Financial Reporting Release – January 2014

Keeping your head above water...

Recent issues in financial reporting

In this issue

When Canada was in the process of deciding whether to adopt IFRS, we can recall confidently saying that such were the forces of globalization that in one sense it didn't much matter, that it wasn't a question of whether the world's accounting standards would converge, it was when. Serves us right for making predictions!

It was over a decade ago now that the IASB and FASB established their joint program to improve and align IFRS and US GAAP. Originally designed to bring the two GAAPs together on a fast track basis, and keep them aligned, it soon settled into the accounting equivalent of long-term trench warfare. The results have been mixed. Sure, there have been a few spectacular successes, but there have been some rather spectacular failures too. You'll see vivid examples of both as we review the status of the convergence projects the boards are still working on—revenue recognition, insurance, leases, impairment, and financial instruments.

With the program drawing to a close, is there a way forward? We expect that it will come as little surprise that expectations and visions on this score differ rather wildly. If there's broad agreement on anything, it's that the past doesn't provide much of a roadmap for the future. What are the alternatives? Read on, dear reader, read on.

Convergence is usually described as bringing US GAAP and IFRS closer together. But that's too narrow a perspective. The same pressures and tensions that come into play in attempts to bring these standards closer together also rear up within the confines of IFRS, as individual countries and regions using these standards do their best to influence their development and impose their particular vision on this world. The stakes are high, and the tactics sometimes can be surprising, as we are about to see. So too is the ground on which battle now is being waged—the IASB's project to improve its Conceptual Framework.

Some of the consequences of non-convergence are on display in this Issue too. The IASB's long awaited hedging standard finally is out—alas, for those of you eager to adopt it, you'll still have to wait a bit. A perennial favourite, rate regulated accounting, is back for yet another appearance, by popular demand (don't groan). There's a new one as well, levies, that has the potential for upsetting more than a few apple carts.

And there you have it. Everything you need to know to be au fait with what's going on in the public company accounting world today. Is there anywhere you'd rather be?

The future of GAAP convergence

"Have you ever noticed that anybody driving slower than you is an idiot, and anyone going faster than you is a maniac?"

– George Carlin

Wither global GAAP convergence?

The IASB and FASB program to converge their respective standards is almost over, or so they say. Though much remains undone, as we shall see, neither board has any inclination to extend the program. If the familiarity that comes from the boards working together on it for more than a decade hasn't bred contempt, it has produced a healthy respect for the benefits of mutual independence. Nonetheless, both the IASB and FASB continue to support the goal of more harmonized global accounting standards, but with uncertainty about what the objectives are and how to achieve them.

The newly installed chair of the FASB, Russ Golden, has been proposing a new model recently. Let the national standard setters of the major capital markets and the IASB co-exist and work co-operatively together, he says, to bring their standards closer together. Let us build stronger inter-relationships and exchange perspectives and concerns. But let us also acknowledge that sometimes it's necessary to accept non-converged solutions to protect the integrity of those markets and national business cultures.

The IASB didn't take long to push back—strongly. The Chair of the IFRS Foundation (the overseer of the IASB), Michel Prada described that vision at various times in a speech he made at a conference as a "false premise", "regrettable step backwards" and recipe for global divergence that was the dominant characteristic of the pre-IFRS world. He also expressed skepticism about cultural differences providing the basis for divergence. If the accounting preferences of France, Germany and the United Kingdom could be bridged by IFRS, Prada asks, then why not the EU, Japan, the United States and other parts of the world?

PwC observation. The Golden vision of the world directly challenges IFRS orthodoxy that IFRS always brings global benefits that outweigh the local dislocations and disruptions that their use can produce. Small wonder, then, that his views provoked the response it did. On the other hand, it's not that some IFRS countries and regions haven't been raising similar issues already. Turn the page and see what we mean.

The future of IFRS

"I always wanted to be somebody, but now I realize I should have been more specific."

– Lily Tomlin

They did what?

That's the question that reverberated throughout the accounting world late last year when the European Union tabled draft legislation proposing to make its annual contribution to the IASB's funding conditional upon the Board making certain changes to its Conceptual Framework that Europe wants (more on this on the following page).

If the move was designed to grab the IASB's attention, it worked. The Chair of the IASB, Hans Hoogervorst, publicly accused the EU of threatening the Board's independence and worried about the impact of the move in other jurisdictions. Threat, what threat? responded the EU. Nevertheless, it subsequently decided to provide funding without any legislative strings attached.

PwC observation. It is perhaps no accident that the EU proposal happened at a time when demands in Europe are getting louder to have much more of a say over the development of the standards it uses. Europe, we suspect, is not alone in this attitude. Indeed, we expect that pressures on the IASB will only grow as other countries and regions, newer to IFRS, also seek to have more of a say over its development. Consider, for example, that China, Japan and South Korea, have recently signed a pact to work together to have their shared views "better reflected in IFRS" and increase the global prominence of the Asian Oceanian Standard-Setters Group. At the risk of belabouring the obvious, how successful the IASB is in balancing and reconciling competing demands of regions and countries will determine IFRS's long-term success as a set of independent, high quality global accounting standards. This will be no easy task, of course. When everybody wants to be a somebody, something often cracks.

The Conceptual Framework

"If you can't get rid of the skeleton in your closet, you'd best teach it to dance."

– George Bernard Shaw

Why was the EU so exercised about the Conceptual Framework that it toyed, however briefly, with making its funding of the IASB conditional on the Board changing it? It's because Europe thinks that changing the Framework is critical to the future of standard setting, at least the way it thinks it should be done.

For those unfamiliar with it, the Framework sets out the basic financial statement concepts the IASB's supposed to consider in developing standards and other accountants are supposed to apply in following them. Not quite a Platonic dialogue setting out the higher ideals for living the good life, but close.

A year or so ago, to general applause, the IASB added to its agenda a project to improve the Framework. Around the middle of last year, it issued preliminary views on a series of fundamental reforms. Chief among them were proposals to add much more specific guidance in certain areas and the Board promising, hand over heart, to follow it much more rigorously than before. Some worry that these proposals risk turning the Framework from a document of higher aspiration into a rigid blueprint, a constitution if you will, for developing standards which will hamstring the Board's ability to make decisions in the future. Others say, "Good!"

Europe wants the IASB to do even more—reinstating traditional financial statement objectives of "prudence", "stewardship" and "reliability" it eliminated a few years ago in favour of "neutrality" and "faithful representation". Europe's vision is that a Framework based on the old values, if consistently applied, would stop, perhaps even reverse, the unwarranted spread of financial statement volatility (that's code for putting the brakes on fair value accounting), provide information that's more consistent with the way businesses operate, and allow companies to take the long term view in their business activities. All of which is near and dear to European hearts. And some Canadian ones as well, dare we say?

PwC observation. The IASB stuck the traditional financial statement values into the closet on the grounds that the primary objective of financial statements should be to tell it like it is in as a neutral and unbiased manner as possible. Europe wants them brought back out at least in part because of its view that GAAP should be serving the public interest in other ways as well, such as promoting economic stability. A major factor influencing that position is its determination never to have another round of public bailouts of banks and other financial institutions such as happened during the financial crisis. All of which explains, we believe, why it's fighting so hard. Much as it might appear otherwise, concepts can have real-life consequences.

Revenue

"Don't wonder why it takes elephants so long to produce offspring, only marvel that it happens at all."
– Ancient African proverb

Last November, after 12 years, 12 long years, the IASB and FASB dashed their pencils to the ground and let loose a mighty cheer. Why? Their long and difficult labour to produce an improved and harmonized standard on revenue from contracts with customers was finally over. Look for the Boards to be parading their new baby around in public sometime this quarter. Like all proud new parents, they'll be hoping you stop them in the street and coo and fawn over the child.

What are the major changes? At a quick glance, you'd think nothing much at all—the basic principles remain intact. A closer examination, however, reveals far more prescriptive guidance. As a result, companies still may be facing some difficult transition issues. This can include having to:

- Use different criteria for determining whether a contract's terms are substantive enough to justify revenue recognition.
- Recognize some types of revenue either earlier or later in the process than now, especially for contracts whose price isn't fixed on day one.
- Change the basis for identifying separate deliverables in a contract and allocating the overall contract price to those deliverables.
- Apply a new framework for accounting for contract modifications.
- Consider using different milestones for determining percentage of completion on long-term contracts.
- Capitalize and amortize the costs of obtaining and fulfilling contracts rather than immediately expensing them.

Companies also will have to present bad debt expense "prominently" on the face of their income statement (as a separate line after the gross margin) and provide significant additional disclosures. The latter include disaggregating the revenue line shown on the income statement, reconciling opening and closing contract asset and liability balances (e.g., trade receivables) and providing more information about performance obligations.

PwC observation. The new standard is proposed to be effective starting in 2017, but… You may need a lot more time than you might think to understand the requirements, assess impacts, revise processes and controls, change business practices, commissions and other compensation programs, etc. It'll take money too. Indeed, we're already hearing worries that in some industries the cost of implementation will be more than that spent on transitioning to IFRS altogether. Best practice for larger companies likely to be impacted would be to form a special project team to consider the standard, assess the implications and oversee implementation. But you already know that.

Hedging

"Ambiguity is something I really respond to."
– Robert Redford

This time last year we told you that new rules for hedge accounting were on the verge of being issued; these got out the door in November of last year. Silly us. We should have remembered that accounting time always runs more slowly than any other.

Invoking hedge accounting allows you to overturn GAAP that otherwise would apply so that offsetting gains and losses on the hedged item and the hedging item in the income statement get recognized in the same period. The IASB changed its rules in this area in response to long standing complaints that existing GAAP are too complicated for mere mortals to understand, and don't always allow companies to report results on a basis that's consistent with the way they manage their risks economically. With simplification as its motto, the new standard provides the following relief:

- It allows hedge accounting for certain management strategies that weren't previously eligible (e.g., crude oil as a component of jet fuel).
- It makes hedge effectiveness testing less onerous and arbitrary and more qualitative. Certain relationships that are economically sensible, but not perfect enough to have achieved hedge accounting under the previous standard will now be allowed.
- It allows more intuitive and less volatile accounting for the premiums and other costs paid to acquire a hedge (including "forward points" and "option time value").

There are also, of course, extensive new disclosure requirements designed to make risk management and hedge accounting activities more transparent.

PwC observation. What do you have to do before you can use the new rules? First, early adopt revised IFRS 9, the IASB's new standard on financial instruments, where the revised requirements reside. Second, revise your existing hedge documentation to comply with IFRS 9 requirements. Third, wait for the Canadian Accounting Standards Board (AcSB) to translate and formally authorize the revisions for use in Canada (expected to be sometime this first quarter). IFRS 9 can have significant knock on effects, particularly for entities with complex financial instruments, and parts of the standard are still under renovation (e.g., loan impairment, classification and measurement of financial assets, which, lucky you, we will be discussing shortly). As usual, it's necessary to look before you leap.

Rate regulated accounting

"As a child my family's menu consisted of two choices: take it or leave it."
– Buddy Hackett

This is another tangled saga of love and hate and sorrow. We've talked about it before, many times, but we've got some important updates. First, the IASB has approved an "interim" IFRS that would allow, but not require, Canadian rate regulated enterprises (RREs) to transition to these standards using special North American style accounting for rate regulation (RRA); this pending the completion of a long-term project by the IASB on whether RRA is appropriate under IFRS. Second, the Canadian Accounting Standards Board confirmed that Canadian RREs will have to adopt IFRS starting in 2015. No ifs, ands or buts. Well, there's one, which we'll come to later.

There are some continuing issues, of course. One is that the IASB's interim rules would require a RRE to provide financial statements showing the results as if they weren't applying RRA with one line adjustments at the bottom of balance sheet and income statements showing the net effect of this accounting. It's a kind of "with and without" presentation, and weird. Another, of course, is that it's possible that the IASB might conclude that RRA isn't appropriate at all or needs to be substantially modified. Not a particularly happy prospect for an industry that embraces RRA with all the fervor of old time politics.

PwC observation. The AcSB spent a lot of capital getting the IASB to issue the interim standard and put the longer term project on RRA back on the front burner. While some in Canada have accepted the "Canadian compromise" with relative equanimity, others are more doubtful about the IFRS temporary solution and the prospects of a permanent one. A few years ago, when the threat of Canadian RREs losing RRA as the result of having to adopt IFRS was at its peak, Canadian Securities Administrators offered publicly listed RRE's the opportunity of transitioning to US GAAP instead of IFRS—unlike IFRS, US GAAP specifically requires RREs to apply RRA. Most RREs that could chose to take this relief. It expires at the end of this year, but some have already obtained another deferral from their regulators. This one is effective until the earliest of 2019, the date that an IFRS standard on rate regulation becomes mandatory or when an entity's rate regulated operations cease. Once it expires, the only way RREs can continue to use US GAAP would be to decide to register with the SEC.

Levies

“Drove my Chevy to the levee, but the levee was dry.”
– *American Pie* by Don McLean

This is one where we don’t know whether to laugh or cry. Well, actually we do know.

Last year, the IFRS Interpretations Committee issued an interpretation that governs when “levies” should be recognized as liabilities. Levies are defined in rather arcane terms but essentially refer to payments to governments prescribed by legislation (excluding things like income taxes for which authoritative guidance already exists). The poster child of a levy, at least in Canada, is property taxes. Other examples include CRTC fees, capital taxes and some payments to First Nations. The Interpretation requires that a company recognize a liability for a levy when, and only when, the triggering event specified in the legislation occurs—recognition at an earlier date is verboten, even if the entity has no realistic opportunity for avoiding the triggering event. While all of this sounds fairly innocuous, applying the principle in practice is proving to be challenging. Counter-intuitive answers are popping up under first readings. Take property taxes for example. The accounting for these payments has never been in dispute—you accrue them over the period to which they relate, right? Well, maybe. Under the Interpretation, a question arises whether recognition in some later period is required—only when the interim or final bill is payable, perhaps? The concern is that ownership of property over a period may not be the triggering event for becoming liable for the payment of the taxes for that period; it may be who owns the property at the payment due date. Once accrued it may also be necessary to expense rather than defer the amount recorded for the liability. When is the Interpretation effective for Canadian companies? Why the first quarter of 2014. There’s not a lot of time to get things sorted.

PwC observation. The IFRIC developed a rule of general application derived from a consideration of a small number of rather narrow fact patterns. Its wider implications are being discovered only now. We and others in the Canadian accounting community are working as hard as possible to clarify the scope of the Interpretation and its impact on certain types of payments, including property taxes. We should also mention that the European Financial Reporting Advisory Group has yet to endorse this standard. This means that European companies can’t apply it yet for 2014. So, once again, Canada is first out of the gate... as usual. Not that we’re bitter or anything…

Own credit

"I went to a restaurant that serves 'breakfast at any time'. So I ordered French toast during the Renaissance."

– Steven Wright

This is mainly intended for those of you that have elected to measure some financial liabilities at fair value and recognize changes in fair value in profit and loss as they arise. Those of you that haven't can flip over to the next page without missing anything. For the six of you that remain, here's the scoop.

If you're measuring financial liabilities at fair value you have to take changes in your own credit risk into account—if it increases, the measurement of your liability goes down and income goes up; if it improves, the value of the liability goes up and income goes down. Many find this a counter-intuitive and pernicious result.

In its new financial instrument standard, IFRS 9 (the one we mentioned when we were talking about hedge accounting a few pages ago), the IASB provided some relief. The Board decided that changes in fair value due to own credit risk should be put to other comprehensive income instead of the income statement. Remember, though, this relief is only when you voluntarily elect fair value measurement. When IFRS forces it on you, (for example, when the liability is a derivative), you've got to continue to take the entire change in fair value to the income statement, including the impact of changes in your own credit risk.

Late in 2013, the IASB changed its requirements to allow those that haven't yet adopted IFRS 9 (almost everybody in Canada) to use this accounting as well for financial liabilities they've designated at fair value—anytime you want. Once approved and issued by the AcSB, of course.

PwC observation. We know what you're thinking—if you don't have to adopt IFRS 9 to access the own credit rules, why do you have to adopt it to access the new hedging requirements? The IASB thought about it, but, alas, no dice. What can we say? You win some, you lose some.

Leases

“Life is hard. After all, it kills you.”
– Katharine Hepburn

Gather round, all of you that want an update as to what’s happening on the IASB and FASB’s joint initiative on leases.

The Board’s overarching objective in this project, as everybody and their mothers already know, is to get all leases on the balance sheet. That’s because a lease, the Boards have decided, economically represents the acquisition of an asset (effectively, the right to use it) and the incurrence of a liability from the lessee’s perspective. If it walks like a duck and quacks like a duck… says Hans Hoogervorst, the Chair of the IASB. You may also recall that the Boards issued a re-exposure draft last year proposing some modifications to their original proposals to make this accounting more palatable.

The Boards are now evaluating the responses it received. It’s fair to say, we think, that there’s not overwhelming support for a number of the major proposals and that more than a few have some fairly violent objections. Major concerns run from disagreement as to whether all or any leases give rise to assets and liabilities, to conceptual and practical objections about distinguishing property leases from non-property leases, to overall complexity. Indeed, some of the heaviest hitters in the game have recommended the Boards focus on improving disclosures at this stage.

PwC observation. Recent comments by the Chairs of the IASB and FASB suggest that the Boards, undeterred by any missteps it might have taken along the way, will press ahead to complete it, this time with a view to further simplifying things for lessees and easing the cost of implementation. As for lessors, muttering has begun that this part of the standard might be less of a priority and put on ice.

Impairment in loans and trade receivables

“Why don’t they make the whole plane out of that black box stuff?”
– Anonymous

If revenue is the poster child for global GAAP convergence, loan impairment is the opposite. For years now, ever since the financial crisis hit, the IASB and FASB have been scratching and scrambling to come up with a common standard for recognizing and measuring impairments in loans and other similar items. It is, says the G20 and many others, a global imperative for financial institutions. Trade receivables is much less of a priority, but have been swept into the same net.

Progress of a sort has been made. Both Boards agree that the existing GAAP of waiting to recognize an impairment loss until it is probable the borrower will default isn’t nearly good enough—too little, too late. Both also agree that the world should move to an expected loss model. (Note: “expected loss” doesn’t mean what anyone unfamiliar with the dark arts of accounting will think it means. It’s not the ultimate loss that you, well, expect to incur. Rather, it’s more what you’d lose if a default were to occur, multiplied by the probability of it happening. Because there almost always is some probability that a loan will default, almost every loan has an “expected loss” attaching to it from inception.)

The gulf between the Boards, and it’s a big one, is that they can’t agree on when to set up the allowance for expected losses and how much it should be. The FASB wants you to whack the income statement for the entire amount of the loss the moment you lend (you’d adjust this amount over time as estimates of the probability of the default and its consequences change). By contrast, the IASB wants this to happen only if and when there’s been a significant increase in the loan’s credit risk. Until then, you book only a portion of the expected loss, weighting it for the probability of default happening in the next 12 months. Because the chances of a loan going bust within a year of origination is usually a lot lower than the probability of default over its lifetime, the day one expense under the IASB’s model typically will be a lot lower than the FASB’s. For those of you that have only trade receivables to worry about, take heart, the IASB’s proposing some simplifications, but only to allow the full expected loss to be used...

The prospects of convergence, never bright over the past few years, dimmed even further late December when the FASB decided to pursue its own model as the basis for developing new US GAAP. The IASB hasn’t made a final decision about what to do yet, at least technically, but it’s already made it clear that it can’t accept the US position. It also wants to wind up its work on impairment this year. You do the math.

PwC observation. The sound you’re hearing is one of the world’s biggest GAAP convergence projects crashing and burning. As things stand now, it’s doubtful anything can be saved from the wreckage.

Classification and measurement of financial assets

"A day without sunshine is like, you know, night."
– Steve Martin

Revenue and loan impairments weren't the only convergence projects whose fate was decided in the past few months. So too was the Boards' project on classification and measurement of financial assets.

The project addresses the accounting for investments in marketable debt securities and other similar financial assets. The issue, as it always is when it comes to financial instruments, is when these assets should be measured at cost and at fair value (and if the latter, where changes in fair value are recorded). This issue is a very big deal for financial institutions, less so for others.

After the financial crisis hit, the IASB replaced its existing requirements with a new model, the aforementioned IFRS 9. Like hedging, the objective was to make financial instrument accounting simpler to understand and easier to apply. Broadly speaking, this standard permits cost measurement only for plain vanilla debt instruments that pay interest and principal and only if your business model is to hold them to collect the cash flows. Otherwise the heavy hand of fair value measurement comes down. A key consequence of the new model it introduces is the elimination of the previous IFRS requirements to split instruments that have sufficiently non-vanilla terms into two—an ordinary debt investment that often would qualify for measurement at cost, and a derivative that would have to be accounted for at fair value with changes recognized immediately in profit and loss. Instead, fair value accounting applies to the whole shebang. This can produce a more volatile result, but hey, into every life a little rain must fall.

Last year the FASB floated a trial balloon of adopting the basics of the IASB model for US GAAP purposes. After getting an earful from constituents, it backed away. Instead, it decided to retain its own existing principles for splitting non-vanilla instruments into derivative and non-derivative components. This decision is tentative but unlikely to change. The FASB may, however, rethink its rules for measuring non-derivative components and thus change the criteria for measuring things at cost. Or it might not.

PwC observation. First it was offsetting, then it was loan impairment, and now it's classification and measurement. Each time, one or other of the Boards, or both, have stared GAAP convergence fully in the face and recoiled. These are dark days for convergence fans.

Insurance contracts

"A lot of people are afraid of heights. Not me, I'm afraid of widths."
– Steven Wright

Memo to those of you that write insurance contracts—Any hope you might have had the IASB would see the light one day and, in the immortal words of Roseanne Roseannadanna, say abashedly "Never mind!" are fast receding.

Recent comments from the IASB suggest the Board is determined to press forward with its proposal to reform IFRS for these contracts notwithstanding deep anxiety in the insurance industry about the standard's complexity, financial statement volatility, and impact on business practices and products. As we write, the IASB is considering the comments it received on its re-exposure draft issued last year. That draft retains the overarching principle that's the root source of the industry's concern—insurance contracts have to be measured at their current value. Current value is a new basis of measurement invented by the Board especially for these contracts. Not quite fair value, but close. Call it a kissing cousin.

And the US? It's considering revamping its insurance standards separately. Increasingly, though, it seems a reluctant player and the rumours now are that it may be considering only targeted improvements rather than going whole hog and converging with the IASB.

PwC observation. Think the IASB project isn't contentious? In October representatives of the Canadian life insurance industry made a submission to the oversight council of the Canadian Accounting Standards Board urging the Board not to endorse any IFRS on insurance until its concerns are resolved. One other thing. As defined, insurance contracts include certain maintenance and service contracts written by non-insurance companies, including manufacturers, retailers, and dealers. If you're engaged in any activities such as these, it's time to arch an enquiring eyebrow in the direction of those truly in the know about whether this is something you should be worrying about. In other words, you may not think you have insurance contracts but could still be caught in the scope of the standard. Scope… financial statement effects… business impacts… politics… this project has every dimension.

For more information

This newsletter has been prepared for the clients and friends of PwC by National Accounting Consulting Services. For further information on any of the matters discussed, please feel free to contact any member of ACS, or your PwC engagement leader. This newsletter is available from the PwC Canada web site, which is located at www.pwc.com/ca/financialreportingrelease.

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