AC Insights

Insights for reviewing financial reports

Perspectives on corporate financial reporting using IFRSs

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Contents

Leases: Now effective

IFRS 16, *Leases*, is effective for annual periods beginning on or after January 1, 2019. The objective of IFRS 16 is to increase the visibility of a company's lease commitments and better reflect the economic reality of these transactions.

IFRS 16 significantly changes the accounting for many 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

Lessees will no longer classify leases as operating leases (off-balance sheet) or finance leases (on-balance sheet). For most lease contracts, contracts are accounted for similar to financed purchases of assets. Balance sheets will reflect "right-of-use" assets and lease liabilities. The income statement will reflect amortization of the "right-of-use" assets and interest expense on the lease liability. There is an exemption for short-term leases and leases of assets with low values, which can be accounted for similar to operating leases under the old standard.

The accounting model for lessees under US GAAP differs from IFRS. While most leases will also be on the balance sheet, US GAAP uses a dual approach for expensing lease costs. Leases are classified as operating or finance leases. A single lease expense is recognized for operating leases and interest and amortization expense is recognized for finance leases.

Lessors

Lessors will continue to classify leases as operating or finance leases based on risks and rewards criteria. The accounting for these leases is generally consistent with previous requirements. Revenue and profit on finance leases is recognized when performance obligations have been met.

IFRS 16 also updates the definition of a lease. A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. This change may affect lessors in assessing whether a contract is a lease and whether contracts for leases and services are combined or separated for accounting purposes.

Under US GAAP, the accounting for lessors is similar to existing US GAAP, with a sale recognized for sales-type leases at the commencement of the lease when control of the underlying asset is transferred.

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Impact

IFRS 16 is likely to have a significant impact on the financial reporting by lessees. For companies that previously classified a number of lease contracts as operating leases, 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. Interest expense and amortization of the right-of-use asset presented separately in the income statement as opposed to a single lease expense. In addition, instead of a consistent total lease expense over the term of the lease, the total lease expense for each period will be higher in the initial years of the lease and decrease over the term of the lease. This impact reflects the asset being depreciated on a straight-line basis, while the effective interest rate method is used to determine the interest on the lease liability.

- Lease payments classified differently in the statement of cash flows with the interest component classified either as operating or financing activities (in accordance with the company's policy) and the principal portion classified as financing activities. Previously, all payments for operating leases were classified as operating activities. Payments for short-term leases and low-value leases, and variable lease payments not included in the lease liability will be classified as operating activities.

- Enhanced disclosures about the effect of leases on the company's financial position, financial performance and cash flows.

In addition to the financial statement impacts, IFRS 16 may also affect negotiations between lessors and lessees as some parties may attempt to mitigate some of the financial statement impacts.

Transition

IFRS 16 can be applied using a simplified approach without restatement of prior periods or a full retrospective approach with prior years restated. The simplified approach also provides certain reliefs from the measurement requirements for right-of-use assets and the lease liabilities. Further, existing contracts do not need to be reassessed as to whether they are lease or service contracts.

IFRS update

During the first quarter of 2019, the IASB met monthly to discuss various projects. Significant efforts were focused on addressing issues arising from the implementation of IFRS 17*, Insurance contracts* for the new standard. The Board also continued work on its projects on primary financial statements, classification of liabilities as current or non-current, and business combinations under common control.

The IFRS Interpretations Committee also met twice to consider a number of issues. None of the issues submitted was added to its agenda on the basis that existing IFRSs provide an adequate basis to address the issues.

No new standards, amendments, improvements or interpretations were issued during the most recently completed quarter.

New IFRSs effective in 2019

In addition to IFRS 16 as described above under *Leases: Now effective,* there are certain amendments and improvements, and an interpretation to existing IFRSs that are effective for annual periods beginning on or after January 1, 2019. Several of these amendments address infrequent transactions or events and may not affect many companies. The interpretation, which deals with uncertain tax positions, may be relevant to many companies. The table below summarizes the amendments, including any significant impacts of these amendments.

Standard affected	Type	Description
IFRS 3: *Business combinations*	Improvement	Clarifies that obtaining control of a business that is a joint operation is a business combination, which requires any previously held interest in the joint operation to be measured at fair value.
IFRS 9: *Financial instruments*	Amendment	Allows some prepayable financial assets with reasonable negative compensation to be measured at amortized cost rather than fair value through profit or loss. This amendment will simplify accounting for certain financial assets with prepayment features.
IFRS 11: *Joint arrangements*	Improvement	Clarifies that a previously held interest in joint operation is not remeasured when a party obtains joint control of the business.
IAS 12: *Income taxes*	Improvement	Clarifies that income tax consequences of dividends on financial instruments classified as equity should be included in the same statements as the transactions or events that generated the distributable profits.
IAS 12: *Income taxes*	Interpretation (IFRIC 23)	Clarifies that IAS 12 applies to accounting for uncertain tax positions. The IFRIC includes recognition and measurement guidance to deal with the uncertainty of tax treatments.
IAS 19: *Employee benefits*	Amendment	After a plan amendment, curtailment or settlement, current service costs and net interest expense for plans must be updated using the most recent assumptions. Any reduction in a surplus because of a plan amendment, curtailment or settlement is to be included in past service cost or the gain or loss on settlement.
IAS 23: *Borrowing costs*	Improvement	Clarifies that if a specific borrowing remains outstanding after the related qualifying asset is ready for intended use or sale, it becomes part of general borrowing.
IAS 28: *Investments in associates and joint ventures*	Amendment	Long-term interests in an associate or joint venture, such as preference shares or long-term loans, should be accounted for using IFRS 9: *Financial instruments.*

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.

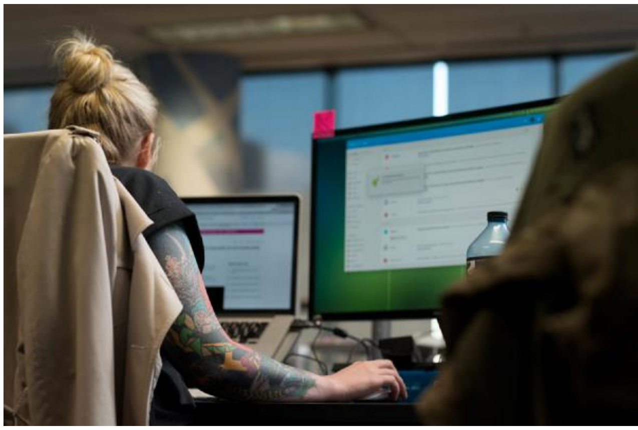
Key changes
Some of the changes to simplify disclosure requirements include:

- 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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