AC Insights

Insights for reviewing financial reports

Perspectives on corporate financial reporting using US GAAP

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Climate change: What are you disclosing?

Climate change is one of the top environmental and societal concerns facing Canadians today. Climate change will likely impact how companies conduct business — and ultimately, their bottom lines. How is your company disclosing the risks and opportunities related to climate change?

In April 2018, the CSA released its ***Report on Climate change-related Disclosure Project*** (CSA Staff Notice 51-354) [the Report]. The Report highlights users' concerns over the extent and quality of disclosures about the consequences of climate change on issuers. The Report also identified the burdens and challenges issuers face in reporting climate change-related information. The CSA undertook to provide more guidance to assist issuers in preparing disclosures on climate changes and developing risk management and oversight processes for material climate change risks. The CSA also indicated that it would continue to monitor practices for the disclosure of climate change-related risks.

We know climate change is a significant concern for many, including investors. However, the nature and extent of the consequences of climate change are often understood differently by economic, market and political participants. Similarly, the solutions to climate change, whether offered by politicians, industry sectors, and consumers, also vary. The challenge for issuers is capturing and disclosing the climate change risks specific to the company.

In August 2019, the CSA issued CSA Staff Notice 51-358***: Reporting of Climate Change-related Risks*** (the Notice) as an educational tool for issuers to use when preparing disclosures about material climate change-related risks. The CSA observed that investors want disclosures about the consequences of climate change on the issuer. Information about a company's material risks, opportunities, financial impacts of risks and opportunities, and governance processes to manage risks are important for investors to make informed decisions. The Notice recognizes the challenges of identifying material climate change risks and preparing information that is useful to investors. Issuers are encouraged to consider the guidance in improving their disclosures.

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Roles and responsibilities of the board and management

The board and management are encouraged to ask knowledgeable questions and make informed decisions about the issuer's risk management processes and disclosures. Disclosures should be relevant, clear, understandable, and entity-specific so investors can understand all material risks resulting from climate change and how the board and management assesses those risks. The Notice provides a series of select questions the board and management might consider in evaluating and preparing the appropriate disclosures.

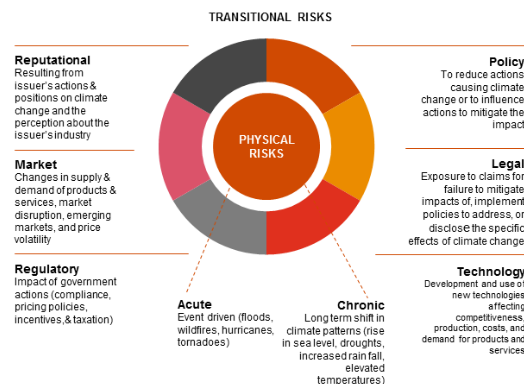
Materiality

The Notice provides a primer on applying materiality to required disclosures. The nature of climate change risks will often require issuers to adapt their existing approaches to risk assessment. Climate change risk assessment may require a different perspective on the materiality of climate change risks by considering the longer time horizon, external frameworks for risk assessment, and disclosures made by their peers. Disclosures may be necessary in the AIF for risk factors and in the MD&A for financial impacts.

Climate change risks

The Notice outlines some common climate change risks (see chart below) and opportunities based on the ***Recommendations (June 2017) of the Task Force on Climate-related Financial Disclosures*** (TCFD Report) and the potential impacts on an issuer's operations, business, financial condition, and financial performance of these risks. Select questions for the board and management are provided in the Notice to assist in the assessment of the extent of climate change risks. [The TCFD Report is available on their website at https://www.fsb-tcfd.org/publications/final-recommendations-report/.]

Nature of risks



Voluntary disclosures

The Notice acknowledges the benefit of disclosures beyond the regulatory requirements. However, voluntarily provided information cannot be in place of disclosures required in regulatory filings. Voluntary disclosures must be reliable and accurate and not obscure material information.

Forward-looking information

Certain disclosures about climate change risks may be forward-looking information. Any forward-looking information must comply with applicable continuous disclosure requirements.

Adding to your toolkit

Various organizations now provide guidance on disclosures about climate change risks. The Notice adds to the toolkit by providing an understanding of the CSA expectations. Also, the Notice provides useful tips on how to improve regulatory disclosures for the benefit of investors. A copy of the Staff Notice is available through the websites of the respective securities regulators. The Notice indicates that the CSA will continue to monitor climate change-related disclosures and we can expect to hear more on this topic.

US GAAP update

The summer months are traditionally a quiet period for standard setting and 2019 was no different – the FASB only issued ASU 2019-07: *Amendments to SEC Paragraphs Pursuant to SEC Final Rule Releases No. 33-10532, Disclosure Update and Simplification*, and Nos. 33-10231 and 33-10442, *Investment Company Reporting Modernization*, and *Miscellaneous Updates*, which updates the Accounting Standards Codification (ASC) for changes to SEC requirements for financial statements. The ASU aligns the ASC with the SEC regulations.

During the summer, the FASB continued to consider implementation issues arising from its new standards on revenue, leases, credit losses, and insurance contracts, including proposals to delay the implementation of the credit losses standard for SEC small reporting companies and insurance contracts for all companies. Also, the FASB proposed amendments to its standards to address the consequences of the cessation of the London Interbank Offering Rates (LIBOR).

CSA regulatory update

Enforcement in the digital world

Annually, the CSA issues an enforcement report outlining the efforts of the securities regulators in Canada to protect investors from unfair, improper, or fraudulent practices. The CSA issued the ***2018/19 Enforcement Report: Evolving Securities Enforcement for a Digital World*** in June 2019. The Report covers the role of and the process used by the CSA members in enforcing securities laws and regulations in Canada. The Report also highlights the outcomes of various enforcement activities.

The CSA has focused significant efforts on the challenges in the markets from new technologies and the growth of the digital economy, which influence the ability of perpetrators to engage in securities misconduct. However, the CSA remains vigilant and continues to develop and leverage new technologies to better identify and analyze market misconduct and the use of digital specialists to enhance enforcement activities.

One of the areas of focus was crypto-assets and initial coin offerings (ICOs). The CSA members participated in Operation Cryptosweep, a coordinated series of investigations into ICOs, crypto-asset related investment products and the people sponsoring these activities. Operation Cryptosweep resulted in about 50 enforcement actions, and closures of several unregistered ICOs.

From April 2018 to March 2019, CSA members closed 94 cases and opened 63 new matters for various securities law infractions and violations, as illustrated by the chart below.

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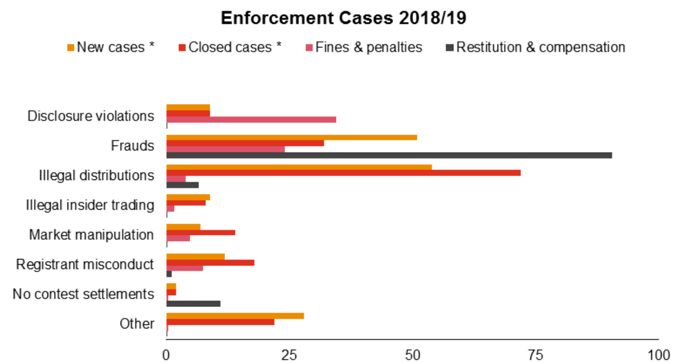
Levied in fines, penalties, restitution, compensation and disgorgement for the year ended March 31, 2019 in 94 cases involving 177 parties.



In addition to the fines and penalties noted above, 11 individuals received a total of 12.7 years in jail terms ranging from 90 days to three years.

During the period, the CSA placed about 100 cease-trade and asset-freeze orders on 145 market participants. Sixty-three individuals (48% life-time) and 18 companies (78% permanent) were banned from the markets, with non-permanent bans ranging from one to 20 years. Nine cases were commenced as proceedings under the Criminal Code. Thirteen individuals were found guilty under the Criminal Code, with 12 receiving jail terms ranging from three months to ten years. In three of the cases, the individuals were also sentenced under the respective Securities Act.

More detailed information about the CSA members' enforcement activities is included in the Report, which is available through the following link http://www.csasanctions.ca.

The CSA will continue to actively enforce the securities laws, working with its CSA members and other agencies around the globe. The CSA aims to protect Canadian investors using sophisticated tools, techniques and methods and its expert resources.

AMF disclosure expectations

In September 2019, the Autorité des marchés financiers (AMF) released its annual ***Summary of Oversight and Regulatory Activities*** undertaken by its Corporate Finance branch. The Summary provides a profile of Quebec issuers, main deficiencies in disclosures observed by the AMF, regulatory initiatives finalized and in process, and innovations being planned by the AMF. In this article, we summarize some of the key issues affecting financial reporting.

Tips for improving disclosure documents
The AMF highlighted certain deficiencies observed by staff and provided illustrations of how the disclosures could be improved.

Common deficiencies in disclosure documents

The AMF reviews required 56% of the issuers selected to improve or amend their continuous disclosures, either by refiling (22%) or making prospective changes (34%). The common deficiencies included failures to comply with:

- IFRS requirements for disclosure of financial instruments, operating segments and accounting policies;
- MD&A requirements for disclosure of significant projects, analysis of significant material changes in financial statements, and disclosures required for non-GAAP financial measures; and
- Regulatory requirements for technical reports by mining companies, disclosure of corporate governance practices in information circulars, and disclosures in the statement of executive compensation.

Status of activities

When proposed activities are disclosed, some companies' disclosures are incomplete or overly promotional, which may mislead investors to believe the activities are further advanced than they actually are. All material facts and risks should be provided, and promotional commentary should be avoided.

Stale-dated or incomplete information

Issuers were reminded to:

- Update financial statements in an ongoing offering document within the prescribed period. Also, issuers need to file on a timely basis its annual financial statements, as well as a statement of the user of proceeds, after making certain offerings.

- Provide sufficient information in the offering document to support informed decisions. The AMF has observed issuers being created to raise funds solely to lend to an operating company without including enough information about the operating company. Issuers were reminded that information about the operating company is required, including annual financial statements.

Problematic promotional information

Some issuers include unsupported information about the potential for a project, growth of markets or demand for a product in presentations, marketing materials, social media posts or other information. This information may be untrue or unbalanced and mislead investors. Issuers have been required to modify these disclosures by issuing press releases; retracting or removing the overly promotional information from continuous disclosure documents, websites and social media; and/or refiling modified continuous disclosure documents. The AMF is particularly concerned with such disclosures in the mining sector.

Compliance reminders

In the section of the report on Informing, the AMF commented on specific compliance matters to remind issuers of their responsibilities.

IFRS 7: *Financial instruments: Disclosures*

The AMF reminded issuers that disclosures required by IFRS 7 enable users to evaluate the significance of risks arising from financial instruments and how the issuer manages those risks. Some areas of focus in the report are:

- Disclosures of risk management strategies for each category of hedged risk;
- Disclosures to understand the effect of credit risk on the amount, timing, and uncertainty of future cash flows, including the method, assumptions, and other information used to measure expected credit losses; and
- Disclosures of how issuers manage liquidity risk inherent in the maturities of financial liabilities.

Discussion of cash flows in MD&A

Some companies analyze and discuss their cash flows from operating activities before the change in non-cash working capital items. Issuers are reminded that in the MD&A, there should be a discussion of the total cash flows from operating activities. In addition, if the amount before changes in non-cash working capital is discussed, it should be properly labelled so as not to mislead investors. If the issuer does not present a subtotal, appropriately labelled in the cash flow statement, the issuer would be required to comply with the requirements for non-GAAP financial measures.

Issue-oriented reviews

The AMF has reviewed disclosures made by issuers in their financial statements related to two new standards – IFRS 9: *Financial instruments* and IFRS 15: *Revenue from contracts with customers.* The staff observed that most companies provided high quality disclosures.

Topics for the current round of disclosure reviews include:

- Disclosures in financial statements related to the new standard, IFRS 16: *Leases.*
- Disclosure in technical reports of mining companies for compliance with regulatory requirements. AMF geologists monitor the technical reports and similar disclosures by mining companies for compliance with the regulatory requirements. Action may be taken for incomplete reports, unreasonable assumptions, missing disclaimers, and not meeting the requirements for a qualified person.
- Disclosures in information circulars and filing statements for reverse takeovers and qualifying transactions. The AMF had noted that these disclosures were often inadequate in explaining the restructuring and providing information about the operating company.

Payment to governments by mining, oil and gas issuers

An annual statement of payments made to governments and Native nations equal to or greater than $100,000 is required to be made by certain Quebec issuers under the *Act Representing Transparency Measures in Mining, Oil and Gas Industries*. The Act applies to entities involved in the mining, oil and gas industry either directly or indirectly if (1) the issuer is listed on a stock exchange in Canada and has a head office in Quebec; or (2) the issuer over a certain size (based on assets, revenues, and/or number of employees) with an establishment, activities, and assets in Quebec. Failure to file the statement attracts a penalty of $1,000 per day.

Timely disclosure of material changes

When a material change occurs, issuers are required to immediately issue and file a news release about the material change. In addition, a Material Change Report must be filed within 10 days of when the material change occurs. Issuers were reminded that the AMF will follow up and possibly seek enforcement action on delays in timely disclosure of material changes.

More information

The Summary includes more information on the AMF's regulatory initiatives on its own and through the CSA and other international bodies. For more information on the matters summarized in this article and other matters discussed in the Summary, please refer to the Summary. The Summary is available on the AMF website at www.lautorite.qc.ca under the tab *Professionals / Shortcut for News*.

SEC regulatory update

Risks on transitioning away from LIBOR

Participating banks that report information used to set the London Interbank Offering Rate are expected to cease providing this information by 2021. LIBOR has been used extensively as a benchmark interest rate for many commercial and financial contracts. The cessation of LIBOR may have a significant impact on financial markets. In July 2019, the SEC staff issued the ***Staff Statement on LIBOR Transition*** to encourage issuers to manage the transition away from LIBOR.

Efforts are being made to develop alternative reference rates. For example, the US markets may migrate to the Secured Overnight Financing Rate or similar rates. In Canada, the Canadian Alternative Reference Rate Working Group (CARR) is considering alternatives for the Canadian market, including strengthening currently available benchmarks. The Bank of Canada has taken responsibility for the Canadian Overnight Repo Rate Average (CORRA), a possible Canadian alternative. Other markets may also develop or strengthen reference rates in their domestic currencies.

To manage the risks of transitioning, the SEC has made some general suggestions as follows:

- Identify existing contracts extending past 2021 with interest rates referencing LIBOR. Issuers should understand the consequences of the cessation of LIBOR and assess whether there are provisions to deal with the termination or the outcome when it is inconsistent with expectations. Changes may be required to contracts to avoid adverse consequences.

- Address the possible cessation of LIBOR in any new contracts. Issuers should consider referencing an alternative rate or including language to ensure any consequences are consistent with critical terms negotiated (fallback language). Various agencies have developed templates for fallback language that could be considered when drafting new contracts.

- Consider other business risks, which the cessation of LIBOR may have on the business. The consequences of the termination of LIBOR may require changes in strategy, products, processes, and information systems.

The transition away from LIBOR may require disclosures in regulatory filings, the MD&A, and the financial statements. Such disclosures may include risk factors, risk oversight processes used by the issuer's board of directors, and the related financial effects. If material, investors would need to be informed about the company's progress in identifying and mitigating the risks and any impact on the company. Since the consequences may span over several reporting periods, the process of risk management may evolve, and disclosures may need to be updated to reflect current knowledge and status.

The transition away from LIBOR may give rise to some accounting issues dealing with modifications of terms of debt arrangements and hedging instruments, changes to hedging relationships, inputs used in valuation models, and potential tax consequences. Accounting standard setters are responding by providing amendments to their accounting standards to address the implications of the move away from LIBOR. Issuers can also consult with the Office of the Chief Accountant of the SEC to discuss questions in making the transition.

The statement reflects the views of the SEC staff and does not alter any laws, regulations, or rules of the SEC. The Statement can be retrieved from the SEC website at www.sec.gov under the tab *News / Public Statements / July 12, 2019*.

Test-the-waters accommodation available to all

On September 26, 2019, the SEC approved a new rule to allow all issuers to use the “test-the-waters” accommodation with qualified institutional buyers and institutional accredited investors for a contemplated registered security offering, prior to, or following, the filing of a registrant statement. This accommodation will allow all issuers to assess whether certain investors are interested in the contemplated securities offering. Issuers will be able to have oral or written communications with eligible potential investors before or after filing a registration statement. This accommodation was previously only available to emerging growth companies.

This change in the rules is expected to increase the likelihood of successful public securities offerings. The rule will be effective 60 days after it is published in the US Federal Register.

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Auditing update

Issues facing audit committees

CPAB held two audit committee roundtables in the summer of 2019 to discuss matters that are on the minds of audit committee chairs and CFOs of Canadian public companies. The findings from these roundtables were communicated in a ***CPAB exchange*** on July 23, 2019.

Some of the principal issues facing audit committees and observations from the participants were as follows:

- Use of new technology in audits − Auditors are increasing the use of automation and data analytics in audits. The use of these new tools raised concerns over assessing audit quality and the protection of data from cybersecurity threats.
- Cybersecurity risks − Cyber threats are significant risks for many issuers. Some best practices used by companies include monthly and annual cybersecurity reports to the audit committee chair and the use of experts to conduct annual assessments and share global trends.
- Reporting of critical audit matters or key audit matters − There was strong support for dry runs, mock-up reports, and meaningful disclosures.
- Audit Quality Indicators − AQIs are useful in improving the quality and depth of discussions with auditors. Audit committees should play a primary role in driving the auditor assessment process. Quarterly reporting may be a useful tool for more frequent assessments. More issuers are including disclosures in regulatory filings about their auditor quality assessment processes, including AQIs.
- Transparency of CPAB inspection findings − CPAB is conducting Quality Management Systems assessments of the major auditing firms. Consideration may be given to publicly disclose information on the strength of the quality systems at each firm.

CPAB also outlined developments in audit quality and obtained observations from the participants on the following:

- Quality Management Systems assessments − CPAB is conducting these assessments to improve the consistency of audit quality. The evaluation includes firm policies and processes − at both the leadership and engagement team levels − that manage risk and the consistent execution of the audit. Firms will be required to demonstrate and evidence the effectiveness of their processes. Participants expressed interest in these assessments as a direct link to audit quality results.
- Global developments − Global audit firms are implementing internal controls at the firm level and putting a greater emphasis on quality processes and systems and the entire audit ecosystem (auditors, audit committees and management). There has been discussion in certain jurisdictions about strategies to increase competition for large audits and reduce potential conflicts of interest. Participants discussed the practical challenges and benefits of these strategies. Concerns were raised about some companies seeking significant fee reductions from their auditors. Participants stressed the importance of audit quality and ensuring audit fees were fair. Participants expressed the view that audits should be seen as an important service for stakeholders, and not merely as an expense to be reduced.

The complete summary of the roundtables is available at the CPAB website at www.cpab-ccrc.ca under the tab *News & Publications / Publications*.

Explaining CAMs

As reported in the Summer edition of ***AC Insights***, auditors of many companies will soon begin reporting critical audit matters (CAMs) in their auditor's reports. In July 2019, the PCAOB issued resources to help investors and audit committees understand the reporting of CAMs by auditors. The Center for Audit Quality has also published materials to assist investor relations professionals in understanding CAMs.

Information for investors

The PCAOB publication, ***Investor Resource: Critical Audit Matters***, explains the basics about what CAMs are, and how and when CAMs are communicated. The Investor Resource includes several frequently asked questions about what CAMs mean and the format of reporting CAMs. This publication is available at www.pcaobus.org under footer heading *Information For Investors*.

Dennis McGowan of the CAQ provides insights on CAMs in a video on the ***Profession in Focus: Critical Audit Matters, Investors, and Investor Relations***. The video provides an overview of the CAMs requirement, why investor relations professionals should anticipate CAMs questions, and what kinds of questions they might expect. The CAQ also issued in July 2019 a publication titled ***Investor Relations: Get Up to Speed Now On Critical Audit Matters***.

This publication explains CAMs to investor relations professionals to prepare them for possible questions from investors and other stakeholders. The CAQ resources are available on the CAQ website at www.thecaq.org on the cover page under the section *Collections / Auditor Reporting*.

Information for audit committees

The Audit Committee Resource: Critical Audit Matters also explains the basics about CAMs and explains the steps in identifying CAMs. Frequently asked questions cover audit committee communications, the meaning of CAMs, and the impact on audit procedures. This publication is available at www.pcaobus.org under footer heading *Information For Audit Committees*.

Investors' confidence in US markets remains strong

Annually, the CAQ surveys US retail investors to measure the investors' confidence in US capital markets, global capital markets, investment in public companies, and audited financial statements. The CAQ released the ***2019 Main Street Investor Survey*** in September 2019.

The Survey measured the level of investor confidence based on online interviews of 1,000 retail investors. Investors were asked to support their conclusions by selecting one of several potential reasons for each of their levels of confidence. A summary of the levels of confidence and the top positive or negative factors cited are listed on next page.

Capital market confidence levels
AICPA 2019 Main Street Investor Survey

	Some, quite a bit, or great deal of confidence			Little or no confidence
	2019	2018	Top 3 factors	Top 3 factors
US capital markets	74%	74%	• Belief US economy is doing well • Confidence in the system of capitalism • Belief US capital markets will continue to perform well	• Lack of confidence in Trump administration • Lack of confidence in US Congress • Belief US economy is not doing well
Markets outside the US	47%	56%	• Belief when US markets perform well, foreign markets will perform well • Belief that foreign markets will continue to perform well • Belief that foreign economies are doing well	• Lack of confidence in foreign governments • Belief that foreign economies are not doing well • Belief that when US markets do not perform well, foreign markets will not perform well
US companies publicly traded	76%	78%	• Belief US economy is doing well • Belief US companies are innovative • Personal experience	• Belief the US economy is not doing well • Government regulation and policy • Belief US companies are not trustworthy
Audited financial statements	78%	75%	• Belief that auditors provide honest and independent third-party scrutiny • Government regulation and policy • Personal experience	• Belief that companies are not trustworthy • Belief that auditors do not provide honest and independent third-party scrutiny • Government regulation and policy

The lack of confidence of US retail investors in capital markets outside the US is based primarily on a lack of confidence in foreign governments and economies. The Survey does not elaborate on the influences that contribute to these reasons. Significant influence factors may be political views about trade, patriotism, and isolationism; the accessibility of unbiased information and news; and the breadth of foreign markets compared to US markets.

The Survey also requested retail investors confidence in various market participants. Below we include the confidence levels for boards of directors, management and auditors. The Survey did not include any reasons for these levels of confidence.

Capital market participants' confidence levels
AICPA 2019 Main Street Investor Survey

	2019	2018
Boards of directors	57%	59%
Independent audit committees	81%	80%
Management	64%	63%
Auditors	83%	81%

The Survey asked investors to rank various risks to the US economy and capital markets. The principal risks identified by investors were:

- The growing national debt,
- US trade policy,
- Corporate corruption,
- Excessive or ineffective government regulation,
- Global political unrest,
- Domestic political unrest,
- Terrorism,
- Cyber-attacks,
- Interest rates and monetary policy, and
- Climate change.

The high levels of confidence in audited financial statements, audit quality, and the performance of independent audit committees are encouraging. Quality audits support active capital markets. The continual efforts to achieve quality audits by audit committees, auditors, and regulators bode well for Canadian capital markets.

Valuation of private equity/venture capital investments

The AICPA periodically publishes nonauthoritative guidance and examples on various topics to assist preparers of financial statements, auditors, and other professionals in applying accounting and auditing standards. In August 2019, the AICPA issued guidance for investment companies on how to fair value their portfolio company investments.

The accounting and valuation guide titled ***Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*** developed by the AICPA Private Equity / Venture Capital Task Force provides insights from industry participants, auditors, valuation specialists and AICPA staff.

This guide:

- Addresses various valuation issues affecting the application of accounting standards such as unit of account, transaction costs, calibration, the impact of control and marketability, and backtesting. The guidance provides best practices to assist investment companies in addressing the challenges in estimating the fair value of these investments.

- Includes 16 user-friendly case studies to explain common scenarios faced by investment fund managers, valuation specialists and auditors.

The publication is available in print or eBook format from the AICPA store at www.aicpastore.com under the tab *Publications.*

Concerns over financial instruments

In the ***AICPA Economic Outlook Survey*** for the second quarter of 2019, the AICPA included questions on the use of financial instruments by companies. The Survey found that "financial instruments are a growing presence on company balance sheets, and... more market awareness is needed to prevent another financial crisis". About 28 percent of participants in the Survey expect financial instruments to have a more significant presence on their balance sheets over the next few years, while only 15 percent see a decrease.

Fifty-nine percent of the Survey participants indicated their companies used complex financial instruments such as mortgage-backed securities, interest rate swaps or other derivatives.

Many participants in the Survey expect financial instruments to become slightly more complex over the next few years. Further, the majority believe that market awareness of complex financial instruments is insufficient to prevent a financial crisis.

Over half of the respondents raised concerns about the valuation of derivatives with 6 percent significantly concerned and 49 percent slightly or moderately concerned.

These insights from company executives highlight the importance of companies understanding the potentially risky nature of certain financial instruments. Also, decision making needs to be supported by information provided using consistent and transparent valuation frameworks.

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