Perspectives on IFRS financial reporting, securities' regulatory, and corporate governance developments / Issue C2019-1 / Winter 2019

IFRS developments p4 / CSA developments p6 / SEC developments p11 / Auditing developments p19

AC Insights

Insights for reviewing financial reports

What is a business?

One of the challenges of IFRS 3: Business Combinations, is determining whether a transaction is an acquisition of a business or just a group of assets. The existing definition is difficult to apply for certain transactions in the real estate, shipping, financial services, pharmaceutical, mining, oil and gas, and technology industries. These challenges have resulted in considerable structuring of transactions to achieve the desired accounting result, without necessarily adding value to the underlying transaction.

On October 22, 2018, the IASB responded by amending the definition of a business to help companies determine whether an acquisition is of a business or a group of assets. The narrow scope amendment to IFRS 3: *Business Combinations* amends the definition of a business and provides supplementary guidance to assist in the application of the definition. In addition, the amendments allow a simplified assessment of whether the acquisition involves a business or a group of assets.

These amendments are similar to changes made to US GAAP in 2017; however, they are not identical. The amendments do not affect the definition of a business under CSA rules and policies for determining disclosures

required by reporting issuers in prospectuses or other filings.

What changed?

Minimum requirements to be a business

The definition of a business continues to focus on three elements:

- Inputs – Economic resources such as intangible assets, rights to use non-current assets, intellectual property, and access to materials, rights and employees.
- Processes – Systems, standards, protocols convention and rules such as strategic management processes, operational processes, and resource management processes.
- Outputs – The result of inputs and processes applied to those inputs that provide goods and services to customers, generate investment income, or generate other income from ordinary activities. The definition of outputs has been narrowed to focus on three streams of income and eliminates the reference to lower costs and other economic benefits.

A business must at least have an input and a substantive process.

While outputs are not necessary at the date of acquisition for a transaction to qualify as a business, there must be, at least, an input and a substantive process for the acquisition to be a business.

An acquired business need not include all inputs and processes necessary to create outputs. The assessment of whether a business exists is based on its current state and condition at the acquisition date. The current requirement to consider whether market participants can replace any missing elements by integrating the acquired activities and assets is eliminated. Instead, IFRS 3 now focuses on whether the inputs and processes acquired have the "ability to contribute to the creation of outputs".

Assessing whether an acquired process is substantive

In applying IFRS 3, companies found it difficult to assess whether the acquired processes were sufficient to represent an element of a business. The existing guidance required companies to consider whether any missing processes were so significant that the transaction did not involve an acquisition of a business. This analysis was challenging when there were no current revenues from the acquired set of activities and assets. To address these concerns, the IASB added guidance to assist in the assessment of whether an acquired process is substantive. The Board specifically focussed on the presence of or ability to access an organized workforce with the relevant skills, knowledge or experience to perform the process as being a key indicator of a substantive process.

The specific guidelines for assessing whether an acquired process is substantive are as follows.

- When there are **no** outputs, an acquired process is substantive **only** if **both** of the following criteria are met:
    a. The process is critical to the ability to develop or convert inputs into outputs; and
    b. The inputs acquired include both:
        i. An organized workforce; and
        ii. Other inputs (such as technology, in-process research and development, real estate, mineral interests) that the workforce can develop or convert into outputs.
- When there are outputs, an acquired process is substantive if **either** of the following criteria are met:
    a. The process is critical to the ability to continue producing outputs and the acquired inputs include an organized workforce; or

b. The process significantly contributes to the ability to continue producing outputs and either:

   i. It is unique or scarce; or

   ii. It cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

The amendments also clarify that an acquired contract is not a substantive process.

Optional concentration test

The IASB also introduced an optional fair value concentration test, which permits a simplified assessment of whether an acquired set of activities and assets is not a business. The test is optional and can be elected on a transaction-by-transaction basis.

The concentration test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. The test excludes cash and cash equivalents acquired, deferred income tax assets, and goodwill arising from the effects of deferred tax liabilities. If the test is met, the transaction would not be accounted for as a business acquisition. If the test is not met, a detailed assessment of whether the set of activities and assets qualifies as a business must be completed.

Illustrative examples

The IASB had provided several examples to help illustrate how the new guidance should be applied.

What do the changes mean?

The changes in the definition of a business will likely result in more acquisitions being accounted for as asset acquisitions across all industries, particularly real estate, pharmaceutical, and oil and gas. However, companies will have to make a careful assessment of the acquired inputs and processes to make their accounting conclusions.

There are some key differences in accounting between business combinations and asset acquisitions including, among other things, the recognition of goodwill, recognition and measurement of contingent consideration, accounting for transaction costs, and deferred income tax accounting.

The amendments to the definition of a business may be relevant to other IFRSs, which refer to a business. For example, the definition of a business may be relevant when a parent loses control of a subsidiary and the applicable accounting for this change in control.

When are the changes effective?

The amendments to IFRS 3 apply to acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2020. Earlier application is permitted.

IFRS developments

The IASB met three times during the last quarter of 2018 to discuss several topics in their current areas of focus, plus work on some maintenance projects. The IASB reviewed several implementation issues for IFRS 17: *Insurance Contracts* and tentatively decided to (a) defer the effective date of IFRS 17; and (b) make an amendment to address the presentation of insurance contracts in the statement of financial position using the portfolios of insurance contracts rather than groups of insurance contracts.

The IFRS Interpretations Committee met in November to discuss issues when the spot exhange rate is not observable, but did not make any decisions.

IASB's current areas of focus

Standard setting on:

- Rate regulated activities

Research on:

- Business combinations under common control
- Dynamic risk management
- Financial instruments with characteristics of equity
- Goodwill and impairment
- Primary financial statements
- Principles of disclosures

Subtle changes to materiality definition

In October, the IASB amended the definition of materiality included in IAS 1: *Presentation of Financial Statements* and IAS 8: *Accounting Policies, Changes in Accounting Estimates and Error*. The amendments are intended to make the definition of materiality easier to understand, while maintaining the underlying concept of materiality in IFRSs.

The new definition of materiality reads as follows, "Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."

The key changes made to the definition are as follows:

- The threshold has been changed from "could influence" to "could reasonably be expected to influence" to narrow the focus of materiality from all potential causes to those impacting informed users.
- "Primary users" are the focus rather than simply users, which was considered too broad.
- The term "obscuring" has been added to address concerns that material information may be obscured by including immaterial information or by aggregating items with different natures or functions.
- The explanatory wording for the definition has been moved from the definition to separate paragraphs to clarify requirements that are part of the definition from those that explain the definition.

Consequential amendments were also made to the Conceptual Framework, the IFRS Practice Statement 2: *Making Materiality Judgements,* and other IFRSs to align with the new definition of materiality introduced in this amendment.

These changes are effective for materiality judgments made in annual periods beginning on or after January 1, 2020 and are applied prospectively. Earlier adoption is permitted.

The changes to the definition address some of the concerns raised throughout the disclosure initiative

and may help preparers use judgment and discretion in making financial statement disclosures.

Impact of hyperinflationary economies on financial reporting

Under IFRS, special accounting rules apply to translation of foreign currency financial statements when operations are conducted in hyperinflationary economies. IAS 29: *Financial Reporting in Hyperinflationary Economies* requires all amounts in the financial statements of the foreign operation to be restated to the year end general purchasing power of the functional currency, before the amounts are translated into the reporting currency.

Based on data from the International Monetary Fund, there are several countries that are considered hyperinflationary in 2018 and are on the watch list for 2019. IAS 29 should be applied in 2018 to entities with a functional currency of the countries listed below:

- Angola;
- Argentina;
- South Sudan;
- Sudan;
- Syrian Arab Republic; and
- Venezuela.

The following economies are not hyperinflationary in 2018, but should be kept under review in 2019:

- Democratic Republic of the Congo;
- Iran;
- Libya;
- Suriname; and
- Yemen.

Venezuelan issues

In recent years, the Venezuelan government has maintained a regime of strict currency controls. Multinational companies continue to face significant difficulties in repatriating earnings from Venezuelan entities. There is significant uncertainty about exchange rates, the amount that can be repatriated at a given exchange rate, and the timing of repatriation. Further, the Venezuelan economy continues to exhibit high inflation. These and other factors may affect the accounting of assets and liabilities held in Venezuela as follows:

- Assets and liabilities denominated in a foreign currency must be measured at the closing exchange rates. Entities will have to consider whether the legal exchange rate in Venezuela, referred to as the DICOM exchange rate, meets the definition of a closing rate. Management should disclose the rate used, the effect on amounts reported in the financial statements, judgments applied in determining the closing rates, and any measurement uncertainties resulting from using that closing rate.

- Consolidation of Venezuelan subsidiaries should continue until the parent no longer has control as defined under IFRS 10: *Consolidated financial statements*. Uncertainty about repatriation of profits and exchange restrictions alone are unlikely to result in loss of control. Disclosures may be required of the judgments applied in the parent company's control assessment.

- Venezuela is considered to be a hyperinflationary economy. IAS 29 requires the use of a general price index that reflects changes in purchasing power. There are no official price indices in Venezuela and it is difficult to estimate inflation rates. Companies will have to estimate a general price index using judgments and other assumptions. These judgments, assumptions and uncertainties about the estimate of the general price index should be disclosed in the financial statements.

Companies with operations in the above noted countries will have to consider the implications of IAS 29 and use the appropriate judgments and assumptions necessary to prepare the financial statements.

Post-implementation review of fair value standard

The IASB completed its review of the findings of its post-implementation review of IFRS 13: *Fair Value Measurement* (the PIR). The Board concluded that the IFRS 13 is working as intended. The IASB's report *Post-implementation Review of IFRS 13 Fair Value Measurement* indicated that:

- The information required by IFRS 13 is useful to users of the financial statements;
- There are some IFRS 13 implementation challenges and areas that result in inconsistent application of the requirements; and
- There are no unexpected costs from the application of IFRS 13.

Some of the challenges of applying IFRS 13 identified during the PIR include:

- The use of judgment in assessing whether a market is active and an input is significant and observable, which sometimes results in inconsistent classifications within the fair value hierarchy and inconsistent fair value measurements.
- The use of one unit of account to measure an item while Level 1 inputs that are available are based on a different unit of account, which results in significant differences in fair value measurements.
- The application of the concept of highest and best use generally based on the current use of the asset.
- The determination of the fair value of biological assets and unquoted equity instruments.

The findings of the PIR will be used by the Board in their projects on Targeted Standards-level Review of Disclosures and the Primary Financial Statements. No other follow-up activities or projects are planned as a result of the PIR.

CSA developments

Supporting issuers and their advisors

Annually, the Corporate Finance Branch of the OSC releases a report covering its activities for the year. The *2017-2018 Annual Report*, issued on October 4, 2018, provides statistics, trends and issues for offerings, insider reporting, and continuous disclosures. The OSC sees the Report as a useful tool to support issuers and their advisors in meeting their disclosure requirements under Ontario securities law.

The Report focuses on novel issues and areas where the OSC Staff have observed material deficiencies. In addition, the Report summarizes regulatory developments during the year, several of which we reviewed in previous editions of *AC Insights*. The Report also provides links to resources available to issuers. The Report is available on the OSC website at www.osc.gov.on.ca.

Continuous disclosure reviews

Through its continuous disclosure reviews, the OSC Staff assesses reporting issuers' compliance with disclosure requirements and provides issuers with guidance on understanding those requirements. The majority of the reviews resulted in an instance of non-compliance, which required either prospective disclosure enhancements, refilings, education and awareness, or other outcomes such as enforcement referrals.

Trends and guidance emerging from the review of continuous disclosure documents are outlined below.

Management's discussion and analysis

- Disclosures about liquidity and capital resources should provide insight beyond the numbers by explaining material cash requirements, how obligations will be met, and how working capital needs related to future business plans or milestones will be funded. Disclosures should be specific about periods and when additional financing is required.

- Discussion of operations should be detailed with analysis and quantification of the factors affecting revenues and expenses, provide insight into past and future performance, and be clear and transparent.

- Disclosures about risks and uncertainties should cover specific material risks and uncertainties applicable to the issuer, describing the anticipated significance and impact of those risks on the financial position, operations and cash flows, and how the risks are mitigated.

- Disclosures about changes in accounting policies, including initial adoption, should include the method of adoption, the expected effect on the financial statements, and the potential effect on the issuer's business and business practices. The extent of quantitative and qualitative details should increase as the effective dates of new standards approach.

- The summary of quarterly results should be annotated when there are changes in accounting policies to describe the impact of such changes.

- The actual use of proceeds from a financing, other than for working capital, should be compared to the proposed use of proceeds, using a tabular format. Variances and the impact of variances should be explained.

Mining disclosures

- Disclosures for estimates of mineral resources should include adequate information on how the qualified persons made the determinations.

- Economic projections on a mineral project, including forecasts of cash flows, operating costs, capital costs, production rates, or mine life are all considered to be preliminary economic assessments (PEA), which require technical reports to support the projections. PEAs will be considered non-compliant if the analysis and models are based on inferred mineral resources with economic studies based on mineral reserves.

Non-GAAP financial measures

- Concerns continue over the prominence of disclosures given to non-GAAP financial measures (NGMs), the lack of transparency about various adjustments made to calculate NGMs, and the appropriateness of adjustments made. Issuers were reminded to consider the guidance in CSA Staff Notice 52-306 (Revised): *Non-GAAP Financial Measures*. The Report provides some examples of NGMs by industry and the Staff expectations for disclosures about these NGMs.

- Issuers were cautioned that the OSC may take regulatory action if an issuer discloses NGMs and information about NGMs in a manner that is considered misleading or otherwise contrary to the public interest.

Forward looking information

- The Report lists several forward looking information best practices and presentation tips.

Investment entities

- Investment entities that carry their investments at fair value through profit or loss should provide specific financial information and operational disclosures about investees that have significant concentrations in the

issuer's investment portfolio. This may require disclosure of summary financial information about the investees in the MD&A.

- Investment portfolios should be presented with sufficient disaggregation and transparency to allow investors to understand the key characteristics of the portfolio. This can be achieved by a statement of investment portfolio.

Crypto-asset disclosures

- Several issuers have entered the block chain and crypto-asset sector. Some of these issuers previously operated in unrelated businesses and are in the early stage of development. OSC Staff are concerned that investors are not being provided sufficient information to understand the business changes being undertaken by these issuers. Disclosures should be made in a news release or a material change report explaining, among other things, the time and resources required for the new business activities and the barriers and obligations involved in realizing the change.

Offerings of securities

During the year ended March 31, 2018, approximately 400 prospectuses were filed and receipted in Ontario, covering a wide range of industries including mining, financial services, and cannabis. The OSC Staff's review of prospectuses highlighted several areas for improvement in prospectus disclosures as well as other guidance to assist issuers in preparing prospectuses.

The OSC also monitors offerings in the exempt market for compliance with the requirements. Comment letters may be issued when there are repeated offerings to retail investors by issuers not using a registered dealer, the disclosure requirements of the exemption are not complied with, marketing materials are not filed, the offering memorandum contains insufficient information about the business of the issuer, structured finance products are being distributed under the exemption, or the disclosure is out of date.

Exemptive relief

OSC Staff reviewed 160 applications for exemptive relief from securities regulatory requirements relating to among other things, an issuer's status as a reporting issuer, prospectus requirements, exempt distributions, and scientific and technical requirements.

Insider reporting

The OSC's oversight of insider reporting is directed to ensuring compliance with the requirements and to providing guidance on filing matters. The Report includes several tips for issuers and for insiders to avoid common errors in insider filings.

The Report provides several helpful insights for reporting issuers in preparing both their continuous disclosure documents and offering documents. The guidance is beneficial in understanding the issues the OSC Staff believe are important to allow investors to make informed decisions. Management will want to read this Report to consider what improvements they might make to their reporting.

Clearing the smoke

The CSA Staff completed a review of 70 reporting issuers operating in the cannabis industry. These reporting issuers included 21 licensed producers (LPs), 23 issuers with US marijuana-related activities, and 31 other cannabis issuers. These reviews identified certain key areas where improvements are expected in financial and regulatory reporting by these reporting issuers. The findings were reported in CSA Staff Notice 51-357: *Staff Review of Reporting Issuers in the Cannabis Industry*.

LPs improving their disclosures

The predominant issue for LPs related to the measurement of biological assets at fair value and the sufficiency of information about those measurements provided in the financial statements and MD&A.

The following deficiencies were identified in the CSA Staff Notice:

- 71% of LPs failed to adequately disclose all fair value amounts included in profit or loss. Issuers are expected to disclose separately (a) the unrealized gains or losses resulting from fair value changes on the growth of biological assets; and (b) the realized fair value amounts included in the cost of inventory sold.

- 95% of LPs did not clearly disclose in their accounting policies how costs were treated. The CSA Staff expects issuers to clearly disclose (a) the direct and indirect costs associated with the production of biological assets; (b) the lines in the profit or loss statement in which such costs are reported; and (c) the capitalization policy for such costs.

- 52% of LPs expensed all production costs related to biological assets as incurred. These issuers are encouraged to provide supplemental information in the MD&A to explain the impact of expensing all production costs to allow investors to understand the cost of products sold in the period and the costs of unsold inventory. Further, issuers were asked to consider whether reporting a gross profit amount which included costs related to goods not yet sold would be misleading.

- All of the LPs did not provide sufficient disclosures about the processes and assumptions used to determine the fair value of biological assets. Key elements missing from the disclosures included a description of the valuation techniques and processes, a description of the inputs used, the level of the fair value hierarchy for the fair value measurements, sensitivity analysis for certain inputs, and the interrelationships between significant unobservable inputs.

- 48% of LPs used a non-GAAP measure similar to 'cash cost per gram' to portray their cost of production; however, there were significant deficiencies in disclosures about the composition of the measure and what adjustments had been made. Further, several issuers did not explain whether they were measuring a gram of cannabis sold, harvested, or extracted. In addition, there was a lack of consistency between measures used by different LPs.

All of the LPs took action to address these deficiencies through prospective changes to future filings.

Other issues highlighted in the report included disclosures about projected production estimates, misleading or unbalanced disclosures about new opportunities, consideration of impairment from industry-wide changes in cannabis related asset valuations, disclosures about licenses and leased facilities, and disclosures about regulatory frameworks in foreign jurisdictions.

US marijuana-related activities

In February 2018, the CSA published a notice outlining its expectations for disclosures by issuers having or expecting to have marijuana-related activities in the US. The CSA Staff review noted inadequate disclosure by most of these issuers, with 74% of the issuers taking action to improve their disclosures.

The CSA Staff Notice highlights several factors issuers in the cannabis industry should consider in preparing their financial statements and disclosures. The Notice emphasizes the need for issuers in a new industry to consider the financial and regulatory reporting guidance when preparing their disclosures.

Reporting performance measures

In our last edition of *AC Insights*, we reported on the CSA proposals to strengthen the guidance on non-GAAP measures (NGMs). In addition to the securities regulatory authorities, standard setters have also been considering how they can assist preparers in developing appropriate NGMs and performance measures.

In December 2018, the Canadian Accounting Standards Board (CASB) issued a *Framework for Reporting Performance Measures*. The Framework

is the CASB's response to concerns raised by investors and other providers of financing about performance measures provided by entities. The CASB hopes that the Framework will stimulate conversations and actions to improve the quality of performance measures reported outside the financial statements.

The Framework covers non-GAAP measures and other non-financial and operations measures. Best practice guidance is provided for:

- Selecting, developing and reporting performance measures; and
- Implementing and maintaining controls and governance practices to oversee the preparation and presentation of performance measures.

The guidance also focuses on:

- The responsibilities of management, directors and others;
- The characteristics of high quality performance measures; and
- Considerations for developing disclosures about performance measures used.

While the Framework is non-authoritative and its application is voluntary, it provides extensive guidance on performance measures that will assist companies in improving the quality of NGMs and other performance measures.

The Framework can be downloaded from the Financial Reporting & Assurance Standards Canada website at www.frascanada.ca under the tab Accounting Standards Board / News Listings / Reporting Performance Measures.

ASC creates a whistleblower program

The Alberta Securities Commission (ASC) has created a whistleblower program and established the Office of the Whistleblower to administer the program. The program is supported by ASC Policy 15-602: *Whistleblower program* and amendments to the Alberta Securities Act. The ASC joins the securities regulators in Ontario and Quebec in providing access to whistleblowing programs.

Under the program, employees, including contractors and directors of an organization, can voluntarily provide information to the ASC on alleged securities law violations by their employer. Employees are encouraged to provide good faith tips on securities-related misconduct by their employer, covering insider trading, market manipulation, fraud, or issues related to corporate disclosures or financial statements.

Details of what to include and how to submit a tip are included in the Whistleblower Policy. The Policy also outlines the steps that will be taken by the Office of the Whistleblower.

The amendments to the Alberta Securities Act mandate that a whistleblower's identity is confidential and can only be disclosed in limited circumstances. Further, it is against the law to take a reprisal against an employee or a relative of an employee for acting as a whistleblower to the ASC. The ASC is empowered to take enforcement action if an event of reprisal occurs. Further, the employer or fellow employees may be subject to civil liability for any reprisal action against the whistleblower.

The program does not include compensation for providing tips.

The program is effective as of November 19, 2018.

SEC developments

Investigating cyber threats

In October 2018, the SEC issued a report on its investigation of certain public companies that were the victims of cyber-related frauds. This report was identified as a "must-read" by several participants at the recent AICPA Conference on *Current SEC and PCAOB Developments* held in December 2018.

The purpose of the investigations was to assess whether these companies had violated federal securities laws by failing to maintain a sufficient system of internal accounting control.

Eleven SEC registrants lost about US$100 million through email spoofs pointing for the need to strengthen internal controls for cyber-related risks.

Background on issuers

Number of issuers investigated	11
Total losses sustained by issuers	About US$100 million
Range of losses for issuers	9 lost at least US$1 million 2 lost more than US$30 million
Industries involved	Technology Equipment manufacturers Real estate Energy Financial services Consumer goods
Size of issuers	All were listed on a national securities exchange and had substantial revenues

Nature of frauds

The issuers were victims of two different schemes, emails from fake executives and emails from fake vendors.

Emails from fake executives – in which perpetrators emailed company finance personnel, using spoofed email domains and addresses of an executive, typically the CEO, so that it appeared to be a legitimate email. In one case, a company made 14 wire payments aggregating more than US$45 million over the course of several weeks before the fraud was discovered after receiving an alert from a foreign bank.

The emails directed finance personnel to work with a purported outside attorney named in the email, which instructed the finance personnel to wire large sums of money to a foreign bank account held by the perpetrators. The perpetrators used a real law firm and attorney names, but altered the email addresses.

The spoofed emails described time-sensitive transactions or "deals" where secrecy was required from other employees; required funds for foreign transactions by wire transfers to foreign banks and beneficiaries, which was unusual for most of the companies; and were sent to midlevel personnel, who generally would not be responsible for such transactions. These were not sophisticated frauds in design or the use of technology and the emails often had spelling and grammatical errors.

Emails from fake vendors – in which a foreign vendor's email account was hacked and used by the perpetrators to make illegitimate requests for payments using the normal electronic communication methods between the vendor and the issuer. In one case, a company paid eight invoices totaling US$1.5 million over several months until the vendor complained about past due invoices.

The perpetrators also corresponded with the issuer personnel to obtain information about an actual

purchase orders and invoices and instructed the issuer's personnel to change the vendor's banking information. When the issuer paid legitimate outstanding invoices, the payments were sent to foreign accounts controlled by the perpetrators rather than the vendors. These scams were more technologically sophisticated and had less red flags than the emails from fake executives.

Importance of controls

The SEC noted that these frauds "relied on technology to search for both weaknesses in policies and procedures and human vulnerabilities that rendered the control environment ineffective". The SEC indicated these examples emphasized the importance of internal accounting controls that are attuned to cyber-related risks. While these companies had authorization and approval controls for payments and verification procedures for changes to vendor data, company personnel interpreted these controls as allowing electronic communications, without other verifications, to process the wire transfers or change the vendor's standing data. Needless to say, these issuers enhanced their procedures in these areas, as well as improving account reconciliation procedures and payment notification processes to detect payments resulting from fraud.

The SEC Staff also noted that these frauds succeeded in part because responsible personnel did not sufficiently understand or follow the company's existing controls or did not recognize flags that the spoofed communications lacked reliability. These issuers have enhanced their training about relevant threats, as well as their existing policies and procedures.

Outcome of SEC investigation

The SEC decided not to pursue any enforcement actions against the public companies. However, the SEC decided to publish its report to make issuers and other market participants aware of these type of cyber-related threats. The SEC's message to issuers is that internal accounting controls may need to be reassessed to mitigate against emerging risks, including cyber-related fraud risks.

More information

The *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetuated Against Public Companies and Related Internal Accounting Controls Requirements* can be found on the SEC website at www.sec.gov under Release No. 84429.

Collaboration and transparency in financial reporting

The annual AICPA Conference on *Current SEC and PCAOB Developments* was held in early December 2018. The theme of the conference focused on collaboration and transparency, emphasizing that all participants in the financial reporting supply chain need to work together to provide investors with transparent and decision-useful information. This is especially important in today's dynamic financial reporting environment. These comments were echoed by the SEC Chair Jay Clayton, SEC Chief Accountant Wes Bricker, other SEC staff members, and participants from the PCAOB, FASB, IASB, AICPA, and preparer and auditor communities.

In this edition of *AC Insights*, we cover the highlights of the Conference that Canadian SEC registrants using IFRSs should consider, including issues focusing on accounting, PCAOB auditing guidance, or SEC regulations that are also relevant because of similar requirements under IFRSs and Canadian auditing guidance.

Audit committee effectiveness

One of the key links in the financial reporting supply chain is the independent audit committee. Speeches given at the Conference by the SEC Staff and other participants highlighted certain roles of audit committees in overseeing the financial reporting process. The SEC Chief Accountant stated that audit committees should have a balanced agenda toward understanding the accounting, internal controls and reporting requirements. Some key points raised at the Conference were:

- Audit committees should understand management's approach to designing and maintaining effective internal controls, especially given changes in technology, accounting and reporting requirements.

- Audit committees should understand (a) management's implementation plans for new accounting standards, including controls and procedures to achieve high quality implementation and ongoing application; and (b) how the effects of new standards will be communicated to investors.

- There should be clear and candid discussions with the auditor to promote audit quality, including the evaluation of the auditor's performance, understanding the audit firm's investment in quality control functions and technology safeguards.

- Audit committees should support the auditors when issues arise.

- Cybersecurity is a significant risk for some companies and the audit committees should understand how management oversees this risk within the company.

Risks

Speeches and panel discussions at the Conference spotlighted certain hot topics for consideration by management, audit committees and others. Some of these hot topics that warranted consideration are:

- **Cybersecurity** is a major issue. The SEC Chair highlighted this risk in the opening speech for the Conference and stressed that it is essential that companies move from a mindset that focuses on prevention of cyber breaches to a more forward-looking perspective that also considers how data can be protected. In October 2018, the SEC Staff released a report (see our article on *Investigating cyber threats*), which highlighted the need to be aware of cyber related threats and consider these risks when designing and maintaining a system of internal accounting controls as required by federal securities laws.

  Cyber risks, if material, should be disclosed in the applicable filings with the SEC. Staff from the Division of Corporate Finance emphasized that these disclosures should be tailored to the issuer's facts and circumstances, and not be boilerplate and generic discussions. Other considerations for dealing with cyber incidents are:

  – Disclosure controls and procedures to identify cyber incidents and escalate such breaches to the appropriate levels within the company, including the IT and financial reporting functions.

  – Insider trading policies that take into account cyber risks and procedures when a significant cyber incident occurs.

  – Disclosure of the role of board in cyber risk oversight.

  The SEC will be reviewing future disclosures about cyber risks and incidents. Issuers were encouraged to continually update these disclosures as cyber risks evolve. The SEC will also be following up on breaches reported in the media.

- **Brexit** – The SEC Chair expressed his concerns that the potential adverse effects of Brexit are not well understood or are under-estimated. Disclosures made by some registrants have been fairly detailed, while others simply state Brexit is a risk. Clayton stated that more robust disclosures are required about how management is dealing with Brexit and the effect it may have on its business and operations. The SEC Staff have been asked to focus on Brexit disclosures in future filings.

  Companies should provide sufficient information about the potential implications of Brexit, including how the company is planning

and preparing for the transition. The extent of disclosure should be based on materiality.

- **LIBOR** – Banks that currently report information used to set LIBOR are expected to stop doing so in 2021. This will eliminate LIBOR as a benchmark reference for short-term interest rates. This elimination of LIBOR as a benchmark interest rate may have a number of potential accounting consequences, including hedge accounting. Some issuers may face significant risks and uncertainties as they transition from LIBOR to a new benchmark interest rate. The SEC Staff expects to see disclosures about these risks and uncertainties in SEC filings, if material.

Non-GAAP measures

The number one topic of SEC comment letters in 2018 was non-GAAP measures (NGMs). Both Clayton and Bricker acknowledged the role of NGMs in making investment decisions, but they also called attention to the importance of policies to support NGMs that are complete, accurate and consistent with the objective of communicating operating results through the eyes of management. Clayton emphasized that registrants should use the same diligence in preparing NGMs as they do in preparing financial statements. This topic was also raised by other SEC Staff and other participants at the Conference.

The SEC Staff focused attention on the need for controls designed to ensure consistency in NGMs and to prevent errors and manipulation. Policies to deal with errors, including how to correct and communicate them, are also important.

In comment letters, the SEC Staff will often raise questions about why and how management uses the NGMs reported in the evaluation of the business. SEC Staff believe these answers are relevant to investors to understand the measures that are important in running the business.

Reasons for any changes in measurement of NGMs are required to be disclosed. However, SEC Staff believe changes should not occur from period to period unless there is an underlying change in the business or in the way management is running the business.

The SEC has been focusing on individually tailored accounting principles used by companies to adjust GAAP measures by changing the accounting policy or method of recognition when presenting a NGM. This approach is different than the simply including or excluding a GAAP determined amount to arrive at a NGM. SEC Staff are objecting to NGMs that result from the application of individually tailored accounting principles and believe they can be misleading. The Staff acknowledged that it may be challenging to identify individually tailored accounting principles and provided four questions for companies to consider in deciding whether a NGM results from the application of an individually tailored accounting principle:

- Does the adjustment shift GAAP from an accrual basis of accounting to cash or modified cash basis (for example, using cash receipts or billings as a proxy for revenue for a subscription based business that recognizes revenue over time)?

- Does the adjustment add transactions that are also reportable in another company's financial statements (for example, making adjustments to gross up revenue as if an entity were a principal when it is the agent in the transactions; or adjustments to consolidate an equity accounted for investment)?

- Does the adjustment reflect part, but not all, of a transaction (for example, adjusting for the income tax effects for cash taxes paid, but not for temporary or permanent differences)?

- Does the adjustment render the measure inconsistent with the economics of the transaction or ignore certain terms of the agreement (for example, adjusting revenue for sale-type or financing leases as if they were operating leases)?

Effective ICFR

Internal control over financial reporting (ICFR) was a key topic at the Conference for both the SEC Staff and other panelists. Bricker noted that adequate ICFR is not just the first line of defense against preventing and detecting errors or fraud, they are good for business and can impact the cost of capital. He believes it is essential for audit committees, auditors and management to have appropriate discussions about ICFR in all areas.

Operating effectiveness of ICFR

SEC Staff noted that the assessment of ICFR was especially important this year as companies implement the new revenue accounting standard. Two broad concepts were laid out to assist in the upfront planning of the evaluation of operating effectiveness.

- Is the control operating as designed? Issuers were encouraged to consider a number of factors, including (a) how the control operates; (b) the consistency of application of the control over a period; and (c) the competency and authority of personnel operating the control.

- Are the nature, timing, and extent of the assessment procedures linked to the assessed risk of control failure and risk of material misstatement? Management should consider the sufficiency of the assessment procedures. Some considerations set out by the SEC Staff covered (a) the use of sample sizes consistent with the number of instances in which the control operated; (b) the quality and extent of evidence needed based on the level of risk; (c) consideration of whether the control is automated or manual; and (d) the extent of evaluation procedures applied to the completeness and accuracy of information relied on by a control.

Assessing significant deficiencies

While the SEC Staff has seen improvement in the assessment of whether significant deficiencies are material weaknesses, the Staff has noted that “there are still some bad habits yet to be fully shaken off”.

The Staff discussed a number of observations directed at making improvements to the assessment of the severity of control deficiencies. Some of the observations expressed at the Conference are noted below.

- The evaluation of the severity of the control deficiency should not be limited to actual misstatement, when, depending on the cause of the control deficiency, it is reasonably possible other financial areas may be affected.

- It is important to define the control deficiency, considering all areas of financial statements that might be affected. A clear definition is necessary to evaluate the severity of the control deficiency, to develop an effective remediation strategy, and make the required disclosures.

- An honest analysis of the severity of the control deficiency should be conducted, considering the magnitude of a reasonably possible misstatement because of the control deficiency.

- Compensating controls may reduce the severity of an identified control deficiency by limiting the extent of a reasonably possible misstatement; however, those compensating controls need to operate to prevent or detect a possible material misstatement and be designed to achieve the same objective as the control identified to be deficient.

The SEC encourages a more holistic and effective evaluation of the severity of deficiencies, as opposed to the some of the more narrow evaluations they have observed. Management should evaluate the level of detail and assurance needed to support its conclusions by considering what a “prudent official” would do in conducting their own affairs.

Disclosure of material weaknesses

Meaningful disclosures of material weaknesses is important to provide investors with enough information to understand the cause of the weaknesses and assess the potential impacts on the issuer’s financial reporting. While the SEC Staff have noted improvements in disclosures of material

weaknesses, these disclosures could be more informative for investors.

The Staff suggested management consider whether the disclosures (a) allow investors to understand what went wrong in the control that resulted in the material weakness; (b) clearly explain the impact of the material weakness on the financial statements (is the weakness pervasive or isolated to specific accounts or disclosures); and (c) provide sufficient details to understand management's plans to remediate the material weakness. These three suggestions are a starting point for management, the audit committee, and the auditor to consider whether the disclosures provide the most meaningful and useful information for investors.

Implementation of new GAAP standards

Companies are implementing some significant new accounting standards starting this year. The Conference participants discussed the application and implementation issues for these new standards. The SEC Chief Accountant reiterated the importance of collaboration in his overview of the implementation of new accounting standards by stating, "Quality in financial reporting starts at the front of the process, management's accounting."

The SEC Staff confirmed that it will continue to accept reasonable judgments in the application of new standards. However, issuers and auditors were reminded that well-reasoned judgment requires consideration of all the facts, the accounting alternatives, and a rigorous analysis of the facts to faithfully apply the new standard to a company's specific facts and circumstances.

The SEC Staff also commented on the disclosures required by Staff Accounting Bulletin 74 in advance of the adoption of new accounting standards. Similar requirements are included in IFRSs. They highlighted their expectation that the disclosures of the impact the new standards may have is generally expected to be more robust in this last period prior to adoption. The SEC Staff, also emphasized the importance of focusing on the implications on internal control over financial reporting when a new accounting standard is adopted, including the impact on the Risk Assessment component of COSO.

Revenue

Most public companies adopted the new revenue standard at the beginning of 2018. Both the US GAAP standard and the IFRS are highly similar and the SEC Staff views will equally apply to companies using IFRSs for accounting.

SEC Staff commented that they are generally happy with issuer's implementation efforts for the revenue standard. They have noted that the application of reasonable judgments could result in diversity in application; however, the SEC Staff is not aware of any issues that require amendments to the standard. A preparer panel also highlighted the importance of well-documented judgments in the selection of accounting policies.

The SEC Staff commented that filing reviews have focused on significant judgments when the nature, amount, or timing of revenue or cash flows were unclear or the application of the standard appeared to conflict with applicable guidance. Frequent areas of comment included the identification of performance obligations, principal versus agent assessments, and disaggregated revenue disclosures.

The SEC outlined certain observations from consultations about areas that require significant and challenging judgments:

- The principal versus agent guidance, particularly when the company never obtains physical possession of the goods – The SEC Staff have indicated that companies should consider the definition of control, of which inventory risk is only one indicator. However, the Staff cautioned issuers that significant judgment does not mean optionality.

- Identifying performance obligations when a transaction includes multiple items – Judgment is require to determine whether the transaction involves the transfer to a customer of a combined item or multiple items individually. The SEC Staff pointed out that

this evaluation should consider whether the items significantly affect each other.

- Timing of revenue recognition – Both the point in time at which control is transferred and the measure of progress for performance obligations satisfied over time require appropriate judgments.

- Financing component – All factors that contribute to the difference in the contract price and the cash selling price should be considered in the analysis. In one specific consultation, there was an upfront payment, which was accepted as not having a financing component on the basis that (a) the upfront payment provided protection from the possibility that the customer could fail to satisfy its obligations under the contract; (b) the registrant could obtain financing at favorable rates in the market if needed; and (c) the parties did not consider structuring the arrangement without the upfront payment.

- Disclosures of significant judgments – Management should assess whether the disclosure is clear about the nature, amount, timing, or uncertainty of revenue being recognized; or whether there are conflicts with other publicly available information. In addition, determining the appropriate disaggregation of revenue for disclosures requires judgment.

Leases

The new leases standard under US GAAP will be effective for 2019. While the new IFRS is different than the US GAAP standard, the issues raised at the Conference would also be applicable to the implementation of the new IFRS. Many participants at the Conference noted that implementation of the new standard is requiring more time and is more costly than anticipated, particularly in accumulating the necessary information to record leases on the balance sheet. These concerns are compounded by the fact that software vendors are still refining their solutions and companies may require manual processes to implement the standard. The FASB and the SEC Staff have indicated there are no plans to defer the effective date of the US GAAP standard.

Bricker indicated that registrants should ensure they have sufficient time to identify arrangements that are leases including embedded leases and to collect information required for new disclosures. The SEC Staff also reminded issuers of the importance of the transitional disclosures required under SEC rules or IFRSs. Issuers were reminded that one size does not fit all and the information provided should help investors assess the impact the standard will have on the financial statements.

Other accounting matters

The SEC Staff discussed the impact of the highly inflationary economy in Argentina on entities with material operations in Argentina. Disclosures in the MD&A, risk factors, and other section of SEC filings will need to be tailored to reflect the issuer's particular circumstances to highlight the impact of operating in Argentina.

Auditing

Audit regulations

One aspect contributing to high quality audits is the PCAOB inspection of auditors. Both the SEC Staff and the PCAOB Staff raised concerns over access to working papers of foreign auditors, in particular the audit working papers and practices of PCAOB-registered auditing firms in China and Hong Kong for US-listed companies with operations in China. The PCAOB publishes lists of companies where the PCAOB has been unable to conduct inspections, which currently shows 224 companies for which the auditor's working papers have not been made available to the PCAOB (213 companies with auditors based in China or Hong Kong and 11 companies with auditors based in Belgium).

Critical Audit Matters

Beginning in 2019, under PCAOB standards, auditors will be required to report critical audit matters (CAMs) in their auditor's report for some public companies. The SEC Staff, PCAOB Staff, and other panelists discussed the implementation of the requirements to report CAMs.

Some of the expectations for the reporting of CAMs outlined at the Conference were as follows:

- Almost every audit should have at least one CAM to report. Auditors were advised not to approach the process expecting to identify no CAMs.
- CAMs should convey issuer-specific information in plain English and avoid boilerplate disclosures.
- CAMs are disclosures about the audit, and should not replicate or replace disclosures in the issuer's financial statements. While CAMs may overlap with disclosures about critical accounting estimates and areas of significant risk, it is unlikely there would be a CAM for every critical accounting estimate.

Some practical tips for implementing the new requirements given at the Conference were:

- Start the discussion about CAMs early and conduct dry runs this year to foster dialogue among the auditors, management, and the audit committee.
- Share implementation questions and observations with PCAOB and SEC early so appropriate guidance can be provided on a timely basis.
- Understand the similarity and differences in disclosure requirements and standards – management must discuss critical accounting estimates and assumptions used in the financial statements, whereas CAMs focus on the audit of these estimates and assumptions.

In panel discussions, some observed that the requirements for reporting CAMs provides an opportunity for companies to take a fresh look at their disclosures.

SEC comment letters

A panel on SEC comment letters discussed the typical comment letter process and frequency of review. There has been a decrease in the volume of comments, driven by many factors including improved disclosures and more tailored and specific comments being issued by the SEC Staff. SEC Staff view the comment letter process as a dialogue between a registrant and the Staff. If the registrant does not understand a comment, a clarification should be requested. Also, if a comment relates to an immaterial transaction or disclosure, the Staff should be advised early in the process to avoid spending significant resources on the question.

The panel also provided a list of the most frequent SEC Staff comment focus areas, which were generally consistent with the topics communicated last year. The topic receiving the highest volume of comments this year was non-GAAP measures. Other common topics receiving attention included MD&A, revenue recognition, and fair value measurements. The SEC Staff also focused on state sponsors of terrorism, intangible assets and goodwill, acquisitions and business combinations, income taxes, segment reporting, and contingencies.

Taking into consideration comments from the Conference

The Conference provides many insights for the various participants in the financial reporting supply chain. We encourage management and the audit committee to carefully consider these matters and discuss them with your auditors and advisors to facilitate the most appropriate communications with your investors.

Modernizing mining property disclosures

In October 2018, the SEC adopted amendments to modernize the property disclosure requirements for mining registrants. The amendments align the SEC requirements and guidance with current industry and global regulatory practices and standards. The amendments also eliminate Industry Guide 7 and consolidates all the mining properties' disclosure requirements in a new sub-part in Regulation S-K.

Registrants with material mining operations will now be required to disclose specified information about its

mineral resources that have been determined on its properties. These disclosures are consistent with the global standards set out in the Committee for Mineral Reserves International Reporting Standards (CRIRSCO). With the update, companies will report mineral reserves, which were previously only allowed to be reported in limited circumstances.

Exploration results, mineral resources, or mineral reserves will be disclosed in SEC filings based on information and supporting documentation prepared by a mining expert. This is also consistent with CRIRSCO standards.

A technical report summary, dated and signed by a mining expert, must be filed as an exhibit to any SEC filing, which discloses mineral reserves or mineral resources for the first time, or when there is a material change in mineral reserves or mineral resources from the last technical report summary filed for the property. The technical summary report would identify and summarize the information reviews and conclusions reached by the mining expert about the registrant's mineral resources or mineral reserves determined on each material property.

Canadian reporting issuers using Form 10-K or 20-F for SEC filings will be required to follow the new rules and requirements when they become effective. Only Canadian issuers eligible to file using the Form 40-F will be able to use the disclosures mandated by the Canadian Securities Administrators.

The new rules will be effective for fiscal years beginning on or after January 1, 2021. Once the SEC has completed its EDGAR programming changes for the new rules, registrants may voluntarily use the new rules.

The new rules are contained in SEC Release Nos. 33-10570 and 34-84509.

Auditing developments

Key audit matters to be reported for TSX-listed companies

At its October 2018 meeting, the Canadian Auditing and Assurance Standards Board (CAASB) approved amendments to Canadian Auditing Standard 700: *Forming an Opinion and Reporting on Financial Statements,* which will require auditors to communicate key audit matters (KAMs) in the auditor's report for audits of financial statements of Toronto Stock Exchange listed entities. The amendment provides an exemption for TSX-listed entities required to comply with National Instruments 81-106: *Investment Fund Continuous Disclosure*.

KAMs are defined in Canadian Auditing Standard 701: *Communicating Key Audit Matters in the Independent Auditor's Report* as "Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance." CAS 701 is based on the guidance in International Auditing Standards. However, this guidance, while similar, is not identical to guidance in the PCAOB standards, which will require reporting of critical audit matters for some companies starting in 2019.

These amendments to CAS 700 will be effective for audits of financial statements for periods ending on or after December 15, 2020.

The CAASB is considering potential expansion of the communication of key audit matters to investment funds and other listed entities.

Survey shows continued support for CPAB efforts

On October 10, 2018, CPAB released the results of its 2017-18 stakeholder survey. The survey solicited views from audit committee members, audit firm leadership, and engagement partners inspected over the last two years.

The four key themes from the survey are:

1. There is continuing support for CPAB's new approach to the assessment of quality processes and systems of audit firms, including additional operational reviews of the effectiveness of firm structure, accountabilities, quality management processes, and culture.
2. The inspection process improved since the 2016 survey, particularly in the areas of timeliness and willingness to work collaboratively with firms. Engagement partners noted that quality of engagement findings report matters might be an area that requires CPAB's attention.
3. Most participants indicated that CPAB provides value to audit committees through its stakeholder events and projects, and the CPAB inspection reports. However, it may be more challenging to reach audit committees of smaller reporting issuers, mainly due to a perceived lack of interest.
4. Audit committees are interested in enhancing audit quality, through staying current on issues affecting audit quality, efficiency and cost effectiveness. Participation in meetings with CPAB, CPAB events, publications and projects were useful to the dialogue on audit quality.

CPAB will consider the feedback from the survey to improve their plans to drive audit quality.

More to be done to fully embed audit quality

CPAB reported its inspection results for 2018 Fall Inspections of the large public accounting firms (Deloitte, E&Y, KPMG, and PwC). The findings of the inspection of 77 engagement files indicated a need for firms to do more to fully embed audit quality across their portfolio of clients.

The inspection results identified 14 significant deficiencies in the application of generally accepted auditing standards that could result in a restatement of a company's financial statements (compared to six in 2017). As of the date of the report, remediation work performed by the audit firms did not result in any restatements of financial statements. Common areas of deficiencies relate to auditing fair value measurements in business combinations, estimates of the recoverable amount for impaired assets, and the measurement of progress for construction contracts.

CPAB has undertaken a new approach to assess the effectiveness of audit firms' quality systems. This approach is similar to documenting and certifying internal controls over financial reporting. CPAB found there is a lack of robust documentation and formalized self-assessment mechanisms across the firms. While firms are making efforts to improve and document their quality management processes and controls, more work is required.

The report outlines some critical audit quality matters that directors of companies should consider including possible impediments to auditor oversight in foreign jurisdictions where some companies have significant operations (such as China), auditing crypto-assets and crypto transactions, and the use of data analytics, artificial intelligences and other emerging technologies in audits.

The complete CPAB report will be made available to PwC audit clients as part of our protocol with CPAB.

Dry runs on critical audit matters

In 2019, PCAOB-registered auditors will begin communicating critical audit matters (CAMs) in their auditor's reports. Some auditors have begun performing "dry runs" of the CAM requirements. During these "dry runs", auditors identified and drafted CAMs and discussed them with management and audit committees. In December 2018, the Center for Audit Quality (CAQ) published some early observations from these exercises in their publication, *Lessons Learned, Questions to Consider, and an Illustrative Example.*

Some of the lessons learned from the "dry runs" include:

- Determining CAMs involves applying a principles-based approach and significant auditor judgment;
- Early and often communications by the auditor with management and the audit committee is important;
- Management and the audit committee should allot sufficient time to discuss drafted CAMs with the auditor; and
- Drafting CAMs can be challenging.

Based on the experiences from the "dry runs", the CAQ issued some frequently asked questions to assist audit committees in understanding the reporting of CAMs covering:

- The relationship between CAMs and
  - Disclosures made by management in the SEC annual report,
  - Critical accounting estimates disclosed by management,
  - Significant risks identified by the auditor as part of the audit, and
  - Significant deficiencies in internal control over financial reporting;
- The more common CAMs likely to be reported;
- Comparability of CAMs across companies in the same industry;
- Similarity between CAMs and key audit matters under International Auditing Standards;
- The expectation of at least one CAM in an auditor's report;
- The auditor's process for drafting CAMs and communicating draft CAMs with management and the audit committee; and
- Preparing for questions from investors.

The CAQ publication provides some valuable insights and observations about this new auditor requirement. The tips in the publication will be beneficial for management and audit committee to understand the reporting of CAMs. The publication is available from the Center for Audit Quality website at www.thecaq.org under the tab Resources / Publications.

Emerging technologies

Emerging technologies are quickly automating functions in the finance departments of corporations. These technologies increase the efficiency and the quality of financial reporting, but they also introduce new risks to the corporation. The Center for Audit Quality has developed a tool for audit committees to provide a framework for conducting effective oversight of a company's emerging technologies in the finance department. The tool is presented in the CAQ publication *Emerging Technologies: An Oversight Tool for Audit Committees.*

The framework includes five key components, which are consistent with the components in the Internal Control Integrated Framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The application of the components to emerging technologies is illustrated by reference to the use of artificial intelligence and robotic process automation technologies and supported by questions the audit committee members might ask management and the

auditor to help inform the audit committee's oversight of financial reporting.

The Framework considers:

- The control environment and the need to understand the company's specific emerging technology strategy and specific technologies contemplated. The audit committee may consider monitoring whether: (a) the company has the right expertise for the project; (b) the technological performance and accurate reporting is being evaluated systematically; and (c) there is an appropriate tone at all levels within the company when implementing new technologies.

- Risk assessment and the need to understand management's risk identification and assessment process. The audit committee may consider (a) whether management has assessed the risks that might arise from the technology changes; (b) whether internal controls have been revised for the new risks arising from the implementation of the technologies; and (c) how management is updating its assessments and controls as the technologies evolve.

- Control activities and the need to understand the control activities that respond to the identified risks. The audit committee may consider (a) how systems relying on emerging technologies will respond to financial reporting needs before deployment; (b) whether the technology is operating as intended and its output is reliable; (c) how the new technologies will be tested and integrated with other systems; (d) how information technology controls will be affected; and (e) how important assets will be safeguarded.

- Information communication and the need to understand controls in place to ensure all information needed for financial reporting is captured, used, and retained in a timely and accurate manner. The audit committee may consider how new systems are being developed and integrated with existing systems.

- Monitoring activities and the need to understand whether controls are operating effectively taking into account the new technologies. The audit committee may consider use of internal audit to effectively examine whether the emerging technology programs are operating effectively and how the external auditor's approach will take into account the risks associated with emerging technologies.

The automation of financial reporting functions through use of emerging technologies can have a significant impact on financial reporting. This tool prepared by CAQ provides audit committees with some insights into the opportunities and risks from these emerging technologies.

The tool is available from the CAQ on their website at www.thecaq.org under the tab Resources / Publications.

Communicating audit committee oversight

Since 2014, the Center for Audit Quality along with Audit Analytics has been analyzing proxy disclosures about auditor oversight activities for companies in the S&P Composite 1500. In November 2018, the CAQ published the results in the *Audit Committee Transparency Barometer*.

The key findings reported for 2018 (with comparatives for 2017) were as follows:

Disclosure of	**% of companies**
Considerations in appointing the audit firm	40% (37%)
Length of audit firm engagement	70% (63%)
Explanation of change in fees paid to audit firm	28% (31%)
Criteria considered when evaluating the audit firm	46% (38%)
Involvement of audit committee in selection of audit partner	52% (49%)

The results indicate that audit committees are voluntarily providing robust disclosures to inform investors about their activities in overseeing the external audit. The publication provides examples of disclosures by certain companies to illustrate effective disclosures.

The CAQ concluded the findings show continued positive trends in providing voluntary enhanced disclosures about the audit committee's role in overseeing the external auditor; however, there were opportunities for increased transparency and clarification of the audit committee's involvement.

The publication is available on the CAQ website at www.thecaq.org under the tab Resources / Publications.

Controls for environmental, social and governance risks

In October 2018, the Committee of Sponsoring Organizations of the Treadway Commission and the World Business Council for Sustainable Development (WBCSD) released the final version of *Guidance for Applying Enterprise Risk Management (ERM) to Environmental, Social and Governance (ESG)-related Risks* (the Guide). The Guide is designed to help entities better understand the full spectrum of environmental, social and governance-related risks (ESG-related risks) and to manage and disclose these risks more effectively.

ESG-related risks refer to sustainability, non-financial and extra-financial risks. While the definitions of these risks are fluid, the Guide has grouped these risks under the three pillars of:

- Environmental covering climate change, natural resources (use of water, land, and natural resources), pollution and waste, and environmental opportunities (clean technology, green building, and renewable energy);
- Social consisting of human capital (labour management, health and safety, labour standards, and human capital development), product liability (safety and quality, privacy and data security, health and demographic risk, and responsible investment), stakeholder opposition (controversial sourcing), and social opportunities (access to communications, finance, nutrition, and health care); and
- Governance encompassing corporate governance and corporate behavior (business ethics, anti-competitive practices, tax transparency, corruption, and instability).

In 2018, four of the five top risks identified by the World Economic Forum were environmental or societal including extreme weather events, water crises, natural disasters, and failure of climate change mitigation and adaption. Some of these issues have also resulted in involuntary migration.

The failure to manage ESG issues have had adverse impacts on corporations including their reputations, customer loyalty, and financial performance. Investors are increasingly interested in how corporations are managing ESG-related risks. To meet these needs, securities regulators and others have been requesting disclosures about ESG-related risks.

COSO and WBCSD believe the Enterprise Risk Management structures and processes provide a path for identifying, assessing, and responding to ESG-risks. The Guide has been designed to help decision makers, risk management practitioners, and sustainability practitioners to apply ERM principles and practices to ESG-related risks based on COSO's ERM Framework: *Enterprise Risk Management – Integrating with Strategy and Performance.*

The Guide covers the five components of the COSO ERM Framework:

1. Governance and culture for ESG-related risks covering the internal oversight of ESG-related risks and support for a culture of collaboration among those responsible for risk management of ESG issues.
2. Strategy and objective setting for ESG-related risks examining the value creation process by understanding the impacts and dependencies

of ESG-related risks in the short, medium and long terms.

3. Performance for ESG-related risks looking at:

   a. The identification of risks using various tools to determine ESG-related risks that threaten an entity's strategy and business objectives.

   b. The assessment and prioritization of risks by assessing risk severity, including emerging or longer-term ESG-related risks and prioritizing them for responses.

   c. Implementing risk responses by adopting a range of innovative and collaborative approaches that consider the source of the risk as well as the cost and benefits of each approach.

4. Review and revision of approaches to ESG-related risks to evaluate the effectiveness and modification as needed.

5. Information, communication and reporting for ESG-related risks to identify the most appropriate information to communicate and report internally and externally to support risk-informed decision-making.

The Guide can be purchased from COSO through its website at www.coso.org under the tab Guidance / Guidance on Enterprise Risk Management. A free executive summary of the Guide is also available on the same page.

FEI on implementing ICFR for new accounting standards

In November 2018, the Financial Executive International's (FEI) Committee on Corporate Reporting released two *ICFR: Insights, Issues, and Practices* documents.

- *A Guide to Implementing Internal Control over Financial Reporting (ICFR) for the Current Expected Credit Loss (CECL) Standard*, which outlines specific issues for companies to consider when changes are needed to document and evidence their governance processes and internal controls to adopt the provisions of the FASB's Measurement of Credit Losses on Financial Instruments (CECL) standard.

- *A Lessee's Guide to Implementing Internal Control over Financial Reporting (ICFR) for Contracts accounted for under Accounting Standards Codification (ASC) 842, Leases*, which is intended to help companies streamline and focus their internal control efforts when adopting the new leases standard.

These publications are valuable resources and may be a starting point for control considerations; however, it is important to assess the company's internal controls in light of the specific risks that result from the implementation of new standards on the company's systems and processes. Companies using IFRSs may find these publications helpful in considering certain aspects of ICFR.

The FEI's publications can be accessed through the FEI website at www.financialexecutives.org under the tab Influence / List of Committees / Corporate Reporting / ICFR: Insights, issues, and practices.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. It does not take into account any objectives, financial situation or needs of any recipient; any recipient should not act upon the information contained in this publication without obtaining independent professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents do not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2019 PricewaterhouseCoopers LLP, an Ontario limited liability partnership. All rights reserved.

PwC refers to the Canadian member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.