some examples of items that might require disclosure, if material, are:

- impact of concessions or modification of terms to lease contracts or borrowing agreements (on the lessor, the lessee, the borrower, or the lender, as applicable).
- operational changes or shutdowns of production facilities, store locations, and operating facilities.
- changes in demand for products and services.
- changes in costs, including changes in prices or constraints on supply.
- any breaches or potential breaches of material contracts by the issuer or its counterparties.

The CSA Staff Notice provided an example illustrating the impact of COVID-19 on operations.

SEC: The SEC staff stressed the importance of disclosing the specific facts and circumstances affecting the company, including management's expectations of any future impacts, how management responds to evolving events, and how management plans for any COVID-19 uncertainties. A company's disclosures are expected to evolve as facts and circumstances change. The SEC staff referred companies to their guidance found in *CF Disclosure Guidance - Topic No. 9* and *CF Disclosure Guidance - Topic No. 9A*.

The SEC staff have observed that some companies provide information about COVID-19 consequences in their earnings calls. Disclosure of this information, if material, needs to be included in a company's filings.

Forward-looking information

CSA: COVID-19 raises significant uncertainties about future operating performance, cash flows, and financial condition of many issuers. Issuers are reminded to consider whether there is a reasonable basis for any forward-looking information (FLI) previously disclosed or planned to be disclosed in current filings. The OSC Staff Notice provides the following questions issuers should consider in assessing how COVID-19 affects their FLI.

- Is there still a reasonable basis for previously disclosed FLI?
- Have risk factors that could cause actual results to vary been identified?
- Have users been cautioned that actual results may vary from FLI?
- How has COVID-19 impacted your company's overall outlook for its future operations and liquidity position?
- Has previously issued FLI been updated?
- Have decisions to update or withdraw material FLI been adequately and promptly communicated to the market?

Issuers may need to update previously disclosed FLI or withdraw previously published guidance and financial outlooks if reasonable assumptions can no longer support the outlooks and there is no reasonable basis for the achievement of the FLI.

Liquidity and capital resources

CSA: COVID-19 will significantly affect some issuers' liquidity and capital resources. To allow investors to understand the impact, those issuers need to provide a comprehensive discussion on both the pandemic's current and expected effects, including quantifying the impact where possible. These disclosures may include: the extent of subsidies and funding received from government programs; increased customer credit risks; reduced cash inflows due to decreased demand for products and services; delays in capital projects; impact on cost structures resulting from increased activities in specific areas such as safety, information systems, and delivery mechanisms, offset by reductions in the workforce, reduced hours, closed facilities, and so on; changes in the issuer's dividend policy; and other programs.

SEC: As the pandemic lingers, a company should not overlook the impact on its liquidity. If disclosures are boilerplate or focus on short-term information without considering long-term factors, companies can expect the SEC staff will raise questions. For example, if a company is drawing down on debt, the disclosure needs to explain the long-term impact of increased financing levels. Some companies disclose the cash burn rate in the MD&A—these companies need to ensure they follow the guidance for key performance indicators published by the SEC Release Nos. 33-10751 and 34-88094: *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations*.

Internal control over financial reporting

COVID-19 has had an impact on internal controls. Some entities may not be focusing on maintaining a satisfactory control environment, as there are other priorities. Cost reductions may put pressure on the control environment. Changed work processes and stresses of keeping the business open are affecting the people responsible for maintaining controls. The disruptions in everyday business operations may make entities more vulnerable to fraud. Companies will want to keep their eye on their internal control over financial reporting (ICFR) to prevent possible misstatements and fraud.

CPAB: CPAB noted that audit committees would need to focus on the impact COVID-19 has had on the quality of internal controls, how deficiencies have been addressed, and how any risks have been mitigated. CPAB observed that an unsatisfactory control environment might undermine internal control effectiveness and heightened the risk of material misstatements, including fraud. A review of management's risk assessment process for COVID-19, including management's response to those risks, will help to gauge whether management has a robust action plan, including well-designed internal controls.

Changes have likely been made to information systems and business processes to respond to the COVID-19 consequences. The process changes may relate to the initiation, recording, processing, and reporting of transactions in the information systems. Accounting personnel may not have current information on business process changes, and policy/procedural manuals may be out of date. Communications with persons responsible for monitoring internal control may have shifted, and exceptions may not be appropriately reported.

CPAB outlined the following areas of concern that may require the auditor's and audit committee's attention.

- Management may not have implemented new controls to respond to the new business risks posed by COVID-19.
- Monitoring controls, including internal audits, may have been scaled back to redirect resources to business operations. Lack of sufficient monitoring controls may be a significant deficiency in internal control.
- Changes in technology to enhance customer interactions, workflows and automation, and remote work environments give rise to new risks. Internal control deficiencies may arise when: access controls over IT applications and databases are not managed appropriately; program changes are not authorized or tested; changes are made to IT applications in the production environment to expedite implementation; monitoring activities are reduced; or staff cuts delay critical IT projects. These control deficiencies can make the organization vulnerable to cyber incidents that shut down networks, corrupt data, or result in fraud.
- Functions outsourced to service organizations may also be affected. Service organizations may be exposed to the same risks and control deficiencies from COVID-19 as their customers. It is important to understand how management has considered the potential risks and whether management has developed appropriate responses, including compensating controls.

SEC: The SEC continues to emphasize the importance of ICFR to high-quality, reliable financial information. Public companies are required to maintain both ICFR and disclosure control procedures (DCP). Management is required to evaluate and certify the effectiveness of its ICFR and DCP.

The ongoing pandemic has affected entities' day-to-day operations and has brought changes to the working environment. These may have introduced additional business risks to entities, necessitating a reassessment of the registrant's processes and controls. It is important for management to evaluate whether changes in internal control are material.

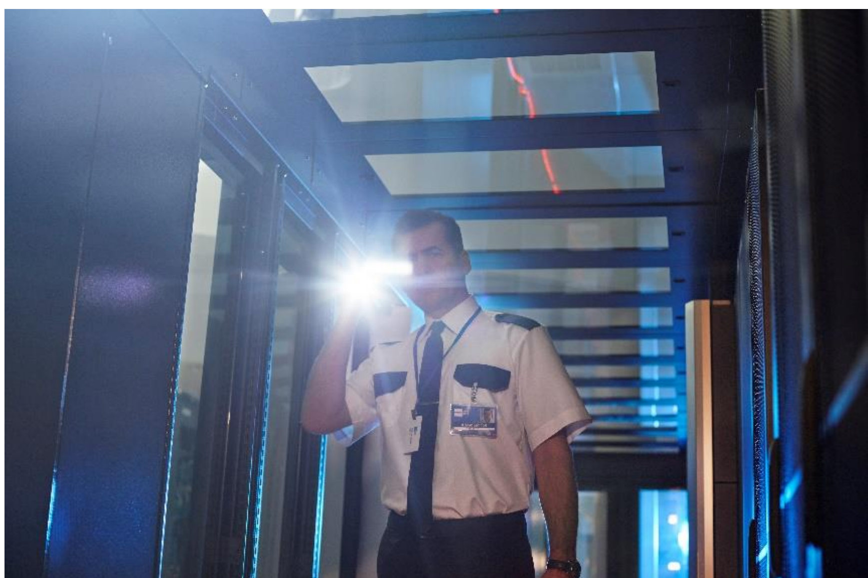
Preparers were reminded that if any changes to business processes materially affect, or are reasonably likely to materially affect, an entity's ICFR, the changes must be disclosed. Changes may have been made to deal with employees working remotely, other accommodations to deal with customers and vendors, and changes to operating procedures.

Domestic issuers would disclose those changes in each quarterly filing and foreign private issuers in their annual filings.

Other disclosures

CSA: For some issuers, the consequence of COVID-19, including any related governmental or regulatory policies, may be unique or more significant to some issuers than to others in their industry. These events may result in a material change. Some examples noted by the CSA include:

- Significant disruptions to an issuer's workforce or operations.
- Adverse changes in markets, economies, or laws.
- Supply chain delays or disruptions that are critical to an issuer's business.
- Changes in credit arrangements.
- The increased cost of goods or services.
- Suspension of exports.



Responding to fraud and misconduct

The current environment has brought out some bad actors; there is evidence that fraudulent activities have increased. Companies are encouraged to be vigilant and have effective internal controls to prevent accounting fraud, misleading disclosures, and cyber-related incidents.

The Center for Audit Quality (CAQ): COVID-19 has created new challenges that heighten the risk of fraud. There is already evidence of increases in financial statement fraud during the pandemic, and more is expected. Julie Bell Lindsay, CAQ Executive Director, stated at the AICPA Conference on SEC and PCAOB Developments that "fighting fraud is a shared responsibility." Fraud is deterred and detected through unrelenting vigilance by regulators, internal and external auditors, audit committees, and company management. Company management is required to implement an effective system of internal controls over financial reporting to provide reasonable assurance that financial statements are free of material misstatements, including misstatements caused by fraud.

Audit committees should be aware of any heightened fraud risk at their companies and take action as necessary. Some options may involve using forensic specialists or asking the auditor to perform additional fraud-related procedures during the audit.

SEC: The SEC Enforcement Division has established a Coronavirus Task Force, which, among other things, has been working to identify and monitor areas of potential misconduct related to COVID-19. The misconduct may include insider trading, financial fraud, and issuer disclosures. During the last year, the SEC has opened 150 COVID-19-related inquiries and investigations. The SEC has suspended the trading of 35 companies because of concerns over possible false or misleading disclosures related to COVID-19. Five companies have also been charged with releasing false or misleading information, with one settling recently.

The SEC has settled with one public company for misleading investors about the financial effects of the pandemic. The registrant disclosed it was "operating sustainably" during the pandemic, while it was losing approximately US$6 million in cash per week and had projected its cash reserves would be depleted in 16 weeks. This information was disclosed to a potential private equity investor, but not to the public. The registrant had also advised its landlords it would not pay the next month's rents due to COVID-19 impacts. In the settlement, the registrant paid a penalty of US$125,000.

The SEC's Enforcement Division continues to monitor companies' disclosures about the consequences of COVID-19. When a company's disclosure seems inconsistent with others in its industry, the SEC staff will take a closer look to assess whether the company may be disguising undisclosed problems or weaknesses as pandemic-related losses.

Adapting the audit

COVID-19 has changed the ways audits are currently planned and completed. Remote audits have many challenges. Through positive cooperation among management, audit committees, and auditors, auditors have been able to complete their work and form opinions on their clients' financial statements.

CPAB: In preparation for upcoming audits of financial statements, CPAB has provided a series of tips and best practices for auditors and audit committees in carrying out their roles and responsibilities.

- Auditors need to understand how the company's environment and business operations have changed, review their risk assessments, and modify audit plans as necessary. Audit committees may consider more frequent dialogue with the auditor to understand the business changes, ensure the audit plan is updated, and proactively monitor audit milestones and audit quality indicators to identify any quality issues early in the audit process.
- The emphasis on fraud considerations should be increased. The current environment creates incentives and opportunities that increase fraud risk through management overrides, collusion, and aggressive accounting and disclosure practices. Companies are addressing these issues through comprehensive ethics and cybersecurity training, employee and supplier attestations, bolstering internal controls to consider fraud risks, using internal audit functions, and involving audit committees in the whistle-blower programs. Audit committees will want to understand changes made to the auditor's risk assessment and related plan for fraud considerations.
- Changes in business processes, IT systems, and personnel will require auditors to assess the extent to which they can rely on internal control structures. Audit committees will be interested in the sufficiency of controls to prevent material misstatements and whether any significant deficiencies increase the risks of misstatements.
- Auditors should maintain professional skepticism and a critical mindset when evaluating the reliability of audit evidence. Auditors are expected to challenge management's cash flow forecasts and other critical assumptions used in valuation models, impairment tests, and going concern evaluations. The increased use of evidence obtained electronically, including internally generated information and management reports, requires a higher level of diligence in assessing whether the documentation is reliable.

- The auditor should understand how component auditors have adjusted their audit work plans and explore ways as the group auditor to exercise sufficient oversight of the component auditor's work. Audit committees should be aware that working with auditors of a component of an entity will not involve site visits by the primary auditor, so the audit committee will want to understand the component auditor's issues and challenges and how audit quality was maintained.
- Supervision and review of the audit should be enhanced to take account of audit work being done remotely. Partners and managers will be spending more time coaching and training associates.

Audit committees can help promote a positive environment for the audit by ensuring management, the auditors, and the audit committee have the time needed to complete their roles. Audit committees may want to consider whether audit engagement teams are developing a sceptical mindset, how fraud risk is assessed in the audit process, and what information the auditor considered in the going concern assessment. Audit committees may assess audit quality by reviewing the company's staff and the audit engagement team's skills and experience and discussing with the auditor's specialists or components auditors complex or subjective areas. Inquiries about disclosures may be helpful to understand the audit quality, particularly for difficult areas such as liquidity and going concern.

Public Company Accounting Oversight Board (PCAOB): During the pandemic, the PCAOB continued its inspections of audit firms, with a modified approach to include review engagements of interim financial statements of public companies and audits of public companies with off-calendar year-ends.

The PCAOB observed that audit firms have taken several early steps to address the risks and challenges of COVID-19. These efforts included setting an appropriate tone, providing training for working in remote environments, providing additional resources and tools to assist in conducting audits in remote environments, emphasizing the need for consultations, and providing targeted resources for audit teams in industries most affected by COVID-19.

The PCAOB's inspection of review engagements completed by audit firms to date have not identified any instances of non-compliance with the PCAOB requirements for reviews of interim financial statements. The PCAOB observed that engagements have increased interactions within their audit firms with industry leaders, subject matter specialists, other engagement teams, fraud and forensic specialists, and audit committees to discuss COVID-19-related accounting, internal control, and auditing issues. Materiality thresholds have been adjusted to reflect the changes in companies' performance and metrics. High risks areas have become a key focus—assessment of going concern, impairment of goodwill and other long-lived assets, and other accounting estimates and valuations. Engagement teams have also enhanced their internal communications to keep up-to-date and facilitate supervision of work on the engagement.

The PCAOB provided some key take-aways for auditors and audit committees to consider for the upcoming audit season.

- Companies must make significant judgments and estimates that can be challenging in the current environment. Auditors need to carefully scrutinize these judgments and estimates and make additional inquiries and perform other procedures when necessary to understand whether any material modifications are required. The assumptions used by management to make estimates should be evaluated to consider whether they are:
  - Reasonable and relevant.
  - Consistent with relevant industry, regulatory, market, and economic conditions.
  - Consistent with revenue projections, cash flow estimates, and other key factors.
  - Based on management's planned courses of actions.
- An auditor's initial assessments of audit risks and materiality as well as the audit plan should be updated to reflect the current environment and the heightened potential for fraud, error, and misleading disclosures. There should be an increased focus on: (1) estimates that rely on forecasts of future events, and (2) management override of ICFR because of changes in staffing, reporting structure, and reduced segregation of duties.
- Responses to COVID-19 may have affected processes, flow of transactions, employees' responsibilities, IT operations, and other aspects. As part of the financial audit, auditors will have to understand and evaluate these changes to assess which controls to rely on and how to adapt their procedures to support their reliance on controls and, when applicable, their opinion on ICFR.

What's next?

The input from standard-setters, regulators, and other stakeholders during the last quarter and previous quarters can be helpful reminders for management and audit committees of possible approaches and considerations to preparing high-quality financial reporting for 2020. While we are all exasperated by lockdowns and not seeing each other face-to-face, we need to stay the course to get to the finish line without any missteps leading to misstatements, errors, misleading disclosures, and regulatory intervention. With the concerted efforts of management, the auditors, and the audit committees, 2020 financial reports can be high-quality, transparent, and timely.

Sources

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"Audit Committee Forum," *CPAB Exchange,* December 10, 2020, www.cpab-ccrc.ca.

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"Staff Observations and Reminders during the COVID-19 Pandemic," *Spotlight,* December 2020, www.pcaobus.org.

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Statement on OCA's Focus on High-Quality Financial Reporting During an Unusual Year and a Discussion of Upcoming Priorities, speech by Sagar Teotia, SEC Chief Accountant, December 7, 2020, www.sec.gov.

Division of Enforcement, *2020 Annual Report,* November 2, 2020, www.sec.gov.

FASB update

The FASB issued three Accounting Standards Updates during the final quarter of 2020. ASU 2020-10: *Codification improvements* updated some references and formatting of standards. The other two ASUs are explained below. The FASB has been mainly focused on accounting for goodwill and intangible assets during the most recent quarter and refocusing its agenda as outlined below under "New FASB Chair."

New FASB Chair

On July 1, 2020, Richard R. Jones became the eighth chair of the FASB. Prior to joining the FASB, Mr. Jones was a partner at EY and served as that firm's chief accountant. He served on the Financial Accounting Standards Advisory Council from 2016 to 2018 and was a member of the Accounting Standards Executive of the AICPA from 2003 to 2008. Mr. Jones is a graduate of the State University of New York, Binghamton and a certified public accountant in the State of New York.

In the first few months, Mr. Jones has been meeting with several stakeholder groups and FASB staff to understand their perspective on the FASB.

The new Chair brings a perspective that there must be a clear case for change. The primary reasons for change articulated by Mr. Jones are to:

- provide users with better, more understandable information that will directly influence their decisions and behaviour.
- remove cost and complexity from the system.
- clarify and improve the consistency around the accounting standards codification.

In December 2020, the FASB had already decided to remove five projects from its agenda dealing with disclosures reviews of share-based payments and foreign currency, income taxes backward tracing, inventory and costs of sales, and variable interest entity-related party guidance. The FASB did add one project on supplier finance programs, which has attracted SEC attention in recent years.

Deferral of updates to long-duration insurance contracts guidance

ASU 2020-11: *Deferral of the effective date and amendments to early application in Update 2018-12.*

Topic 944: Financial services – Insurance

ASU 2020-11 delays the effective date of ASU 2018-12: *Targeted improvement to the accounting for long-duration contracts* applicable to insurance companies by one year. For SEC filers, other than smaller reporting companies, the ASU is effective for fiscal years beginning after December 15, 2022. For other entities, the effective date is for fiscal years beginning after December 15, 2024.

To facilitate early application, the ASU also allows insurance companies to restate one period rather than two if they early adopt ASU 2018-12.

Amortization of premiums on callable debt

ASU 2020-08: *Codification improvements to Subtopic 310-20, Receivables – Non-refundable fees and other costs*

Topic 310: Receivables

The amendment clarifies that for a callable debt security, the entity should amortize any excess of the amortized cost over the amount payable at the next call date over the period to the next call date.

For public business entities, the clarification is effective for years beginning after December 15, 2020. Early application is not permitted. The ASU is effective for all other entities for fiscal periods beginning after December 15, 2021 (interim periods after December 15, 2022), with early adoption permitted for fiscal years beginning after December 15, 2020.

ASUs applicable for 2021

There are two ASU*s* previously issued that are effective for public business entities in 2021 (financial years beginning after December 15, 2020).

ASU 2019-12: Simplifying the accounting for income taxes

Affects: Topic 740: *Income taxes*

The ASU eliminates certain previous exceptions from the model for accounting for income taxes for:

- The allocations of income taxes between continuing operations and other components of comprehensive income (prospective transition).
- The recognition of deferred tax liabilities when a foreign subsidiary becomes an equity method investment or when a foreign equity method investment becomes a subsidiary (modified retrospective transition).
- The calculation of income taxes in an interim period when a year-to-date loss exceeds the anticipated loss for the year (prospective transition).

The amendments also simplified the accounting for:

- Franchise and similar taxes partially based on income by requiring the income portion to be accounted for as income taxes (retrospective or modified retrospective method).
- A step up in the tax basis of goodwill either as part of the original business combination or a separate transaction (prospective transition).
- The allocation of current and deferred incomes of a consolidated group to a legal entity not subject to income taxes by eliminating the requirement (retrospective transition).
- The requirement to reflect the enacted change in tax laws or rates in the annual effective tax rate computation in interim periods including the enactment date (prospective transition).
- Income taxes for employee stock ownership plans (prospective transition).

The ASU applies to other entities for years beginning after December 14, 2021.

ASU 2020-01: *Clarifying the interactions between Topic 321, Topic 323, and Topic 815, a consensus of the FASB Emerging Issues Task Force*

Affects: Topic 321: *Investments – equity securities,* Topic 323: *Investments – equity method and joint ventures,* and Topic 815: *Derivatives.*

The ASU addresses:

- How to measure the investment when applying or discontinuing equity accounting, when the measurement alternative is used instead of observable fair values.
- How to account for forward contracts and purchase options to purchase securities that upon settlement of the forward contract or exercise of the option would be accounted for under the equity method of accounting.

The amendments are to be applied prospectively as of the beginning of the interim period when the ASU is applied. The ASU is applicable for other entities in years beginning after December 15, 2021.

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CSA regulatory update

Annual check-up

The securities regulatory administrators review the continuous disclosure filings of a select number of reporting issuers each year. This annual check-up may be based on specific issues of interest or reviews of issuers' disclosures in general.

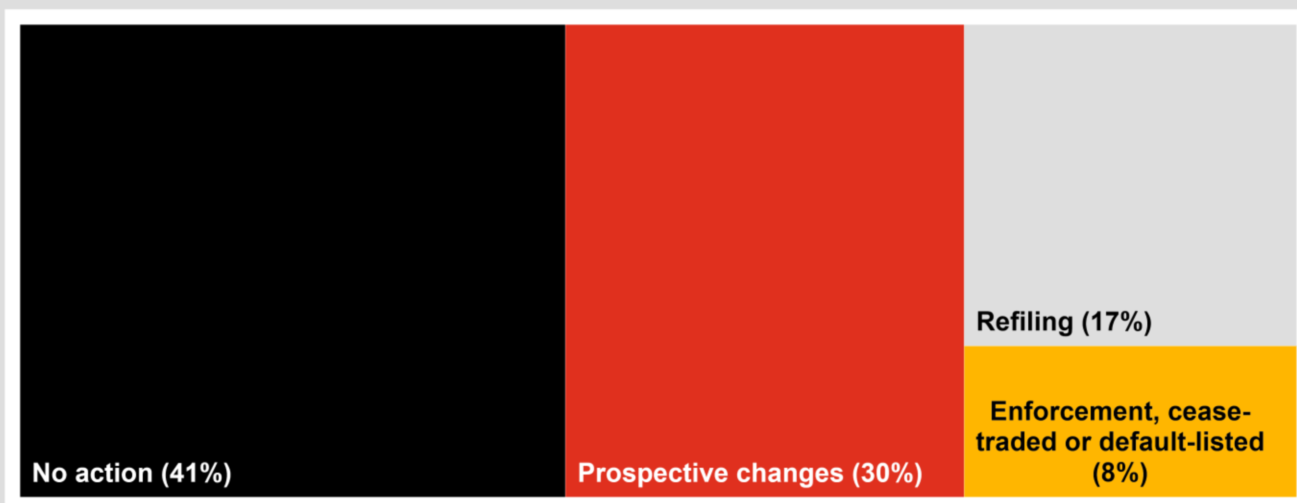
In November 2020, the CSA released its report summarizing its 2020 continuous disclosure review programs' key findings and outcomes. The review programs' goal is to improve the completeness, quality, and timeliness of continuous disclosure filed by reporting issuers. The report in CSA Staff Notice 51-361: *Continuous Disclosure Review Program Activities for fiscal years ended March 31, 2020, and March 31, 2019* also includes guidance on reporting the impact of COVID-19 on issuers' operating performance, financial position, liquidity, and future prospects.

The Ontario Securities Commission also published its Corporate Finance Branch Report (OSC Staff Notice 51-731) in November, which includes some of the same findings as well as additional findings. We have combined the comments of these reports (the Reports) in our summary below. The forward-looking comments on responding to COVID-19 issues have been included in "Stay the course" in this edition of *AC Insights*.

During the 2020 review cycle, 583 reviews (2019: 514) were completed, with about 426 (2019: about 360) focusing on specific accounting, legal, or regulatory issues. In the 2020 cycle, the CSA members focused on financial reporting (financial statements and MD&A), technical reports for mining and oil and gas issues, news releases, material change reports, change of auditor notices, and emerging issues such as cryptocurrencies and the cannabis industry.

The chart below illustrates the outcomes for the 2020 cycle reported in the CSA Staff Notice.

Outcomes of CSA continuous disclosure reviews



Financial statement issues

Recognition and initial measurement of intangible assets acquired: Some issuers do not measure intangible assets acquired in a business combination at fair value under IFRS 13: *Fair value measurement.* The CSA members observed this practice most often occurs when the consideration for the business combination consisted of a fixed number of shares and the share price changed significantly between the agreement and consummation dates. In some cases, the change in the overall consideration was simply allocated to the intangibles without the use of any valuation techniques. IFRS 3: *Business combinations* requires intangible assets to be measured at their fair value.

The OSC staff have indicated that they closely monitor the recognition of intangible assets in financial statements, either acquired from third parties or internally generated. The staff may require both quantitative and qualitative analyses to support the probability that the economic benefit attributed to each intangible asset will flow to the issuer. Information may be required on the allocation of the purchase price to each of the intangible assets acquired, including any assumptions used to assign values and a reconciliation to the seller's original book value for the assets. Also, if non-cash consideration, such as shares, is issued in the transaction, the issuer may be asked to explain how the consideration was valued

Impairment of non-financial assets in response to triggering events: Some issuers tested for impairments only on an annual basis and did not consider impairment indicators at each interim period-end. IAS 36: *Impairment of assets* requires issuers to test assets for impairment when certain triggering events indicate possible impairment, even if there is a minimum requirement to test goodwill and indefinite-lived intangibles on an annual basis.

Entity-wide disclosures also required in segment note: Some issuers failed to provide entity-wide disclosures about products and services, geography, and major customers. IFRS 8: *Operating segments* requires disclosures of revenues from external customers for each type of product and service or each group of similar products and services; revenues from customers and certain non-current assets by country; and major customers representing 10% or more of consolidated revenues.

MD&A issues

The Reports are clear that disclosures within the MD&A should be entity-specific and transparent, providing a detailed explanation and breakdowns of the causes of changes in financial performance and financial condition. Issuers should avoid boilerplate disclosures and simply repeating information in the financial statements. In the Reports, the staff outlined some of the common deficiencies noted in the reviews of MD&A.

Non-GAAP financial measures should not be more prominent than GAAP measures or have confusing labels: The securities administrators acknowledge non-GAAP financial measures can supplement and explain financial performance, cash flows, and financial condition. However, it is essential to follow the disclosure requirements found in CSA Staff Notice 52-306 (revised): *Non-GAAP Financial Measures.*

Non-GAAP financial measures continue to be presented more prominently than the comparable GAAP measures and are not appropriately labelled. Issuers need to ensure non-GAAP financial measures do not mislead investors.

Variances in lines of profit or loss statement need to be explained: Often, variances are stated, but without narrative discussion of factors causing the variances and any actual or potential trends. MD&A should provide a detailed analysis and quantified discussion of the factors that affect revenues and expenses. The discussion should provide clear and transparent insights into historical and future performance.

Incomplete discussion of capital resources and liquidity: Some issuers make boilerplate and incomplete statements about their capital resources and liquidity. Others simply reproduce numbers from their financial statements without any contextual discussion. Several issuers reported negative cash flows from operations or material risks about their ability to continue as a going concern. Still, they did not explain how these factors affect the operations and how these risks will be managed.

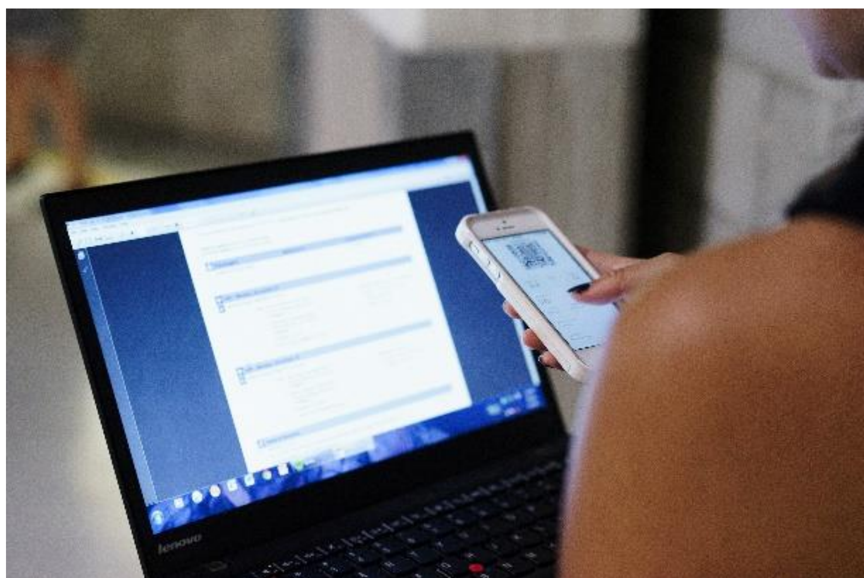
Under the requirements of NI 51-102: *Continuous disclosure obligations,* the MD&A should provide an analysis of:

- the short- and long-term cash requirements to fund working capital and other commitments for current operations and planned growth.
- information on how cash requirements will be funded, including funding currently arranged but not used, and funding sources available through private and public debt and equity and operations. The disclosure of funding sources must have a reasonable basis and be clear about conditions that may apply to obtain the funding.
- trends, fluctuations, and risks associated with cash requirements for funding needs, including risks related to working capital, renewal of credit facilities, defaults on credit facilities, and changes in cash flows from acquisitions or disposals.

Issuers experiencing negative operating cash flows or going concern issues may consider disclosing their current working capital position, significant obligations maturing in the near term, cash burn rates on a periodic basis, expected period over which cash may be depleted, changing priorities for expenditures, and consequences on obligations for asset retirement obligations.

Insufficient information to understand related party transactions: Some issuers do not provide sufficient quantitative and qualitative information to understand the business purpose and economic substance of transactions between related parties. In certain non-cash transactions between related parties, the disclosures did not provide sufficient and transaction-specific disclosure to understand how the transaction amount was measured.

Improvement needed for disclosures about forward-looking information: Some issuers failed to identify forward-looking information (FLI) and only provided boilerplate disclosures about the FLI included in the filing. Information about material risks associated with and assumptions and factors used to prepare the FLI were missing. Some issuers did not disclose their policies for updated FLI or that they do not intend to update the FLI. National Instrument 51-102: *Continuous disclosure obligations* and its companion policy set out requirements when FLI is included in securities filings. Guidance on applying the requirement has been provided in CSA Staff Notice 51-330: *Guidance Regarding the Application of Forward-looking Information Requirements under National Instrument 51-102 Continuous Disclosure Obligations.*



Lists of risks and uncertainties are general in nature: Material risks and uncertainties should be fully explained, including the significance to the issuer and how the risks and uncertainties may affect the financial position, operations, cash flows, and future prospects of the business. Mitigating factors should be included in the disclosures. The disclosures should be updated when events and circumstances change.

Early-stage or development issuers' business plans lack sufficient detail: Business plans should identify reasonable milestones for the business's development, including the steps and associated costs to achieve the milestones and the anticipated timing of completion.

Improvements needed for other filings

The Reports also highlighted some hot topics in other filings like news releases, material change reports, and insider reports.

Promotional disclosures: Some issuers are making disclosures that are overly promotional and sometimes either untrue or unbalanced. Issuers are prohibited from making false and misleading statements. Disclosures should be balanced—positive news and events should also state any relevant risks and contingencies. Early-stage plans should be supported by discussing the issuer's business plans, milestones, capital requirements, and associated risks. Disclosures of pending favourable transactions should explain the material conditions necessary to complete the transaction. Updates should be provided when the conditions are not expected to be met, or the transaction is not completed.

Timely and accurate filing of insider reports: Reporting insiders are failing to file insider reports at all or on a timely basis. Several insider reports contain inaccurate information, such as transaction dates. Discrepancies in the number of securities held by insiders have been noted between issuers' disclosures in continuous disclosure filings and the insider in the insider reports. Often these differences arise because the insider has not been notified of the issuance of additional securities on a timely basis. Details about filing requirements are contained in NI 55-104: *Insider Reporting Requirements and Exemptions*; CSA Staff Notice 55-315: *Frequently Asked Questions about National Instrument 55-104: Insider Reporting Requirements and Exemptions*; and CSA Staff Notice 55-316: *Questions and Answers on Insider Reporting and the System for Electronic Disclosure by Insiders (SEDI).* Issuers are encouraged to implement internal processes to eliminate the reporting discrepancies.

Security holders are failing to provide early warning of significant acquisitions of an issuer's securities on a timely basis: The early warning reporting system is intended to let the marketplace know that a significant acquisition in the securities of an issuer has occurred and to warn that a take-over bid could be imminent. The requirements are set out in NI 62-103: *Early Warning System and Related Take-over Bid and Insider Reporting Issues,* NI 62-104: *Take-over Bids and Issuer Bids,* and National Policy 62-203: *Take-over Bids.*

Material change reports not filed timely or at all: When a material change occurs as defined in securities legislation, a material change must be filed within ten days of the event. A news release must be issued and filed immediately on the occurrence of the event.

Reminders about mineral project disclosures

In the past few years, the CSA members have completed reviews of technical reports filed by mining entities to support their mineral resource estimates disclosures. The CSA published a summary of the findings of these reviews in June 2020 through CSA Staff Notice 43-311: *Review of Mineral Resource Estimates in Technical Reports.* The Reports summarized the critical deficiencies arising from those reviews related to the mineral project disclosures' technical content, the disclosure of estimates, and the integration of information with other filings. We summarized the findings of the reviews in "CSA regulatory update: Improving mineral resource estimates" of *AC Insights,* US2020-3 (Summer 2020): 10-11.

Areas of focus in prospectus disclosures

The OSC Corporate Finance Branch also highlighted some areas that can be improved in prospectus disclosures related to the description of the issuer's business and regulatory environment, risk factors relating to the business and offering, MD&A disclosures, and the use of proceeds. The Reports also mentioned several other concerns. Issuers planning to make a prospectus offering should refer to these comments when drafting the prospectus to shorten the comments received.

What's next?

These Reports provide valuable insights into the concerns that the securities regulatory authorities have about disclosures made by issuers. The Reports are suitable primers for considering key issues before preparing the filings for the current year-ends. You should also read "Stay the course" in this edition of *AC Insights* to understand issues related to reporting during the pandemic.

Reference rate reform

With the pending cessation and replacement of many of the current reference or benchmark rates, the CSA issued CSA Staff Notice 25-302: *Matters relating to CDOR, LIBOR, and Other Interest Rate Benchmarks*.

The Notice, issued in November 2020, aims to increase awareness about the pending interest rate benchmark changes. We refer to the reference rates to be ceased as Current Reference Rates.

The table on the next page shows the current status of various inter-bank offering rates as of October 2020.

The Notice encourages issuers to use replacement reference rates in new instruments with terms going past the announced or estimated effective cessation dates for the Current Reference Rates. An issuer should include appropriate fallback language in the terms and conditions of new instruments where the reference rates may change in the future.

For existing instruments, the CSA staff encourages issuers to take appropriate action for securities, derivatives, and loans with terms beyond the actual or estimated effective dates of the Current Reference Rates by:

- adopting replacement rates.
- making changes to information systems to accommodate new reference rates.
- reviewing contractual provisions that would apply when Current Reference Rates cease to be published, including fallback provisions that may need to be amended to deal with the cessation of Current Reference Rates.
- making appropriate disclosures if the rates, terms, or conditions of securities are changed.

The Notice references the IBOR fallback supplements and protocols implemented by the International Swaps and Derivatives Association (ISDA). The ISDA has amended its standard definitions for interest rate derivatives to incorporate fallbacks for derivatives linked to certain IBORs. Also, the ISDA changes allow revisions to legacy non-cleared derivatives trades with other counterparties. These fallback supplements and protocols have been available since October 23, 2020 and will be effective January 25, 2021.

As noted, there is an urgency for issuers to focus on these pending changes and be prepared to have a smooth transition when IBORs are no longer available.

Status of inter-bank offering rates
October 2020

	Canadian Dollar Offering Rate	Interbank Offering Rates
Name and associated currencies	CDOR (CAD)	LIBOR (CHF, GBP, JPY, USD), CDOR (CAD), EONIA (EUR), EURIBOR (EUR), HIBOR (HKD), TIBOR (JPY), SIBOR (SGD) SOR (SGD)
Commonly used for	Reference rate for Bankers' Acceptance Borrowings	Various purposes
Administrator	Refinitiv Benchmark Services (UK)	Various
Rates affected	6-month and 12-month	Multiple
Effective	May 17, 2021	Estimated end of 2021
Replacement reference rates	CORRA (CAD: Canadian Overnight Repo Rate Average)	SARON (CHF: Swiss Average Overnight Rate) €STR (EUR: Euro Short-term Rate) SONIA (GBP: Sterling Overnight Interbank Average Rate) HONIA (HKD: Hong Kong Overnight Index Average) TONA (JPY: Tokyo Overnight Average Rate) SORA (SGD: Singapore Overnight Rate Average) SOFR (USD: Secured Overnight Financing Rate)

Tips for your automatic securities disposition programs

An automatic securities disposition program (ASDP) is an arrangement between an insider and a dealer or plan administrator (collectively, a Dealer) to sell the insider's securities over a predetermined period following a set of predetermined instructions. Investors and others have raised concerns over ASDPs—whether insiders arranged the plans in good faith and whether insiders have material non-public information (Inside Information) when the plans are adopted, amended, suspended, or terminated. The CSA Staff has issued CSA Staff Notice 55-317: *Automatic Securities Disposition Plans* to assist insiders and issuers in managing the market perception of insider trades under ASDPs. The Notice does not change any existing legal requirements. The Notice supersedes the guidance related to ASDPs in OSC Staff Notice 55-701: *Automatic Securities Disposition Plans and Automatic Securities Purchase Plans.*

Under securities legislation, insiders are prohibited from trading in an issuer's securities if they have Inside Information. Insiders may rely on a defence against insider trading when the insiders make trades in securities under an ASDP entered into before the insider had acquired any Inside Information. With the growth in share-based compensation plans, ADSPs allow insiders to monetize their securities received as compensation even if there are black-out periods and the officers and directors have Inside Information.

The CSA staff developed the guidance to assist issuers in developing well-designed and well-administered plans to allow securities trading by insiders. However, issuers and insiders were cautioned to seek legal advice when establishing and managing ASDPs.

The Notice provides the following principles and best practices for ASDPs.

- ASDPs should be established in good faith by the insider and not to evade insider trading prohibitions or benefit from Inside Information. Insiders might consider the timing of creating ASDPs, issuer certification that insider does not have Inside Information when forming the plan, issuer certification of insider's compliance with issuer's policies, limits on trading at the beginning of the term of the plan; and disclosure of trades under ASDPs in insider reports.
- The terms and conditions of ASDPs should be clear and designed to prevent any perception of acting on Inside Information. Insiders and issuers might consider trading parameters and other instructions for Dealers, what can be communicated to Dealers, the appropriate term for ASDPs (12 months) to avoid potential misuse of Inside Information, waiting periods for any trades when plans are established, and meaningful restrictions on the insiders' ability to amend, suspend, or terminate the ASDPs to benefit from Inside Information.
- Issuers should oversee the establishment and administration of ASDPs to ensure compliance with securities legislation and any issuer insider trading policies. Issuers might consider reviewing the terms and conditions of ASDPs for compliance, obtaining compliance confirmations from insiders, monitoring the use of ASDPs before significant events are announced, and requiring amendments, suspensions, or terminations of ASDPs when significant events are announced.
- Public disclosure of relevant information about ASDPs by either the issuer or insiders through news releases filed on SEDAR.

The CSA expects that following these best practices will enhance the transparency of trading by insiders and assist issuers and insiders in managing the market perception of trades made under these plans.

Enforcement actions

Each quarter we highlight successful enforcement actions by Canadian securities regulatory administrators to illustrate the issues considered violations of or misconduct under securities requirements.

The Ontario Securities Commission is the only securities regulatory administrator that pays for whistle-blower tips. During the last quarter of 2020, three whistle-blowers received $585,000, including a company outsider who provided specialized technical analysis on a complex security law area that led to the investigation's initiation.

During the fourth quarter of 2020, the Alberta Securities Commission and a reporting issuer concluded a settlement agreement relating to two news releases issued by the reporting issuer. The mining company issued a news release that it had received an order for its minerals from a major international company. In fact, the material supplied was a minimal sample order with a nominal value. No commitment existed for the international company to take any amount of the mineral at any time. The reporting issuer paid a fine of $62,500 and has undertaken that all news releases will be authorized by two directors and officers of the company for the next four years.

SEC regulatory update

Annual check-up

"Our public capital markets more generally, have a thirst for clear, high-quality, timely information regarding the financial and operating status of companies. While 2020 has undoubtedly been a challenging year, our financial reporting system has risen to the challenge, and we extend our sincere gratitude to all stakeholders who continue to meet professional standards and fulfill their related responsibilities to provide this clear, high-quality, timely information to investors."

- Sagar Teotia, the SEC's Chief Accountant at the AICPA Conference on Current SEC and PCAOB Developments.

The annual Conference, held virtually this year, brings together representatives of the SEC, the FASB, the IASB, the PCAOB, and the AICPA, along with panellists from industry, audit committees, and the audit firms, to discuss a wide range of developments related to financial reporting, auditing, and securities regulation. The Conference highlights the SEC and PCAOB staff's issues and concerns and the future directions of securities regulation and enforcement.

As expected, the impact and consequences of COVID-19 on the capital markets, financial reporting, and audits were a central theme of the Conference, with topics such as "Resilience Beyond Recovery: Reimagining Accounting in Extraordinary Times," "Current Accounting Challenges Driven by the COVID-19 Environment," "Forecasting and Impairment in Times of Uncertainty," and "Focus on Fraud During COVID-19." We have summarized the comments about COVID-19 and its consequences on financial reporting in "Stay the course" in this edition of *AC Insights*.

Beyond COVID-19, the Conference provided updates on emerging issues and current developments in accounting standards, auditing standards, and SEC rules and regulations. The annual Conference offers a forum for the SEC and PCAOB to highlight the challenges and issues arising from applying new standards. These hot topics emerge from consultations with the SEC staff, through the comment letters process, enforcement activities, and PCAOB inspections of audit firms. This year was no exception as accountants, auditors, and lawyers explained how they addressed some issues and challenges.

Much of the Conference is based on US GAAP. In this article, we bring you highlights of the Conference relevant to Canadian issuers that are using US GAAP for their financial statements.

Emerging issues

Reference rate reform
In our article, "IFRS update: Reference rate reform preparation" in *AC Insights,* C2019-4 (Fall 2019): 3-6, we discussed the potential impact of transitioning away from LIBOR and similar inter-bank offering rates (often referred to as reference rate reform), along with how the IASB was addressing these issues. The FASB has also addressed these issues with amendments to its standards (see "FASB update: Q1 2020 ASUs," *AC Insights,* US2020-2 (Spring 2020): 9). Further amendments are currently in progress.

Various speakers at the Conference mentioned the complexities this change could bring to some issuers and cautioned issuers to begin assessing the risks of transitioning to replacement reference rates, planning for the potential accounting consequences, and consulting with the auditors and the SEC staff, as necessary.

Both the FASB and IASB have considered amendments to the existing accounting guidance for financial instruments and hedging to provide current reliefs from some existing guidance and deal with transitional issues. The SEC staff continues to be consulted on matters evolving from changes being made to reference rates in contracts for debt securities and derivatives.

The SEC staff expects to see disclosures about reference rate reforms in a registrant's filings if debt securities or hedging exposures linked to IBORs are material to the entity. The SEC Corporate Finance staff have noted increased disclosures about rate reference reform in financial reports from the financial services sector. However, disclosures from entities in the non-financial services sectors have been more limited even though many companies have debt or exposures to derivatives linked to LIBOR. The SEC staff expects companies will focus on these disclosures in their upcoming filings with the SEC. Registrants are also reminded of the SEC Statement on LIBOR Transition issued in July 2019, explaining the SEC staff's views on managing the transition.

Risks from Brexit, international trade arrangements, and political positions
Companies may face exposures to their strategies and operations from evolving international trade developments, including Brexit and nation-states' political positions. These exposures may present opportunities and increased risks for companies. While the SEC staff has seen increasing disclosures about Brexit, they reminded registrants that enhanced disclosures are required on the impact of Brexit and other international trade and political risks. The SEC staff provided the following disclosure questions for companies to consider when crafting their disclosures.

- How is the risk assessed, and how does it affect operations?
- How is management mitigating the risk?
- How does the board of directors evaluate the risks and monitor management's responses?
- If the effects of the risks are unknown and cannot be quantified at the current time, have statements to that effect been presented?

The SEC staff expects that as these issues evolve, companies will revise and increase the disclosures.

Demands for ESG disclosures
Investors are keen to obtain more information about a company's response to environmental, social, and governance (ESG) issues. The environmental element would include responses to climate change, effective use of natural resources, management of pollution and waste, and developing opportunities in response to environmental issues. Management of human capital, product liability, and stakeholder opposition to company initiatives, along with opportunities from socially responsible programs, form the social plank. Finally, governance considers both corporate governance practices and policies and corporate ethics and responsibilities.

ESG reporting may include purpose-led, sustainability, corporate social responsibility, and ESG risks and opportunities reports. The market is interested in knowing how companies weigh the risks and shape their business strategy in response to ESG issues. Rating agencies are scoring companies to provide comparative information to investors on a company's response. Some international regulators require the disclosure of ESG information in a company's filings.

The Conference discussion indicated that analysts are unsure how to incorporate ESG information into their models because of a lack of historical sustainability data and consistency and comparability in the data among companies in the same industry. The current SEC disclosure framework does not mandate specific ESG disclosures; however, certain ESG disclosures may be captured in the discussion of material risks such as climate-change risks, cybersecurity concerns, and so on. The SEC does read ESG disclosures made outside of required filings to ensure that information in SEC filings is consistent and complete.

The IASB is developing a practice statement on management commentary, similar to MD&A required by Canadian securities regulators and the SEC. The IASB's proposals consider how broader financial reporting can complement and support IFRS financial statements. The impact of events such as climate change may be relevant for reporting in such a management commentary.

Also, internationally, the International Federation of Accountants (IFAC) has asked the IFRS Foundation to establish a global standard-setter for sustainability reporting. The IFRS Foundation is considering its response to this request. Simultaneously, the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) are proposing to merge to form the Value Reporting Foundation, intending to build a simplified corporate reporting system.

Cybersecurity
There have been several high-profile cyber incidents in recent months, including the shutdown of the Alphabet (Google) network, ransomware attacks against governments and public and private entities, phishing activities to fraudulently re-route payments, and other data breaches. The dependence on computer networks and systems is vital to most businesses, and strong cybersecurity is essential. Government agencies and computer technology companies have been raising the alarm bells. At the Conference, the SEC staff stressed the importance of being focused on these issues. Further, companies were reminded not to overlook their internal controls for information, communications, and accounting systems with the increase in remote access as employees work from home during the pandemic.

Implementing accounting standards

The SEC staff is involved in the development and implementation of accounting standards through its oversight of the FASB, consultations with registrants, the review and comment letter process, and enforcement activities. The SEC staff encourages stakeholders to reach out on complex, unique, and novel accounting and other emerging issues. The SEC staff is fully cognizant that certain judgments and estimates can be challenging when dealing with new standards and increased uncertainty or volatility in the economic landscape. The SEC's chief accountant stated, "Staff has consistently not objected to well-reasoned judgments made by companies." During the Conference, the SEC staff cited several examples of issues where the SEC staff has accepted well-reasoned judgments and not objected to a registrant's proposed accounting or disclosures.

The SEC's chief accountant recognized the FASB's response to current challenges by shifting their priorities, working with stakeholders and the SEC staff, and issuing implementation guidance on new standards. The FASB Chair, Richard Jones, has set the tone for the FASB moving forward with the objective of listening to understand the perspectives of the diverse stakeholder groups while ensuring standards provide investors with relevant, unbiased information in the most cost-effective way. The FASB will continue to improve the big three standards—revenue, leases, and credit losses. The drivers for future changes will be: (1) providing investors with decision-useful information; (2) doing cost-benefit analyses for standards and removing unnecessary cost and complexity from the model; and (3) maintaining and improving existing standards.

Revenue recognition
Revenue recognition continues to be a topic that the SEC staff is frequently consulted on or comments on in the review process. Two issues that continue to be challenging are determining whether the company is the principal or an agent in a revenue transaction and identifying performance obligations in a revenue contract. The SEC staff reminded registrants to assess their transactions against the principles in the revenue standard—assertions that the goods or service are inputs to a solution without any in-depth analysis is not sufficient to support the accounting conclusions. Another hot topic has been the accounting for incentive payments made to end-customers.

The SEC staff illustrated by examples that they accept proposals based on well-reasoned judgments.

Principal versus agent:

- Intermediary between an advertiser and digital platform: The intermediary acquired advertising space, which required the customer's ad to be uploaded. The intermediary could not redirect the advertising space to other ads and had no inventory risk. The primary responsibility for fulfillment was with the publisher. The intermediary concluded it was an agent because it could not direct the use of and obtain substantially all of the advertising space's remaining benefits. Revenue was accounted for on a net basis. The SEC staff did not object to the proposed accounting.

- Intermediary between a related party and a customer: The intermediary sold commodities to customers sourced from a related party. The intermediary took possession and legal title to the commodities. Also, the intermediary could redirect the delivery of the commodities to other customers. The sales price less a fixed commission was paid to the related party. The registrant concluded it was an agent based on its view that it did not control the product, any inventory risk was covered by insurance, and it only received a commission. The SEC staff objected based on the total mix of information. The registrant recognized the revenue on a gross basis.

Performance obligations:

- A vendor sells a data analytics software with future updates: These components were considered a single performance obligation because the software license and related updates were highly interdependent or interrelated. The customers needed the updates to continually deploy and monetize content using third party platforms of their choice. The SEC accepted the registrant's position that there was a single performance obligation.

Incentives:

- Some incentives are paid to end-users so that the payments are not considered payable to a customer. These payments are treated as marketing expenses. In other cases, incentive payments may exceed revenues (resulting in negative revenue) and may be included in sales or marketing expenses. The SEC staff reminded registrants that these situations require adequate disclosure in the MD&A so investors can understand the nature and consequences of the programs on revenue recognition and expenses.

Leases

Both the FASB and the SEC staff have had consultations with issuers on the implementation of the new leases' standard. The FASB has addressed issues related to determining the appropriate discount rate for lease liabilities and identifying embedded leases. Panellists at the Conference also noted the challenges registrants are struggling with identifying leases, particularly embedded leases.

Some issues the SEC staff have discussed with registrants include:

- The accounting for assets under a lease that are being abandoned before the end of the lease term. This issue is not addressed in US GAAP, requiring consideration of other accounting literature.
- In sale-leaseback accounting under US GAAP, a sale can only be recognized if control has been transferred based on the revenue standard's principles. In a transaction involving a VIE, a third party obtained control of the VIE and had a purchase option to acquire the asset at the end of the lease term. If the option were not exercised, the registrant would regain control of its financial interest in the VIE. After discussion with the SEC staff, the registrant concluded that a sale had not occurred.

Credit losses

The new FASB standard on credit losses will apply to certain registrants in the coming year. The FASB continues to consider the scalability and flexibility options for implementation of the standard by companies adopting the standard in future years. The SEC also referred registrants to its updated Staff Accounting Bulletin No. 119, which set out guidance and expectations for policies, procedures, and controls over the accounting for credit losses. Industry panellists noted that the new disclosure requirements would present challenges for some issuers.

Equity method investments

US GAAP requires certain investments to be accounted for using the equity method. While the equity method usually is not prescribed when a registrant holds less than 20% of an investee's voting interests, this is not always the case. The SEC staff reviewed a situation where a registrant held less than 20% of an investee's voting stock but had access to non-public information about the investee through some informal agreements and shared managerial personnel with the investee. Also, the registrant was party to a contractual agreement with certain other investors to vote in concert in the election of the board of directors of the investee. As a group, the group could appoint a specified number of members to the board, holding a majority. The registrant had the right to one member on the board of the investee. The registrant concluded they did not have significant influence; however, the SEC staff did not agree.

Consolidation

Consolidation of another entity can be required under US GAAP if a registrant has control through voting rights or other contractual arrangements or the registrant is the VIE's primary beneficiary. When an investor has an interest in a VIE, the factors for determining the primary beneficiary focus on the risks and activities that most significantly affect the economic performance.

The SEC staff addressed consolidation issues under both models during the year. Key take-away points were:

- Control is based on investors' substantive rights, not speculation: A investor held a majority voting interest in LLC with one other member. The nature of the LLC required the investor to consolidate if it had control of the LLC. Significant financial and operating decisions required the consent of both members, with a buy/sell agreement in place to break decision-making deadlocks. Either member could offer to pay fair value for the other member's interests. The majority investor held the view that the buy/sell agreement was not substantive. The SEC disagreed, and the majority member did not consolidate the LLC.
- General partner with discretion to make the day-to-day decisions: An investor established investment guidance for investments to be made by a VIE. The investor had the contractual ability to modify certain aspects of the investment guidelines for the VIE. However, while using the investor's guidelines, the general partner had the discretion to make significant day-to-day investment decisions. This discretion meant the investor was not the primary beneficiary.
- Buy-out agreement did not create a de facto relationship: Two investors planned to wind-up a VIE, with one investor agreeing to buy out the other at a fixed price at the wind-up date. In the interim, both investors continued to participate in decision making and sharing of power. This change was not considered to result in the investor agreeing to buy out the other on wind-up as being the primary beneficiary.

Consideration received from a vendor
Accounting for consideration from a vendor requires careful consideration of the reasons for the payment. A registrant purchased fixed assets from a vendor and had a non-cancellable contractual obligation to buy additional assets in the future. Due to issues, the vendor made repairs and provided the registrant with cash compensation. The vendor was not obligated to make these payments. The registrant concluded that the vendor made the payment to retain the customer relationship and not in exchange for distinct goods or services provided by the registrant, reimbursement of costs to sell the vendor's products, or sales incentives. With the SEC staff's concurrence, the payment was allocated to reduce the purchase price of the actual and future acquisitions.

Segment reporting
The SEC staff noted some unacceptable practices for segment reporting:

- Revenue reported in segment disclosures not following GAAP by leaving out deductions for discounts, returns, allowances, and other concessions.
- More than one measure of segment profit or loss is presented, while GAAP requires a single measure. The measures may be an operating profit or net income for each segment.

Impact of technology

Technology continues to make a significant contribution to high-quality financial reporting. The use of data analytics is providing opportunities for efficiencies for registrants, capital markets, and auditors. However, at the same time, there are risks and challenges to protect data integrity and privacy. Also, blockchains provide opportunities to increase business value by transforming the way transactions are conducted and the related accounting and auditing.

Both the SEC staff and the AICPA representative outlined concerns over accounting for digital assets (tokens, coins, crypto assets). The AICPA has established a working group to develop a guide on accounting and auditing digital assets. The nonauthoritative guide will address classification and initial measurement issues, derecognition, ownership of digital assets, and the accounting for rights to receive digital assets if held in a third-party wallet. In the interim, the AICPA has issued publications: *Practice Aid: Accounting for and auditing of digital assets* and *Blockchain Universal Glossary*.

SEC response

Throughout the year, the SEC has engaged with various stakeholders through consultations with registrants and auditors on complex, novel, or unique financial reporting matters, reviews of registrants' filings, and dialogue with audit committees. Timely advice is provided on developing issues through public statements, notices, and bulletins. The Conference offers a platform for the SEC staff to highlight some common themes and recurring issues from their engagement with stakeholders that require the attention of registrants, audit committees, and auditors.

The SEC staff outlines some best practices for working with SEC staff. While some are administrative tips, the key points are to: (1) clearly and directly address questions in comment letters, (2) not assume what is seen in another filing is precedent, (3) call to ask a question or get clarification if the comment is not clear, (4) if something raised in a comment is not material, advise staff on a timely basis, and (5) be upfront about the purpose of novel transactions.

Updated regulations

During the Conference, various SEC staff members provided overviews of regulations updated in 2020, including rules and regulations about:

- financial information about guarantors and issuers of guaranteed securities (see "SEC regulatory update: Easing burden on disclosures about guarantors and pledges of assets," *AC Insights,* US2020-2 (Spring 2020): 13-14).
- disclosures about the business in annual reports and registration statements (see "SEC regulatory update: Simplifying and modernizing the disclosure regime," *AC Insights,* US2020-4 (Fall 2020): 8).
- disclosures in the MD&A (see "A modern, simplified, and enhanced MD&A" in this edition of *AC Insights*: 26-28).
- financial information for businesses acquired (see "SEC regulatory update: Disclosures about business acquisitions and disposals," *AC Insights,* US2020-3 (Summer 2020): 11-15).
- auditor independence (see "Modernizing auditor independence" in this edition of *AC Insights*: 30-31).

Non-GAAP measures

Non-GAAP financial measures are a continual topic at the annual Conference. In January 2020, the SEC published SEC Release Nos. 33-10751 and 34-88094: ***Commission Guidance** on Management's Discussion and Analysis of Financial Condition and Results of Operations*, which sets out guidance on using key performance indicators and metrics. In the guidance, the SEC acknowledged key performance indicators and metrics could be key variables and factors necessary to understand and evaluate a company.

Through its reviews, the SEC staff noted some practices where improvements were required to ensure the adjustments made to prepare non-GAAP measures were consistent with the SEC guidance and were not misleading. The tips provided by the SEC staff include:

- The use of accounting principles that have been superseded or opposite to those required by the revenue standard may be misleading. The SEC staff indicated that revenue is "special," and any revenue adjustments would be challenged. Disclosures of "billings" or "bookings" may be acceptable.
- Any presentation of non-GAAP adjusted gross profit or contribution margin should be reconciled to fully loaded gross margin as implied by GAAP.
- Measures prepared using individually tailored accounting principles may be misleading. For example, excluding credit losses would not be appropriate. When registrants want to show the impact of a new standard, the explanation should be in the MD&A. The SEC will look at the substance of the disclosures in assessing a non-GAAP measure.

It was observed that the IASB has a proposal under review in its primary financial statements project to require alternative measures publicly communicated to be included in the financial statements with explanations and reconciliation to GAAP measures.

Structured payables disclosures

Structured payables are supplier finance programs, including supplier financing arrangements, reverse factoring, vendor payable programs, and supply chain financing. The SEC staff expects disclosures about these programs, if material, to be included in the MD&A. Disclosures would consist of the purpose of the programs, the material and relevant terms of the program including the general risks and benefits, any guarantees provided by subsidiaries or a parent company, any plans to further extend terms to suppliers, factors that might limit the ability to continue to increase cash flows using the strategy in the future, and information about trends and uncertainties related to the extended payment terms.

SEC enforcement

The SEC Enforcement Division continues to be active in following up leads and investigating potential accounting and disclosure violations. The Enforcement Division continues to use data analytics in its efforts. It has recently begun an earnings per share (EPS) initiative using risk-based analytics to uncover possible earnings management and other similar practices.

The Enforcement Division's priorities for 2021 include monitoring of gatekeepers' roles and actions (audit committees and auditors), investigation of earnings management practices, review of revenue and expense recognition issues, inquiries into the adequacy of disclosure of material information, trends and uncertainties, and consideration of non-GAAP measures.

Internal control over financial reporting

The Chief Accountant noted that there had been recent improvements in ICFR disclosures, but improvements are still needed in evaluating the severity of identified deficiencies. Also, registrants will need to consider whether disclosures should be enhanced because of changes in controls due to:

- the application of new standards.
- changes made to controls in response to the pandemic to deal with employees working remotely, other accommodations to deal with customers and vendors, and changes to operating procedures.

Thorough evaluations may be necessary to determine whether any changes made were material.

Audit committees and auditors

"The audit committees of companies play a vital role in the financial reporting system through their oversight of financial reporting, including ICFR and the external, independent audit process. We believe the measures related to audit committees have proven to be some of the most effective financial reporting enhancements included in the Sarbanes-Oxley Act. In these times of rapid change and increased uncertainty, the need for the oversight role that audit committees play is as critical as ever."

- SEC Chief Accountant

These expectations are clear. As an illustration of the role, the SEC Chief Accountant elaborated that no consultation with the SEC staff is complete without knowing the audit committee's view. Further, the SEC believes that auditor independence is fundamental to obtaining an independent view of management's work. Audit committees should make this a top priority.

PCAOB response

In 2020, the PCAOB responded to the current conditions, modified its operations, and shifted its focus to understand how audit firms were adapting their policies, procedures, and methodologies due to the COVID-19 constraints and reviewing current audits and reviews of interim financial statements. The SEC has commended the PCAOB for its efforts in achieving its goal of enhancing audit quality.

The PCAOB continues to improve its communications by enhancing its inspection reports to make them more accessible and understandable. Also, the PCAOB provides its observations and perspectives on the most recently completed inspections on a more timely basis through webinars and publications.

CAMs

One focus of the PCAOB and the SEC has been the successful implementation of the new Auditor's Report under PCAOB auditing standards, including critical audit matters (CAMs). The PCAOB has worked closely with auditors and stakeholders, providing extensive outreach and an interim analysis of CAMs' implementation, published in October 2020 (see *Interim Analysis Report: Evidence on the Initial Impact of Critical Audit Matter Requirements*, October 29, 2020). The PCAOB observed that auditors had made significant investments in preparing for the new requirements. At the Conference, the SEC staff and the PCAOB outlined some observations about the implementation of CAMs.

- Communications tailored to the specific facts and circumstances of the registrant are more meaningful to investors. The auditors should avoid general language about audit procedures, including internal control testing, and describe the specific procedures applied to address the principal considerations that led to the matter being identified as a CAM. In the future, the SEC staff will be reviewing audit reports and commenting on the disclosure of CAMs.
- CAMs are unique to each audit, and stakeholders should use caution when comparing CAMS reported by different companies.
- All matters communicated to the audit committee related to material accounts or disclosures must be evaluated by the auditor when determining what will be reported as CAMs. The PCAOB has observed inconsistencies between wording for matters disclosed as CAMs and the documentation in the auditor's working papers.
- Audit committees need to be involved early and review drafts of CAMs to be reported for internal consistency with financial statements and other disclosures being made by the registrant.
- Industry panellists observed that some CAMs prompted registrants to take a fresh look at disclosures because of the requirement to report CAMs.

What's next?

The Conference provided management, auditors, and audit committees with many observations and comments to assist them in preparing high-quality financial disclosures. All parties should reflect on these observations and comments and consider those that are relevant to their companies for further analysis and review.

A modern, simplified, and enhanced MD&A

On November 19, 2020, the SEC adopted amendments to modernize, simplify, and enhance financial disclosures required in the MD&A and other sections of annual reports and registration statements. The amendments were published in SEC Release Nos. 33-10890 and 34-90459: *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information.* The MD&A requirements were significantly restructured. Specific provisions have been eliminated, and other prescriptive guidance has been replaced with a principles-based, registrant-specific approach. The SEC believes these amendments will improve disclosures by enhancing their readability, discouraging repetition, and eliminating information that is not material.

The SEC has emphasized that MD&A should provide analysis that encompasses short-term results as well as future prospects. Issuers should focus on disclosing the information that is necessary to understand the business and its financial condition, operating results, and cash flows. MD&A should not duplicate the disclosures included elsewhere in a filing; the discussion is intended to be additive and to limit any repetition of the underlying reasons that might apply to changes in multiple line items.

These amendments affect Regulation S-K, which governs disclosures mainly for domestic US registrants. The SEC has also amended Form 20-F, which provides the relevant guidance for foreign private issuers, except certain Canadian issuers eligible to use the multijurisdictional disclosure system (MJDS). The Form 20-F incorporates the substance of the changes made to Regulation S-K. For Canadian MJDS issuers, MD&A has always been based on Canadian securities requirements augmented by the requirements to provide the tabular disclosure of contractual obligations and discuss off-balance sheet arrangements. The changes to these additional disclosures for Canadian MJDS issuers are explained in the section on liquidity and capital resources.

In many respects, the MD&A requirements in Canada parallel the US requirements. While the CSA has been simplifying the requirements for continuous disclosures in Canada, it is unclear whether and when the MD&A requirements may be updated. The IASB is also working on a project to update its Practice Statement 1: *Management Commentary*, which was initially issued in 2010. The IASB proposals are expected to be broader than current CSA and SEC MD&A requirements. They are being built on concepts related to value creation, business models and strategy, integrated reporting, key resources and intangibles, and materiality. It is unclear how the IASB Practice Statement will affect reporting for regulatory filings in Canada or the US.

Objective

The MD&A requirements now begin with an introduction setting out the objective for MD&A. This objective incorporates many elements of the SEC's existing interpretative guidance, emphasizing that disclosures are to be from "management's perspective." The purpose of MD&A is to provide a discussion and analysis, on a historical and prospective basis, of the registrant's financial condition, results of operations, and cash flows, emphasizing future prospects.

Prospective disclosures include information about matters that are "reasonably likely" to have a material impact on future operations. This likelihood is based on management's

assessment based on materiality and what a reasonable investor might consider important. The "reasonably likely" threshold is used throughout the MD&A requirements. These subtle changes to the language of the requirements do not change the challenges of preparing prospective disclosures, and registrants will need to assess how they will apply this new direction.

The rule requires a narrative discussion of the "reasons underlying" any material changes from period-to-period in and within line items in the financial statements. The reasons would be both qualitative and quantitative. The discussion should focus on each reportable segment or other subdivision, if necessary, to understand the business. Analysis by product lines and geographic regions is also to be considered if necessary.

Since the objective only refocuses the guidance previously issued by the SEC, significant changes are not expected in the substance of a registrant's MD&A. However, registrants should review the objective to ensure that the tone and content of their MD&A meet the spirit of the requirements.

Liquidity and capital resources

The requirements for liquidity and capital resources have been combined. The information should be provided in a format that facilitates easy understanding and does not duplicate information disclosed elsewhere in the filing.

Registrants are required to disclose material cash requirements, including but not limited to capital expenditures, as of the end of the latest fiscal period. Cash requirements include cash needed to fund key resources such as property and equipment, human capital, and intellectual property. Cash requirements also include cash to meet known contractual and other obligations, such as lease obligations, purchase obligations, or other liabilities. The time horizons cover both short-term (the next 12 months from the most recent period end) and long-term needs. Information on the anticipated source of funds and the general purpose of the cash requirements are to be included in the disclosures.

The amendments clarify the requirements for disclosing material short- and long-term liquidity needs while emphasizing a principles-based approach. Liquidity is defined as the ability to generate adequate amounts of cash to meet the needs for cash.

The separate requirement to discuss off-balance sheet arrangements has been eliminated for all filers except Canadian MJDS issuers. The disclosure about these arrangements is incorporated into the broader discussion of liquidity and capital resources. Canadian MJDS issuers must continue to provide disclosure about off-balance sheet arrangements to the extent that the disclosure is not already provided in the MD&A required by Canadian securities requirements. The CSA Form 51-102F1: *Management's Discussion & Analysis* still requires disclosures about off-balance sheet arrangements. Canadian MJDS issuers will need to ensure that their disclosures meet both the CSA and SEC requirements.

The separate requirement to provide a tabular disclosure of contractual obligations has been removed to prevent duplication of information required in the financial statements and the disclosures about capital resources. For Canadian MJDS issuers, the tabular disclosure is no longer required under the SEC rules; however, the CSA Form 51-102F1: *Management's Discussion & Analysis* still requires the tabular presentation. The SEC rules indicate that the MD&A should analyze material cash requirements for known contractual and other obligations.

Results of operations

The rules still require a discussion of material changes in and material unusual or infrequent events affecting revenue and income from continuing operations. The guidance on the discussion of known trends and uncertainties has been updated. The description of known trends, demands, commitments, events, or uncertainties should focus on matters that are *reasonably likely* to cause (as opposed to *will* cause) a material change in the relationship between costs and revenues. Reasonably likely matters are determined from management's assessment of what is material and would be considered important to a reasonable investor. Examples of items that might be disclosed are known or reasonably likely future increases in costs of labour or materials or selling prices, or inventory adjustments.

The specific requirement to discuss the impact of inflation or changing prices has been eliminated. However, these factors may still require discussion if they had or are reasonably likely to have a material effect on revenue or income from continuing operations.

Critical accounting estimates

The rules now explicitly require the disclosure of critical accounting estimates. Critical accounting estimates are defined as "those estimates made in accordance with generally accepted accounting principles that involve a significant level of estimation uncertainty and have had or are reasonably likely to have a material impact on the registrant's financial condition or results of operations." Disclosures about critical accounting estimates would include, if material:

- Why the estimate is subject to uncertainty.
- How much the estimate has changed over a relevant period.
- The sensitivity of the reported amounts to the methods, assumptions, and other estimates underlying the calculation. The changes can be explained through a discussion of changes in assumptions during the period.

Quantitative information is included when it is reasonably available and will provide material information to investors.

These disclosures need to be tailored to a registrant's business, uncertainties underlying its financial statement line items, and other relevant circumstances.

The SEC believes that critical accounting estimates' disclosures will not necessarily result in duplicative disclosures with critical audit matters. The former is management's perspective, and the latter is the auditor's perspective.

Interim periods

The rules allow the discussion of material changes in its results of operations to reflect the business cycle. Registrants are now permitted to compare the most recent quarter with either (1) the corresponding quarter of the prior year (current requirement) or (2) the immediately preceding quarter. The requirement to discuss material changes in the results of operations between the most recent year-to-date interim period and the preceding fiscal year's corresponding period is unchanged. If a company elects to discuss changes from the immediately preceding quarter, the MD&A must include a summary of financial information being discussed and analyzed or reference to the prior filing that includes the information. Any changes in the method used for comparing the results of a current interim period must be explained.

Consistent with the annual requirements, the reference to discussing the impact of inflation and changing prices has been removed.

Selected financial data

Currently, certain registrants provide selected financial data in a comparative table generally for the last five fiscal years. This requirement has been eliminated. Registrants are encouraged to consider whether:

- The MD&A should include trend information for periods earlier than those presented in the financial statements "to provide material information relevant to an assessment of the financial condition and results of operations."
- A tabular presentation of relevant financial or other information is needed in an overview section of the MD&A to illustrate material trends.

This change will reduce or eliminate challenges in updating the tabular disclosures for five years following a disposition treated as discontinued operations and other events requiring retrospective revisions to historical financial statements.

Further, companies will only be required to provide quarterly data for the two most recently completed financial years in their Form 10-K and registration statements when there are retrospective material changes to the related interim statements of comprehensive income. Companies may voluntarily disclose quarterly information to provide investors and analysts with a snapshot of the fourth-quarter results.

What's next?

The changes will become effective 30 days after they are published in the Federal Register. Registrants are required to comply with the new rules beginning with the first fiscal year ending on or after the date that is 210 days after publication in the Federal Register. Registrants may early adopt the amended rules at any time after the effective date (on an item-by-item basis) if they provide disclosure responsive to an amended item in its entirety.

The changes remove duplicative requirements between financial statements and MD&A and build on the ability to use technology to extract specific information. However, the tone and tenor of the MD&A requirements have not changed substantively. The updating of the requirements for known trends and uncertainties should provide disclosures relevant to understanding an issuers' future prospects. The revised critical estimates section is an opportunity for issuers to clean up those disclosures by removing the elements that are simply repetitions of the accounting policies and focus on material estimates that are subject to significant uncertainty.

Disclosure of payments by resource extraction issuers

In December 2020, the SEC adopted rules that will require resource extraction issuers to disclose payments made to the US federal government or foreign governments for the commercial development of oil, natural gas, or minerals. The rules implement specific requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These rules are the SEC's third round at establishing the regulations required by the Dodd-Frank Act. The new requirements were published in SEC Release No. 34-90679: *Disclosure of Payments by Resource Extraction Issuers*.

The rules will require a domestic or foreign reporting issuer to annually disclose payments made by the issuer (including a subsidiary or entity controlled by the issuer) to the US federal government or a foreign government when the issuer engages in the commercial development of oil, natural gas, or minerals. All issuers required to file an annual report with the SEC on Form 10-K, 20-F, or 40-F must provide the disclosures.

Use of alternative disclosure regimes

An issuer that provides similar disclosures under a foreign jurisdiction's reporting regime accepted by the SEC may furnish those disclosures instead, provided they are tagged for XBRL. The SEC has endorsed disclosures under the EU Directives, the UK's Reports on Payments to Governments Regulation 2014, Norway's Regulations on Country-by-Country Reporting, and Canada's Extractive Sectors Transparency Measures Act.

Disclosures of payments

Payments include taxes, royalties, fees, production entitlements, bonuses, and other material benefits, whether paid in cash or in-kind. Material benefits include community and social responsibility payments required by law or contract, payments of certain dividends, and infrastructure payments. The payments are reflected on a cash basis, not an accrual basis. The payments can be reported in either US dollars or the issuer's reporting currency.

Resource extraction issuers are required to disclose payments by type and total amount per project. Projects are based on three factors:

- Type of resources as either oil, gas, or a specific mineral, such as gold, copper, coal, sand, gravel, or some other generic mineral class. The particular type or quality of oil or gas or subcategories of the same mineral type will not be required.
- Method of extraction as either use of a well, open pit, or underground mining.
- Major subnational political jurisdiction such as a state, province, district, region, or territory consistent with the International Organization of Standardization classifications.

Two or more types of resources and extraction methods can be combined per jurisdiction as one project.

The rules will require disclosures of payments made to each foreign government in the host country or the US federal government that equal or exceed US$100,000 or the equivalent, whether made as a single payment or in a series of related payments. The disclosures are made on Form SD, which will be publicly furnished through the EDGAR system. The information must also be furnished in XBRL format.

Form SD would include payment information by each project and all projects, by government, and by payment type.

Disclosure of payments may be omitted from the SD filings under three conditional exemptions when:

- foreign laws prohibit disclosure.
- terms of a pre-existing contract prohibit disclosure.
- the resource extraction issuer is a smaller reporting company or emerging growth company.

Disclosure of payments for exploratory activities can be delayed so as not to create competitive harm. Any such payments would be reported in the filing of Form SD in the subsequent year.

Transitional reliefs

Transitional reliefs are provided in two situations.

- When an issuer has acquired or obtained control over another extraction issuer, disclosures are not required until the first full year after the acquisition date; however, this relief does not apply if the acquired issuer was required to provide the information in its last full fiscal year under the SEC rules or rules of an alternative regime.
- After an IPO of an issuer until the first full year after the IPO.

Companies can also request exemptions from the SEC for unique situations.

Form SD must be filed within 270 days after the most recently completed fiscal year-end of the extraction issuer. The new rules will apply two years after the effective date, which is 60 days after the rules are published in the Federal Register. This likely means that for calendar year-end companies, the first reports will be filed for 2023 year-ends and due in September 2024.

The SEC expects these current rules will complete the process of complying with the Dodd-Frank Act. Companies are encouraged to consider the impact of these requirements so as to be prepared when the payments will have to be disclosed.

Modernizing auditor independence rules

On October 16, 2020, the SEC adopted amendments to certain auditor independence rules in Regulation S-X Rule 2-01. These amendments modernize the rules by focusing on relationships and services that may threaten an auditor's objectivity and impartiality. The amendments grew out of consultations over many years in which technical rule violations were found not to be impairments. The amendments included in the SEC Releases No. 33-10876 and 34-90210: *Qualifications of Accountants* are summarized below. The new requirements apply to auditors of both domestic and foreign private issuers, including Canadian issuers that are registrants of the SEC.

The PCAOB, which had parallel rules, also adopted amendments to its independence standards on November 19 to align with the SEC's changes. The PCAOB's changes should eliminate confusion, differences, and duplications between the PCAOB and SEC independence requirements.

Definition of "Affiliate of the Audit Client"

The SEC amended the definition of "affiliate of the audit client" in Rule 2-01(f)(4) to address certain affiliate relationships, including entities under common control. Sister entities are now only included as part of the "audit client" if both the entity under audit and the sister entity are material to the controlling entity. If either the sister entity or the entity under audit is not material to the controlling entity, the sister entity will not be deemed an affiliate of the audit client. This change should eliminate many technical violations where immaterial entities related to the audit client received non-audit services from the auditors.

Easing loan restrictions

Currently, an auditor is not considered independent if specified persons within the audit firm, or their family members, maintain loans to or from an audit client. Current exceptions to this rule include most automobile loans/leases, loans collateralized by insurance policies or cash, mortgages obtained under normal market conditions, and credit card debt reduced to $10,000 or less on a current basis. The amendments add certain student loans and consumer loans to the list of exclusions. Consistent with the treatment of credit card debt, consumer loans with outstanding balances of $10,000 or less are excluded. Consumer loans would include retail instalment loans, cell phone instalment plans, home improvement loans, and other similar loans not secured by a mortgage on a primary residence.

Business relationships with owners

The audit firm and any covered person are currently prohibited from direct or material indirect business relationships with an audit client or the audit client's decision-makers, such as officers, directors, and substantial stockholders. The amendments change "substantial stockholders" to beneficial owners (known through reasonable inquiry) of the audit client's equity securities that significantly influence the entity under audit. The term significant influence is to be interpreted as used in the accounting literature. The SEC believes these amended requirements will clarify the existing rules and make them less complicated.

Inadvertent violations when mergers and acquisitions occur

In the past, inadvertent independence violations have arisen when mergers and acquisitions have occurred between clients of the respective firms' auditors. One or both auditors of the combining companies may have provided prohibited services to the combined company. The amendments develop a framework to address these situations, with the expectation that the independence violations will be corrected as promptly as possible, preferably before the effective date of the merger or acquisition. Auditors must have quality controls to identify services and relationships that could impair the auditor's independence. The transition framework will not apply to mergers or acquisitions that are in substance like IPOs.

Effective date

The amendments will be effective 180 days after publication in the Federal Register, which was on December 11, 2020. Voluntary early compliance is permitted after the amendments were published in the Federal Register, provided that the final amendments are applied in their entirety from the date of early compliance. Retroactive application is not permitted.

These changes should address some of the technical violations of the independence rules, which have not impaired the auditor's objectivity and impartiality. Audit committees will no longer need to spend time and effort addressing situations that in substance did not impair the auditor's independence.

Exempt offering regime

In November 2020, the SEC amended its rules to improve the exempt offering framework for the benefit of emerging companies and more seasoned issuers while still protecting investors.

The amendments to the Securities Act of 1933 simplify, harmonize, and improve certain aspects of the exempt offering framework to promote capital formation while preserving or enhancing important investor protections. The amendments address the timing and use of exemptions, the limits of offerings and investments under the exemptions, rules for communications about the offerings, disclosure requirements, and eligibility requirements.

For Canadian issuers using the exempt markets in the US, these rules may facilitate new financings. The details of these amendments are in SEC Release Nos. 33-10884 and 34-90300: *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets.*

Enforcement in action

In November 2020, the Enforcement Division of the SEC released its *2020 Annual Report*, which provides a comprehensive overview of the Enforcement Division's accomplishments over the past year, significant actions, critical areas of strategic change, and details the Enforcement Division's COVID-19-related enforcement efforts. Below are some of the highlights from the report that deal with financial fraud and issuers' disclosures. Also, we provide a summary of critical actions settled or resolved during the most recently completed quarter.

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One of the focus areas for the Enforcement Division is identifying and investigating securities law violations involving different components of the financial reporting process. The Enforcement Division takes a proactive, risk-based analytic approach to identify potential violations. This approach has resulted in several important actions.

The Enforcement Division has started an EPS (Earnings Per Share) Initiative that uses risk-based data analytics to uncover potential accounting and disclosure violations caused by earnings management practices. The EPS Initiative has already resulted in settled actions against two registrants for improper accounting practices for quarterly EPS designed to meet or exceed analyst consensus estimates. Also, the Enforcement Division staff used risk-based data analytics to uncover potential violations related to corporate perquisites. In one case, a registrant settled with the SEC for failing to disclose all perquisites and personal benefits provided to executive officers.

The report lists several actions taken against several types of companies and individuals dealing with:

- overstatements or inappropriate timing of revenue recognition.
- misstatements of expenses.
- failures to recognize or accurately measure provisions and reserves.
- fraudulent accounting practices.
- frauds by using company resources for personal purposes.
- misleading or incomplete disclosures about known facts, known trends, and likely events.
- failure to disclose practices to enhance business and revenue.
- inaccurate or misleading presentations of and disclosures about non-GAAP financial measures and key performance indicators.
- failures to disclose material liquidity problems, related party transactions, and executive compensation arrangements.
- violations of the books and records and internal accounting controls provisions resulting in errors in accounting.
- violations of the Foreign Corrupt Practices Act provisions by making payments to government officials.
- improper handling of whistle-blower complaints.

The report also included its findings on specific COVID-19-related inquiries and investigations. We have summarized those in "Stay the course" in this edition of *AC Insights*.

Actions during the quarter

The SEC whistle-blower program continues to result in several successful leads, as shown by the announcement of 12 payments totalling more than US$172 million in the final quarter of 2020.

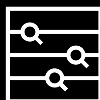
The SEC closed three cases during the final quarter of 2020 as follows:

- **Unregistered offering of digital tokens:** An entity sold digital asset securities to US investors without registering their offer and sale as required by the US securities laws. The court established that the sales of tokens were sales of investment contracts, and therefore securities. The final judgment requires the entity, for the next three years, to provide notice to the SEC before engaging in future issuances, offers, sales, and transfers of digital assets and to pay a US$5 million penalty.
- **False and misleading disclosures about plans:** A registrant, its subsidiaries, and two former senior executives claimed that a project to build a plant would qualify the company for more than US$1 billion in tax credits. They knew the project was far behind schedule and therefore unlikely to be eligible for the tax credits. The SEC complaint alleged that the false statements and omissions boosted the registrant's stock price and the sales of bonds in an offering. Ultimately, the registrant announced it was scrapping the project, and investors are said to have lost hundreds of millions of dollars when the facts were disclosed. The registrant and its subsidiary agreed to a permanent injunction and to pay US$112.5 million in disgorgement plus prejudgment interest and a US$25 million penalty. The litigation against former senior executives is still ongoing.
- **Failure to report material information about the performance of segments:** A SEC order found that the registrant misled investors by failing to disclose material information about two of its key reportable segments.
  - For one segment, the registrant failed to disclose that a significant portion of the profits for certain quarters resulted from reductions in its cost estimates to complete specific multiyear projects accounted for using the percentage of completion method. The same reportable segment also monetized some of its accounts receivable by using a sister finance company. The registrant failed to tell investors that its reported increase in current cash collections came at the expense of cash in future years and came primarily from internal receivable sales between two affiliates.
  - Another reportable segment lowered projected costs for claims and failed to inform investors of the corresponding uncertainties resulting from lower estimates of provisions at a time of rising claims.

  The SEC's order found that the registrant violated the antifraud, reporting, disclosure controls, and accounting controls provisions of the securities laws. The registrant paid a $200 million penalty and agreed to report for one year to the SEC regarding specific accounting and disclosure controls in the two reportable segments.

This *2020 Annual Report* and more recent cases highlight the importance the SEC places on having a strong enforcement branch as a deterrent against accounting fraud and misleading and inaccurate disclosures.

Auditing update



Key audit matters to be reported for TSX listed companies

Canadian Auditing Standard 701: *Key audit matters* (KAMs) was issued in 2017. The Canadian standard is based on International Auditing Standard 701. Key audit matters are those matters that, in the auditor's professional opinion, were the most significant in the audit of a company's financial statements for the current period. KAMs are to be included in a new section of the auditor's report.

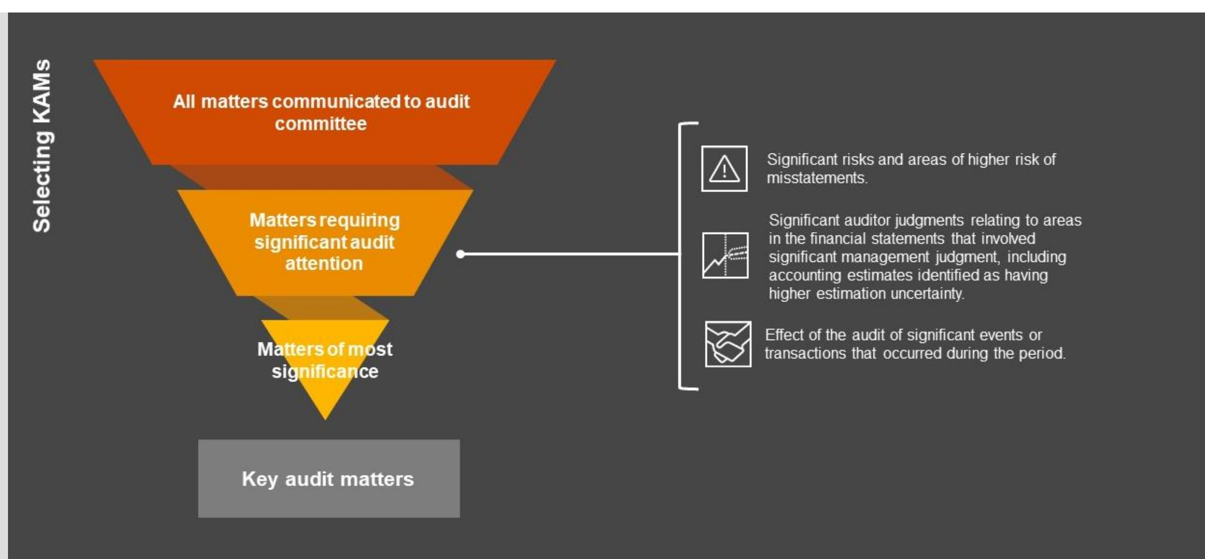
Auditors will begin to include the new section for KAMs in their auditor's reports of companies listed on the TSX, other than certain investment companies, for periods ending on or after December 15, 2020. KAMs have been reported by many non-Canadian companies following International Auditing Standards. Some Canadian SEC registrants' audit reports prepared using PCAOB standards have included critical audit matters (CAMs), which are similar but not identical to KAMs.

How will auditors select KAMs?

The selection of KAMs involves a process as illustrated by the chart below. Auditors will use their professional judgment to determine which and how many KAMs are included in the auditor's report. This will be an important judgment assessment for auditors. While KAMs will be drawn from matters discussed with the audit committee, it is expected that not all matters communicated to the audit committee will be considered KAMs for inclusion in the auditor's report.

The intention is not to provide a comprehensive list of matters, but only the most significant matters communicated to the audit committee or similar governance committee. The purpose of KAMs is to provide information to the users of the financial statements about the significant areas of the audit and the audit procedures performed to address those risks.

The KAMs will be selected from those matters requiring significant auditor attention during the audit. These matters will reflect areas with higher risks of misstatement in the financial statements, other significant risks, matters requiring significant auditor judgment, and subjects involving significant transactions or events.



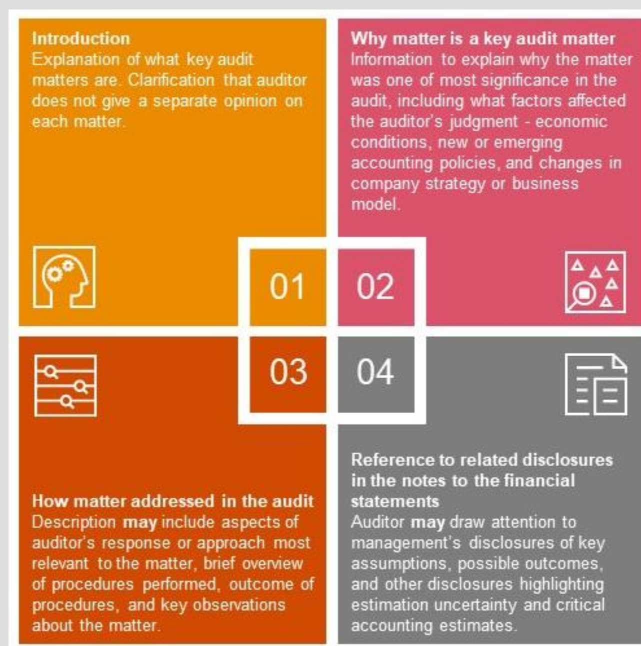
For potential matters, the auditor will consider:

- How material it is to the financial statements as a whole.
- How important it is to the understanding of the financial statements as a whole.
- How complex or subjective are the related accounting policies.
- The nature and extent of any corrected or uncorrected misstatements.
- The nature and extent of audit effort required, including the use of experts.
- Any difficulties encountered in the audit, including obtaining sufficient audit evidence.
- Any severe internal control deficiencies identified.
- The importance of interactions among the auditor, management, and the audit committee.

The auditor would not be required to disclose a matter if the disclosure was precluded by law or regulation, or in extremely rare circumstances, the disclosure would have adverse consequences that would be reasonably expected to outweigh the public interest benefits.

How will KAMs be described in the auditor's report?

The auditor will describe each KAM, include a reference to the related financial statements disclosures, if any, explain why the matter was one of the most significant in the audit, and disclose how the matter was addressed in the audit. The elements of the required disclosures are shown in the chart below.



The standard indicates that the auditor might include disclosures about the auditor's response or approach to the matter or the assessed risk, a brief overview of procedures performed, the outcome of the procedures, and key observations about the matter. It is expected auditors will use their judgment in deciding what would be relevant to disclose. While the standard has been applied in other countries using International Auditing Standards and similar PCAOB standards in the US, it is expected that the reports will vary in wording, tone, and depth. There will be a learning curve as auditors implement the new standard and adapt over time with more experience.

Some observations on the implementation

While KAMs are disclosed in the auditor's report, management and the audit committee will have a keen interest in what is reported. The starting point is the discussion of audit matters with the audit committee. Audit committees are expected to be engaged and discuss the matters to be disclosed and how they will be disclosed.

The determination of the KAMS will be challenging for the auditors. While most auditors will intuitively know which matters are most significant, the disclosures may be challenging. The matters and disclosures will differ from entity to entity. The challenge will be describing succinctly and clearly the particular area of focus, why it was focused on, and how the audit addressed it. The disclosure will have to be entity-specific and avoid boilerplate and generic disclosures. The disclosure will have to be understandable to all stakeholders.

What to expect?

Audit Analytics classifies and analyzes data from public companies to be used by various institutions and professionals. The firm has analyzed KAMs reporting and provided summary reports on its blog.

In the Audit Analytics 2019 review of KAMs (Steve Dixon, "An Overview of KAMs – 2019," Audit Analytics, accessed December 30, 2020, www.blog.auditanalytics.com), Dixon observed for 2019, 3,673 companies reported 9,231 KAMs, or 2.51 per company. For 2020, based on partial data, 290 companies have reported 838 KAMs, or 2.89 per company.

The key topics reported identified by Audit Analytics (with breakdowns by asset class when greater than 25% and by industry when greater than 25%) were as follows:

- asset impairment and recoverability (24.2%) – primarily goodwill, intangible assets, property, plant and equipment – manufacturing, retail trade, and wholesale trade industries.
- revenues and other income (17.2%) – finance, insurance, real estate, manufacturing, retail trade, and wholesale trade industries.

- valuation of investments, including fair value measurements (10.1%) – finance, insurance, and real estate industry.
- going concern (6.5%).
- income taxes (4.5%).
- inventory (4.3%) – retail trade and wholesale trade industries.
- business combinations (3.7%).
- subsidiaries and affiliates (3.2%).
- contingent liabilities and provisions (3.1%).

In an update on November 23, 2020 (Audit Analytics Staff, "COVID-19 Impacts on European Audit Opinions," Audit Analytics, accessed December 30, 2020, www.blog.auditanalytics.com), Audit Analytics noted that 57% of the KAMs identified for European companies were COVID-19-related. The majority of these KAMs were for small-cap (50%) and mid-cap (28%) companies with a market cap of under EUR 100-million and between EUR 100 million and EUR 1,000 million, respectively. The finance, insurance, real estate (30%) and service (23%) industries reported the most KAMs, partially attributed to potential impacts of the economic downturn affecting impairments.

KAM versus CAM

KAMs and CAMs are highly similar, but not identical. The International Auditing and Assurance Standards Board adopted a principles-based approach to defining KAMs, focusing on all matters arising from the audit. The PCAOB adopted a narrower scope for critical audit matters, focusing on matters related to auditing accounts and disclosures material to the financial statements. The PCAOB definition scopes out those matters that are not included in an account or a disclosure. So, while the auditing frameworks begin with matters communicated or required to be communicated to the audit committee, CAMs immediately exclude those not related to an account or a disclosure. For example, under both frameworks, an auditor may communicate to the audit committee the implementation of a new information technology system that required significant auditor attention during the current audit. However, this matter would not be a CAM, but it may be identified and reported as a KAM.

In "Survey of CAMs reporting in the US" in this section of *AC Insights*, we also provide observations from the PCAOB and the CAQ on reporting CAMs under the PCAOB standards. The observations by the PCAOB and CAQ give a North American flavour of the possible disclosures that may be made for Canadian reporting issuers.

What's next?

Since many companies around the world have already applied similar requirements, Canadian auditors will have access to the knowledge and experiences from other auditors and companies that have implemented KAM and CAM reporting. These valuable insights should facilitate a smooth transition, although with every new standard there is a learning curve, which will mean continual improvements as auditors gain more experience.

Survey of CAMs reporting in US

Critical auditing matters (CAMs) communicated in auditors' reports prepared using PCAOB standards have been required for large accelerated SEC filers for years ended after June 2019. As a follow-up to the initial implementation of the new requirements, the PCAOB completed an analysis of the initial impact of CAMs. The purpose of this analysis was to understand the impact of the new reporting and evaluate whether there was any early evidence of significant costs, benefits, or unintended consequences. The findings were published in the PCAOB's *Interim Analysis Report: Evidence on the Initial Impact of Critical Audit Matter Requirements* dated October 29, 2020. Details to support the analysis were published in October 2020 in two staff white papers: *Econometric Analysis on the Initial Implementation of CAM Requirements* and *Stakeholder Outreach on the Initial Implementation of CAM Requirements.*

The Center for Audit Quality (CAQ) also reviewed auditor's reports to identify trends in the communication of CAMs. The CAQ's findings were published in *Critical Audit Matters: A Year in Review*.

PCAOB finds no unintended consequences

The PCAOB's analysis indicated that 2,420 auditor's reports contained CAMs' communications with the average number of CAMs reported as 1.7. The number of CAMs included in an auditor's report ranged from one to seven. The PCAOB observed that the top four matters communicated related to revenue recognition (604 instances), goodwill (462), other intangible assets (385), and business combinations (355).

For its analysis, the PCAOB conducted surveys of audit firms, individual engagement partners, and investors; interviews of audit committee chairs and preparers; statistical analysis of audit hours, audit fees, time to issue auditor's reports, and capital markets reaction to the new reporting; and a request for comments from interested stakeholders.

The key findings of the PCAOB analysis were:

- Audit firms made significant investments to support the implementation of CAMs reporting. These investments included tools and guidance, training personnel, developing subject matter specialists, and establishing consultation and review protocols. Efforts also included extensive upfront preparations, including pilot and dry runs. On average, one percent of the audit hours were spent identifying, developing, and communicating CAMs. Many engagement partners reported improved communications with audit committees, and some indicated companies made changes to their disclosures as a result of communications about CAMs. Engagement partners also commented about the challenges and extra work required to implement the standards.
- Investor awareness of CAMs being communicated is still developing, but some investors find the information conveyed beneficial. Investors have indicated they find CAMs helpful in understanding the auditor's work and the company's disclosures, mainly when they are specific and tailored to the company. Some investors are interested in understanding the outcomes of the matters communicated.
- No evidence of unintended consequences arose from the implementation of the CAMs requirements. The PCAOB's statistical analysis did not find any increased costs because of the new standards, delays in issuing the auditor's reports, or market reaction.

Straightforward communications by auditors

The CAQ took an in-depth look at the auditor's reports for companies in the S&P 100. The CAQ found that auditors' reports provided straightforward descriptions about matters that involved especially challenging, subjective, or complex judgments. The auditors provided insights into how the matters were audited and how they became comfortable with the matters. The CAQ believes that the result is an increase in the total mix of information available to investors.

In the S&P 100 group, the average number of CAMs reported was less than two, with 32 issuers with one CAM, 43 with two CAMs, 21 with three, 3 with four, and one with five. In the larger population of accelerated filers, 16 auditor's reports did not report a CAM. One of the principal drivers for CAMs reported was the high degree of judgment required by management, which led to a high degree of judgment by the auditor to assess and evaluate management's conclusions.

The common categories of CAMS noted by the CAQ were:

- Income taxes (16%): various judgmental taxation areas such as the impact of new federal tax laws, deferred tax assets, unrecognized tax benefits, and accounting for income taxes in general.
- Goodwill and intangibles (14%): impairment of goodwill and indefinite-lived intangibles using different assumptions, reporting units, or nature of intangible assets.
- Contingent liabilities (12%): legal and regulatory contingencies, insurance-related liabilities, and contingent interest and penalties on international tax positions.
- Revenue (9%): timing of revenue recognition in software, consulting services, long-term contracts, and royalties.
- Other (49%): consisting of 23 topics such as business combinations, sales returns and allowances, pensions and post-retirement benefits, and asset retirement and environmental obligations. There were also some industry trends: financial institutions – allowance for loan and lease losses, insurance – insurance contract liabilities, petroleum refiners – proven and unproven reserves and asset retirement and environment obligations, and energy companies – regulatory assets and liabilities.

While some critical accounting policies or estimates were also CAMs, more critical accounting policies or estimates were disclosed by companies than CAMs reported by the auditors. In some cases, the auditor identified CAMS, which were not considered critical accounting policies or estimates, for example accounting for business combinations. None of the companies in the S&P 100 had a significant internal control deficiency linked to a CAM.

The format of discussing CAMs differed by auditor and company. Auditors included a description of the auditor's response or approach that was most relevant to the matter or a brief overview of the audit procedures performed, or both. Auditors described how they addressed the CAM by identifying the internal controls tested, specific audit procedures performed, the audit evidence evaluated, and personnel with specialized skills or knowledge used.

The CAQ believes the early trends from the initial reporting of CAMs "demonstrate the additional transparency provided by the auditor within their reports … and provide users of auditor's reports with a better understanding of the areas that involve especially challenging, subjective, or complex auditor judgment."

What's next

The PCAOB's and CAQ's initial analyses indicate that identifying and communicating CAMs, although challenging, went smoothly. The communications provided useful information, although investors are still considering how they will use the information. Although key audit matters to be communicated under Canadian Auditing Standards are not identical to CAMs, the two reports provide some helpful insights for TSX companies whose auditor's reports will soon include CAMs.

CPAB 2020 Interim inspection results

In October 2020, CPAB set out its interim inspection results for 2020 in its report, *CPAB Audit Quality Insights Report: 2020 Interim Inspection Results*. The report includes observations from inspections completed during 2020 and the impact of COVID-19 on public company audits. The report also provides tips for auditors and audit committees for the upcoming year-end audits and the continuing challenges for 2020. We have summarized the COVID-19 comments in "Stay the course" in this edition of *AC Insights*. The other comments are outlined below.

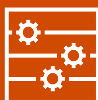
As of the date of the CPAB report, CPAB has completed 51 of its 72 planned file inspections and found significant deficiencies in five of those files.

The most common inspection findings, which should have been detected and corrected through effective supervision and review, related to:

- the audit of estimates of fair values, recoverable amounts, and measurement of revenue.
- the quality of audit procedures in testing the reliability of management documentation, understanding the accounting and business processes, testing transactions and reconciling transactions to amounts in the financial statements, and considering contradictory evidence in publicly available information or other information in the audit working papers.
- failure to summarize and report to the audit committee misstatements individually less than materiality.

Most of these findings require firms to carry out additional audit procedures to assess whether financial statements need to be restated due to material error; others may require adding evidence to the audit file that supports the original audit work.

Corporate reporting update



Interconnecting corporate reports

In September 2020, the International Federation of Accountants (IFAC) called for a new sustainability standards board to enhance corporate reporting. The IFAC laid out a framework in its document, *Enhancing Corporate Reporting: The Way Forward*. IFAC recommended a new standard-setting board be established "to build and coordinate a coherent global system of interconnected corporate reporting."

On September 30, 2020, the International Financial Reporting Standards Foundation (IFRS Foundation) issued the *Consultation Paper on Sustainability Reporting* to seek stakeholder input on the need for global sustainability standards and whether the IFRS Foundation should play a role in developing such standards. The Consultation Paper sets out possible ways the IFRS Foundation might contribute. The Consultation Paper focuses on one option, under which the IFRS Foundation would establish a new sustainability standards board. The consultation is open for comment until December 31, 2020.

In December 2020, five leading organizations in sustainability and integrated reporting published a paper to address standards for reporting enterprise value through a prototype climate-related financial disclosure standard. The paper, *Reporting on enterprise value: Illustrated with a prototype climate-related financial disclosure standard* was co-authored by CDP, the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC), and the Sustainability Accounting Standards Board (SASB). The paper illustrates how current frameworks, standards, and platforms, along with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), can be used as a starting point for the development of global standards for sustainability-related financial disclosures.

The paper provides input to the IFRS Foundation's Trustees about possible ways the IFRS Foundation might contribute to this development by broadening its current role beyond the development of financial reporting standards. The paper demonstrates that standard-setting for sustainability-related financial disclosure is a natural extension of the IFRS Foundation's current role and provides insight into how such an ambition can be achieved by building on content that already exists.

In the paper, the group of five explain that financial disclosure standards would enable disclosure of how sustainability matters create or erode enterprise value. Sustainability-related financial disclosures are distinct from sustainability reporting. Sustainability reporting has been designed to describe a company's significant impacts on the environment, people, and economy, rather than value creation. The authors provide prototypes of a climate-related financial disclosure standard and presentation standard.

Investors are demanding better information about climate risks and sustainability indicators that is comparable and consistent. An increasing number of corporations develop their own sustainability reporting to meet the demands of regulators, consumers, investors, and other stakeholders. There is a consensus that the current practices for sustainability reporting are inefficient and ineffective because of a lack of commonly accepted standards. Government public policy initiatives are also influencing demand. This recent push engaging the IFRS Foundation may be the catalyst to developing standards that companies, regulators, investors, and other stakeholders will find acceptable.

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