

Transition to IFRS_s

Communicating the Impact of the Changeover

A Canadian Performance Reporting Board Publication

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PREFACE

The Canadian Performance Reporting Board (CPRB) October 2008 publication *Pre-2011 Communications About IFRS Conversion* provided guidance about reporting progress towards IFRS conversion. *Transition to IFRSs—Communicating the Impact of the Changeover* discusses how to summarise the effects of the changeover in the MD&A.

The conversion from existing Canadian GAAP to IFRSs will potentially result in a myriad of changes in an entity's financial statements. Recognizing this, IFRS disclosure requirements provide that an entity's first IFRS interim financial report must set out various reconciliations between the two bases for reporting, including the entity's equity at the date of the changeover and its comparative comprehensive income for the most recently completed year and first quarter. As well, material changes to cash flows must be explained.

The reconciliations in the financial statements are unlikely to highlight key matters, however. Accordingly, this guidance sets out examples of ways to provide a succinct MD&A discussion of the impact of the changes in a way that highlights significant differences, including how changes will impact an entity's future financial reporting.

In assessing the effects of the changeover, investors will want to understand the impact of any elections that were made, such as the elimination of the Cumulative Translation Adjustment that would otherwise have been carried forward to affect future income. As well, investors may want to separately identify the effects of reclassifications and any pervasive changes that result in significant differences in reporting, for example the effect of consolidating previously

non-consolidated entities where investors may not have a sufficient historical perspective to formulate expectations. Therefore, the guidance suggests ways to summarise the effects of various categories of changes.

Comments on this guidance, or suggestions for future CPRB projects should be sent to:

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TABLE OF CONTENTS

Introduction	1
Comparing IFRSs to old Canadian GAAP	1
The IFRS conversion protocols	2
Other matters related to interim reporting in the year of the changeover	3
Analyzing the effects of differences between existing Canadian GAAP and IFRSs	4
The MD&A should supplement the financial statement reconciliations	5
Suggestions for reporting the impact of the changeover to IFRSs	6
Conclusion	7
Example 1: Summary of the effects of changes to income, cash flow and financial position for the year ended December 31, 2010	8
Example 2: Summary of the effects of changes to income and cash flow for the year ended December 31, 2010	10
Example 3: Summary of changes in net assets as of December 31, 2010	12
Example 4: EBITDA—summary of changes in year ended December 31, 2010	13



INTRODUCTION

Most Canadian public companies will commence reporting in accordance with International Financial Reporting Standards (IFRSs) in 2011. At that time, the changeover will potentially result in a myriad of changes to an entity's financial statements. In the three years leading up to the changeover date, the Canadian Securities Administrators (CSA) expect entities to provide increasingly more detailed discussions of the effects of the changeover in the MD&A¹. As well, the CICA publication *Pre-2011 Communications about IFRS Conversion* set out various recommendations for reporting an entity's progress towards conversion. In *Transition to IFRSs—Communicating the Impact of the Changeover*, we focus on reporting in the MD&A when an entity is able to quantify the impact of the changeover on its financial reporting. This information may be available in the latter half of 2010, although some entities may not be able to complete quantifying the impact of the changeover until Q1 2011.

COMPARING IFRSs TO OLD CANADIAN GAAP

Investors want to compare an entity's performance from one period to the next. On the changeover to IFRSs, this comparison will be distorted because of the application of a different set of accounting rules. After the changeover, old Canadian GAAP will not exist and the entity will have converted its systems to IFRSs, making post-changeover comparisons to old Canadian GAAP time consuming and costly. Accordingly, the impact of the changeover to IFRSs needs to be considered from the perspective of the period leading up to the changeover.

¹ See CSA Staff Notice 52-320.

THE IFRS CONVERSION PROTOCOLS

IFRS 1 *First Time Adoption of IFRSs* governs the conversion to IFRSs when an entity first adopts IFRSs. This IFRS addresses both the mechanism for changing from a local GAAP to IFRSs and the financial statement disclosures about the changeover.

When an entity converts from old Canadian GAAP to IFRSs, the conversion is generally executed so that the converted financial statements appear as they would have been if the entity had always reported under IFRSs. Two provisions in IFRS 1 modify this general principle of retrospective application. One provision prohibits retrospective application of some aspects of a few IFRSs. The second permits an entity to elect to apply specified exemptions that provide for alternative treatments in some standards, primarily to simplify the conversion process. The mandatory and elective changes resulting from the conversion may introduce significant differences in the expected future behaviour of balances and accounts, as well as one-time differences on the date of transition.

Under IFRS 1, the first quarterly report under IFRSs (the quarter ended March 31, 2011 for entities with calendar year ends) will need to provide several reconciliations from Canadian GAAP to IFRSs. For December 31 year ends, these will address equity at December 31, 2009, March 31, 2010, and December 31, 2010, and comprehensive income for the three months ended March 31, 2010 and the year ended December 31, 2010. An explanation of material adjustments to the cash flow statements for those periods is also required. While the reconciliations must be in sufficient detail to enable users to understand the material adjustments to the statement of financial position and the statement of income, there is no requirement that the reconciliations distinguish those differences caused by an entity's elections.

OTHER MATTERS RELATED TO INTERIM REPORTING IN THE YEAR OF THE CHANGEOVER

Two other matters related to an entity's interim reports in the year of the changeover are worthy of note.

Entities follow International Accounting Standard (IAS) 34 *Interim Financial Reporting* when preparing quarterly financial statements. Under IAS 34, condensed financial statements may be produced. Accordingly, the reconciliations to Canadian GAAP in the interim 2011 financial statements may not highlight all the items that will be reported in the 2011 annual financial statements. Such condensed reporting emphasizes the need for discussion in the MD&A of the impact of important differences, for example those that will have a significant effect on future results.

While interim financial statements need to be prepared in accordance with IAS 34, it is only when preparing the first annual IFRS financial statements that decisions about optional exemptions under IFRS 1 are required to be finalized. Investors will not want provisional information, however, and it seems likely that most entities will want to have finalized these decisions by Q1 2011 reporting. When this is not the case, an entity should explain in its 2011 interim MD&As that decisions about IFRS 1 exemptions in 2011 quarterly reporting are expectations of the final elections to be reported in the first annual IFRS financial statements.

ANALYZING THE EFFECTS OF DIFFERENCES BETWEEN EXISTING CANADIAN GAAP AND IFRSs

The changes in recognition, measurement, presentation, and/or disclosure requirements on the conversion to IFRSs can result in various types of difference. A difference may arise due to the way in which a standard reflects an underlying financial condition, for example, IAS 36 measures an impairment loss in a different way to that adopted under Canadian GAAP. Alternatively, a difference may relate to one set of standards being more prescriptive than another. For example, under IFRSs, the revenue recognition criteria for the sale of goods can be less prescriptive than under existing Canadian GAAP, in some cases leading to a broader range of revenue recognition policies being available for the sale of goods under IFRSs. Then again, one set of standards may address an issue which is not considered by the other. For example, the IFRSs include a standard for agricultural activity that has no equivalent under existing Canadian GAAP.

A difference can have a pervasive effect on net income. For example, IFRSs may require consolidation of special purpose entities (SPEs) that are not consolidated under Canadian GAAP, a difference that may be fundamental to all aspects of an entity's financial reporting. A similar but opposite effect would occur under proposals in the IASB's Joint Arrangements Exposure Draft that contemplates many joint venture arrangements being accounted for under the equity method rather than using proportionate consolidation. Alternatively, a difference may be restricted to presentation within the income statement. For example, only disposals of significant operations, such as a major line of business or geographical area of operation, meet the IFRS requirements to present the results as discontinued operations. This is a narrower test than under old Canadian GAAP and could result in some reclassifications in the income statement, affecting income from continuing operations, but not net income. Current IFRS proposals call for an even narrower definition of discontinued operations that could mean that this reclassification difference will be even more widespread.

THE MD&A SHOULD SUPPLEMENT THE FINANCIAL STATEMENT RECONCILIATIONS

The reconciliations under IFRS 1 will provide the required details about how each amount reported under existing Canadian GAAP changes under IFRSs. However, the reconciliations will not generally:

- highlight (other than by quantifying in the reconciliations) the key matters; or
- discuss how the changeover could be expected to affect future financial reporting.

To form revised expectations of financial performance under IFRSs, investors need quantitative disclosure or alternatively qualitative discussion of the effects of significant changes in the financial statements as a result of the changeover to IFRSs. As soon as the effects of the changeover have been quantified, they should be communicated succinctly in the MD&A, aggregating the impact on financial statement line items and key performance indicators (KPIs) in a manner that highlights significant consequences, including consequences for future reporting. The MD&A could usefully perform this function if it were to summarize and discuss the impact of the changeover on an entity's financial position, net income, and cash flows.

Matters discussed with the board of directors or audit committee about the impact of the change to IFRSs are likely to be a good indication of the areas of most interest to investors. In some circumstances, the most important aspect of the communication in the MD&A may be to distinguish those differences that relate to elective as opposed to mandatory changes, together with their anticipated impact on future key performance indicators and how they relate to executive compensation. These differences would include those arising from IFRS 1 exemptions the entity expects to exercise and any other changes in accounting policy selected by the entity. As well, it may be helpful to segregate reclassification differences that do not affect net income. In addition, it may be important to isolate and quantify the pervasive impact of one particular difference in reporting, for example the consolidation of special purpose entities or the removal of each line item of the assets and liabilities of particular joint ventures.

SUGGESTIONS FOR REPORTING THE IMPACT OF THE CHANGEOVER TO IFRSs

The preferred method for summarizing the impact of the changeover in the MD&A will depend on the extent of the differences and the disclosure provided in the financial statements. Whatever method is selected, however, the objective should be to communicate in one place the effect of the change, the reason for the change, and its expected effect on future reporting, if known. In addition, it may be as important to emphasize the absence of differences as it is to discuss those financial statement line items that have experienced significant change. For example, investors will usually be particularly interested in the effect of the changeover on cash flows, even though more often than not the message will be that cash flows have not been affected by the change.

In some circumstances where there are few differences and where financial position, income statement and cash flow statement line items relate easily to each other, it may be possible to summarize the effects on income, cash flows, and the financial position in one tabular format that also highlights the reasons for the differences and their future impact on financial reporting (example 1). In other circumstances, the preferred method may call for a focus on the changes in income and cash flow (example 2).

The use of charts should also be considered. For example, when changes in income and cash flow have been discussed in a tabular format, the impact of the changeover on the financial position may best be communicated in a chart (example 3).

Investors will likely be especially interested in the effects of the changeover on KPIs. Accordingly, depending on users' needs and the extent and quality of disclosure of the changeover's impact in the financial statements, the MD&A may best be focused on reviewing the impact on KPIs such as EBITDA etc. (example 4).

The above discussion presumes that the quantitative impact of the changeover has been finalized. Prior to the changeover, when an entity is still assessing the quantitative effect of the changeover, the tabular format discussed above could still be used to summarize the financial statement line items identified as likely to be affected and the issues being analyzed. This may be preferable to reporting a narrative that does not provide any context for the significance of the items to the complete financial statements.

CONCLUSION

Investors want to know how an entity's performance has varied from the preceding period and the extent to which its performance is likely to be indicative of the future. To assess this when an entity first reports in accordance with IFRSs, investors will need to understand the extent to which prior reported performance has varied because of the changeover and the extent to which that change can be expected to affect future reporting. While the effect of the conversion on prior periods will be available in the financial statements, a concise summary in the MD&A, dealing with the impact on key items, the reason for the change, and the likely impact on future reporting, should assist investors in making decisions about investing or continuing to invest in an entity.

EXAMPLE 1

SUMMARY OF THE EFFECTS OF CHANGES TO INCOME, CASH FLOW AND FINANCIAL POSITION FOR THE YEAR ENDED DECEMBER 31, 2010

CAPTION	CHANGE IN					
	2010 INCOME			2010 CASH FLOW		
	M	E	Total	M	E	Total
	\$ million			\$ million		
M—mandatory E—elective						
OPERATIONS						
Revenue	—	100	100	—	—	—
Operating & admin. costs	(10)	(80)	(90)	—	—	—
Working capital	—	—	—	—	—	—
Plant & equipment/Amortization	20	—	20	—	—	—
Pension expense/Other assets	—	19	19	—	—	—
Total operations	10	39	49	—	—	—
FINANCES						
Current debt	—	—	—	—	—	—
Long-term debt	—	—	—	—	—	—
Future income taxes	(4)	(16)	(20)	—	—	—
Total finances	(4)	(16)	(20)	—	—	—
EQUITY						
Accumulated other comprehensive income	—	—	—	—	—	—
Retained earnings	—	—	—	—	—	—
Total equity	—	—	—	—	—	—
Net income	6	23	29			
Net cash flow				—	—	—
Net assets						
Standardized EBITDA	(10)	39	29			
Standardized free cash flow				—	—	—
Net income/increase in cash/net assets under old Canadian GAAP			105			43
Change			29			—
Net income/increase in cash/net assets under IFRSs			134			43

In this example, the main differences result from a revised revenue recognition policy, recognition of a Cdn. GAAP contingency as a provision, reclassification of a bank loan from long-term debt to current, plant & equipment impairment, transfer of defined benefit pension plan actuarial losses to retained earnings, and transfer of cumulative foreign currency translation gains/losses to retained earnings. The differences have been categorized as either mandatory or elective.

FINANCIAL POSITION DECEMBER 31, 2010			COMMENT/FUTURE IMPACT
M	E	Total	
\$ million			() amounts—additional liability or equity, or reduced asset, reduction in income, or reduction in cash flow.
—	—	—	
—	—	—	
(10)	20	10	M A lower threshold for recognizing contingencies under IFRSs makes recognition more likely. E The ability to separate some contracts into two components under IFRSs expedites revenue recognition.
(250)	—	(250)	M Impairment evaluation under IFRSs using discounted cash flow makes impairment more likely under IFRSs, although reversal is also possible. Impairment on transition reduces 2010 amortization, and, unless reversed, future amortization.
—	(200)	(200)	E An election to transfer defined benefit pension plan actuarial losses to retained earnings reduces 2010 and future pension expense.
(260)	(180)	(440)	
(40)	—	(40)	M Bank debt refinanced after the year end is reclassified as current debt under IFRSs.
40	—	40	
90	70	160	M and E Future taxes on adjustments.
90	70	160	
—	(30)	(30)	E Electing to transfer the balance of foreign currency translation adjustments for pre-2010 self-sustaining subsidiary acquisitions to retained earnings results in deferred gains and losses being excluded from income on the subsidiary's eventual disposal.
170	140	310	M and E Adjustments to retained earnings result from the above changes.
170	110	280	
(170)	(110)	(280)	
		739	
		(280)	
		459	

In this example, where the entity did not early-adopt CICA Handbook Section 1582, *Business Combinations*, the main differences arise from changes in accounting for a business acquisition, immediate recognition of defined benefit pension plan actuarial gains and losses in other comprehensive income, the transfer of the cumulative foreign currency translation account to retained earnings, and reclassifications, including computer software amortization. The differences have been categorized as mandatory, elective or reclassifications.

COMMENT/FUTURE IMPACT

() amounts – increase in expense, reduction in income, or reduction in cash flow.

No material impact.

M Previously capitalized provisions for certain restructuring costs in acquisitions are expensed under IFRSs, affecting cash flow from operating activities when paid [(67)].

E The company has elected to recognize all defined benefit pension plan actuarial gains and losses immediately in other comprehensive income, instead of deferring and amortizing to them income using the “corridor” approach [33].

E Resetting the CTA balance to zero results in excluding pre-transition deterred exchange gains from income on a going-forward basis [(17)].

R Under IFRSs, gains and losses on the disposal of property or a business usually form part of operating profit [68].

R Operating costs will continue to be reduced by the reclassification of computer software amortization to amortization [60].

R Other [(9)]

R Primarily relates to operating gains noted above.

M Change in income taxes relates to other adjustments [21].

M Changes in the treatment of adjustments to purchase price allocations increased amortization costs that will continue to be based on revised allocations [(19)].

M A change in the method for determining the carrying value of assets held for sale that increased impairment is not anticipated to have a material impact in the future [(14)].

R See computer software above [(60)].

M The above noted restructuring adjustment increased cash flows from investing activities [67].

R IFRSs include income from non-controlling interests in net income [14].

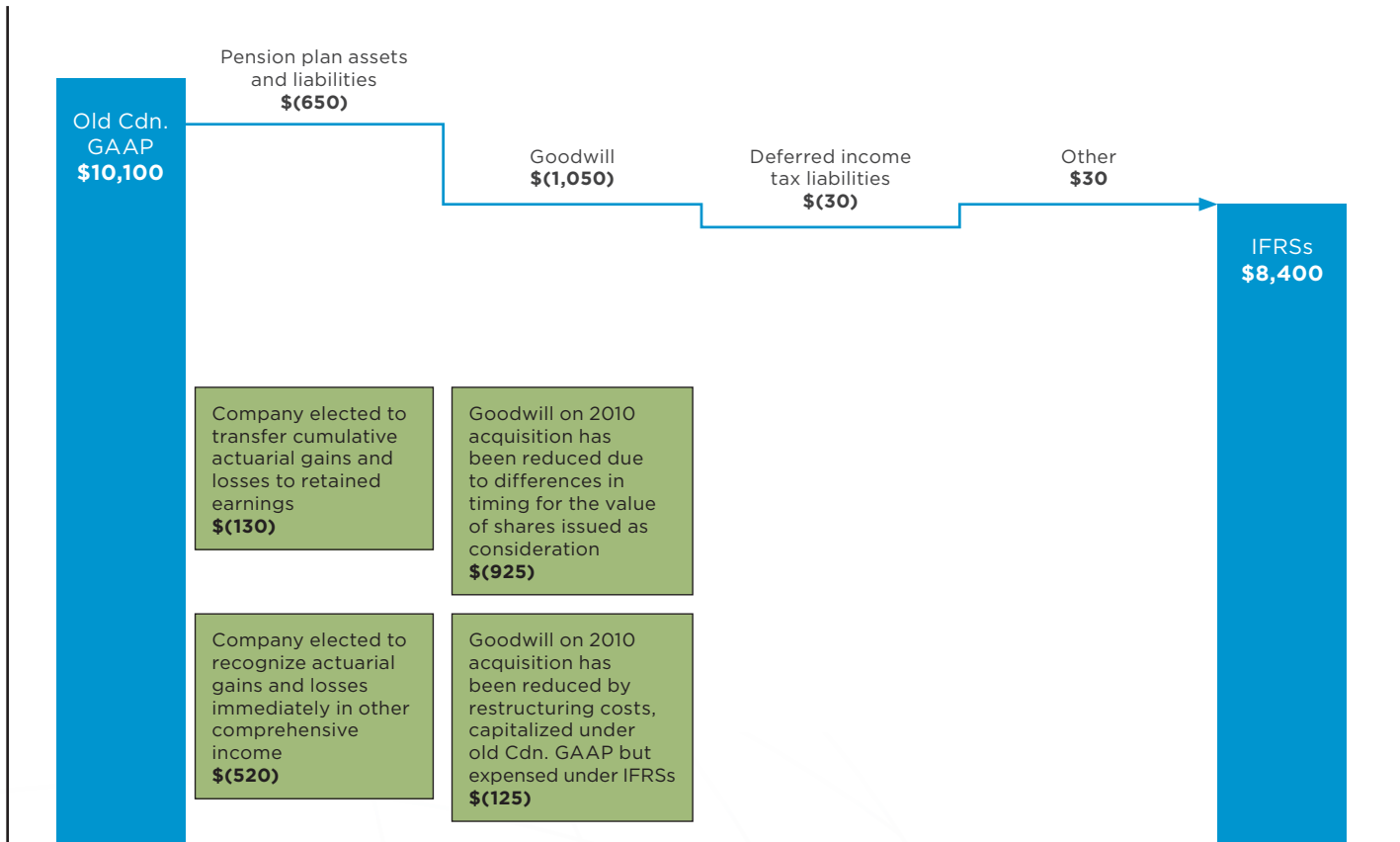
M Foreign exchange difference related to change in valuation of acquisition [(30)].

E Elimination of transfer to income under old Canadian GAAP in respect of deferred exchange gains on disposals in the period [17].

E Company elected to recognize actuarial gains and losses immediately in other comprehensive income. Actuarial gains and losses will continue to be recognized immediately in other comprehensive income [(273)].

EXAMPLE 3 SUMMARY OF CHANGES IN NET ASSETS AS OF DECEMBER 31, 2010

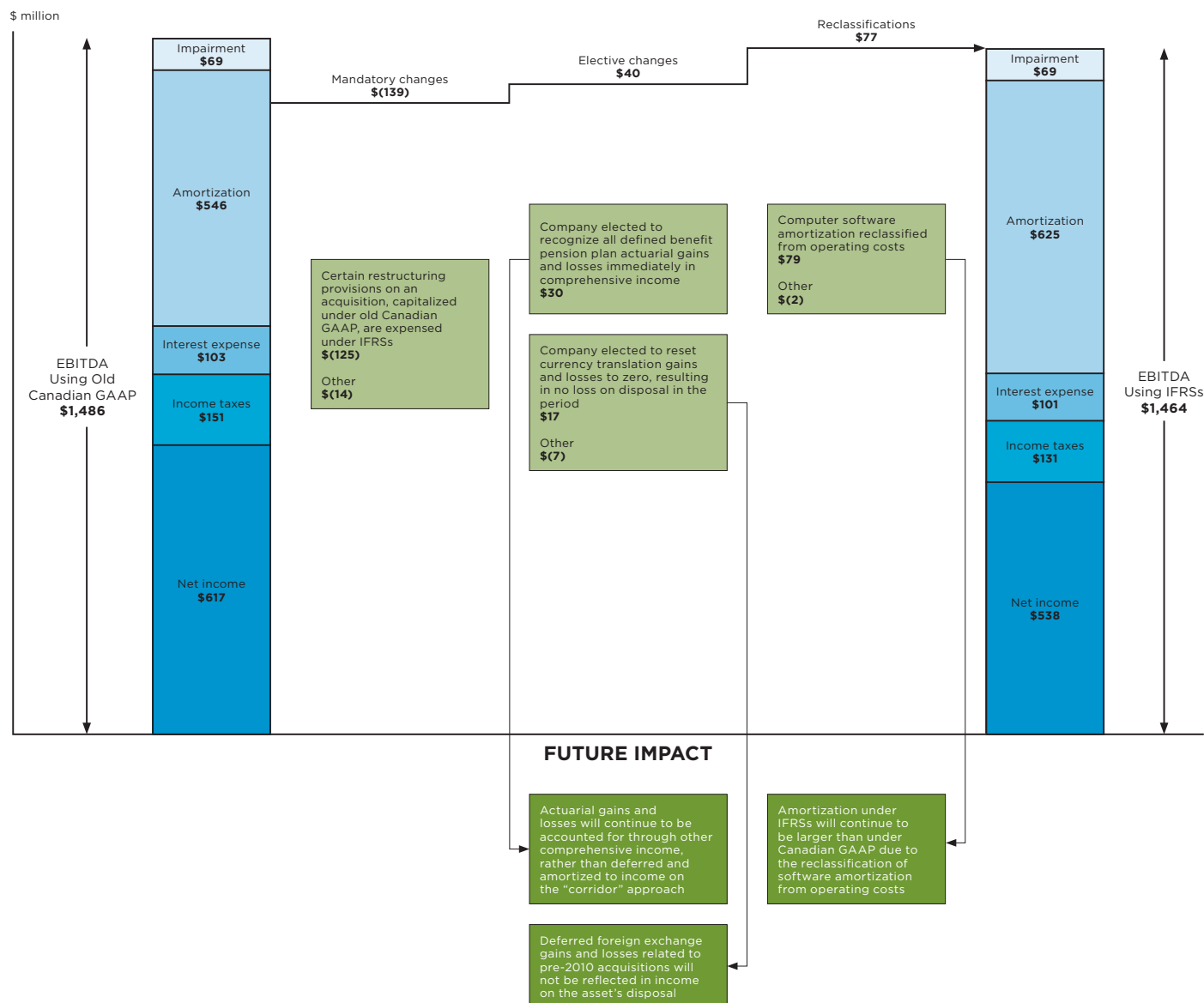
\$ million



Note: This example assumes the entity did not early-adopt CICA Handbook Section 1582—Business Combinations

EXAMPLE 4

EBITDA – SUMMARY OF CHANGES IN YEAR ENDED DECEMBER 31, 2010



Note: This example assumes the entity did not early-adopt CICA Handbook Section 1582—Business Combinations



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