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Keeping your head above water

Recent issues in financial reporting

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About this Issue

We may as well come right out and say it. There are no major new accounting standards or regulatory pronouncements to tell you about. Nothing, nada, zilch. After two decades of constant changes inspired by accounting scandals, the financial crisis and globalization, the well has run dry. For the moment, anyway.

Before you start to cheer too loudly, there are still some significant financial reporting matters you need to know about. A few relate to how existing standards apply, or should apply, to complex emerging issues, such as the impact of the impending disappearance of LIBOR and climate-related changes on financial statements. Others relate to efforts by the IASB to clarify and simplify standards. By far the most significant of these is insurance, the great white whale the IASB has been chasing for twenty years, so far in vain, but there are others – debt classification, onerous contracts and incidental revenue – that cross industry lines. These won't affect everyone, of course, but they're bound to affect someone. The question is, is that someone you? Are you listening, mining and oil and gas companies?

And then there's earnings reporting. In December the IASB released a proposal to revolutionize existing IFRS income statement presentation and disclosure requirements. Trust us, if this Exposure Draft goes through, your income statement will never be the same again. Neither will you. Part and parcel of the Exposure Draft is a proposal that would require you to include in the footnotes information about non-GAAP earnings measures you've already published outside the financial statements. This would automatically subject these measures to IFRS fair presentation requirements and to audit, the point of the exercise. What can we say? If there ever was an Exposure Draft that requires your response, this is it.

The IASB isn't the only one attempting to improve non-GAAP reporting. The conversation about what regulators, investors and industry associations intend to do continues unabated. Of course, talk is cheap. The question for reporting in Canada is, when, if ever, will all this talk turn into action?

We shouldn't forget developments affecting key/critical audit matters reporting. There are two things to be aware of. The first is that Canadian auditing authorities have finalized their decision as to which Canadian public companies will have the pleasure of seeing their auditors highlighting the most significant matters they discussed with the audit committee in their opinions on the financial statements. The second is that the early returns from SEC companies' initial reporting of critical audit matters are in. Now's your chance to see if your expectations as to what this reporting will be like are close to reality.

The content of this issue of the *Financial Reporting Release* may seem a little different in comparison to past ones, and it is, but we think it's a fair reflection of the new reality in financial reporting. In that reality, the dominant focus is no longer on changing the rules on how you should be recognizing and measuring things – that infrastructure is now more or less complete, with insurance the major laggard. Now the broad themes are on simplifying and clarifying accounting standards and reducing the regulatory financial reporting burden while maintaining the quality of information being delivered to investors. In this new reality, the controversies might change, but they certainly won't disappear.

Benchmark Interest Rate Reform

"That's the secret to life . . .replace one worry with another."
– Charlie Brown

We suspect you've already heard that the world's most popular interest rate benchmark, LIBOR, will almost certainly disappear in 2022, with new alternative benchmark rates rising to fill the void (see the sidebar). This has some rather narrow geek-like, but nonetheless important, financial reporting ramifications the IASB is addressing, which we discuss below. But there are larger business and operational issues that regulators and others are spending their nights worrying about. In brief, these are whether companies are underestimating the impact the transition to new rates will have on their business and operations. The SEC has been waving the flag furiously trying to get everyone to pay attention – this isn't just a bank reporting issue, it can impact almost all corporate reporters. Critical issues include:

- Identifying LIBOR-based contracts that extend beyond 2021, including whether they contain effective fallback provisions that specify how interest is calculated if LIBOR disappears, and assessing their impact.
- Developing a game plan to address issues relating to these contracts; e.g., renegotiating them to shift over to new rates. If debt is publicly traded, it may be necessary to convene a meeting of debtholders to approve any changes.
- Deciding as a matter of business policy when in the next two years to changeover to contracts referencing alternative interest rate benchmarks. If you continue to use LIBOR, ensuring there's appropriate fallback language.
- Changing operations, systems, products and processes, including accounting, forecasting, budgeting, fair value modelling, taxation, etc. to accommodate the new benchmarks.
- If the changeover to new rates is expected to be material, alerting investors to the implications and the progress of transition plans.

As to the accounting implications, two things have happened. First, the IASB late last year rushed out changes to IFRS to eliminate any possibility that the expected loss of LIBOR would cause one to conclude that hedges tied to this benchmark will no longer be effective. These changes are mandatory in 2020, but entities with LIBOR referenced hedges may discover that the additional disclosures required are a small price to pay for staying on the safe side of hedge effectiveness and early adopt these changes. Second, the Board has tentatively decided that a renegotiation of a contract to substitute an alternative benchmark rate for LIBOR can be treated as the latest change in the contract's floating interest rate and so would not affect either the contract's measurement or a company's hedge accounting. Certain conditions would have to be met. An Exposure Draft is expected by the summer.

PwC observation. Clearly, the impact on individual companies will depend on the extent of their exposure to LIBOR-based financings, swaps, and other contracts, but everyone's got to at least make that assessment. Another worry to address, sure, but, if everybody is shouting that the sky is falling, you've got to at least look up to see if you should be diving for cover.

The New Benchmark Interest Rates

- The alternative benchmark rates are essentially risk-free rates for secured overnight borrowings. Examples include SOFR (US$), SONIA (UK£), and ESTR (euro).
- The Canadian dollar equivalent of LIBOR is CDOR. Unlike LIBOR, CDOR isn't scheduled to disappear in 2022, but it may eventually be superseded in the markets by CORRA, a newly upgraded Canadian dollar overnight risk-free rate.
- LIBOR is an inter-bank lending rate and thus the quoted rate always includes an invisible spread for bank credit risk that's not present in the alternative rates. Replacing that spread in contracts tied to new benchmarks will be the subject of negotiation between counterparties.
- LIBOR is a forward-looking rate; i.e., the interest rate that applies for a period (e.g., one month, three months, six months, etc.) is always reset at the beginning of the period. The replacement rates are backward-looking rates; i.e., the rate for a period is the average of the daily rates for the period and thus won't be known until the end of the period. Treasurers hate this. The US is aiming to have forward-looking LIBOR-like rates for SOFR in place by the end of 2021.

Climate Change Reporting in Financial Statements

"I went to a general store, but they wouldn't let me buy anything specific."
– Stephen Wright

The IASB has published an article authored by one of its Board members that explains how IFRS applies to the recognition, measurement and disclosure of the effects of climate change in financial statements. The article comes at a time when investors are pressing for much more detailed reporting, especially of risks and assumptions. Last year, for example, a group of major European investors wrote to the Big 4 audit firms expressing their concern that companies and auditors were ignoring climate change in accounting and audits. Now the IASB is getting questions as to why it's not developing standards specifically addressing the related issues. Consider this article as its response.

Here are the key messages:

- The main issue for companies to decide about their financial reporting is whether climate-related effects, risks and uncertainties are material. Under IFRS, information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions of the primary users of financial statements.

- IASB Practice Statement provides IASB's guidance on making materiality judgments. Even though the Statement isn't mandatory, the article observes that investors may have reason to expect that directors, preparers and auditors will consider the Statement in preparing and auditing financial statements.

- The article emphasizes that qualitative external factors, such as the industry in which a company operates and investor expectations, may make some risks material and require their disclosure in the financial statements regardless of their numerical impact. For instance, disclosure of the assumptions about climate change in impairment assessments may be necessary even if you haven't recognized an impairment, or are unlikely to materially adjust the carrying amount of assets and liabilities within the next year. Moreover, if you've decided not to include a specific assumption about climate-related risks in impairment testing, you may have to explain why. You also may have to disclose that you're not subject to specific risks or exposures if they're common in your industry.

Also summarized are the key IFRS standards that are relevant in determining appropriate accounting and disclosure for climate change in the financial statements.

PwC observation. We expect the spotlight on climate change reporting and disclosure in financial statements – and on the IASB's article – will shine all the brighter in the wake of a very recent announcement by a major European oil and gas company that it's taking a €4.88 billion write down consistent with its commitment to lower its carbon emissions to zero by 2050 in line with the Paris Agreement. It remains to be seen whether the market will think the IASB's general response is enough. Specifics are what it's looking for.

Income Statement Presentation and Non-GAAP Earnings

"In order to fly, all one must do is simply miss the ground."
– Douglas Adams

Warning! Late in December the IASB issued an Exposure Draft proposing wholesale changes in income statement presentation and related note disclosures. The changes are so big that describing them as merely dramatic is an understatement.

Here's what the Exposure Draft would have you do:

- Use a standardized income statement presentation format separating operating, investing and financing activities:

Revenue	xx
Expenses	xx
Operating income	xx
Income from integral joint ventures and associates	xx
Operating income and income from joint ventures and associates	xx
Investing income and expense	xx
Profit before financing and income taxes	xx
Financing expenses	xx
Profit before income taxes	xx
Income taxes	xx
Profit	xx

- Follow basic requirements that will establish what revenues and expenses go where (there are exceptions for certain companies). You won't have much discretion.

- Report operating expenses on the statement solely "by function" (e.g., cost of sales and general and administration expenses) or "by nature" (e.g., employee benefits and depreciation) based on which is the more informative. Mixing the two approaches – a very common approach in practice – is prohibited. If you present operating expenses by function, you've got to disclose total expenses disaggregated by nature in the notes.

- Apply a new "shared characteristics" model for grouping income and expenses and determining line items to be displayed. This applies to the other primary statements too.

- Avoid using an "other" category as much as possible. Doing this will trigger additional note disclosure.

- Identify and disclose unusual income or expenses based on their predictive value is limited. Presenting unusual items separately on the income statement is banned for "by function" presentations and difficult even when a "by nature" presentation is used.

- Disclose non-GAAP earnings measures in the notes and provide essentially the same information about these measures (purpose, reconciliation to GAAP, etc.) that you now report outside of the statements, along with the related effects on tax and noncontrolling interest. Operating income before depreciation and amortization, an IFRS sanctioned alternative to EBITDA, is deemed to be GAAP, but presenting this subtotal on the income statement would be possible only for "by nature" expense classifications.

There are also a few proposals affecting the balance sheet and cash flow statement – present goodwill, integral and non-integral investments separately, start the operating cash flow reconciliation with operating income, and classify interest income as investing activities, and interest expense and dividends as financing activities on the cash flow statement (as with the income statement there are exceptions for certain companies).

PwC observation. The Board has justified its proposals on the grounds that they will facilitate inter and intra industry comparisons. However, make no mistake, a driving force behind this project is providing a more relevant IFRS alternative to non-GAAP reporting, regularly criticized by the Board as providing "too rosy" a view of the world. A standardized income statement will, says the Board, allow more meaningful comparisons to non-GAAP performance measures, and cast a more penetrating light on differences. It may even cause some companies to drop non-GAAP reporting, or so the Board hopes. Regarding the non-GAAP earnings proposal, the Board makes no bones that its purpose is to improve the transparency of non-GAAP earnings measures and the discipline over their preparation. We encourage everyone to map out how the proposals would impact their reporting and provide their views to the Board on whether the proposals fly.

More on Non-GAAP Earnings

"Those are my principles and if you don't like them…well, I have others."
– Groucho Marx

The IASB isn't the only one to cast a jaundiced and cynical eye over non-GAAP earnings measures, of course. In the past few years there has been a steady stream of regulations, requirements, comment letters and exhortations from securities regulators designed to bring more order and coherence to this parallel universe of reporting. We summarize below the initiatives being undertaken in Canada below to improve non-GAAP reporting and the SEC's observations on key issues in practice at the *2019 AICPA Conference on Current SEC and PCAOB Developments* in December.

- Canadian Securities Administrators ("CSA") have acknowledged that they are retooling their 2018 proposals to upgrade their guidance on non-GAAP measures and convert it into a mandatory rule. The modified proposals will be released for public comment, but the CSA hasn't set a target date for when that might be. There's little or no chance of a new rule being effective in 2020.

- The Canadian Accounting Standards Board's initiative last year to "start the conversation" on non-GAAP reporting in Canada seemed not to have spurred significant changes to reporting. However, …

- Financial Executives International is preparing to release its own guidance on alternative performance measures. According to press reports it will urge boards to take a stronger role in overseeing the measures and company management to develop better policies and procedures for their use; and…

- The Canadian Coalition of Good Governance, a group of institutional investors, will make companies' use of non-GAAP measures as it relates to executive compensation one of its focus areas for 2020.

- The Chair of the SEC emphasized at the AICPA Conference that companies should be responsible in their use of non-GAAP reporting. He also observed that non-GAAP measures used by management are more meaningful than those prepared for disclosure to investors, which he described as mere "window dressing". SEC staff also reminded companies to follow a consistent basis for calculating measures, and repeated previous years' warnings that it will object to the use of "tailored" non-GAAP measures that don't appropriately represent the underlying economics or that have been developed solely to do an end run around new accounting pronouncements. Examples include changing gross revenue under GAAP to net or vice versa, reporting contribution margins that exclude costs of generating revenue, or using a non-GAAP measure that excludes the effects of the new US expected credit loss model or loan loss provisions in their entirety.

PwC observation. The absence of a specific rule in securities legislation requiring Canadian companies to comply with CSA guidance for identifying and reporting non-GAAP measures has been fingered as a major reason why the quality of Canadian non-GAAP reporting has not improved like the US's. We suspect that voluntary frameworks, by themselves, may not be effective. Developing appropriate principles for the identification and reporting of non-GAAP measures is one thing; putting enough teeth in them to ensure that they're properly applied is quite another.

Goodwill Amortization

"I wish I had an answer to that because I'm tired of answering that question."
– Yogi Berra

Believe it or not, the question of whether goodwill should be amortized has become a hot issue internationally – with investors, companies and others anxious to weigh in on the matter. There's something about goodwill amortization, it appears, that strikes a responsive chord in people's souls.

The issue has resurfaced primarily in reaction to concerns and complaints about the effectiveness, complexity and cost of applying the existing impairment test for goodwill. Goodwill amortization, so the argument goes, is the antidote that cures these ills, because it would reduce the pressure on the test and even allow for its simplification. Of course, there are also zealots out there that have always believed that goodwill is a wasting asset and that the decision taken almost 20 years ago not to amortize it constitutes a sin against basic financial statement concepts. The IASB and FASB have established their own separate projects to reconsider the question. Here's where things stand now.

- The IASB will be issuing a Discussion Memorandum for comment outlining its tentative view that goodwill amortization should not be reinstated. This view passed only by the narrowest of margins.
- A FASB Invitation asking constituents their views on the subject has attracted an unprecedented response. However, that response was well and truly mixed, with a diversity of views being expressed by preparers, users and auditors, both across and within each of these groups about the pros and cons of amortization. A few commentators even raised the question of whether goodwill qualifies as an asset at all, an issue that's not on the table.
- Although a variety of views were expressed, there was only one issue on which there was unanimity – that whatever the answer is, it should be the same under both US GAAP and IFRS.

PwC observation. What came through loud and clear in the US responses is that there's no consensus as to exactly what goodwill represents. If you can't agree on what goodwill is, it's hardly a surprise if you can't agree on whether it should be amortized. For that reason, this question may be resolved on practical cost-benefit considerations rather than conceptual ones.

Insurance

"Success is often the result of taking a misstep in the right direction."
– Al Bernstein

The latest on the longest running soap opera, oops, accounting standards project in history.

Recall that the Board had to tow its insurance standard back to drydock not long after its issuance in 2017 because of concerns, primarily by insurers, about its quality and operationality. The IASB is now considering responses it received on the proposals it issued last year in an Exposure Draft to clarify and simplify certain aspects of the standard, and extend its effective date by a year.

Most of the changes the Board has contemplated are very technical in nature – far too technical to get into here (is that a cheer or a groan we hear?) But there's one topic that at least deserves mention. That is that the Board expects to consider whether to defer the mandatory effective date of the standard from 2022 to 2023. This will be done towards the end of its re-deliberations so the Board can take into account the entire package of its amendments. However, most respondents to the Exposure Draft supported the Board's proposed 2022 transition date, so don't hold your breath.

PwC observation. The most important message emerging from the IASB's deliberations is their timing of their completion – the Board has announced that it expects to issue a revised standard by the end of the second quarter of this year. Consistent with this, the Board has made it clear that it won't entertain any requests for further changes. If any imperfections in the standard remain, they'll be addressed through a post implementation review. Twenty years spent developing a standard is long enough.

Other Changes to IFRS in 2020

"Your secret is safe with me, I wasn't even listening."
– Anonymous

Listen up. The following summarizes the more significant changes to IFRS the Board will be introducing in 2020, or made in earlier years that are now effective.

Changes that will be introduced this year (all effective in 2022)

Classifying liabilities as current or non-current

These changes clarify that the classifying of a liability as non-current depends solely on whether the creditor has the contractual right at the balance sheet date to defer payment for at least the next 12 months. All else is current.

PwC observation. These changes were made in the hope of improving the consistency of the standard's application. In Canadian practice, this has been fairly uniform, and we're not expecting huge changes as the result of the Board's amendments.

Onerous contracts

Under IFRS, companies must estimate the cost of fulfilling a contract to see whether it's onerous and thus should be accrued as a loss. The IASB has clarified that the cost for this purpose is the incremental cost of completing the contract plus an allocation of costs that relate directly to fulfilling it and other contracts.

PwC observation. The IASB refused point blank the pleas of many respondents to the Exposure Draft to clarify other aspects of the onerous contract test, especially how to identify the "economic benefits" of a contract to determine whether its onerous.

Incidental revenue during the development of PPE

This prohibits reducing the cost of property, plant and equipment for any revenue received from running the asset during the testing phase. Revenue is revenue, and revenue always goes to the income statement, is the underlying theory here, no matter when it's earned.

PwC observation. Mining and oil and gas companies, beware!

Definition of an accounting estimate

The Board has redefined what accounting estimates are. The new definition emphasizes that estimates are subject to measurement uncertainty, and result from applying measurement techniques that require judgments and assumptions. A change from one technique to another qualifies as a change in estimate, too.

PwC observation. This is the latest in the eternal quest to provide a bright line that distinguishes accounting estimates from changes in accounting policies.

Changes made in prior years that are effective in 2020

Business combinations

The IASB's business combinations standard has been amended to update the definition of a business and introduce an optional screening test that, if met, eliminates the need for a more detailed assessment of the definition.

PwC observation. We suspect that the changes to the definition will rarely change determinations as to whether or not something is a business, but if they do, the accounting for the transaction will be significantly different. Remember that you can recognize goodwill only for business acquisitions. Other differences in accounting relate to the treatment of transaction costs, contingent consideration and deferred taxes.

Key/Critical Audit Matters

"There are lies, damned lies and statistics."
– Mark Twain

There have been a few developments.

First, the Canadian Auditing and Assurance Standards Board finally has donned its black cap and pronounced sentence. It's decided the scope of "key audit matters" (KAMs) reporting requirements for auditors of Canadian listed public companies that have their audits done under Canadian generally accepted auditing standards. The verdict is that, but for the exception discussed below, all companies listed on all Canadian exchanges, not just those on the TSX, are subject to this reporting. That exception is for investment funds subject to National Instrument 81-106 (which beat off a last-minute attempt by the Board to capture them as well). The Board reaffirmed that auditors of TSX companies will have to report KAMs in audit opinions on 2020 financial statements, with reporting beginning two years later for companies listed on other Canadian exchanges.

Second, the initial wave of "critical audit matters" (CAMs) reporting by auditors of SEC registrants has now washed up onto the shore for examination – over 100 audit opinions including this reporting have now been issued. According to a recent Audit Analytics survey of these opinions, the top five CAMs being identified are:

- Business combinations
- Goodwill and intangible assets
- Revenue
- Income taxes
- Contingencies

The SEC also recently confirmed that most CAMs being identified are critical accounting estimates the company has disclosed or a subset of critical estimates (example: the company discloses revenue recognition as a critical estimate, but the auditor identifies the revenue of a segment as a CAM). This is not a surprise as the expectation is that most audit committees and auditors will work together to coordinate their reporting.

Third, according to the Audit Analytics survey mentioned previously, the average number of CAMs per opinion was 1.7 for US companies. The latest published average for Canadian SEC registrants was 1.5 with registrants outside of North America racking up an average of 3 per audit opinion.

PwC observation. We're already hearing worries that too much attention is already being paid to statistics about the kind of issues that are being raised and the average number of KAMs/CAMs per audit opinion. At the AICPA Conference the point was made repeatedly that comparing companies on this basis is unlikely to be meaningful – it's what the CAMs say that's important, not how many there are. Nevertheless, we expect that audit committees will be taking this information into account in assessing their own auditor's reporting.

For more information

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

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- Readiness assessments for public reporting
- Advice on regulatory and exchange requirements
- Assistance with financial statements, prospectus and other documents
- Assistance with due diligence process
- Advice on alternatives

Complex Mergers and Acquisitions

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

Regulatory Issues and Restatements

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

GAAP / IFRS Interpretation and Conversions

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

Accounting Standard Adoption

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

Other Services and Products

- On-site assistance / expert secondment
- Quantitative analysis and model development
- Tax Accounting Services
- Comperio
- Automated Disclosure Checklists
- PwC IFRS Manual of Accounting

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