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AC Insights

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

In this edition

The fall meetings of the IASB were focused on the conceptual framework, rate regulated activities, and several maintenance projects. A final conceptual framework is expected in early 2018.

The US tax reform may affect Canadian companies with US subsidiaries and operations. We have outlined the possible accounting consequences of this tax reform in this edition of *AC Insights*.

Amendments were issued in the final quarter of 2017 to clarify or correct certain existing standards. These amendments addressed certain issues in IFRS 9: *Financial instruments,* which is effective in 2018, and three improvements to other standards. A summary of these changes are provided in this edition of *AC Insights*.

In CSA developments, we highlight the results of the latest review of disclosures about women on boards and in executive positions, as well as other recent notices and developments. In December, the annual AICPA SEC conference was held and the highlights of that conference, from a Canadian perspective, have been summarized for you under *SEC developments*.

There have been a number of auditing developments, including an announcement to require disclosure of key audit matters by Canadian auditors, the CPAB report on key inspection findings for the Big 4, commentary about discussions at CPAB industry forums, and a brief from the PCAOB on its 2016 inspection findings. This edition provides a summary of these notices, reports and developments.

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IFRS developments

US tax reform may materially impact financial reporting

On December 22, 2017, US President Trump signed into law the *Tax Cuts and Jobs Act* (the Act). The Act makes significant changes to the US tax code including a significant reduction in the federal tax rate for corporations.

IAS 12: *Income taxes* requires companies to recognize the effect of tax law changes in the period of enactment. This means that financial statements for years ending on or after December 22, 2017 will reflect some of the consequences of the tax reforms, even if many of the provisions are only effective in the subsequent taxation year.

The changes are substantive and extensive and will have a significant impact on the current and deferred taxes of entities with a US tax presence. In reaction to the timing of the Act and its consequences, the SEC staff have issued Staff Accounting Bulletin No. 118, which provides practical guidance to facilitate timely reporting for year-end results. The SEC endorsed this guidance on December 22, 2017.

Tax law changes

The tax law changes will, among other things, reduce tax rates, substantially change the international tax rules, and make significant changes to the way tax losses are carried forward and recovered. The key changes are highlighted below. Most of these changes are effective for tax years ending after December 31, 2017.

Domestic provisions

- ***Tax rates*** – The reduction of the corporate tax rate from the existing graduated rates of 15% to 35% to a flat 21%. The Act also eliminates the Alternative Minimum Tax.
- ***Tax depreciation*** – Corporations can elect a 100% depreciation rate on new and used qualifying property acquired and placed in service after September 27, 2017 and before January 1, 2023. The accelerated rate will be phased down gradually over several years from 2024 and ending in 2027 (with some exceptions). Certain research and experimentation expenditures, including software development costs, can no longer be expensed starting for tax years beginning after December 31, 2021, but must be capitalized and amortized over five years (or 15 years if conducted outside the USA).
- ***Limited interest deduction*** – The deduction of interest expense arising on both related party and third party debt is limited to 30% of the adjusted taxable income (EBITDA for the first four years, and EBIT thereafter) of a tax filer, with an exemption for small businesses and regulated public utilities. Disallowed interest deductions can be carried forwarded indefinitely.
- ***Incentive for domestic production*** – The 3% tax rate reduction for domestic manufacturers is eliminated.
- ***Deductibility of expenses*** – No deduction will be allowed for:
  - Expenses for entertainment, amusement, or recreation activities; membership dues for business, pleasure, recreation, or other social purposes; and expenses of a facility or portion of a facility used for those activities. In addition, the 50% limitation on meals expense was extended to in-house cafeteria and similar meals.
  - Expenses for employee transportation, such as transportation pools, transit cards and qualified parking expenses.
  - Lobbying expenses related to legislation before local government bodies.

- Settlements paid subject to nondisclosure agreements in connection with sexual harassment or sexual abuse.
- Executive compensation limit of $1 million will now include performance-based compensation and includes the CFO as well as a broader range of SEC filers.

- ***Net operating losses*** – The utilization of net operating losses (NOLs) arising in tax years beginning after December 31, 2017 is limited in any tax year to 80% of taxable income. Carrybacks of NOLs to the two prior years is generally eliminated for NOLs arising in tax years after December 31, 2017. NOLs may be carry forwarded indefinitely.

International provisions

- ***Territorial perspective*** – For multinational entities, a new territorial tax system has been introduced focusing on the taxation of US sourced income generally as earned and the permanent exemption of foreign income from US taxation. The key features of the new system for US corporations include:
  - Tax-free repatriations of future foreign income from any 10% owned foreign corporations. Foreign income excludes income effectively connected with the conduct of trade or business in the USA. No foreign tax credit or deduction is allowed for any taxes paid or accrued for the dividend.
  - A minimum tax on foreign income generated by controlled foreign corporations with a small aggregate foreign fixed asset base and earnings taxed at low foreign rates (referred to as the GILTI tax). The effect of this provision will result in foreign income taxed at foreign tax rates lower than 13.125% being taxed in the US, although at a rate that is effectively about 10%.
  - A one-time transition tax (toll charge) on accumulated untaxed earnings of controlled foreign corporations and 10% owned corporations at a rate of 15.5% for liquid assets and 8% for physical assets, payable over eight years. Existing foreign tax credits and net operating losses can be used to settle the toll charge.

- ***Earnings stripping rules*** – A Base-Erosion Anti-abuse Tax (BEAT) has been introduced on outbound payments (interest, royalties, group reinsurance, and similar payments) paid or accrued to foreign related parties by US corporations above a specified size. The BEAT is structured as alternative minimum tax to prevent companies from stripping earnings out of the US entity to foreign affiliates in lower tax rate jurisdictions. A rate of 5% (increasing to 10% in 2018 and 12.5% in 2026) is applied to the difference between the tax liability normally computed and tax liability based on the BEAT rate and the modified taxable income (taxable income after adding back base erosion payments). Several other base erosion measures were included in the Act.

What's the accounting impact?

The tax law changes will affect the December 2017 financial statements of all Canadian entities with US subsidiaries and joint operations, all US entities, as well as subsidiaries of US entities based outside the US. The impact for many entities will be material.

The changes will affect:

- The current income tax charge for the year, to the extent that the changes affect tax deductions applicable to 2017 profits – for example toll charge or retroactive immediate expensing of certain property placed in service.

- Deferred tax assets and deferred tax liabilities, which will need to be remeasured using the tax rate expected to apply when the temporary differences reverse. The change in the deferred tax balances will be recognized in income tax expense from continuing operations. The new GILTI and BEAT taxes may also affect deferred tax balances.

- The recoverability of deferred tax assets for losses and deductible temporary differences.

Dealing with changes to the tax code will be complex and may be time consuming. Given the timing of the enactment of the new laws, many companies will face operational challenges for the 2017 year-end accounting.

SEC relief

The SEC staff has addressed the income tax accounting implications of the Act in its Staff Accounting Bulletin No. 118 (SAB) issued on December 22, 2017. In a footnote to the SAB, the SEC staff indicate they will not object to a registrant using IFRS from using the guidance in the SAB to determine the tax consequences of the Act. The SAB permits a best efforts approach to implementing the tax consequences of the Act on a piecemeal basis as follows:

- ***Measurement of certain income tax effects is complete*** – Those amounts must be reflected in the financial statements.

- ***Measurement of certain income tax effects can be reasonably estimated*** – If the entity does not have all the necessary information available, prepared, analysed or computed in reasonable detail to complete the tax accounting for specific income tax effects of the Act, but reasonable estimates can be made, the reasonable estimates should be used as provisional amounts in the Company's financial statements.

- ***Measurement of certain income tax effect cannot be reasonably estimated*** – If the entity does not have all the necessary information available, prepared, analysed or computed in reasonable detail to complete the tax accounting for specific income tax effects of the Act and reasonable estimates cannot be made, the tax consequences of those income tax effects would be based on the provisions of the tax law immediately before the Act was enacted.

The staff expects registrants will act in good faith to complete the accounting for income taxes. It is possible that an entity will apply all three scenarios in determining the tax consequences of the Act based on the information available. The accounting for the specific tax effects of the Act will be completed when the entity has obtained, prepared and analysed the information needed to complete the accounting under the accounting standards. The staff believes that the time to complete this work should not extend beyond one year from the enactment date.

Any changes to the provisional amounts reported or new provisional amounts determined are to be included as an adjustment to tax expense in income from continuing operations in the reporting period the amounts are determined.

The SAB includes extensive disclosure requirements about the financial impacts of the Act when the accounting for the tax consequences is incomplete.

While the SEC has indicated they believe foreign private issuers using IFRS can apply the SAB, there are views that the measurement period concept for business combinations cannot be extended to other IFRSs. However, IFRSs do allow companies to make estimates using all the information and analysis that is available and then revise estimates as more information and analysis becomes available. IFRS also requires extensive disclosures of estimates and measurement uncertainty. Further discussions of these views are expected and you should discuss your processes and estimates with your audit engagement teams early in the process, particularly if you are a SEC registrant.

What's next?

The accounting for the Act will be complex and time consuming for most companies with a significant US presence. Companies should carefully assess the impact of the Act and ascertain what steps need to be taken to comply with the requirements of IAS 12. Companies should consult with tax experts and the company's auditors early in the process to assess the materiality of a company's US presence and the consequences of the Act, if any.

Companies should also evaluate whether they have the necessary internal controls in place to implement the Act. Further disclosures about the material effects and any measurement uncertainties may be required in both the financial statements and the MD&A.

Annual maintenance completed

In October and December 2017, the IASB issued a series of narrow-scope and minor amendments to existing standards. These amendments are part of the IASB process to clarify standards or correct minor oversights or conflicts among standards. The amendments in 2017 were included in projects dealing with narrow-scope amendments to IFRS 9: *Financial instruments* and the *Annual Improvements (2015 to 2017 cycle)*.

The effective date for these amendments is for annual periods beginning on or after January 1, 2019. Early adoption is permitted.

Standard amended	**Amendments and *observations***
IFRS 9: *Financial instruments*	Permits companies to measure some prepayable financial assets (in the held to collect business model) with negative compensation at amortized cost rather than fair value through profit or loss. Negative compensation occurs when the prepayment amount is less than the unpaid amounts of principal and interest. To qualify, the compensation must be a reasonable amount for early termination. *Reasonable compensation is not defined and judgment will be required to assess whether the test is met.* When a modification of a financial liability does not result in the derecognition of the financial liability, a gain or loss is still required to be recognized. The gain or loss is the difference between the original and the amended cash flows discounted using the original effective interest rate. *This change affects all companies that make modifications to debt arrangements and differs from the recognition of gains and losses under IAS 39, currently used by most companies for the recognition and measurement of financial liabilities.*
IFRS 3: *Business combinations* & IFRS 11: *Joint arrangements*	Clarifies how to account for an increase in interests in a joint operation that is a business. If the company acquiring the interest maintains or obtains joint control, any previously held interests are not remeasured. If the company acquiring the interests obtains control, then the transaction is treated as a business combination and all of the previously held interests are remeasured at fair value.
IAS 12: *Income taxes*	Clarifies that all income tax consequences of dividends and similar payments on financial instruments included in equity are recognized consistently with the transactions that generated the distributable profits. *Distributable profits are not defined and judgment may still be required to assess whether the payments are generated from profit or loss, other comprehensive income, or equity transactions. However, it is expected most tax consequences of dividends will be included in profit or loss.*
IAS 23: *Borrowing costs*	Clarifies that the general pool of borrowings to calculate the eligible borrowing costs that are capitalized includes borrowings that were specifically used to finance qualifying assets once the qualifying assets are ready for their intended use or sale. These changes are to be applied on a prospective basis.

CSA developments

Women on boards and in executive positions

In October 2017, the securities regulatory authorities of several provinces and territories jointly released CSA Multilateral Staff Notice 58-309: *Staff review of women on boards and in executive officer positions – Compliance with NI 58-101: Disclosure of corporate governance practices*. The report includes the findings based on a review of disclosures by 660 issuers that had year-ends between December 31, 2016 and March 31, 2017.

The disclosure requirements about women in public companies were intended to increase the transparency for investors and other stakeholders about the representation of women on boards and in executive positions.

Key findings on status of women

The review found that the representation of women on boards has increased annually over the three-year period since the disclosure requirements were introduced. Sixty-one percent of the issuers have one or more women on their boards (2016 – 55% and 2015 – 49%). However, the board seats held by women for large issuers was only 20% for companies with a market capitalization over $1 billion and 24% over $10 billion. Overall, total board seats occupied by women was only 14% in 2017 compared to 12% and 11% in 2016 and 2015, respectively.

The number of issuers with at least one woman in an executive officer position remained relatively consistent over the three-year period. The number of issuers with at least one woman in an executive officer position in 2017 was 62%.

More issuers adopted policies relating to the representation of women, with 35% of issuers having such a policy (2016 – 21% and 2015 – 15%). However, improvements in the number of issuers adopting targets for the representation of women on boards and executive positions was not as significant (Boards: 2017 – 11%, 2016 – 9% and 2015 – 7%; and Executive positions: 2017 – 3%, 2016 – 2% and 2015 – 2%). The majority of issuers indicated they considered the representation of women in the selection process for board members and executives.

The adoption of director term limits has been slow with only 21% of issuers having term limits (2016 – 20% and 2015 – 19%).

Compliance with disclosures

The staff of the securities regulatory authorities noted a high level of compliance with the requirements; however, they noted some of the disclosures were vague or boilerplate in nature.

Data for analysis

In December 2017, the detailed data collected for the report from public documents filed on SEDAR was published on the websites of the securities regulatory authorities. This detailed data shows the results for each topic by issuer.

What's next?

Members of the board of directors, committees of the board of directors, and executive management responsible for corporate governance should read the report to obtain a more in-depth analysis of the findings to assess how their policies and practices align with other peer companies.

Marijuana related activities in USA

Recently, the CSA set out its disclosure expectations for issuers that have or are developing marijuana related activities in the USA. Certain states have legalized the sale and use of marijuana, but such activities remain illegal under US federal laws. The current federal government in the USA may enforce the federal laws resulting in prosecution and other consequences.

The CSA expected issuers with marijuana related activities in the USA to address the current legal and regulatory environment in the USA, including any risks that could result from the change in enforcement activity by US federal authorities. These disclosure expectations are explained in CSA Staff Notice 51-352: *Issuers with US marijuana-related activities* and vary by the nature of activities undertaken by the issuers, including companies that only have ancillary involvements (financing, leasing, branding, recipes, providing goods and services, consulting, or administrative services).

Independence of directors and audit committee members

The CSA is seeking comment and discussion on the appropriateness of the criteria for assessing whether directors and audit committee members are independent. The request for comments were published in October in CSA Consultation Paper 52-404: *Approach to director and audit committee member independence*. Comments are due January 25, 2018.

The paper reviews the historical development of the CSA approach to determining independence; a comparative analysis to approaches in Canada, Australia, Sweden, the UK and the USA; and a discussion of the benefits and limitations of the Canadian approach.

The expected outcome is a discussion of whether changes are required to the approach to ensure that boards and audit committees can attract strong candidates. Concerns have been raised that the current approach precludes individuals with the requisite expertise and sound judgment from being considered as independent directors and audit committee members.

Interprovincial crowdfunding

The Provinces of Alberta and Saskatchewan have changed their start-up crowdfunding exemptions to allow businesses in Alberta and Saskatchewan to raise fund from residents in those two provinces. Alberta has changed the Companion Policy to its Rule 45-517: *Prospectus exemption for start-up businesses* to clarify how these offerings will work.

Issuers will be required to comply with the requirements of each jurisdiction, which may not necessarily be identical.

SEC developments

AICPA SEC conference

The 2017 AICPA National Conference on *Current SEC and PCAOB Developments* was held in early December 2017. The conference featured representatives from the SEC, FASB, IASB, PCAOB, and the AICPA Centre for Audit Quality, as well as preparers, investors, audit committee members, and auditors.

The theme for the conference was communication among various stakeholders in financial reporting. The presenters encourage dialogue among: (a) management, the audit committee, and the auditors; (b) management, the regulators, and the standard setters; and (c) regulators, standard setters, and their international counterparts.

In this edition of *AC Insights*, we bring you the highlights from the conference from the perspective of Canadian SEC registrants. Some topics discussed at the conference related solely to US domestic issuers have not been covered in this article.

Foreign private issuers

Most Canadian companies and companies located outside the USA are considered foreign private issuers (FPIs). The SEC staff disclosed at the conference that 60% of the FPIs used IFRSs for preparing financial statements and 40% used US GAAP. Very few companies are using local GAAP reconciled to US GAAP.

Audit committee effectiveness

Several ways to strengthen audit committee effectiveness were outlined by the SEC staff:

- Regular communications with the auditor and management to ensure the audit committee is informed about the latest information and key issues;
- Basing the composition of the audit committee on what is best for the company and its particular facts and circumstances; and
- Meaningful interaction with the auditor and management to assess whether the right issues are being focused on, rather than simply covering required communications.

New accounting standards

Several significant accounting standards become effective in the next few years. The SEC staff believes audit committees can contribute to the effective implementation of new accounting standards by setting an appropriate tone at the top. The audit committee can also establish expectations for dialogue between the auditor and management and for understanding concerns raised by the auditor.

Registrants were reminded that internal control over financial reporting might need to be adapted to address the changes in the standards. Under the COSO framework, this will require companies to identify and assess changes that could significantly affect their system of internal control.

Revenue recognition

Most Canadian issuers will adopt the new revenue standard, IFRS 15, on January 1, 2018. Various speakers and panelists discussed the implications of adoption with an emphasis on (a) the types of judgments required, (b) the internal control implications, and (c) the effort required to meet the disclosure requirements. All presenters stressed the importance of getting the accounting for revenue right for users of the financial statements.

The SEC staff reiterated that they would respect well-reasoned judgments made in applying the new standard. However, the SEC staff will issue comments if they suspect the accounting may be incorrect or if the required disclosures are missing.

The SEC representatives emphasized the importance of disclosures under the new revenue standards.

Registrants were encouraged to dedicate appropriate resources to planning for the preparation of the disclosures and designing and testing related processes and controls.

A panel of preparers shared best practices they have implemented to adopt the new standard. They stressed the need for a robust process around disclosures. In addition, it will be important to educate analysts and investors as to the outcomes of the implementation of the new standards. This may require the support of the executive team and the board of directors.

The SEC staff also reviewed some matters they have addressed in discussions with registrants as follows:

- Pre-production arrangements – The current accounting for such arrangements differs among registrants, with some treating the arrangement as a service (and recognizing revenue) and others as research and development (recognizing receipts as a reduction of costs). The SEC staff indicated that a registrant that currently recognizes revenue from such arrangements should consider whether there is a performance obligation. In addition, the SEC staff encouraged those planning to change from a research and development approach to a revenue approach to consult with the SEC staff.

- Performance obligations – In assessing whether promises in a contract are separately identifiable, the SEC staff has taken the view that promises must significantly affect each other if they are to be combined as a single performance obligation. The staff rejected a registrant's request to consider the licensing of a portfolio of existing patents and additional patents to be provided when and if available as a single performance obligation.

- Principal versus agent – The SEC staff observed these assessments may be challenging for certain industries and the importance of assessing the relevance of indicators of control. This assessment requires reasonable judgment.

- Classification of shipping and handling costs – The SEC has indicated they will not object to the classification of these costs as cost of sales or as costs outside of cost of sales. If amounts are classified outside of cost of sales, disclosures are required.

US tax reform

The SEC staff acknowledged the challenges companies may face with the US federal tax reform because of the enactment on December 22, 2017. As noted in our article on US tax reform under *IFRS developments*, the SEC staff have issued a Staff Accounting Bulletin, which provides accommodations for reflecting the tax consequences of the tax reform in the financial statements. Registrants were reminded to disclose any material effects of the tax reform in the MD&A.

SEC comment letters

A panel on SEC comment letters reminded registrants that the SEC reviews information beyond SEC filings, such as earnings releases, earnings calls, investor presentations, and registrant's websites. Comments are frequently issued when such information from these sources is inconsistent with information in the financial statements.

The highest volume of SEC comments have been on non-GAAP measures. While the volume of comments is declining as registrants improve their disclosures, the SEC staff will continue to question misleading labelling and presentation of non-GAAP measures with greater prominence than GAAP measures.

The other most common topics for SEC comments are on the MD&A, fair value disclosures, segments, and revenue recognition. In addition, comments are frequently raised on business combinations, goodwill, intangible assets, and income taxes.

Over the next few years, the SEC staff will focus on the implementation of major new standards by registrants.

Common areas of focus for companies using IFRSs are similar to those for many US registrants. These include non-GAAP measures, revenue recognition, fair value measurement, intangibles and goodwill, acquisitions and business combinations, and the MD&A. In line with continued monitoring of non-GAAP measures, the SEC expects to focus on

subtotals presented in financial statements to assess compliance with IAS 1: *Presentation of financial statements*.

PCAOB new auditor's report

The new auditor's report required under PCAOB standards will require disclosure of Critical Audit Matters (CAMs). The new requirements will be effective for certain companies in 2019.

The SEC staff encouraged auditors to begin discussions with audit committees and management about the content and format of the new reports. A panel consisting of a preparer, an audit committee member, an investor and an auditor emphasized the importance of communications so management and the audit committee can understand the process for identifying CAMs and the nature of information to be disclosed in the auditor's report.

The AICPA Centre of Audit Quality has issued a publication (*The Auditor's report: Considerations for audit committees*) which outlines key considerations for audit committees (see a summary under *Auditing developments*).

Cybersecurity

The SEC continues to be focused on cybersecurity and indicated registrants should consider whether:

- Disclosure controls and procedures address cyber threats and incidents and involve all relevant parties, including the information technology and business functions, in assessing the effect of a breach and the related disclosures; and
- Insider trading policies take into account cyber risks and incidents.

Auditing developments

Reporting key audit matters

Recently, the Chair of the Auditing and Assurance Standards Board (AASB), Darrell Jensen, indicated that the AASB is planning to require the reporting of Key Audit Matters (KAMs) for TSX-listed companies starting in 2020. This plan is still subject to the AASB's due process. This announcement follows on the heels of the PCAOB approving its revised audit-reporting standard that will require disclosure of Critical Auditing Matters in PCAOB auditor's reports.

Earlier in the year, the AASB published CAS 701: *Communicating key audit matters in the independent auditor's report,* which allowed for voluntary reporting of KAMs in the auditor's report or required reporting if mandated by a regulator. We covered this development in the summer 2017 edition of *AC Insights*.

KAMs are matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

International auditing standards already require the reporting of KAMs by auditors.

CPAB report on Big 4 inspections

In November 2017, CPAB released its *2017 Big Four Inspections Report*, which provides an overview of annual inspections of the four largest accounting firms in Canada. Under the CPAB protocol, PwC shares this report with audit committees of its clients along with any client specific inspection findings.

Over the last three years of inspections, CPAB has noted improvements in the number of files with significant findings. In 2017, less than 7% of the files reviewed had significant findings (2016 – 13% and 2015 – 26%). A significant inspection finding is a deficiency in the application of generally accepted auditing standards that could result in a restatement.

A significant inspection finding requires the accounting firm to carry out additional auditing procedures to verify that there is no need to restate the financial statements. However, the findings indicated a continuing need for consistent application of auditing standards and the need to embed audit approach improvements into every practice and each engagement.

Full details of the findings can be found in the CPAB report provided to the audit committee.

CPAB industry forums

CPAB held a number of industry forums during 2017. These forums cover issues facing audit committees, developments in audit quality, and areas of audit focus.

In this edition, we highlight the key matters raised at the respective forums by industry. For more information, you should refer to the publications found on the CPAB website (www.cpab-ccrc.ca).

Mining industry

Issues facing audit committees

- Enterprise risk management, including cybersecurity.
- Exposure to geopolitical risks and resource security risk.
- Complexity and risks of transfer pricing strategies for tax purposes, including oversight of processes and controls over cross border transactions and transfer pricing policies.
- Impact of low commodity prices on the business model. Cost containment measures can affect staffing to manage quality control systems and the retention of employees with the relevant expertise.
- Compliance with requirements of the *Extractive Sector Transparency Measures Act* (Canada), the *Corruption of Foreign Public Officials Act* (Canada) and the *Foreign Corrupt Practice Act* (USA).

- The determination of key performance indicators, including non-GAAP measures, which companies often apply differently. Robust disclosure controls and procedures are important as well as adequate disclosures of how KPIs align with the company's strategy and management compensation plans.

Areas of audit focus

- Impairment and reversal of impairment of mining properties, including the key inputs and assumptions used by management, the qualifications and oversight of reporting on mineral reserves and resources, and timeliness of such reports.
- Group audits, including the reliance on auditors in foreign jurisdictions and understanding the business practice, legal structures, customs and cultural norms in foreign countries.
- Tax balances given complexity of understanding foreign tax regimes, transfer pricing, and the impact of foreign currencies on tax balances.
- Internal controls, including the skills and knowledge of internal auditors and the governance over reporting on mineral reserves and resources.
- Asset retirement obligations, including key inputs and assumptions used.
- Implementation of new accounting standards, in particular revenue recognition and lease accounting.

Oil and gas industry

Issues facing audit committees

- Key performance indicators (KPIs), including non-GAAP measures, are used widely in the industry, but there are differences in how KPIs definitions are applied. Better disclosures could improve the use of KPIs. Audit committees should ensure KPIs are subject to robust disclosure controls and procedures.
- Enterprise risk management, including cybersecurity.
- Climate change reporting, including the difficulty of the quantification of impacts and lack of comparability among companies in the same industry.
- International exposure to tax complexity and risks, particularly related to transfer pricing strategies.

Areas of audit focus

- Impairment and impairment reversals of oil and gas assets, including key assumptions used and the oversight of reported reserves.
- Group audits, including the reliance on auditors in foreign jurisdictions and understanding the business practice, legal structures, customs and cultural norms in foreign countries.
- Tax balances given complexity of understanding foreign tax regimes, transfer pricing and impact of foreign currencies on tax balances.
- Internal controls and strength of corporate governance.
- Implementation of new accounting standards, in particular revenue recognition and lease accounting.

Real estate industry

Issues facing audit committees

- Use of external management to manage real estate introduces unique challenges requiring the attention of the audit committee, such as effectiveness of internal control of the external managers, compensation arrangements for external managers, and alignment of external managers' incentives with the interest of shareholders/unitholders.
- Compliance with the SIFT tax rules for REITS.
- Tenant quality and the implications on property valuations and risks to the entity.
- Key performance indicators such as net operating income (NOI), fund from operations (FFO), and adjusted FFO (AFFO). Concerns were raised over differences in the application of these measures among different entities and consistency of application from period to period within an entity.
- Estimating the fair value of properties under development and the lack of comparability among real estate companies.

Areas of audit focus

- Valuation and impairment of investment properties, including key inputs and assumptions used to value properties, the extent of expertise of persons preparing valuations, quality of internal controls over valuation processes, and the impact of current trends on valuations.
- Taxation, including maintenance of REIT exception status and the complexity for tax structures for corporate entities.
- Determination of whether joint arrangements are joint operations or joint ventures subject to equity accounting.
- Appropriateness, measurement and disclosure of related party transactions, including governance over these transactions.

These concerns raised by audit committee members and auditors may be beneficial to audit committees in considering their dialogue with management and auditors at the year-end audit committee meetings.

PCAOB auditor's report approved by SEC

On October 23, 2017, the SEC approved the new PCAOB standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. The new standard will result in the first significant changes to auditor reporting in over 70 years.

These changes to the auditor-reporting standard were explained in the summer 2017 edition of *AC Insights*. The new standard retains the existing "pass/fail" opinion, but makes significant changes to the form and content of the auditor's report for public companies. For example, auditors will be required to disclose audit firm tenure and make other changes to the wording of reports to clarify the auditor's role and responsibilities. These initial changes will come into effect for auditor's reports as of the 2017 calendar year end.

Starting in 2019 for certain audits, auditors will be required to include a description of critical audit matters, as defined, in their reports.

In December 2017, the AICPA Centre for Audit Quality published a guide for audit committees on the application of the new reporting standard. *The Auditor's Report: Considerations for audit committees* provides an explanation of the changes, questions the audit committee members might ask and other considerations for the audit committee.

This new tool for audit committees considers:

- The determination of auditor tenure and what information might need to be communicated to explain any complexities;
- The extent of disclosures to be made in company filings;
- An overview of the changes required to the auditor's report; and
- Implementation plans by auditors for CAMs, including their methodology and guidance on identifying and communicating CAMs.

Copies of the report can be obtained through the AICPA website at Enhancing the Audit Committee Report: A Call to Action | The Center for Audit Quality.

PCAOB Inspection Brief

In November, the PCAOB issued a Staff Inspection Brief: *Preview of observations from 2016 inspections of auditors of issuers*. The Brief highlights the most frequent audit deficiencies observed during the 2016 inspection cycle.

While the Brief states many firms continue to make progress in improving audit quality, auditing firms still need to consider additional or different steps to improve and sustain audit quality. These actions include evaluation of the firm's systems of quality control and analyzing the root cause of recurring deficiencies.

Most frequent deficiencies

The most frequent deficiencies occur in three key areas of inspection focus:

- Assessing and responding to risks of material misstatement – Auditors frequently fail to comply with the risk assessment standard, which may result in inadequate audit testing, including testing of internal control over financial reporting and accounting estimates. The PCAOB found that substantive audit procedures applied, including tests of details, were not always specifically responsive to the assessed fraud risks or other significant risks. Shortcomings include failure to address audit evidence that appeared to contradict certain assertions. Auditors also needed to evaluate the presentation of financial statements and the accuracy and completeness of disclosures.

- Auditing internal control over financial reporting – The most frequent deficiencies related to insufficient testing of the design and operating effectiveness of selected controls, in particular procedures used by management to review forecasts and other assumptions used in estimates. In addition, failures were noted in assessing whether the control being tested addressed the relevant risk of material misstatement; and in conducting sufficient testing over completeness and accuracy of system generated data or reports used.

- Auditing accounting estimates, including fair value measurements – this deficiency generally relates to impairment analysis of goodwill and long-lived assets, the valuation of assets acquired and liabilities assumed in business combinations, revenue-related estimates and reserves, the allowance for loan losses, inventory reserves, and financial instruments. Concerns were raised over the auditor's lack of understanding of how estimates were developed, insufficient testing of significant inputs, and the evaluation of significant assumptions used by management.

The Brief noted other areas of focus that raised audit deficiencies that were not pervasive among all firms. These include the failure to: (a) consider economic conditions and risks (high levels of acquisition activity, the search for higher yielding investment returns, and fluctuations in commodity prices); (b) assess an entity's ability to continue as a going concern; and (c) evaluate the entity's controls and procedures to identify, account for, and disclose related party transactions.

The PCAOB also observed certain deficiencies in applying the independence requirements of the PCAOB and the SEC. In addition, improvements were needed in the application of the standards on engagement quality reviews.

What's next?

The matters observed in the Brief provide a basis for considering how to improve the upcoming audits for 2017.

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