AC Insights

Insights for reviewing financial reports

Perspectives on corporate financial reporting using US GAAP

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Contents

Leases: Now effective

Accounting Standards Codification Topic 842, *Leases*, is effective for annual periods beginning after December 15, 2018. The objective of the new leases standard is to improve users' understanding about an entity's leasing activities and to enhance transparency about and comparability of financial effects of those activities.

Topic 842 significantly changes the accounting for lease contracts. The accounting for lessees is significantly affected, while the accounting for lessors generally remains the same. Changes made to key concepts such as the definition of a lease, criteria for determining lease and non-lease components, criteria for classifying leases, and other changes may affect the accounting for certain lease contracts.

Key provisions

Lessees

For most lease contracts, lessees recognize "right-of-use" assets and lease liabilities on their balance sheets. Leases are classified as either operating or finance leases. For operating leases, lease expense is recognized in the income statement on a straight-line basis; whereas for finance leases, lease expense comprises amortization of the right-of-use assets and interest on the lease liabilities. There is an exemption to allow short-term leases to be treated similar to operating leases. Variable lease payments that are not dependent on an index or rate are expensed as incurred.

The accounting model for leases under IFRS differs from US GAAP. While most leases will be on the balance sheet under IFRS, the method of expensing lease costs differs. IFRS uses a single model, which treats all leases effectively as finance leases. IFRS also provides an exemption for short-term and low-value leases.

Lessors

The accounting for lessors is substantially similar to the accounting under the old leases standard. Leases are classified as operating, sales-type or direct financing leases. However, certain classification criteria have changed, which may result in different classifications for some leases previously classified as operating. Leverage leases have been eliminated. For sales-type leases, a sale is recognized at the commencement of the lease when control of the underlying asset is transferred to the lessee.

Under IFRS, lessors will continue to account for leases as operating or finance leases on a basis substantially similar to their previous accounting. Revenue and profit on finance leases are recognized when performance obligations have been met.

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Sale-leaseback transactions
Substantial changes were made to the accounting for sale-leaseback transactions, with the recognition of a sale of the underlying asset by the seller-lessee being aligned with the requirements for a sale under the new revenue standard or other applicable standards for sale of assets. A failed sale-leaseback transaction is accounted for as a financing transaction.

Impact

The new leases standard requires more judgment in several areas, and some of these judgments are complex. The areas requiring significant judgment may include the determination of the lease term, distinguishing between lease and non-lease components in a contract, determination of the discount rate, assessment of implications of lease modifications, and assessment of contingent lease payments.

Topic 842 is likely to have a significant impact on the financial reporting by lessees. You can expect to see:

- More assets and liabilities on balance sheets. This change will also affect balance sheet ratios, such as debt to equity.

- For operating leases, higher values for right-of-use assets during initial years, because the amortization of assets is essentially a residual number between the straight-line expense and the interest on the lease liabilities. This means the amortization applied against assets will increase over the lease term.

- Higher expenses when leases are entered into because the capitalization of initial direct costs is limited to incremental costs.

- Changes to key performance indicators such as the current ratio, interest coverage, EBIT, and EBITDA.

- Enhanced qualitative and quantitative disclosures about the effects of leases on the company's financial position, financial performance and cash flows. Lessors will also have to provide enhanced disclosures.

The new standard effectively eliminates the use of sale-leaseback transactions by lessees as off-balance sheet financings because the standard requires most leases to be presented on the balance sheet.

In addition to the financial statement impacts, Topic 842 may also affect negotiations between lessors and lessees as some parties may attempt to mitigate some of the financial statement impacts.

Transition

Topic 842 is applied using a modified retrospective basis. Comparative periods can be adjusted retrospectively to the beginning of the earliest period presented or not adjusted by recognizing a cumulative adjustment at the beginning of the year of adoption. Several optional practical expedients are provided to facilitate implementation of the standard.

FASB update

During the first quarter of 2019, the FASB met six times to discuss various projects. Work continues in three major areas dealing with distinguishing between debt and equity, accounting for identifiable intangible assets and goodwill, and disclosure reviews of selected standards.

The Emerging Issues Task Force met in January 2019 to finalize its consensus on accounting for episodic television series, which was subsequently issued as ASU 2019-02: *Improvements to accounting for episodic television series* in March 2019 (see further details below).

Just-in time simplifications for lessors

On March 5, 2019, the FASB issued ASU 2019-01: *Codification improvements to Leases (Topic 842)* to address implementation issues identified by stakeholders. The ASU addresses two issues for lessor accounting and one transition issue for both lessors and lessees. These changes are clarifications and improvements to correct unintended application of the guidance.

Determining the fair value of the underlying asset when the lessor is not a manufacturer or dealer
Topic 842 did not specify how a lessor that is not a manufacturer or dealer would determine the fair value of the leased asset for purposes of classification of the lease. This was a change for the old leasing standard and concerns were raised that fair value would now be determined on some other basis. The amendments in this ASU reinstate the exception in the old standard that permitted lessors that are not manufacturers or dealers to use the cost of acquisition, net of any volume or trade discounts, in determining the fair value of the underlying asset. However, if there has been a significant period of time between the asset acquisition and the commencement of the lease, the fair value would be determined using ASC Topic 820: *Fair value measurement.*

Presentation of cash flows for sales-type and direct financing leases
Topic 842 required lessors to present all cash receipts from leases within operating activities. However, many lessors that are financial institutions previously presented, by analogy to guidance on loans, the principal portion of cash flows for sales-type and direct financing leases as investing activities. The ASU now requires such entities to apply the guidance in Topic 942: *Financial services – depository and lending* for the classification of cash flows from sales-type and direct financing leases.

Transition disclosures
Upon adoption of the new standard, companies were required to provide the standard disclosures for accounting changes, except for the effect of the accounting change in income, earnings per share and certain financial statement items. However, Topic 842 was not clear that these disclosures were also not required in interim financial statements. The ASU clarifies that interim disclosures should be on the same basis as annual disclosures.

Aligning accounting for television series with films

ASU 2019-02: *Improvements to accounting for costs of films and license agreement for program materials,* a consensus of the EITF, was issued by the FASB in March 2019. The production and distribution models used in the industry today have changed significantly from the models used when the original standard for films and television series were established. The ASU updates the accounting standard for broadcasters, and producers and distributors of films and television series to reflect current industry conditions.

What has changed?
The capitalization of costs for episodic television series have been aligned with those for films. The limitation of cost capitalization for television series in the existing standard has been eliminated.

Amortization methods for films and television series (collectively, films) have not changed. However, clarifications have been provided that will allow entities to use judgment in determining the estimate of use that is most representative of the use of film, particularly when monetized with a group of films. Companies will be required to review and revise estimates of remaining use of a film or a group of films as of each reporting date, with changes accounted for prospectively. Changes in the monetization strategy for a film may also affect the amortization basis or methods used.

The impairment guidance has been enhanced to address impairments of film groups, including allocation of the impairment loss to individual films in the group; to improve indicators of impairment; and to apply the fair value threshold for testing impairment for films and broadcasters' licenses for program materials.

The ASU eliminates the requirement that film costs be classified as noncurrent on the balance sheet, which allows companies to use judgment to determine the classification of film costs and license agreements. However, the costs of films and television series are required to be presented or disclosed separately. In addition, broadcasters are to present the carrying value of license agreements for program materials separately from films.

Broadcasters will be required to present cash outflows to acquire rights to program materials under a license as operating activities in the statement of cash flows.

Improvements were made to the requirements for disclosures about films and license agreements for program materials to provide information that is more useful to investors.

When are the changes effective?
The ASU will apply to public business entities for fiscal years and related interim periods beginning after December 15, 2019. Early adoption is permitted. The new guidance is to be applied prospectively from the beginning of an interim period that includes the adoption date.

What does this mean?
These improvements to the standards harmonize the accounting for similar types of assets. This harmonization is consistent with the changes in the industry to the production and distribution of these assets and the economics of how those assets are monetized. Presentation and disclosure enhancements have been made to increase the transparency of information about produced and licensed content.

ASUs effective in 2019

The FASB issued ASU 2016-02: *Leases* in 2016, which is effective in 2019 as outlined earlier in this ***AC Insights***. Since the issuance of ASU 2016-02, the FASB has issued six additional ASUs providing amendments, clarifications and improvements to the new leases standard. These ASUs are also effective in 2019. No other new standards are effective in 2019.

CSA regulatory update

Whistleblowing payments

In February 2019, the Ontario Securities Commission (OSC) announced that it had awarded close to $7.5 million to three whistleblowers on separate matters. These were the first awards under the OSC program. The three individuals provided high quality, timely, specific and credible information, which was used in successful enforcement actions. These actions resulted in monetary payments to the OSC from the wrong doers. The nature of the infractions was not disclosed by the OSC.

SEC regulatory update

Modernizing and simplifying disclosures

In March 2019, the SEC adopted several amendments to modernize and simplify disclosure requirements for public companies. The amendments eliminate outdated and unnecessary disclosures, and make it easier for investors to access and analyze material information.

These amendments align with the SEC's goal of reducing compliance costs. The amendments also clarify ambiguous disclosure requirements, remove redundancies, and further leverage the use of technology. Registrants should take note of these changes and plan to make appropriate updates to their filings.

Key changes
Some of the changes to simplify disclosure requirements include:

- Allowing companies to exclude a discussion of financial information for the earliest of the three years in Management's Discussion and Analysis (MD&A), if this earliest year has been discussed in a previous filing and the location of the prior filing is identified. In some circumstances, information about the third year could be material and should be provided. These changes also apply to the Form 20-F used by foreign private issuers.

- Allowing registrants to omit certain confidential information from most exhibits without filing a confidential treatment request, provided the information is not material and would likely cause competitive harm if publicly disclosed. The SEC staff may request redacted copies of the information to assess whether the confidential treatment is appropriate.

- Limiting the requirement to file completed material contracts that were entered within two years of the applicable registration statement or report to "newly reporting registrants", as defined in the amendments; and

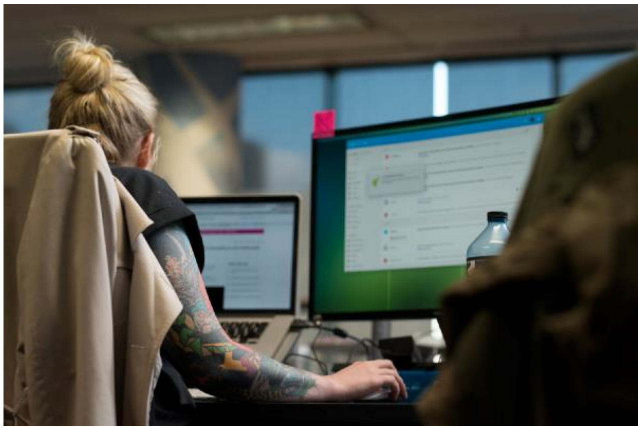
- Clarifying that certain disclosures (such as, the list of physical properties, and attachments to material agreements) are only required if they present material information.

Some of the amendments designed to make it easier for investors to access and analyze material information include:

- Prohibiting the financial statements from incorporating by reference or cross-referencing information outside of the financial statements, unless specifically permitted or required by Commission rules, US GAAP or IFRS;

- Requiring a description of securities in the annual reports on Forms 10-K, 20-F and 40-F by including the description in an exhibit or hyperlinking to a previously filed exhibit;

- Requiring companies to disclose on the form cover page of their reports (Forms 8-K, 10-Q, 10-K, 20-F and 40-F) the national exchange or principal US market for their securities, the trading symbol, and title of each class of securities;



- Requiring hyperlinks to documents available on EDGAR incorporated by reference instead of including them as an exhibit; and

- Tagging of all cover page data in Inline XBRL for Forms 10-K, 10-Q, 20-F and 40-F.

Certain clarifying and housekeeping changes were made to corporate governance disclosures. In addition, some disclosures in registration statements were fine-tuned.

Many of the changes apply equally to domestic registrants and foreign private issuers. A number of items are not applicable to Canadian companies filing on multijurisdictional disclosure system forms, as these companies only have to comply with CSA requirements.

Effective date of changes
The amendments will be effective 30 days after they are published in the Federal Register, except for the following:

- The ability to omit certain confidential information from most exhibits without filing a confidential treatment request will become effective immediately upon publication in the Federal Register.

- The tagging of information on the cover page is subject to a three-year phase-in, depending on the type of filer.

More information
The details of these amendments are contained in the SEC release on *FAST Act Modernization and Simplification of Regulation S-K* (SEC Release Nos. 33-10618, 34-85381, IA-5206, IC-33426 and File S7-08-17).

Long-standing ICFR failures result in enforcement action

Four companies have settled charges brought by the SEC for failing to maintain internal control over financial reporting (ICFR) for seven to 10 years. These companies continually disclosed material weaknesses in ICFR related to certain high-risk areas in their financial statements. These companies took months or years to remediate their material weaknesses after the SEC staff contacted them. One of the companies is still in the process of remediating material weaknesses. In one case, the company had recurring restatements.

Three of the companies had made efforts to remedy the material weaknesses and made payments to the SEC ranging from $35,000 to $100,000.

One company, which had not made significant progress in remediating the material weaknesses, was required to retain a consultant to review and evaluate its ICFR and provide recommendations for improvement. The report of the consultation is to be provided to the company and the SEC. The company is required to implement recommendations of the consultant, unless they are considered unduly burdensome or impractical. In that case, the company can make alternative proposals to the consultant. If the consultant does not accept the alternative proposals of the company, the company will be required to implement the consultant's recommendations. In addition, the company made a payment of $200,000 to the SEC.

These actions by the SEC demonstrate that companies need to take ICFR seriously and address material weaknesses that have been detected through timely remediation.

Auditing update

Naming the engagement leader

Under Canadian generally accepted auditing standards, for audits of financial statements of listed entities for financial periods ending on or after December 15, 2018, the auditor's report must include the name of the engagement leader for the audit of the respective financial statements. This requirement differs from the requirements of the PCAOB in that the PCAOB does not require the name of the engagement leader to be included in the auditor's report, but does require the name to be posted in a PCAOB database.

In the implementation process for these requirements, audit practitioners have identified potential consent and liability issues when a Canadian GAAS auditor's report (including the engagement leader's name) is included or incorporated by reference by an issuer in an annual report or registration statement filed with the SEC.

To provide the Canadian Auditing and Assurance Standards Board with sufficient time to consider the issues and its possible consequences, the Board has deferred the application of these requirements to auditor's reports for these issuers, provided the engagement leader's name is included in the PCAOB database. The requirements to identify the engagement leader in the auditor's report will now apply for such issuers for financial periods ending on or after December 15, 2019, unless further extended or modified.

AC Insights covers developments in accounting, financial reporting, securities regulatory reporting, and auditing that have occurred during the most recently completed quarter. Developments may occur after the quarter end date that affect these developments.

To have a deeper discussion on these topics, contact your engagement team members.

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