Financial Reporting Release

Keeping your head above water…

Recent issues in financial reporting*

January 2009

In this Issue

I have a new philosophy. I'm only going to dread one day at a time – Charlie Brown

Remember our friend Dave? Our neighbour? Well, Dave was over for some pop during the holidays, and we got to talking about the economic crisis. Now Dave's a pretty sharp guy, and was wondering what all the fuss was about fair value accounting. "Do you recall", we said, "when you bought your house and immediately got a market value tax assessment for more than you paid for it?" "Ah", said Dave, "so fair value accounting's all about estimating the market price for something, even though you already own it"? "Sort of", we said. "OK", said Dave, "but if you already own it, and aren't planning to sell it, why should you care about the cash you won't get by not selling it? Shouldn't you be more worried about the cash you will get by holding it"? "Ah", we said, "that depends on who 'you' is". "Can I have some more pop"? said Dave.

In these days of economic doom and gloom, fair value accounting has come in for some heavy criticism. In this edition of *Financial Reporting Release,* we'll tell you all about how standard-setters are reacting and how standards are going to change as a result. Our prediction? Not everybody's going to be happy.

Fair value isn't the only accounting issue that's attracting attention these days. Other questions loom large as well. What's happening to asset derecognition and consolidation standards as a result of concerns about off-balance sheet accounting? What are securities regulators expecting companies to report about the financial crisis in their MDA and financial statements? Why are EPS and discontinued operations standards changing? Is it really true there's gonna be new one-size-fits-all models for revenue recognition, consolidations and financial statement presentation? What's happening with IFRS? And why, for goodness sake, are private enterprises skipping down the street singing, "The witch is dead, the witch is dead"? We explain all here.

We know, we know. It's tempting these days just to pull the covers over our heads and forget about all this stuff. Be calm, be cool. At least we know that debits always will equal credits. Happy reading.

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The Future of Canadian GAAP

I do desire we may be better strangers – William Shakespeare, *As You Like It*, Act iii, Scene 2

In November, the Accounting Standards Oversight Council, keeping a steady hand on the tiller and steering wide-eyed between the shoals, reconfirmed its support for IFRS as well as for Canada's plan to require publicly accountable enterprises ("PAEs") to adopt IFRS as Canadian GAAP.

So what about financial reporting by non-publicly accountable enterprises? As we've mentioned in earlier editions of *Financial Reporting Release,* these companies will have the choice of following either IFRS or a new GAAP that the Accounting Standards Board ("AcSB") is developing especially for them by adapting existing Handbook standards. If the Board determines that the cost of applying a particular standard exceeds its benefits to private company financial statement users, some pruning will result, and in some cases, considerable pruning. As a generalization, there will be much less emphasis on fair value accounting and disclosures. This new GAAP thus may bear a greater resemblance to GAAP of many years ago than GAAP of today.

IFRS for Canadian PAEs and the new GAAP for private companies are set to hit the streets in 2009, with adoption permitted in both cases before 2011.

A word of caution: GAAP for businesses in the public sector has yet to be sorted out. In December, the Public Sector Accounting Standards Board ("PSAB") announced it will be seeking additional input from constituents before finally deciding whether government business enterprises and business-type organizations will have to apply IFRS.

Observation. The AcSB elected to develop a special Handbook-based GAAP for private companies rather than import the newly minted "IFRS for private entities", which is scheduled for release in 2009. Over the medium- or longer-term, Canadian policy-makers must face the question of whether these two GAAPs should be reconciled, or kept as strangers forever. Hmm … Haven't we heard that question somewhere before?

The Future of Canadian GAAP – NPOs

Our hoard is little, but our hearts are great – Alfred, Lord Tennyson, *The Coming of Arthur*

NPOs have always been the lost souls in Canadian financial reporting. No more. Late in December, the AcSB and the PSAB issued a joint Invitation to Comment on their tentative plans for future financial reporting by these entities.

The AcSB proposes that NPOs in the private sector use IFRS or GAAP for private companies, supplemented by the existing financial statement requirements for NPOs already in the Handbook. However, unlike the requirements for publicly accountable enterprises, IFRS would not be mandatory for any private sector NPO. Rather, each would make its own decision as to whether to apply IFRS or private company standards, based on its own assessment of which set of standards best meets its reporting obligations to its financial statement users. This choice, as well as the reasons for it, would be included in the NPO's accounting policy disclosures. A practical issue with IFRS is that the standards weren't developed with NPOs in mind and contain no specific guidance for these entities.

For public sector NPOs, such as schools, hospitals, colleges and universities, PSAB has tentatively concluded that Canadian public sector accounting standards, or those standards supplemented by existing Handbook standards for NPOs, might be appropriate. Regardless of which of these alternatives PSAB ultimately chooses, the result will be a departure from existing GAAP – NPOs in the public sector traditionally have used the same GAAP as private sector NPOs.

The boards are requesting responses on their Invitation to Comment by June 30, 2009.

Observation. In considering the Invitation to Comment, constituents should give thought to whether the constraints on private company GAAP, such as reduced disclosure requirements, are so significant as to preclude their use by NPOs. We also wonder why NPOs that choose to apply IFRS are being left on their own to figure out how to do it. Might a better approach be to supplement IFRS with the existing Handbook requirements for NPOs? Or, preferably, perhaps use supplemental GAAP consistent with IFRS, as we understand has been done in some other parts of the world?

The Future of US GAAP

The shortest distance between two points is usually under repair – Unknown

What's that you say? What's happening with IFRS in the US? In November 2008, the US Securities and Exchange Commission ("SEC") issued for comment a suggested roadmap for transitioning to IFRS. Sort of. Loosely translated, the proposal says "Look, IFRS standards, funding, oversight and some other stuff like XBRL have to be improved a bunch before we can even think of getting rid of US GAAP for domestic financial reporting purposes. Also, we've got to increase the level of US experience with IFRS and bring education systems up to speed. Let's wait until 2011 to see how things shake out and we'll decide what to do then".

There's one exception to this strategy. A US registrant, one of the 20 largest in its industry, would have the choice of using IFRS, provided the other companies in its group use IFRS more than any other basis of accounting. If enacted, this option would be available starting in 2010.

The suggested roadmap doesn't affect the SEC's earlier decision to allow foreign registrants that prepare their primary financial statements using IFRS to file the statements in the US without reconciling to US GAAP. That means, as a general rule, that Canadian SEC registrants can drop US GAAP reconciliations as soon as they adopt IFRS.

If the SEC does decide to move over to IFRS in 2011, domestic US companies would transition to IFRS over a three year period. The biggest companies would adopt IFRS in 2014, the large companies in 2015 and the rabble in 2016.

The roadmap was the baby of the outgoing Chair of the SEC, Christopher Cox. Whether the incoming Chair, Mary Schapiro, will embrace the roadmap with the same level of affection and enthusiasm remains to be seen. At her confirmation hearing, she commented on issues identified in the roadmap, such as the lack of details in IFRS and the fear that the switch may be too expensive for companies during the financial crisis. She was also worried about the International Accounting Standards Board's ("IASB") independence. Her parting shot: "I have some concerns about the roadmap that has been put forth by the SEC. I will tell you I will take a big, deep breath and look at this entire area again".

Observation. Canada's plan to migrate to IFRS was developed independently of the US and before the SEC started to consider IFRS for domestic reporting purposes. We therefore don't think a decision by the SEC to reassess its roadmap would have any implications on Canada's timetable. We've charted our path; the US's is yet to be fixed.

Fair Value Accounting

It's Alright, Ma (I'm Only Bleeding) – Bob Dylan, Song title

Surprise! The IASB and the FASB have been taking a hammering about fair value accounting.

Things got so bad at one point that the G20 was asked to consider whether the IASB's mandate should change to include promoting financial stability (that's code for "Back off on fair value, buster!") and the US government demanded that the SEC reflect on whether fair value accounting really was the devil incarnate. On the other side of the fence, the Chairman of the IASB started to mutter publicly about resigning, and various movers and shakers around the world voiced support for the transparency that fair value accounting provides.

The upshot of all of this? Some give, some take. Fair value accounting hasn't been abandoned by any means, but standard-setters have taken some urgent action to address concerns. Here's a quick blow-by-blow summary:

- The IASB amended its financial instrument rules to give entities the option of yanking certain financial assets that were no longer being held for trading out of their trading book. While this was done in the name of conforming IFRS to US GAAP, the result was that financial institutions were able to avoid recognizing significant declines in the fair value of these assets that occurred in the last half of 2008. We're not talking chump change here.
- The IASB and the FASB rushed out more user-friendly guidance on how to estimate fair value in illiquid markets.
- The IASB proposed amendments to improve disclosures about liquidity and fair values.
- The FASB will clarify the need to account for certain types of credit default swaps embedded in structured financial products under US GAAP.
- The IASB and the FASB are considering improvement of impairment standards affecting investments in debt instruments. More on this on the next page.
- The two boards have committed to fast-tracking a comprehensive project to re-examine the role of fair value measurement for financial instruments. This project is supposed to take months, not years.

In Canada, the AcSB immediately amended Canadian GAAP by issuing guidance on estimating fair value and proposing changes to its disclosure rules on liquidity and fair value to align with moves by the IASB. It's also keeping a watching brief over the IASB and the FASB proposals and other developments.

Observation. Historically, the debate over fair value accounting has been waged almost solely over concerns about its reliability. The credit crisis emphasized another concern – whether fair values in depressed markets are the most relevant consideration for all financial statement users and their differing needs. Since this is one of the fundamental debates in accounting, we don't see any final resolution coming anytime soon. Like our friend Dave, maybe the best thing to do would be to sit back, relax and have another pop.

Asset Impairment

I am two with nature – Woody Allen

We've got news. Big news. Standard-setters are reconsidering the rules for impairments in investments in debt securities. OK, OK, so the project's narrow in scope. Pay attention anyway. It raises the issue whether impairment rules for other assets, such as goodwill, will also need revision.

Debt securities are corporate bonds, government debt, and the like. Debt instruments look, taste and feel like loans, and you account for investments in them the same way – with one important exception. If a debt instrument is impaired, you've got to write it down to, wait for it now – fair value. Impaired loans, however, you write down only to the amount of cash you expect to realize, discounted at the loan's original effective interest rate. This has caused much wailing and gnashing of teeth.

The IASB and the FASB propose a unique response for 2008 financial reporting – entities would continue to apply existing GAAP for income statement purposes but disclose in the notes what their pre-tax income would have been had they measured debt investments like loans. What good is that, you ask? Why, you've got an alternative GAAP income measure to use in explaining your results – it allows a sort of, "on the one hand, on the other hand" type of discussion. There's a catch, though – you'd also have to disclose what the income would have been if you'd been measuring debt instruments and loans at fair value. Also, folks might be confused about seeing three different GAAP measures of income.

The IASB and the FASB are also thinking about relaxing their respective restrictions on reversing impairment losses if an investment in a debt instrument recovers.

We expect the AcSB will change Canadian GAAP to conform to any revised IASB and FASB requirements in this area, but at this late date, it's unlikely anything could be done in time for 2008 reporting.

Observation. Accounting standard-setters never have been able to sort out whether you should be paying more attention to fair value or expected future cash flows in assessing assets for impairment. The anomalous treatment of investments in debt instruments and loans is only one example of this issue. Want another? Under existing Canadian GAAP, you assess goodwill for impairment based on fair values, but fixed assets based on expected future cash flows. While you can have heated arguments as to which impairment model is more appropriate, one thing is reasonably clear: using two approaches for similar kinds of assets is one too many.

Derecognition and Consolidation

It is no use to blame the looking glass if your face is awry – Nikolai Gogol, *The Inspector General*

Don't look now, but questions about the accounting rules for asset derecognition and consolidation have hit the headlines again. That's because of structures used by financial institutions and others which have resulted in liabilities, and their related assets, being kept off-balance sheet.

How are standard-setters responding? By tightening existing rules or issuing new ones. For example, the FASB is amending its existing standards to make it harder to account for securitizations of loans, receivables or other financial assets as sales and to increase the likelihood that somebody, anybody, will have to consolidate special purpose entities (the more technically inclined call them "variable interest entities"). Look for the changes to be effective for 2010.

There's action in IFRS land as well. The IASB has rushed out an exposure draft on consolidation. Expect another one on asset derecognition shortly. Under the basic model in the exposure draft, you'd have to consolidate another entity whenever you've got the power to direct that entity's activities to generate returns for yourself. While the rules appear to be consistent with Canadian GAAP in many respects, there are some differences. For example, an entity holding less than a majority of the voting shares of another entity, but a lot more than anyone else, would have to consolidate that entity if the holders of the other shares are widely spread and haven't organized themselves to frustrate the dominant shareholder's use of its power. Think of the House of Commons, minority governments and coalitions, and you'll get the drift.

We expect final IFRS standards for consolidation and asset derecognition to be issued in 2009 with probable effective dates of 2010 or 2011.

In Canada, there's no move afoot to modify standards because of the impending move to IFRS. If you don't like this approach, you'll have the chance to throw your two cents in – the AcSB is issuing an exposure draft of the IFRS consolidation rules, but proposes not to make them effective until an entity crosses over to IFRS.

Observation. The AcSB's proposal is the only realistic option. Any other would lead to multiple changes to GAAP within the space of a couple of years – that can't be good for anybody.

Impact of Current Market Conditions on Disclosure

Cappy: Bullwinkle, allow me to be frank.
Bullwinkle: Okay, Frank. Allow me to be Bullwinkle – The Adventures of Rocky and Bullwinkle

This is the last bit about the credit crunch. Promise.

In early January 2009, the Canadian Securities Administrators ("CSA") published a staff notice reminding issuers about the need for clear disclosure to help investors understand the impact of current market conditions on issuers' operations, financial condition, liquidity and future prospects.

Here's a summary of the CSA's recommendations:

- Discuss specific economic factors affecting the industry and performance in the MDA.
- For entities facing going concern issues, make appropriate disclosure of the material uncertainties in the financial statements.
- Supplement financial statement going concern disclosures with MDA discussion to provide further insight into management's assessment and planned strategies, or known events that might mitigate uncertainties.
- Assess the need for asset write-downs in accordance with applicable accounting requirements.
- Review valuation techniques used in fair value estimates to ensure that they are based on assumptions that are appropriate in the current market conditions.
- For income trusts, carefully consider CSA requirements relating to distributable cash flow.
- Comply with CSA requirements for the use of non-GAAP financial measures.

For more guidance on non-GAAP measures, refer also to the October, 2008, CICA Canadian Performance Reporting Board's publication, *Improved Communication with Non-GAAP Financial Measures, General Principles and Guidance for Reporting EBITDA and Free Cash Flow.*

Recent comment letters from the CSA and the SEC also have focused on financial reporting and disclosure issues arising from current market conditions.
The December report of the Alberta Securities Commission on its 2008 continuous review program provides a helpful summary of common reporting deficiencies and suggestions for improvements.

Observation. Be sure to carry out a frank and discriminating review of your accounting and disclosure about the effects of the credit crunch; you can bet that securities regulators will be doing the same.

Discontinued Operations

Include me out – Samuel Goldwyn

In September, the IASB and the FASB issued joint proposals to change the criteria for determining when an entity should apply discontinued operations accounting ("DOA").

DOA involves presenting net in the income statement the revenues and expenses of any operation an entity has sold in the year or has decided to sell, together with any gain or loss on disposal. Ditto for related assets and liabilities on the balance sheet. The thinking here is that by segregating discontinued operations, financial statement users will have a clearer picture of what the ongoing revenues and expenses of the entity will be. It's a "less is more" sort of thing.

DOA has had a long and checkered past. In the old, old days, you could only apply DOA to business operations that you reported as business segments in your notes. This practice drew criticism that some major disposals were being left in continuing operations, and distorting analysis. So, a few years ago, the rules under Canadian and US GAAP bounced way over to the other extreme – any operation, no matter how small, that the entity truly walks away from, qualifies for DOA. More criticism, this time that too much was being included in discontinued operations, and not enough was being left in continuing operations. What financial statement users really want, it appears, is for disposals representing strategic shifts in the business plan to be treated as discontinued operations.

The IASB and the FASB exposure drafts propose a sort of middle ground solution – DOA would apply to disposals of any of an entity's "operating segments". Operating segments are those business units of an entity important enough for the CEO to review the results separately in deciding how to run the business. DOA will also apply if you acquire a business operation as part of a larger acquisition that you've got no intention of keeping. The timetable for issuance of a final standard is the second quarter of 2009.

So when is this coming to Canada? The AcSB originally planned to make these requirements effective as soon as the IASB and the FASB did. The AcSB has since concluded that the implementation of any new requirements should be deferred until an entity changes over to IFRS.

Observation. We agree that existing discontinued operations accounting needs improvement. We expect there will be ongoing debate whether it's appropriate to use operating segments as the basis for distinguishing strategic changes.

Earnings per Share

Read the directions and directly you will be directed in the right direction – Lewis Carroll, *Alice in Wonderland*

The basis for calculating earnings per share (“EPS”) under Canadian GAAP might soon change. Thought you’d like to know.

In October, the AcSB issued an exposure draft proposing adoption of existing IFRS requirements for calculating earnings per share, but only after the IASB and the FASB have amended their respective standards to simplify and further align them. The proposals call for Canadian companies to apply these rules after the IASB and the FASB have made their amendments. This is scheduled for 2009, so you may be seeing a change to EPS requirements earlier than you might think. The proposed timing for implementation of the change in Canada is a departure from the AcSB’s usual practice of deferring global GAAP changes until an entity converts to IFRS.

The sole focus of the project is the denominator in EPS calculations – how many shares you divide earnings by to get basic and diluted EPS. The exposure draft lists seven principal differences between the revised IFRS and existing Canadian GAAP for calculating EPS. These are rather technical in nature. One example is the use of period-end rather than average share prices to calculate diluted EPS.

Observation. While the changes are technical in nature, it would behoove you to take the time to understand the possible impact on your EPS calculations now. Forewarned is forearmed.

Revenue Recognition

Lucy: Do you think anybody ever really changes?
Linus: I've changed a lot in the last year.
Lucy: I mean for the better – Charles Schulz, *Peanuts*

Just before year-end, the IASB and the FASB issued for comment a joint discussion paper on revenue recognition. This is a precursor to an exposure draft, sort of a "What do you think about this idea"? Exposure drafts are a lot more definitive than discussion papers about where things are going. Not quite written in stone, perhaps, but almost.

The aim of the revenue recognition project is to establish a single model for recognizing revenue from contracts with customers. It doesn't matter which industry you're in, you'd still have to follow these requirements.

Under the proposals you'd have to:

- Recognize revenue when you perform under the contract. Performance means the customer has control of the asset or has received the service you promised to deliver.
- Measure revenue at the contract's "transaction price" – that's fancy accounting double-speak for the amount specified in the contract that the customer has to fork over when you've done whatever you said you'd do.
- If you've promised to do more than one thing under the contract, split the transaction price using the relative stand-alone selling prices of each of the things you promised to do.
- Allocate some portion of the transaction price to warranties and post-delivery services. No more accruing for these obligations based on your estimated costs of honouring them.
- Recognize a loss on the contract whenever the cost of delivering a product or service is more than the transaction price.
- Forget about deferring sales commissions until you recognize the related revenue – no matching allowed.

An exposure draft is expected in 2010 with the final standard scheduled for 2011.

Observation. The revenue recognition model being proposed carries forward many of the principles that form the basis of much of existing Canadian GAAP. Nevertheless, there are some significant changes, and different industries will be affected differently. If you don't like some of the changes, think hard about hollering now. If you wait until the exposure draft comes out, it may be too late.

Financial Statement Presentation

Did you ever wonder if the person in the puddle is real, and you're just a reflection of him?
– Bill Watterson, *Calvin and Hobbes*

In October, the IASB and the FASB issued a discussion paper suggesting standardization of the way that entities present their financial statements. Under the proposals you'd have to:

- Use the same basic captions throughout the financial statements – business (operating and investing), financing, income taxes, and discontinued operations.
- Split assets and liabilities on the balance sheet and under each heading between current and non-current, unless an entity considers presentation in order of liquidity to be more informative.
- Report a statement of comprehensive income ("CI"), not a statement of net income. CI includes certain gains and losses that usually don't find their way to net income until later periods (e.g. exchange gains and losses on foreign subsidiaries). Don't despair. You still get to report a sub-total for net income and calculate EPS based on this number.
- Disaggregate revenues or expenses in the income statement by their function (e.g. selling goods, providing services, manufacturing, marketing, etc.). Further sub-divide revenues and expenses by their nature (e.g. breaking cost of goods sold between materials, labour, transport and energy costs) if this is helpful in predicting future cash flows.
- Use the direct method for determining cash flows from operating activities in the statement of cash flows, not the indirect method. What this means is, presenting operating cash receipts and cash payments rather than reconciling net income to operating cash flows.
- Reconcile the income statement to the statement of cash flows on a line-by-line basis in the footnotes. That reconciliation would disaggregate the individual lines on the statement of CI into their cash and accrual components. The accrual components would be broken down further between fair value remeasurements and other accruals and allocations.

An exposure draft is expected in 2010.

Observation. Would the vision of reality reflected by financial statements be improved by moving to a completely different style of income presentation which eliminates, or at least blurs, distinctions between net income and CI? This will be addressed in a separate phase of the project. Bet you just can't wait.

Financial Instruments – Canadian Private Enterprises

You have delighted us long enough – Jane Austen, *Pride and Prejudice*

Back to financial instruments for a minute. This time, though, you're guaranteed to walk away with a smile on your face – if you're a private company, that is.

Mindful that GAAP for Canadian private companies will be different than existing Canadian GAAP, the AcSB gave private companies an early Christmas present in late November – the option of not having to adopt Section 3855 and other financial instrument standards that public companies had to adopt in 2007. Requiring private companies to adopt these standards in 2008 seemed more than a little churlish to the AcSB, especially when a new private company GAAP is supposed to be up and running by 2009.

The AcSB even had a present for those private companies deciding to stick with Section 3855. It amended that standard to provide private companies elective relief from some of the harder bits. NPOs also got the right to avoid new disclosure rules otherwise applicable for 2008.

The reaction by private companies to all of this? "Yippee"!!!

Observation. Sooner or later this particular song had to die. Sooner was better.

Emerging Issues Committee Abstracts

Here's a summary of Abstracts the EIC has been working on since our last issue. Oops, there's only one.

EIC-173*, Credit Risk and the Fair Value of Financial Assets and Liabilities.*

This Abstract, which is expected to be issued by the end of January, requires entities to take both counterparty credit risk and their own credit risk into account when measuring the fair value of financial assets and liabilities, including derivatives. This can result in gains and losses on the measurement of liabilities that appears to be counter-intuitive to many, i.e. deteriorations in the entity's credit standing will produce gains while improvements will produce losses. The Abstract will be effective for interim and annual periods beginning on or after January 1, 2009 for entities that apply Section 3855, and for 2010 financial statements for those entities that do not.

Observation. The EIC confirms existing Handbook requirements. However, in practice, derivatives usually have been valued using models that make standard assumptions about credit risk. It would appear that the Committee gave companies a three month grace period to modify systems and controls. Under US GAAP, counterparty and own credit risk must be reflected in December 31, 2008 valuations.

For more information …

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