AC Insights

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AC Insights provides audit committee members with a summary of financial reporting developments for public companies using IFRS, how those developments might affect your company and things you may want to think about.

In this edition

In May, the IASB and FASB issued a new global accounting model for revenue recognition that will replace all existing guidance on revenue recognition. The new revenue guidance may result in significant changes for some companies. The IASB also finalized certain amendments to existing standards dealing with the acquisition of joint operations that are businesses and methods of depreciation and amortization for property, plant, equipment and intangible assets.

The IASB has completed its redeliberations of the exposure drafts on the classification, measurement and impairment of financial assets. A final standard to be incorporated into IFRS 9: *Financial Instruments* is expected to be issued in the third quarter. The IASB has tentatively announced that IFRS 9 will be effective for years beginning on or after January 1, 2018. The Board is also continuing with its project on macro hedging.

The Board is also finalizing some of its annual improvements for the year and narrow scope amendments and expects to issue those amendments in the upcoming quarter. These primarily deal with implementation issues related to accounting for investments in joint arrangements and associates, financial instruments disclosures, employee benefit plans and assets held for sale.

During the quarter, the SEC issued an order to amend some requirements of the Conflict Minerals Rule because of a proceeding at the US Court of Appeals. SEC registrants are still required to provide Conflict Minerals Reports to the SEC. There were no other CSA or SEC regulatory developments during the quarter.

In auditing developments, CPAB has developed a Protocol for discussing their overall inspection findings as well as significant inspection findings for the audits of individual reporting issuers. The Protocol was designed to improve audit quality and provide for discussions between the auditor and the audit committee. In addition, CPAB released its 2013 report on its inspections of audit firms. Also, the PCAOB issued a new auditing standard on related parties and made amendments to existing standards to enhance auditor performance for significant unusual transactions and relationships and transactions with executive officers.

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IFRS developments

One global revenue model

The IASB and FASB have issued their new standards on revenue recognition. Both IFRS 15: *Revenue from Contracts with Customers* and FASB ASU 2014-09: *Revenue from Contracts with Customers* will be the single source for accounting for revenue for all companies in all industries. The new standards replace all current guidance on revenue recognition, including industry or product specific guidance.

While the standard setters have tried to preserve many of the existing principles and practices commonly used in revenue recognition, it is expected that **virtually all companies will see some level of change**. Current IFRSs have limited guidance and provide significant flexibility in developing and applying revenue accounting policies and practices. IFRS 15, on the other hand, provides more specific and detailed guidance in many areas. There will be more judgment calls, changes to business processes and controls, and expanded disclosures. The implementation of the new standard may affect your company's key performance indicators and metrics, cash taxes, payments under compensation plans, compliance with financing and other agreements, and how you do business.

It is expected that implementation issues will evolve as companies begin to think about the implications of the new standards on their industry and business. Implementation resource groups have been established by the IFRS, FASB and other accounting and auditing bodies. These groups as well as others will be providing implementation guidance and that guidance may influence initial views on what the standards mean.

What has changed?

Revenue will be recognized when control of the promised goods or services is transferred to the customer, not simply on the passing of risks and rewards to the customer. The measurement of contract consideration and how it is allocated to multiple elements of a contract will also change for many companies.

Disclosures about revenues have been increased significantly and are required in both annual and interim financial statements. Even entities with minimal changes to their revenue accounting policies will need to develop procedures to gather the data necessary to make the disclosures.

IFRS 15 will apply to all revenue contracts with customers except for lease contracts, insurance contracts, financial instruments, investments in other entities and certain non-monetary exchanges. These exceptions are similar to the previous IFRSs.

The new model for revenue recognition includes a five-step approach. The five steps may appear simple, but significant judgment will be needed in applying the underlying principles.

Step 1: Identify contract(s) with customer

Step 1 sets the contract boundary. Sellers must assess whether the contract is enforceable including whether the customer will pay the expected consideration. Similar to current IFRSs, two or more legal contracts are to be combined if, in substance, they are one arrangement. Detailed guidance is also provided on the accounting for contract modifications for all contracts, **not just construction contracts**.

Step 2: Identify the performance obligations in the contract

Step 2 focuses on identifying the elements within an arrangement, which are referred to as performance obligations. Performance obligations are to be accounted for separately if they are distinct functionally and distinct based on the substance of the contract.

Step 3: Determine the transaction price

The transaction price is the amount of consideration that the seller expects to be entitled to for the promised goods or services in the contract. The amount may be fixed or vary because of discounts, rebates, refunds, sales incentives, performance bonuses, penalties, contingencies or similar items. Variable consideration must be estimated and included in the transaction price if it is highly probable that the amount recognized will not result in a significant reversal of revenue in subsequent periods. Deferred or advance payments are required to be discounted unless the receipt of cash and the performance occur within 12 months of each other.

Step 4: Allocate the transaction price to the performance obligations

The transaction price is allocated to the separate performance obligations identified using a relative stand-alone selling price basis. The stand-alone selling price of a good or service is the price when the good or service is sold separately to a customer in similar circumstances and to similar types of customers. If a stand-alone selling price is not available, it may be estimated. In very limited circumstances, a residual approach may be used. The standard also permits allocation of discounts and variable consideration to some of the performance obligations if certain criteria are met.

Step 5: Recognize revenue when the performance obligation is satisfied

Revenue is recognized when the control of the goods or services is transferred to the customer. This may be over time or at a point in time. Examples of contracts that would be recognized over time include service type arrangements, contracts to develop or enhance assets that are controlled by the customer, or the development or production of items for a specific customer which cannot be redirected to other customers and for which the customer is obliged to pay for work completed. When revenue is recognized over time, the seller would recognize revenue by measuring the progress to completion using input or output methods. Contracts not meeting the criteria for revenue recognition over time are recognized at a point in time. Specific guidance has been provided for determining whether license revenue should be recognized over time or at a point in time.

IFRS 15 also includes specific guidance on contract costs. Contract costs include incremental costs to obtain a contract and costs incurred to fulfil future performance obligations. These two types of costs must be accounted for separately. Recoverable incremental costs to obtain a contract are to be capitalized and amortized on a systematic basis consistent with the pattern of revenue recognition. Non-incremental costs such as salaries and benefits of sales persons cannot be capitalized. An exception is provided permitting costs to be expensed immediately if they would be amortized in one year or less.

Costs to fulfil a contract, such as design and preproduction costs, are capitalized if the costs relate to a contract or an anticipated contract that can be specifically identified, the assets will be used to satisfy performance obligations in the future, and the costs are recoverable. The capitalized fulfilment costs are amortized and subject to impairment assessments.

The IASB also made changes to the accounting for the disposal of property, plant, equipment, intangible assets and investment properties. The measurement and timing of recognition of a disposal of these assets will be based on the guidance in IFRS 15.

When is the standard effective?

IFRS 15 will be applicable for years beginning on or after January 1, 2017. Early adoption will be permitted. The standard may be applied using a full retrospective method (with prior periods restated) or a modified retrospective basis (applied to open contracts as of beginning of the year of adoption with no restatement of prior periods). If the modified retrospective method is selected, comparative disclosures are required for the current year as if the prior revenue policies continued to be applied.

What should you do now?

Management will want to know what the standard means to their business and what changes will need to be made. Further, implementation guidance will evolve as the various resource groups consider the implications of the standard. Management will have to keep informed about these developments.

Management will need to perform a comprehensive review of existing contracts, business models, company practices, accounting policies, information technology systems, and internal processes and controls to assess the extent of changes needed as a result of the new standard. While all companies are expected to be affected to some degree, the impact of the new standard will differ depending on the industry.

Management will also have to consider the transition provisions. Revenue is often a key figure for trend analysis and how the implications of the standard will be communicated to stakeholders. Until management understands the significance of the change to their revenue reporting, they may want to keep their options open.

PwC is ready to assist companies in preparing for the revenue changes. We can assist with project management and communication, a diagnostic survey of focus areas for the new standard, facilitate the assessment of key revenue streams and contracts to understand the qualitative and quantitative impact, and assist with pro-forma modelling to understand the key changes and facilitate communication with stakeholders. If you are interested in more information about our services, your engagement team will be pleased to discuss our services with you.

Is there more information?

For more information on the details of IFRS 15, please ask your engagement team for *In depth: Revenue standard is final—A comprehensive look at the new model*. This analysis is supplemented by industry guides.

Acquisition of interests in joint operations

In May 2014, the IASB published amendments to IFRS 11: *Joint arrangements* to provide guidance on accounting for acquisitions of interests in joint operations that are businesses. Joint operations are arrangements where the parties have rights to the assets and obligations for the liabilities of the joint arrangement.

These amendments address the diversity in practice in accounting for acquisitions of such interests in joint operations. Currently, entities may account for acquisitions of such interests as business combinations using IFRS 3, asset acquisitions, or by analogy to other standards.

What has changed?

The amendment requires an entity's initial and subsequent acquisitions of interests in a joint operation that is a business to be accounted as if those acquisitions were business combinations. The guidance will also apply when an existing business is contributed by an investor to a joint operation on its formation. However, the amendments do not address the accounting for the contribution of assets that are not a business to a joint operation at its formation.

Entities will have to use the principles in IFRS 3: *Business combinations* and other IFRSs to account for such acquisitions. This means that:

- An entity's share of assets acquired and liabilities assumed will be measured at fair value as specified in IFRS 3 with any residual recognized as goodwill.
- Deferred income taxes will be recognized as required under IFRS 3.
- Acquisition-related costs, except for debt and share issue costs, will be expensed as incurred.
- Acquisition disclosures will be required in the financial statements.

In step acquisitions, any previously **held interests in the joint operations will not be remeasured if the joint operator retains joint control**.

When do the amendments apply?

The amendments will apply prospectively to any acquisitions of interests in a joint operation that is a business occurring on or after January 1, 2016. The amendments may be adopted early. No adjustments are made to acquisitions that occur before the date that amendments are first applied.

What should you be doing now?

Entities in the oil and gas, mining and power industries will be most affected by the amendments. However, joint arrangements are frequently used by other entities to access emerging markets and those entities will also be similarly affected.

Companies applying one of the alternative approaches will need to consider the consequences of the amendments and assess whether they should adopt the new amendments early to have comparability going forward. In addition, entities making acquiring interests in joint operations will need to understand whether the joint operation is a business or not.

Revenue-based depreciation is out

Amendments have been made to IAS 16: *Property, plant and equipment* and IAS 38: *Intangible assets* to clarify when the use of methods based on revenue to calculate depreciation and amortization may not be appropriate. The amendments were issued to address concerns over the use of revenue-based depreciation or amortization methods, which allocated the cost of an asset based on revenue generated in a period over the total expected revenue to be generated over the asset's useful economic life.

What has changed?

IAS 16 has been amended to prohibit the use of a revenue-based method to calculate depreciation of property, plant and equipment.

IAS 38 has been amended to clarify that revenue-based amortization methods are presumed to be inappropriate. This presumption can be rebutted when either the use of the intangible asset is limited by the achievement of a revenue threshold or there is a high correlation between the revenue and the consumption of the asset.

Guidance was also added to IAS 38 to assist entities in selecting an appropriate amortization method for intangible assets. The IASB concluded that the method should reflect the predominant limiting factor of the intangible asset's use. This may be a period of time, a number of units produced or a fixed total amount of revenue.

When are the amendments effective?

The amendments will be effective on a prospective basis for years beginning on or after January 1, 2016. Early adoption will be permitted. Consistent with IAS 8, any change in the method of depreciation or amortization would be accounted for as a change in estimate in the period the method is changed.

What should you do now?

Revenue-based depreciation methods for property, plant and equipment are rarely used and the amendment is not expected to have a significant impact on depreciation of those types of assets. Revenue-based amortization methods for intangibles assets are used in some industries, particularly those in the entertainment and media industry and possibly some entities in the engineering and construction sector.

If you are using or planning to use revenue-based depreciation or amortization methods, you will need to determine which method is the most appropriate and consider the consequence of any change to another acceptable method of depreciation and amortization. Communication with stakeholders may be important if a significant change in estimates of depreciation and amortization is expected.

Bearer plants are PP&E

In June, the IASB amended IAS 16: *Property, plant and equipment* and IAS 41: *Agriculture* to define a bearer plant and require such plants to be treated similar to property, plant and equipment. Bearer plants are used solely to grow produce over several years and are scrapped at the end of their life (for example, apple trees, grape vines).

What has changed?

Bearer plants are now included in IAS 16 and are to be accounted for the same way as other property, plant and equipment. Before bearer plants are mature and are capable of producing produce, they are accounted for as self-constructed items. The produce growing on bearer plants continue to be accounted for using IAS 41.

When is the standard effective?

Entities are required to apply the amendment for years beginning on or after January 1, 2016. The standard can be applied earlier. The amendments are to be applied retrospectively with an election to measure the bearer plants at their fair value at the earliest period presented and use that fair value as deemed cost at that date.

What should you do now?

Companies that hold bearer plants will want to consider the implications of this change and assess whether early adoption would be appropriate. Also these companies will want to consider whether the impact of the change on the financial performance of the company will be significant and should be communicated to its stakeholders before transitioning to the new requirements.

SEC developments

Partial stay of Conflict Minerals Rule

In May 2014, the SEC issued an order staying the effective date for compliance of portions of the Conflict Minerals Rule on the basis that the US Court of Appeals for the District of Columbia concluded that certain statements required in the Report would violate the First Amendment. The statements that were at issue were those in reports to the SEC and on a registrant's websites that any of the registrant's products have "not be found to be 'DRC conflict free'". Companies are still required to file their Conflict Minerals Report, but will not have to identify any products as "DRC conflict undeterminable" or "not found to be 'DRC conflict free'". Rather the companies will have to report the products, the facilities used to produce the conflict minerals, the country of origin of the minerals and the efforts to determine the mine or location of origin.

On April 7, the SEC staff also updated their publication on *Frequently Asked Questions: Conflict Minerals*.

Auditing developments

Communicating CPAB inspection findings to audit committees

In March 2014, the Canadian Public Accountability Board (CPAB) issued the *Protocol for audit firm communication of CPAB inspection findings*. The Protocol was developed with the objective of having a positive impact on audit quality by enhancing the audit committee's ability to evaluate the quality and effectiveness of the audit. The Protocol is in response to the 2013 report on *Enhancing Audit Quality: Canadian Perspectives – The Role of the Audit Committee in External Audit Oversight* issued by The Role of the Audit Committee Working Group.

What has changed?

Audit firms will be required to provide audit committees of their reporting issuer clients with:

- CPAB's *Annual Public Report*, which outlines CPAB's common findings for the inspection of all firms for a given year. The Report also includes CPAB's recommendations to improve audit quality.
- Communications about the specific inspection of the audit file related to the reporting issuer. The communications would:
  - Describe the focus areas of the CPAB inspection.
  - Indicate whether or not there were any significant inspection findings. A significant inspection finding is "a significant deficiency in the application of generally accepted auditing standards related to a material financial balance or transaction stream when the audit firm must perform additional audit work in the current year to support the audit opinion and/or is required to make significant changes to its audit approach."
  - Disclose the significant findings, if any, as written by CPAB, the audit firm's response, actions taken by the firm in response to the findings and CPAB's disposition. The findings are expected to be communicated on a timely basis, shortly after the findings are finalized by CPAB.

This information will be confidential and audit committee members should ensure it remains confidential.

Audit committees are expected to discuss any significant finding with the audit firm to understand: the nature and cause of the significant finding; the additional work performed by the audit firm to address the finding and related results of that work; the impact, if any, on the previously issued or future financial statements of the reporting issuer; and any changes the auditor will make to its audit approach to address the finding.

The Protocol is voluntary. PwC has agreed to participate in the Protocol.

When is the Protocol effective?

The Protocol is effective for CPAB audit inspections commencing on or after March 1, 2014.

CPAB looks for sustainable improvement

In March 2014, CPAB issued its *Report on 2013 Inspections of the Quality of Audit in Canada – Ten Years of Progress*. The key insights resulting from the 2013 Report are:

- The trend in audit quality is positive and audit firms in Canada are taking the challenge to improve audit quality seriously. CPAB encourages audit committees to discuss with their audit firm how their audits will continue to be of the highest quality.
- The challenges and/or risks of operating in foreign jurisdictions also affect the audit. Management, the audit committee and other professional advisors need to understand these risks and mitigate them effectively.
- Changes to businesses including acquisitions of new businesses or entering into ventures often increases risk. Audit committees need to understand how the business and audit risks are addressed.
- CPAB encourages audit committees to have open dialogue with their auditors about how their audit firm has responded to the systemic findings in the CPAB Report.

The common inspection findings for the Big Four firms focused on the experience and scepticism of the auditors. The key findings were as follows:

- Firms need to enhance the professional scepticism of their staff. CPAB believes:
  - Senior members of the audit engagement team should be rotated frequently to avoid complacency or the threat of familiarity.
  - Senior engagement team members should be visible to both the client and the engagement staff, complete reviews of all significant areas of the audit file at the client site, engage staff in discussions about audit risk and quality and challenge their judgments, and never accept substandard work.
  - Engagement teams should be more challenging in their audit approach.
  - Training about exercising professional scepticism should be enhanced.
- Senior members of the engagement team, including the partner, should be involved in the process of auditing estimates, in particular impairment of assets and going concern evaluations.
- Audit firms should critically evaluate how they approach an internal control audit and ensure engagement teams are appropriately trained to identify key controls and testing those controls.

A copy of the 2013 Report can be found at www.cpab-ccrc.ca or you can request a copy from your engagement team.

PCAOB amends certain standards

On June 10, 2014 the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 18: *Related Parties*, which is intended to strengthen auditor performance requirements for identifying, assessing and responding to the risks of material misstatement associated with a company's relationships and transactions with its related parties. The PCAOB also adopted amendments to certain PCAOB auditing standards that address the auditor's responsibilities with respect to a company's significant unusual transactions and a company's financial relationships and transactions with its executive officers.

The Board determined the existing standards in these areas do not contain sufficient required procedures and are not sufficiently risk-based, which can lead to inadequate auditor effort. Additionally, the Board's inspection and enforcement activities indicate that there are continuing weaknesses in auditors' scrutiny in these areas.

What has changed?

The related parties' standard is designed to strengthen the auditor's performance requirements by setting forth specific procedures for the auditor's evaluation of a company's identification of, accounting for and disclosure of relationships and transactions between the company and its related parties. The auditor is also required to communicate to the audit committee the auditor's evaluation and other significant matters arising from the audit regarding the company's relationships and transactions with related parties.

The amendments regarding significant unusual transactions were made to strengthen the auditor's performance requirements for the identification and evaluation of these transactions, including obtaining an understanding of their business purpose (or lack thereof) and whether significant unusual transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

Other amendments require the auditor to perform specific procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers, including compensation. The amendments do not require the auditor to make any determination regarding the reasonableness of compensation arrangements or recommendations regarding compensation arrangements.

When are the changes effective?

The standard and amendments, if approved by the SEC, will be applicable to all audits performed using the PCAOB standards for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial statements within those years.

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