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# *AC Insights*

## **Spring 2018** – Issue US2018-2

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

## *In this edition*

The FASB's efforts have been focused on implementation issues with some of the new blockbuster standards. Improvements or amendments have been made or are in progress for financial instruments, hedging, leases, and income taxes in response to the *Tax Cuts and Jobs Act*. We cover updates finalized in these areas in this edition.

FASB has also concentrated on its disclosure review initiatives during the first quarter of 2018 and is hoping to finalize some of its work in this area soon. Work on distinguishing liabilities from equity is in the early stages and improvements to insurance contracts are being redeliberated.

The IASB continued its standard setting work on rate regulated activities. The Board continues its research projects on primary financial statements, principles of disclosure, and dynamic risk management. Work is expected to continue on most of these projects into 2019. Certain narrow scope amendments are expected to be completed in the next quarter.

Cybersecurity risks continue to be on the SEC's radar, with new guidance issued on disclosures about cybersecurity risks and incidents in public company disclosures.

On the auditing front, the AICPA has issued some guidance to assist audit committees with their oversight of the disclosure of non-GAAP measures. In addition, the SEC has taken action against certain auditing firms that failed to register with the PCAOB.

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# FASB developments

## Stranded tax effects from US tax reform

When items are included in other comprehensive income (OCI), the corresponding income tax effects are also included in OCI. These tax effects are only removed from OCI when the related items are reclassified from OCI to income. Current US GAAP requires the effects of all changes in tax laws to be reflected in the income statement within continuing operations, irrespective of whether the original tax consequences were reported in OCI. As a result of the US tax reform, significant amounts of income tax effects would be stranded in OCI until the corresponding item was reclassified. Upon release, the income provision may skew the effective tax rate because the stranded tax consequences are included.

To address these concerns, the FASB issued ASU 2018-02: *Reclassification of certain tax effects from accumulated other comprehensive income*. The ASU allows companies to reclassify the disproportionate income tax effects of the 2017 *Tax Cuts and Jobs Act* (the Act) on items within accumulated other comprehensive income to retained earnings. The reclassification is optional and applies only to the income tax effects of applying the Act.

When the Act is adopted, the ASU will require certain disclosures about the transition elections and methods used by companies. In addition, all companies must disclose their accounting policy for releasing disproportionate income tax effects from AOCI. This latter disclosure is ongoing and not specific to the Act.

These amendments are effective for all years ending after December 15, 2018, but may be adopted early for financial statements that have not yet been issued.

There are several complexities to applying the ASU. Companies will want to consult with their tax specialists to assess whether to apply the option and to understand the complexities of applying the option.

The FASB is also conducting further research as to whether changes should be made to its income tax standard to allow backward tracing for other changes in income tax rates and laws.

## Implementation issues in lease accounting

The FASB did not establish a Transition Resource Group for its new leases standard because the concepts in the new standard were similar to those in the existing leases standard. As implementation has started, some issues have surfaced which the FASB has addressed through targeted improvements and narrow scope amendments.

### Land easements

Land easements are the right to use, access, or cross another party's land for a specified purpose. Many entities do not account for these land easements as leases under current US GAAP.

Due to the cost and complexity of applying the new lease requirements to land easements, the FASB has provided an optional transitional practical expedient which will allow land easements existing or expired at the transition date to be exempt from the new accounting rules. If the option is elected, companies can continue to account for such easements using the company's current accounting policies. New or modified land easements would be subject to the new standard. Companies that do not elect this option, would apply the new lease standard to land easements.

These changes included in ASU 2018-01: *Land easements expedient for transition to Topic 842* are effective at the same date as the new leases standard, which is for years beginning on or after December 15, 2018.

## *Components in a contract*

The new standard requires lessors to separate lease and non-lease components combined in a contract, and account for each of the components under the applicable standard. The FASB is proposing to provide lessors with a practical expedient on transition, by class of underlying assets, to not separate non-lease components from related lease components and account for all components in the contract as a single lease component.

To apply this practical expedient, the following conditions must be met:

- The timing and pattern of revenue recognition for both the non-lease and lease components must be the same; and
- The combined single lease component must be classified as an operating lease.

Disclosure will be required of the class or classes of underlying assets for which the election has been applied and the nature of the non-lease components.

These changes are still under discussion by the FASB.

## *Comparative for transition year*

An additional and optional transition method is being included which will allow entities to adopt the new leases standard in the period of adoption with a cumulative-effect adjustment to the opening balance of retained earnings. This would not require comparative financial information for prior periods. Disclosures about leases in the comparative periods would be made using current requirements.

The FASB has affirmed this change and the changes are expected to be codified when the FASB has finished it redeliberations of the exposure draft on this and the previous issue.

# ***Tweaks to financial instruments accounting***

On February 28, the FASB issued six amendments in ASU 2018-03: *Technical corrections and improvements to financial instruments* affecting the new guidance in the Accounting Standards Codification (ASC) Subtopic 825-10 on the recognition and measurement of financial assets and financial liabilities, which is effective for years beginning after December 15, 2018.

### *"Un-electing" the measurement alternative*

Currently, the ASC allows a measurement alternative to the fair value through current earnings model for certain equity investments that do not have readily determinable fair values. The new guidance provides an option for a company to "un-elect" the measurement alternative and elect to account for the investment at fair value through current earnings. However, once a company makes this election for a particular investment, it must apply the fair value through current earnings model to all identical investments and/or similar investments from the same issuer. Further, a company cannot elect the measurement alternative for future purchases of identical or similar investments of the same issuer.

ASU 2018-03 also clarifies the following:

- For equity investments that do not have a readily determinable fair value that are measured using the measurement alternative, the objective of the ASU is to remeasure the equity investment at its fair value as of the date of the observable price/transaction for a similar instrument from the same issuer.

- For forward and option contracts measured using the measurement alternative, the contracts must be remeasured when there is an observable price/transaction or impairment of the underlying equity instrument.

- The presentation guidance requiring the portion of the total change in fair value that results from changes in instrument-specific credit risk to be reported in accumulated other comprehensive income applies when the fair value option is elected under either ASC 825, *Financial Instruments*, or ASC 815, *Derivatives and Hedging*.

The financial instruments update issued in 2016 is effective as of January 1, 2018. The new guidance in ASU 2018-03 must be adopted in the third quarter of 2018 (an interim period). Early adoption of the new guidance is permitted.

## *Standards effective January 1, 2018*

The following changes to FASB standards will be effective January 1, 2018 for companies with December 31 year-ends. There may be other standards with a mandatory effective date subsequent to January 1, 2018 that may be adopted earlier. These standards are not referred to in the table below.

| ASU No. | Title & ASC Topic No. | Description of change |
|---|---|---|
| 2014-19<br>2015-14<br>2016-08<br>2016-10<br>2016-12<br>2017-05<br>2017-13 | *Revenue from contracts with customers* (Topic 606) | New comprehensive standard for the recognition, measurement, presentation, and disclosure of revenue and the measurement of certain gains and loss on non-revenue transactions. Several amendments were made to address implementation issues, provide clarifications, and rescind SEC staff announcements included in the ASC. |
| 2016-01 | *Recognition and measurement of financial assets and financial liabilities* (Topic 825) | Amends *Financial Instruments – Overall* to require (1) all equity investments to be measured at fair value through net income (with the exception for equity-accounted and consolidated investments); and (2) the changes in the fair value of financial liabilities (measured at fair value) due to instrument specific credit risk to be presented separately in other comprehensive income. |
| 2016-04 | *Recognition of breakage for certain prepaid stored-value products* (Topic 405) | This EITF consensus is a narrow scope exception, which permits breakage accounting consistent with the revenue standard, to be used for certain prepaid stored-value products. |
| 2016-15 | *Classification of certain cash receipts and cash payments* (Topic 230) | Addresses the classification of cash flows in the cash flow statement for:<br>1. debt repayment or debt extinguishment costs;<br>2. settlement of zero-coupon debt instruments or similar debt instruments;<br>3. contingent consideration payable after a business combination;<br>4. proceeds from the settlement of insurance claims;<br>5. proceeds from the settlement of corporate-owned life insurance policies;<br>6. distributions received from equity investees;<br>7. beneficial interests in securitization transactions; and<br>8. separately identifiable cash flows and the predominance principle. |
| 2016-16 | *Intra-entity transfer of assets other than inventory* (Topic 740) | Requires the income tax consequences of an intra-entity transfer of assets (other than inventory) to be recognized when the transfer occurs. |
| 2016-18 | *Restricted cash* (Topic 230) | EITF consensus requires restricted cash to be included in cash and cash equivalents in the cash flows statement. |

| ASU No. | Title & ASC Topic No. | Description of change |
|---|---|---|
| 2017-01 | *Clarifying the definition of a business* (Topic 805) | Introduces a screen test to assess whether a collection of assets is a business, clarifies the nature of processes for the business criteria, and removes the requirement to assess whether a market participant could replace the missing elements. |
| 2017-07 | *Improving the presentation of net periodic pension cost and net periodic postretirement benefit cost* (Topic 715) | No longer permits presentation of the net periodic cost of pension and postretirement plans as a net amount. Requires the service cost component to be presented in the line item for compensation costs, and other costs to be presented separately outside of income from operations. Only the service cost component is eligible for capitalization. |
| 2017-09 | *Scope of modification accounting* (Topic 718) | Clarifies when changes to terms and conditions of a share-based payment award are subject to modification accounting. |
| 2017-10 | *Determining the customer of the operation services* (Topic 853) | EITF consensus concludes that in a service concession arrangement the grantor is the customer of the operations services in all cases. |
| 2018-03 | *Recognition and measurement of financial assets and financial liabilities* (Topic 825) | See article *Tweaks to financial instruments accounting* on page 3. |

# CSA developments

## CSA plans to reduce regulatory burden

In March 2018, the CSA published an update to the CSA Consultation Paper 51-404: *Considerations for Reducing Regulatory Burden for Non-Investment Fund Reporting Issuers,* which was published in April 2017. The purpose of the Paper was to identify and consider areas of securities regulation that could be improved by reducing regulatory burden, while still providing investor protection and the efficiency of the capital markets. Based on the feedback received from stakeholders, the CSA has initiated six projects to make changes to the regulatory regime. There is no assurance that changes will ultimately be adopted because of these projects.

The six projects are:

- Potential alternative prospectus model that is more concise and focused than the current short form prospectus model.
- Facilitating at-the-market (ATM) offerings by providing exemptive relief from or eliminating shelf prospectus requirements and conditions.
- Reconsideration of the historical financial statements required for the primary business in an initial public offering.
- Business acquisition reporting by either removing or modifying requirements.
- Revisiting continuous disclosure requirements, which may consider eliminating disclosures that are duplicative among the financial statements, MD&A, and other requirements; consolidating annual disclosures into one reporting document; and reducing the volume of information required in annual and interim filings to improve the quality and accessibility of the information. This will be a longer-term project.
- Enhancing electronic delivery of documents to investors.

## US marijuana views

The CSA has revised its guidance on disclosure expectations for specific risks facing issuers with marijuana-related activities in the US. These views are based on the fact the cultivation, distribution and use of marijuana is illegal under US federal laws. We reported on the original guidance in our winter 2018 edition of *AC Insights*. The revised guidance is included in CSA Staff Notice 51-352 (Revised): *Issuers with US marijuana-related activities.*

### Background

In 2013, the US federal government allowed states to legalize marijuana activities if certain criteria were met, which were set out in a Department of Justice memo, referred to as the Cole memorandum. In January 2018, the US Attorney General Jeff Sessions rescinded the Cole memo. This rescission allows federal prosecutors to decide individually how to apply the federal law. This change in policy could increase risks for companies that are operating in states that have legalized marijuana for medical and/or recreational purposes.

### Disclosures of enforcement risk

The CSA Staff Notice provides the staff's specific disclosure expectations for issuers with US based marijuana activities. The extent of disclosures will depend on the nature of the issuer's activities, which may include (a) the cultivation and distribution of marijuana under a state license; (b) a non-controlling investment in a US marijuana-related business; or (c) provision of goods or services (financing, branding, recipes, leasing, consulting and administrative services) to US marijuana-related businesses.

All issuers with US marijuana-related activities are required to:

- Disclose the nature of their involvement;
- State that marijuana is illegal under US federal law and enforcement of the laws is a significant risk;
- Disclose the current US position on enforcement;
- Disclose risks of suspension or withdrawal of services or financing by third parties and regulatory restrictions;
- Quantify the balance sheet and operating statement exposure to US marijuana activities; and
- Disclose any legal advice obtained on compliance with regulatory frameworks and potential exposure to US federal law.

For issuers with a controlling or non-controlling interest in such businesses, information should be provided on state regulations and the issuer's compliance with the state licensing requirements and regulatory framework. For issuers with ancillary association with US marijuana-related activities, the issuer should comment on the customer's or investee's compliance with state licensing requirements and regulatory framework.

These disclosures should be updated when a government policy changes or there are legislative amendments on marijuana sales and use in the US.

Failure to make appropriate disclosures could result in non-receipt of prospectuses, restatement of disclosures, or referral to enforcement.

The CSA will continue to monitor industry developments and consider whether further regulatory action is required.

# SEC developments

## Cybersecurity disclosures for investors

The SEC issued interpretative guidance in February 2018 to assist public companies in preparing their disclosures about cybersecurity risks and incidents. The guidance is based on existing reporting requirements and addresses the importance of cybersecurity policies and procedures.

In the statement from the SEC Chair, Jay Clayton stated, "cybersecurity is critical to the operations of companies and our markets." He requested public companies to stay focused on these issues and take required action to inform investors about material cybersecurity risks and incidents on a timely basis.

The interpretative release (1) stresses the importance of establishing and maintaining comprehensive policies and procedures related to cybersecurity risks and incidents; and (2) reminds companies and their insiders about insider trading and use of selective disclosures when cybersecurity risks or incidents occur.

### Policies and procedures

Companies are encouraged to adopt comprehensive policies and procedures for cybersecurity and assess the company's compliance regularly, including their disclosure controls to ensure there is timely reporting of risks and incidents. The controls and procedures should enable companies to identify the risks and incidents, assess and analyze their impact, evaluate their significance, involve the appropriate personnel with expertise in the area, and make timely disclosures as appropriate.

### Disclosures

In assessing the materiality of disclosures about cybersecurity risks and incidents, the SEC indicates that companies need to assess the importance of the compromised information and its impact on company operations. Companies should consider the range, nature, extent and potential magnitude of the harm such incidents could cause. Harm may result to the company's reputation, financial performance, customer and vendor relationships, or results in litigation or regulatory actions.

The SEC does not expect detailed disclosures of a company's security plan and understands that information about incidents may evolve. The information is expected to be tailored to each company's particular risks and incidents and companies are discouraged from making generic cybersecurity related disclosures.

SEC disclosure requirements for annual reports on Form 10-K or 20-F require companies to disclose risk factors. In evaluating disclosure of cybersecurity risks, companies should considered the severity and frequency of past cybersecurity incidents, the probability and magnitude of potential incidents, the adequacy of the company's preventative actions, company specific risks that may heighten cybersecurity risks, costs of maintaining cybersecurity protections, potential of reputational harm, and other consequences of a cybersecurity breach.

MD&A disclosures may be required considering the cost of ongoing cybersecurity efforts and the costs and consequences of cybersecurity incidents. The description of a business may warrant disclosure about cybersecurity matters if cybersecurity incidents or risks materially affect a company's products, services, relationships, or competitive conditions. Any material legal proceedings from a cybersecurity incident would require disclosure in the annual report. Disclosures about a board's oversight of risk management may also need to consider cybersecurity when such risks are material.

### More information

Further information on the SEC guidance can be found in SEC Release Nos. 33-10459 and 34-82746: *Commission Statement and Guidance on public company cybersecurity disclosures.*

# Auditing developments

## AICPA roadmap on non-GAAP measures

The AICPA issued a publication in March 2018 to provide a set of considerations for audit committees on non-GAAP measures presented by companies. The publication: ***Non-GAAP measures: A roadmap for audit committees*** was released with a companion video featuring interviews with audit committee chairs on their experiences in overseeing non-GAAP measures.

The objective of the publication is to support audit committees in carrying out their oversight of non-GAAP measures and achieve more transparency, consistency, and understanding of non-GAAP measures.

In addition to presenting the current environment surrounding the preparation, presentation and oversight of non-GAAP measures, the AICPA has provided audit committees with guidance on assessing non-GAAP measures including:

- Topics of discussion between management and the audit committee on the non-GAAP measures to be presented;
- Understanding the auditor's role regarding non-GAAP measures; and
- Best practices that can be applied to support the presentation of non-GAAP measures.

Copies of the publication can be obtained from the Center for Audit Quality of the American Institute of Certified Public Accountants.

## Improvements in Canadian audits encouraging

CPAB's report on its findings of its 2017 inspections was released in March 2018. CPAB inspected 128 annual audit files of 14 audit firms during 2017. CPAB was encourage by the decreasing trend in significant findings, but found that audit quality remains inconsistent, indicating firms need to review their approach to audit quality and enhance their focus on consistent execution across the respective firm.

Significant findings were made in 15 files in 2017 compared to 24 in 2016. The majority of these significant findings required audit firms to carry out additional procedures to determine the need, if any, for a restatement of the client's financial statements due to material error. Three restatements resulted from these additional procedures.

### *Firm level quality management seen as the key to improvements*

CPAB believes that higher quality audits are achievable when "the right people, policies and procedures are in place." CPAB has begun to focus on firm level quality management systems and processes of the Big Four firms. CPAB will focus on the accountability for audit quality within the firm; the management of client and audit risk; the management of people from partners to all levels of staff including industry and other specialists as well as the allocation of the right people to each audit; and the oversight of audits by the firm leadership.

### *Performance across all firms improving*

For the Big Four firms (Deloitte, EY, KPMG and PwC), CPAB found that each firm demonstrated an acceptable level of inspection findings overall, but there was a need to embed audit approach improvements into every practice and every engagement. Out of the 86 engagement files inspected, 6 had significant findings resulting in two restatements.

Twenty engagement files of other national / network firms (BDO, Grant Thornton, MNP and Raymond Chabot Grant Thornton) were inspected resulting in 6 with significant findings, but no restatements. CPAB found significant improvements in three of these firms, but noted one firm continues to experience challenges.

Six large regional firms were inspected resulting in 3 significant findings and one restatement out of the 19 engagement files examined. The number of significant findings decreased from the prior year indicating firms had undertaken targeted improvement to resolve recurring issues; however CPAB continues to identify potential weaknesses in the quality control systems of these firms.

## *Some common issues continue to be challenging for auditors*

CPAB outlined in their report certain common issues that continue to challenge auditors. Areas requiring improvements related to (1) the execution of basic audit procedures; (2) the use of professional judgment and scepticism in assessing the appropriate of audit tests and the reasonableness of evidence provided by management; and (3) the auditing of significant accounting estimates, particularly the appropriateness and consistency of management's financial inputs.

The report provides several questions that the audit committee could ask of the auditors to understand the quality of the audit, including the quality management systems and processes at the audit firm.

Under the CPAB Protocol with PwC, a copy of this report will be provided to audit committees.

## ***CPAB supports Audit Quality Indicators***

In 2016, CPAB launched an Audit Quality Indicators (AQIs) Pilot project with Canadian audit committees to obtain feedback about the usefulness of AQIs and to encourage innovation in the use of AQIs. In November 2017, CPAB held a roundtable with audit committee chairs, management and lead audit partners of the participants in the project. CPAB's 2017 Interim Update was issued in March 2018.

The Update outlined five key themes of the Roundtable:

- Growing support for management related AQIs measuring management's project management, the quality of management control systems, or the timeliness of management's remediation of control deficiencies.
- Upfront discussions among management, the auditor and the audit committee about AQIs provide the most value by developing an understanding of audit quality, expectations around audit quality and the coordination of the various parties efforts.
- The selection of AQIs should be limited to 10 or less (with the average number selected by participants in the project being eight). The selection of AQIs should be well thought out and consider the cost-benefit of each.
- Need for continual review of the AQIs selected to ensure they require changes at the audit firm, the business environment, audit risks, and the needs of the audit committee.
- Development of objective benchmarks to evaluate AQIs is challenging, and development of acceptable ranges or directional trends may be an alternative to consider.
- There are diverse opinions on the usefulness of specific AQIs depending on the unique needs and circumstances on individual audit committees.

The update outlined that strong project management was key to audit quality and many participants selected project management type AQIs. In addition, the following AQIs are frequently used by participants:

- Timing of audit execution;
- Use of specialists;
- Partner / manager leverage;

- Experience of engagement team;
- Management deliverable; and
- Number of hours spent of key risk.

CPAB will be wrapping up the project in 2018 with one final feedback and will publish a summary of their findings from the project. CPAB will continue to promote AQIs and plans to:

- Work with CPA Canada and the Institute of Corporate Directors to develop an AQI Guide to assist audit committees in implementing AQIs for the first time; and

- Launch an AQI Network to share information among and provide support to current and future AQI users.

## *Tips for audit committees of financial institutions*

On December 13, 2017, CPAB held its annual Financial Institutions Industry Forum for audit committee chairs of large Canadian banks and insurance companies. The Forum covered emerging and topical developments for audit committees of these institutions.

The following matters were addressed at the forum:

- Technology risk relating to industry innovation, transformation, implementation of systems, and cybersecurity; the need to have sound strategies dealing with these risks; the scope of the board's oversight over technology partnerships and joint ventures with third parties; and plans to respond to crisis and other unforeseen events.

- The new auditor reporting requirements under Canadian Auditing Standards and the PCAOB standards, the differences in the reporting models, and concerns of disclosure of proprietary or sensitive information in key audit matters section of the reports.

- Implementation challenges of new standards that will become effective for financial institutions in the upcoming year.

- The efficiency and effectiveness of the audit committees, including efforts to streamline information provided to audit committees, use of pre- and post-meetings with the chair to direct management and the auditors on matters of focus for meetings and communications with the committee, and the use of consent agendas to deal with routine matters.

- Tools and activities to enhance the oversight of the financial reporting process and the audit including audit quality indicators and comprehensive reviews of the auditor's performance.

CPAB holds similar forums with other industry groups to foster an open dialogue on improving audit quality and the oversight of auditors.

## *Improper foreign audits result in fines and loss of profits*

In March 2018, the SEC charged the principal auditors of two SEC registrants with improperly relying on the work of two foreign component auditors that were not registered with the PCAOB. The foreign component auditors had audited the majority of the assets and revenues of the publicly traded companies. The SEC claims that the principal auditors had failed to consider the registration status of the firms that did the majority of the audit work.

The SEC found that (1) the foreign component auditors had violated the Sarbanes-Oxley Act because they were not registered with the PCAOB; and (2) the principal auditors had engaged in improper professional conduct, violated the auditing requirements of Regulation S-X, and caused their audit client to violate their reporting requirements.

Without admitting or denying the charges, the principal auditors agreed to pay significant fines and the secondary auditors agreed to disgorge the profits from their audits as well as interest.

The key message of this SEC action is that it is important that all auditors substantially involved in the audit of a SEC registrant be properly registered with PCAOB to allow the PCAOB to exercise its oversight responsibilities.