



*Keeping your head above
water ...*

Recent issues in financial reporting



In this issue

“The present tense made him nervous.” – William Gibson

Gather round. It's time, once again, for taking stock of what's happening in the Canadian financial reporting world. What? Is that a groan we hear? Stop it.

Indeed, if you're a fan of the status quo, we have good news to report – no major accounting standards or Canadian regulatory requirements were issued in the last six months or so, not even an exposure draft of one. The only sign of activity has been the release of a few technical amendments, clarifications and interpretations. These might excite the techies of the world, but not anyone who actually has a life.

Don't get too happy though – there are still plenty of things to worry about. Perhaps the most pressing is the prospect of having to adopt changes to International Financial Reporting Standards in the last few years that you were able to set aside when transitioning from old Canadian GAAP because of their delayed effective dates. Implementing these changes isn't mandatory until 2013, true, but that's now very near. Which of the new requirements are proving particularly troublesome to interpret and apply in practice? Which have potentially major income statement consequences? Are there other implications? We have some quick observations.

The other worry is that there are a lot of changes still in the hopper, major ones – like revenue recognition, leases, financial instruments, impairment, insurance and hedging. They're taking a little longer to finish than originally anticipated. Well, okay, a lot longer. Hence the lull in action. Confused about the reasons for the delays? Wondering where things are going and when the changes will be effective? Need something to talk about at the dinner table? We've got a status update that'll put you in the know.

The Canadian Securities Administrators (“the CSA”) have always carried our detailed reviews of the quality of companies' financial reporting and, IFRS transition notwithstanding, last year was no exception. We've summed up their findings on what you should be doing to improve your own reporting as well their priorities for their 2013 year's reviews.

Fans of the soap rate regulated accounting opera, never fear, we've got the latest. This time it's a good news show – a long-term solution may be at hand. We've also got a few new messages for Canadian SEC registrants. First, “Big Brother is watching!” Second, “Get ready” – auditors are about to engage you in a dialogue more than they ever have before. Way more.

And, finally, there are the developments affecting the International Accounting Standards Board and its quest to develop IFRS into a single set of high quality global accounting standards. Learn the latest about how well the IASB is faring in convincing the SEC to move the US over to IFRS, and its new strategic and agenda priorities. The game is about to change. Big time.

And there you have it. Everything you need to know in the next eight pages. Can it get any better?

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Upcoming IFRS Changes

*“I’m going to live through this even if it kills me.” – Klinger, M*A*S*H*

One of the downsides for Canadian companies that moved to IFRS in 2011 is that it came in the middle of the IASB’s and FASB’s joint program to improve and converge IFRS and US GAAP. The consequence is that they’ll be forced to change the IFRS they just adopted to give effect to any GAAP changes arising from the program that weren’t already in place at transition. The old double switcheroo! Ain’t life grand.

Here are the main changes, all effective for 2013:

- Consolidation – redefines when one entity controls another and so must take up the controlled entity’s assets, liabilities, revenues and expenses into its financial statements. This one affects not only special purpose entities (“SPEs”) and other structured arrangements, but operating companies too. A key feature of the new requirements is the concept of “de facto” control, under which holding of a large block of voting shares might be sufficient to trigger consolidation even if you don’t have a majority of the votes. Everything depends on how widely dispersed the other votes are.
- Joint arrangements – eliminates proportionate consolidation for “joint ventures” but permits it for “joint operations”. Which is which? Aye, there’s the rub.
- Disclosures of interests in other entities – requires more discussion of nature and risks. Please.
- Employer accounting for defined benefit pension and other employee plans – mandates immediate recognition of changes in the value of plan assets and liabilities in other comprehensive income, limits the rate of return on plan assets used in calculating pension expense to a high quality bond rate, even if the company expects to (and actually does) earn a higher one. Oh, there’s more disclosure too.
- Fair value measurement – reconciles diverse and sometimes conflicting guidance previously in IFRS about what fair value is and how to measure it. Some measurements may change as a consequence; e.g. some derivatives, liabilities, etc. Did we mention that there are more disclosures?
- Mining stripping costs – introduces rules for accounting for overburden by mining companies. These may not be a big issue given previous practice in Canada, but you never know till you look, do you? Dig deep.

pwc observation. *In practice, the rules relating to SPE consolidation and joint arrangements are proving to be the most difficult to understand and apply. Significant judgment and consultation often will be necessary. Also, some companies are using the rules on mining stripping costs as an opportunity to reconsider and refine aspects of their existing accounting.*

Other 2013 changes include presentation of OCI, disclosures about offsetting assets and liabilities, a few amendments to IFRS transition rules (relax, they apply only to new transitions), and some modifications to existing standards.

IFRS in the Pipeline

“Dese are da conditions dat prevail.” – Jimmy Durante

Alas, the 2013 IFRS changes on the preceding page are just the beginning – there’s much more in the pipeline. We provide a brief overview of the nature and objectives of these projects below. All of them, save one, are joint ones with the US, so when we say “the Boards” we mean the IASB and FASB working together. Well, sort of...

- Revenue – establishing a one-size-fits-all model for recognition and measurement. After ten years of study and debate (scary that), the (evil?) forces of fair value have been beaten back, and existing revenue recognition principles are largely being carried forward in triumph. Nevertheless, the new model will affect some companies, especially those relying on industry-specific guidance.
- Leases – putting all leases on the balance sheet as assets and liabilities (the project is also known as “death to all operating leases”). Some on both Boards now are threatening to vote against a compromise proposal designed to make it more palatable for the masses. Is this project in trouble? Maybe.
- Classifying financial assets – revisiting when you have to measure financial assets at fair value and whether changes in fair value go to the income statement or OCI, or both. The IASB got rid of OCI for financial assets when it bashed out a revised financial instruments standard in 2008 (still your beating hearts, it’s not mandatory until 2015) but the FASB still wants it and it looks like the IASB is going to agree, for convergence’s sake, of course.
- Impairment – recognizing and measuring loan losses using the so-called “three bucket approach” under which the losses get bigger as you move from bucket to bucket. Or maybe not. After consultation with constituents, the FASB has very recently decided the model just isn’t workable. It’s now going to develop a different solution all on its own, which it’ll then share with the IASB. And what’s the IASB going to do? We don’t know, but it’s not happy. Convergence in this area is critical to financial institutions. The Chair of the IASB has gone so far as to describe the prospect of the project’s collapse as an embarrassment to both Boards.
- Hedging – simplifying and expanding hedge accounting using a business model approach. This isn’t really a joint project – the only link to US GAAP is that the FASB has agreed to ask constituents what they think of the IASB solution at the same time it proposes something completely different. The IASB also has a “macro hedging” project on the go, something we suspect the US wouldn’t touch with a ten foot pole.
- Insurance contracts – figuring out a common model for all insurers, well, not quite, as the Boards have fallen out over one technical aspect (you don’t want to know). Still, they’re way closer than they are on impairment or hedging. So far anyway.
- Investment entities – providing an exception for these entities that would allow them to measure investments in subsidiaries at fair value instead of consolidating them. The Boards don’t see eye to eye on some major aspects but getting the IASB to provide an exception of any kind has been quite the achievement. Until recently, the IASB viewed any idea that you might not consolidate a subsidiary as blasphemy.

pwc observation. *The IASB has promised the G20 and the Financial Stability Board that it would get all of these projects out the door by the middle of next year, but that seems almost impossible now. Regardless of the timing of finalization, we expect that the more significant projects, such as revenue, impairment and leases, will have extended transition periods (e.g., three full years) to give companies ample opportunity to properly consider them. So, you don’t have to start sweating just yet. Unless you want to, of course. For instance, some companies are eager to adopt the new hedging rules as soon as possible. The IASB is targeting issuing these particular rules by the end of this year (don’t forget the Canadian Accounting Standards Board will have to ratify them too).*

CSA Views on the Current State of Canada's Financial Reporting

"I feel like a fugitive from the law of averages." – William H. Mauldin

In June, the Canadian Securities Administrators issued their annual report on the results of their continuous disclosure review program for their year ended March 31, 2012. Not only does it provide the CSA's views on Canada's cross-over to IFRS last year, it also assesses the quality of the country's ongoing IFRS accounting, Management Discussion and Analysis and other reporting such as executive compensation details. The report thus isn't merely a memorial to a transition exercise that no one cares about anymore, but rather one that is actually relevant to your future reporting.

Here are the principal findings:

pwc observation. *You might want to consider how well your own financial reporting stacks up against the CSA's findings and take appropriate remedial action if necessary. Remember, it's not a question of whether your reporting gets reviewed, it's when. The alternative of hoping the CSA won't notice significant deficiencies usually isn't a very good bet. As to CSA's priorities for this year, impairment and business combinations are predictable choices, but some might be surprised to see judgments and estimation uncertainty disclosures on the list. The CICA's IFRS Discussion Group raised companies' practices in this area as an issue earlier this year. The objective of the disclosure is to discuss only those key uncertainties and estimates that are most significant and provide meaningful disclosure about their effects. Not, repeat not, throw everything in but the kitchen sink with little or no discussion of impacts.*

- Canada's transition to IFRS. "Generally positive" (though about five percent of issuers were required to restate financial statements).
- Financial statement presentation. Debt too often is being shown as long-term when it's current, at least under IFRS.
- Accounting policies. Too much boilerplate and vague disclosure. Also, a failure to disclose all policies that are relevant to understanding the financial statements (e.g., companies that issue flow through shares not disclosing their accounting for these arrangements).
- Business combinations. Frequent failure to make all IFRS-required disclosures.
- MDA. Often insufficient and less than incisive analysis (e.g., for revenue, not quantifying volume and price changes and their reasons, including the impact of competition; for liquidity not being sufficiently forthcoming about commitments, events or uncertainties – remember, the MDA is supposed to complement the financial statements, not just duplicate them). Companies in specialized industries, the high-tech sector for example, beware! The CSA has fingered reporting in these industries as being especially problematic.
- Other areas. Spotty compliance with statutory disclosure requirements for mining projects and oil and gas activities, the statement of executive compensation, and corporate governance practices.

The report's overarching observation is that companies should be focusing on providing "entity specific" disclosures, in both their financial statements and the MDA. For this year's reviews, impairment, business combinations and judgments and estimation uncertainty disclosures are particular priorities.

Rate Regulated Enterprises

“Record-Setter for Longest Time to Live with Bullet in Head Dies at 103.” – Recent obituary headline

For Canadian rate regulated enterprises, the path to IFRS has been a rocky one, full of near death experiences.

Recall that the Canadian Accounting Standards Board gave RREs until 2012 to transition to IFRS, rather than forcing them to move over in 2011 like almost everyone else. The RRE deferral came about because of the IASB’s last minute decision in 2010 not to provide clarity on whether IFRS allows an RRE to set up assets and liabilities as the result of a regulator’s rate order, as old Canadian GAAP does. Many hold the view that IFRS doesn’t permit setting up assets or liabilities at all. We don’t agree, but even under our view, you won’t always get the same answers as old Canadian GAAP.

In 2011, Canadian provincial securities commissions responded to RREs concerns about the impact of IFRS by giving those listed on exchanges the option of following US GAAP instead. This generally requires the same accounting as old Canadian GAAP. There’s a catch, though. The CSA’s relief is only good through to the end of 2014. Then companies will have to either switch to IFRS or register with the SEC to maintain the right to follow US GAAP that exists under current Canadian securities legislation. The CSA hasn’t said why it imposed this limit but the best guess is that they were trying to avoid setting a game changing precedent by allowing an entire industry to use US GAAP and at the same time allow for an IFRS-based solution to develop.

pwc observation. *For the longest time now, accounting for rate regulation, Canadian style, has been among the walking wounded. Whether the IASB’s actions are a prelude to a full recovery and a long and healthy life remains to be seen. We understand that the IASB’s tentative agenda decision is the result of special pleading from Canada, Brazil and India. We say, Good on you!*

If so, it might just work! In May, the IASB announced a decision to consider whether to put RRE accounting back on its agenda. While a final standard wouldn’t be in place in time for 2015 reporting, some members of the IASB also have raised the possibility of introducing interim measures that would allow Canadian RREs to continue their existing basis of accounting. Seizing on this possibility, the Canadian Board promptly extended the date of mandatory transition to IFRS for RREs until 2013. This decision mostly benefits non-public ones (such as entities in the public sector) unable to take advantage of the US GAAP reporting option available to public ones.

Developments affecting Canadian SEC Filers

“Most conversations are simply monologues delivered in the presence of a witness.” – Margaret Miller

Two things have happened recently that you need to be aware of if you’re a Canadian SEC registrant.

The first is that the SEC has begun to review and comment on first time IFRS financial statements included in Canadian SEC filings. If you haven’t got one already, you can expect a friendly letter soon. Remember, too, that communications with the SEC are a matter of public record.

The second relates to communications between auditors and audit committees. In August, the US Public Company Accounting Oversight Board approved new requirements for the auditor to discuss:

- Its evaluation of the quality of the company’s financial reporting.
- Certain matters about the company’s accounting policies and practices on estimates including a description of the processes and assumptions management used in critical estimates.
- Significant unusual transactions including the underlying business rationale.
- Its views on significant accounting or auditing matters when they are aware that management has consulted with other accountants about these matters and the auditor has a concern.

pwc observation. *With respect to SEC reviews of Canadian IFRS filings, so far the SEC seems to be asking interesting questions about IFRS matters but generally isn’t raising an extensive number of comments. With respect to auditor communications, the PCAOB has emphasized that the objective of the requirements is to establish meaningful dialogues between auditors and audit committees, not to create yet another compliance checklist.*

The new rules also formalize PCAOB required communications that many auditors already are making to audit committees as a matter of practice or as the result of other regulations (e.g. audit strategy and risks, specialized skill needs (such as actuaries, valuers and others), principal auditor determinations, concerns about management’s proposed adoption of new standards, outside consultations, contentious matters, going concern issues, qualifications in audit reports, etc.)

The requirements, if approved by the SEC, would apply for years beginning on or after December 15, 2012 however, there may be some scope exceptions.

IFRS in the US

**Georgia: “Jonathon, will you marry me?”
Jonathon: “Not even a little bit.”
The Bad and the Beautiful, 1942**

pwc observation. *There appears to be a number of factors that weighed against the SEC taking a stand on IFRS right now. Perhaps the most significant are (1) support for IFRS in the US business community is very much on the wane, and the small business sector, which sees substantial costs but no benefits, actively opposes it, (2) the SEC report raises significant issues about the completeness of IFRS relative to US GAAP, the consistency of IFRS application and enforcement around the world, and the adequacy of the IASB’s interpretative processes and funding, (3) this is a presidential election year and the SEC is leery about doing anything that might be politically controversial, and (4) the possibility of having to involve Congress in any decision. Of course, among the risks to the US of continuing to sit on its hands is that it gets booted off the IASB and its oversight bodies, losing some of its influence over global standard setting. Might that happen? We’ll see.*

That whooshing noise you’re hearing? It’s the sound that comes from rapidly deflating expectations.

Devout readers of Financial Reporting Release will know that the IASB has been pressuring the SEC for years to incorporate IFRS into US financial reporting. Getting a firm commitment out of the US to do this has been a very big deal for the IASB, not only because the US is the world’s biggest economy but also because a US move to IFRS would go a long way to convincing China, Japan and India to embrace it as well. In short, the US is the biggest thing standing in the way of the IASB realizing its goal of becoming the world’s sole purveyor of global accounting standards.

Hopes among IFRS supporters were high that the SEC staff would recommend the US make a positive commitment of some kind or another in its long-awaited final report to the Commission about its IFRS investigations. Alas, the report, issued in July, is limited strictly to a pros and cons assessment of IFRS and the IASB. All the report says about transition is that there’s substantial backing in the US for the idea of exploring methods for incorporating IFRS on a basis that both reflects US support for a single set of high quality global accounting standards and considers US concerns. So the door hasn’t been closed completely, but it hasn’t been opened either. Not even a crack.

What’s been the response from the IASB and its supporters? Frustration, disappointment, and, in some quarters, more than a little bitterness. In their view, the time for exploring options has long since past. Whoosh!

The Future of the IASB

“... I’m designing T-shirts now. They’re gonna be huge. Also medium and small.” – Dylan, Modern Family

Some months before the SEC released its report on IFRS that we discussed on the preceding page, the oversight bodies of the IASB, the IFRS Trustees and the Monitoring Board, unveiled a new strategic plan for the IASB – a new vision, if you will, establishing the IASB’s direction, operations, governance and funding for the next ten years.

The plan affirms that the IASB’s foremost objective is developing IFRS as a single set of high quality, understandable and enforceable global accounting standards. Major new strategic initiatives flowing from this objective include:

- Given the widespread and growing use of IFRS, focusing activities on serving the needs of the countries that have adopted or plan to adopt IFRS.
- Maintaining a network of national and regional bodies involved with standard setting as an integral part of the standard setting process. The idea here is that the network would undertake research, provide guidance on priorities, encourage stakeholder input from their own jurisdiction into the IASB’s due process, identify emerging issues, etc. The goal is to reduce the risk of non-endorsement of new IFRS.
- Improving the clarity of its standards and the responsiveness of the IFRS Interpretations Committee.
- Developing a mechanism for securities and audit regulators, the accounting profession and the IASB to discuss ways to enforce the application of IFRS and identify and address areas of divergence.
- Establishing funding on a basis that relies more on long-term fixed commitments from participating countries and less on short-term voluntary contributions.

pwc observation. *The Chair of the IASB describes its new strategic initiatives as establishing global financial reporting supply chain, and the final piece in the jigsaw that is international reporting standards. While the concept and its design have been greeted with enthusiasm, let’s face it – plans come cheap. The real challenge will be their implementation. For IFRS to be an effective set of high-quality global accounting standards, it’s not enough that the standards be “enforceable”; they must be consistently enforced. And that will require extensive co-operation, co-ordination and commitment from local regulators and other bodies that participate in this process. This is a huge challenge if the difficulties the IASB and FASB have had in co-operating over the development of converged standards are any guide.*

The IASB's New Agenda Priorities

“I was a peripheral visionary. I could see the future, but only way off to the side.” – Steven Wright

pwc observation. We have two general observations about the Board's agenda priorities. The first is that we are very glad to see disclosure and basic financial statement concepts becoming priorities. Both are root causes of complexity in financial statements. While the disclosure initiative perhaps may seem a bit tentative, we expect it's only a first step. As for the financial statement concepts project, a key priority will be re-examining measurement and financial statement presentation, areas which constituents have been complaining about for years but nobody has done much about. Certainly the time is ripe for action. Did you know, for instance, that collectively IFRS has over 20 different bases of measurement now in play? Our second observation relates to the role that convergence with US GAAP now plays in the Board's agenda decisions – none whatsoever. Once its existing projects are done, that's it; the IASB has no further interest in convergence as a long-term strategy. Such an approach can't help but to raise the risk of divergence, but, as we've already seen earlier on these pages, working together provides no guarantee that converged answers will result anyway. In the IASB's view, a single global GAAP can emerge only if everybody uses the same standards. And in the IASB's view, those are IFRS. If the US doesn't want to play ball, so be it.

Coincident with its new strategic priorities, the IASB has been doing some forward thinking about what its agenda priorities should be after it completes its existing projects (see “IFRS in the Pipeline”). This has been preceded by an unprecedented level of consultation with constituents, something that is itself a new feature of the IASB's standard setting processes.

Reacting to concerns constituents expressed about standards overload, the Board adopted a new attitude in developing its agenda priorities, one best summed up by its Chair in a recent speech as “Fix what needs fixing and no more”. (As a motto, not quite as catchy as “No wine before its time”, perhaps, but not bad.) The result is that the Board has decided to consider adding only three standards-level projects to its agenda – rate regulated enterprises (see our earlier discussion); applying the equity method in separate financial statement of the investor; and improving existing IFRS on agriculture. That's it, at least for new standards... but there are a few other initiatives as well:

- Hosting a public forum to assess strategies for improving the quality of financial reporting disclosures within the framework of existing requirements.
- Reactivating its project to re-examine basic financial statement concepts.
- Initiating a staff research program focusing initially on discount rates, the equity method of accounting, extractive industries/intangible assets/R&D, financial instruments with characteristics of equity, foreign currency translation, non-financial liabilities, and financial reporting in high-inflation and hyper-inflationary economies. Also, recommending research on emissions trading schemes and business combinations under common control.
- Establishing a consultative group to assist the IASB with matters relating to Shariah law.

The idea behind separating the research function from the standard setting one is to limit to the scope and sharpen the focus of the standards-level projects.

For more information ...

This newsletter has been prepared for the clients and friends of PricewaterhouseCoopers 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.

The partners and managers in National Accounting Consulting Services are:

Carolyn Anthony	416 815 5266	carolyn.anthony@ca.pwc.com	Toronto
Scott Bandura	403 509 6659	scott.bandura@ca.pwc.com	Calgary
Martin Boucher	514 205 5415	martin.boucher@ca.pwc.com	Montreal
Sean Cable	416 814 5831	sean.c.cable@ca.pwc.com	Toronto
Michel Charbonneau	514 205 5127	michel.a.charbonneau@ca.pwc.com	Montreal
David Clément	514 205 5122	david.clement@ca.pwc.com	Montreal
Lucy Durocher	416 869 2311	lucy.durocher@ca.pwc.com	Toronto
Larissa Dyomina	416 869 2320	larissa.dyomina@ca.pwc.com	Toronto
Will Foster	604 806 7183	william.p.foster@ca.pwc.com	Vancouver
Charlotte Galais	416 687 8594	charlotte.x.galais@ca.pwc.com	Toronto
Vicki Kovacs	416 941 8363	vicki.kovacs@ca.pwc.com	Toronto
Robert Marsh	604 806 7765	robert.marsh@ca.pwc.com	Vancouver
Rosemary McGuire	416 869 2599	rosemary.mcguire@ca.pwc.com	Toronto
Celeste Murphy	403 509 6680	celeste.k.murphy@ca.pwc.com	Calgary
Mi Li Ng	604 806 7030	mi.li.ng@ca.pwc.com	Vancouver
Morakinyo Okusami	403 509 6638	morakinyo.a.okusami@ca.pwc.com	Calgary
Alpa Patel	905 738 2912	alpa.k.patel@ca.pwc.com	Toronto
Claire Patra	403 509 7356	claire.a.patra@ca.pwc.com	Calgary
Jim Saloman	416 941 8249	james.s.saloman@ca.pwc.com	Toronto
Michael Tambosso	416 941 8388	michael.a.tambosso@ca.pwc.com	Toronto
Michael Walke	416 815 5011	michael.walke@ca.pwc.com	Toronto
Andrew White	416 941 8479	andrew.white@ca.pwc.com	Toronto
Chris Wood	416 365 8227	christopher.r.wood@ca.pwc.com	Toronto

