Financial Reporting Release

Keeping your head above water…

Recent issues in financial reporting*

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*connectedthinking

PricewaterhouseCoopers

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There's an old proverb: May you live in interesting times. For accountants these days, nothing is more interesting than what's happening with Canadian GAAP. We are witnesses to a new era, one where International Financial Reporting Standards ("IFRS"), not US GAAP, dominates the Canadian financial reporting landscape. This phenomenon results, of course, from last year's decision by the CICA Accounting Standards Board ("the Board") to adopt IFRS as Canadian GAAP and, more broadly, the steadily increasing influence of IFRS throughout the world.

This issue of *Financial Reporting Release* reflects the new reality. Consider the topics: implementing IFRS in Canada, IFRS in the US, Canadian financial reporting for private enterprises in the IFRS age, new CICA standards with roots in, or substantially affected by, IFRS – inventories, the matching principle, pension plans, rate-regulated enterprises, going concern uncertainty, etc. If this doesn't demonstrate that IFRS is everywhere, nothing will. So get ready – sooner rather than later, one way or another, it's going to hit you, right between the eyes.

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Implementing IFRS in Canada

Every time I find the meaning of life, they change it – Unknown

Who in Canada will have to apply IFRS? When? Is early adoption possible? What will the Canadian version of IFRS look like? How does one change over? How hard will the changeover be? Will Harry Potter live? We aim to answer at least some of these questions below. Keep in mind that some of the answers are tentative and subject to final confirmation by the Board.

Who will have to apply IFRS?

All "publicly accountable enterprises". These include profit-oriented enterprises holding assets in a fiduciary capacity for a broad category of outsiders or enterprises that have filed or are in the process of filing financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market. Look for the Board to identify the types of not-for-profit organizations that are publicly accountable in the near future.

Observation. The definition of publicly accountable looks a bit fuzzy around the edges. We're hoping for more clarification.

When will a publicly accountable entity have to apply IFRS?

Look to the Board to make a final decision on this by March 31, 2008, following an assessment of environmental and other factors affecting the country's ability to assimilate IFRS. Right now, the Board is working on the basis that affected enterprises will have to apply IFRS for fiscal years beginning on or after January 1, 2011.

Observation. We'll eat our hats if 2011 is not the date.

Will an enterprise be able to adopt IFRS early?

Yes. There's a caveat, though – entities wanting to adopt early will have to wait until the Board approves IFRS as Canadian GAAP. This might be as early as 2009. Further, securities and other regulators have yet to make their views known.

When will the Board issue an exposure draft on the Canadian version of IFRS for comment?

Some time around mid-2008.

Will any unique Canadian standards be carried forward on convergence to IFRS?

No. The Canadian version of IFRS simply will be a photocopy of the IFRS issued by the International Accounting Standards Board. Consistent with this objective, the Board announced that the following Handbook standards will get the axe upon crossover to IFRS even though there is no equivalent international standard: Accounting Guideline 16, *Oil and Gas Accounting – Full Cost; Section* 1625; *Comprehensive Revaluation of Assets and Liabilities*, Section 3610, *Capital Transactions*; Section 3831, *Economic Dependence*, and AcG 7, *The Management Report*.

Observation. Eliminating Canadian-specific standards will cause some problems. For example, oil and gas companies are justifiably upset about having to give up a specific Canadian standard on full cost accounting for IFRS standards that don't adequately consider the special circumstances of extractive industries. While an IFRS standard on this topic is in the planning stage, it's still a very long way off. The dilemma the Board is facing is that if it starts tampering with IFRS, it won't be IFRS anymore.

How will entities transition from existing Canadian GAAP to IFRS?

By applying the guidance in International Financial Reporting Standard 1, *First Time Adoption of International Financial Reporting Standards*. The basic principle in this guidance is that you'll have to adjust your balance sheet to state assets and liabilities at the amounts you would have reported had you always been applying the particular edition of IFRS adopted by the Board. There are a number of exceptions to this principle. For instance, if you're can't or don't want to calculate the IFRS cost of your fixed assets, investment properties or intangible assets, you'll have to measure them at fair value. Adjustments, by the way, go to shareholders' equity (usually retained earnings), not net income. Study IFRS 1 with care. The financial statements you save may be your own.

Observation. Successful transition to IFRS will depend on education, planning and developing, and executing a well thought out conversion strategy. Even then, it can be a tough chore. Leveraging our experience with IFRS conversion in Europe, we're taking a leading role in helping Canadian companies address the accounting, systems and control ramifications of adopting IFRS. Need help? Give us a shout.

IFRS in the US

I'm beginning to like you, Mr. Bond – Goldfinger

Surprise! IFRS is infiltrating the US as well as Canada. In July, the SEC issued a proposal to drop its US GAAP reconciliation requirement for foreign registrants preparing their financial statements in accordance with IFRS. Even more surprising perhaps, is that the SEC also said it was prepared to consider allowing US companies to use IFRS as well, so as to keep the playing field level for domestic and foreign registrants.

The foreign registrant proposals are subject to public comment, but pundits say the fix is in – the reconciliation requirement will be gone by 2009 at the latest. Allowing US companies to use IFRS instead of US GAAP may take a little longer. Indeed, it may never happen as the SEC is only soliciting views from constituents right now.

There's no special accommodation under the SEC's proposals for Canadian SEC registrants. What this means is that a Canadian registrant will be able to drop its US GAAP reconciliation only if it first adopts IFRS as Canadian GAAP. Of course, this presumes that there is a Canadian version of IFRS to adopt. As we discussed earlier, it looks like the Board is shooting to have IFRS in place in Canada as early as 2009. Coincidence? We think not.

Observation. IFRS is sweeping the world. Over 100 countries use IFRS now, including those in the European Union, the UK, Australia and New Zealand. By 2011, the number will have grown to over 150 with Canada, China, and India having joined the ranks. Even Japan has agreed to converge its standards to IFRS. Dare we think the unthinkable? That someday, not soon, but someday, IFRS will become the standards of choice even in the US?

Canadian GAAP for Private Enterprises

And now for something completely different – Monty Python

A few words now about what the future of Canadian GAAP for private enterprises. Under its IFRS conversion strategy, the Board is committed to consider an alternative Canadian GAAP that private enterprises could elect to apply instead of IFRS. What would such a GAAP look like? How to develop it? Good questions, says the Board. It issued a Discussion Memorandum during the summer which requested public feedback on the following alternative approaches to establishing a separate GAAP for private enterprises:

- Modify GAAP for publicly accountable enterprises by deleting some requirements or giving some options for alternative treatments. This is similar to the "differential reporting" model that exists today.
- Adopt the standards for small and medium sized enterprises proposed by the International Accounting Standards Board.
- Establish an independent set of Canadian GAAP standards for private enterprises.

The Board also identified a "non-GAAP" solution – establishing a simple accruals-based accounting model closely linked to cash transactions.

Comments on the Discussion Memorandum are due by the end of October 2007.

Observation. For over 30 years, the private sector has argued that Canadian GAAP is excessive to the needs of private enterprises – way too hard and way too costly to apply. Proposals for relief vary. At the extreme end of the range are those who want to be able to use a simplified accrual basis of accounting and label it GAAP. Quite rightly, the Board has made it clear that hell will freeze over before this happens. How would it be possible to call a model GAAP if that model contradicts the very concepts on which GAAP is founded? We think the simplified accrual basis, appropriately labeled and explained, almost certainly would meet the needs of a large number of smaller users, particularly owners and managers, even if it isn't GAAP. The Board should take the lead in considering the establishment of such a model for general use in Canada, including the related issue of auditor involvement. The larger question of how a GAAP specially tailored for private enterprises should be developed is much harder to answer. We'll let you know what we think once we've had a chance to consider the Discussion Memorandum.

Financial Instruments and Private Enterprises

The man who lives only by hope, will die by despair – Italian proverb

You will all, we're sure, remember last year's hot topic – financial instruments, more specifically, CICA Handbook Section 3855, *Financial Instruments – Recognition and Measurement*. Among other things, the Section requires enterprises to measure derivatives at fair value. So arduous is the task of identifying these beasts and so significant is the financial statement impact of measuring them at fair value, that accountants generally get a glazed look in their eyes and mutter disconnectedly, "the horror, the horror" at the very mention of the words "Section 3855".

We have news, or more accurately, no news about Section 3855 – private enterprises still will have to adopt Section 3855 for fiscal years starting on or after October 1, 2007. That's next year for a company with a calendar year-end. Hopes were high in the private sector that the Board would suspend the application of Section 3855 for private enterprises in light of its project to develop separate GAAP for these enterprises (see above), but in May the Board said no dice.

Section 3855 is but one of a suite of financial instruments standards. Others are Section 1530, *Comprehensive Income;* Section 1535, *Capital Disclosures;* Section 3862, *Financial Instruments – Disclosure;* and Section 3865, *Hedges*. For private enterprises, these are effective at the same time as Section 3855.

Observation. The Board refused to suspend or defer Section 3855 on the basis that whatever special GAAP it develops for private enterprises, that basis almost certainly will involve accounting for derivatives at fair value. Remember – the Board has never said that GAAP for private enterprises was going to be easy. Which leads us, of course, to the broader topic of …

Complexity in Accounting

You have nothing to lose but your yolks – Adlai Stevenson

GAAP has become increasingly the preserve of specialists, so-called eggheads who spend all of their time dissecting the entrails of specific areas of GAAP that are all but inaccessible to mere mortals. One such area is financial instruments. There are others – stock-based compensation, business combinations, employee future benefits, fair value measurement, etc. The list goes on and on.

Calls to reduce the complexity in accounting have been made repeatedly over the years and especially after Enron and other US accounting scandals in the early 2000's. The SEC's have been the most recent. It has formed a blue ribbon committee to examine ways to reduce unnecessary complexity in the US financial reporting system and how to make it more useful to investors. Perhaps more encouraging are signs that standards-setters finally are starting to get it. The FASB has added a project to simplify its rules on hedge accounting, perhaps the most complicated accounting rules out there.

Observation. Standards-setters like to say that GAAP is complex because business transactions these days are complex. There is some truth to this, but only some. Arcane standards incapable of being understood or properly applied are major contributors to the volume of financial statement restatements we are seeing today. We are pleased to see efforts being made to reduce complexity but, gosh, it's slow. Another committee? What's that all about? It's time to start walking the walk, not talking the talk. Down with the eggheads!

Inventories

There is nothing either good or bad, but thinking it makes it so – Hamlet

We've got new rules on inventories, formerly the oldest, sleepiest section in the Handbook. New Section 3031, *Inventories*, applies to interim and annual financial statements for years beginning on or after January 1, 2008. Earlier application is encouraged.

Section 3031 aligns Canadian GAAP with IFRS. It establishes four basic principles:

- Inventory should be measured at the lower of cost and net realizable value.
- The cost of inventory includes costs directly attributable to its acquisition as well as an appropriate portion of fixed and variable production overheads.
- If the units in inventory are interchangeable, their cost should be determined using either a FIFO or weighted average cost formula. In general, an entity should use the same formula for similar types of inventory. Yes, Virginia, this means that LIFO is no longer Canadian GAAP.
- Write-downs of inventory to its net realizable value should be reversed if the value subsequently recovers.

There are disclosure requirements and special rules for not-for-profit organizations. Also, pay special attention to the scope provisions. In some cases, entities can account for inventories at net realizable value or fair value less costs to sell rather than cost.

An entity can adopt the standard by re-measuring opening inventory in accordance with the requirements and charging the difference to opening retained earnings. Alternatively, the entity can adopt the standard retrospectively, that is, by restating prior periods.

Observation. Was existing Canadian GAAP for inventories really that bad? The Board's answer – a resounding yes. Who knew? While the new rules sound straightforward, implementing them may be more complicated for some than we thought.

The Matching Principle

KAOS Agent: Look, I'm a sportsman. I'll let you choose the way you want to die
Maxwell Smart: All right, how about old age?
– Get Smart

In July, the Board issued a re-exposure draft that proposed to kill dead any idea you can defer costs on the balance sheets to match against future expected higher revenues or lower expenses as the result of those costs. Costs, harrumphs the Board, must be expensed unless their incurrence has resulted in a distinguishable asset – for instance, something you can use, sell, or rent.

If the re-exposure draft goes through, the infamous (well, infamous to accountants) standard, EIC 27, *Revenues and Expenditures during the Pre-Operating Period*, will be eliminated. This standard allows entities to defer operating losses incurred during the pre-operating period of a business. While some accountants will cheer, many business people will sit back and wonder, but isn't a new business with its kinks worked out worth more than one that's not? Why not defer the losses? Ah, say the accountants, working out kinks contributes to the internally generated goodwill of the business. We have to expense the related costs because the benefits are just too soft to justify its recognition as an asset. Furthermore, it's impossible to identify those costs that generate goodwill and those that don't.

Also included in the exposure draft, and the reason for its re-issuance, is a proposal to align Canadian GAAP for the recognition and measurement of internally developed intangible assets with, wait for it now, IFRS. The resulting standard would apply to all types of intangible assets, including those resulting from research and development activities. If this proposal is approved, the existing Handbook section on accounting for R&D costs would be eliminated. However, the basic principles for such costs would remain the same – research costs would be expensed as incurred and development costs would be capitalized only if certain criteria are met.

The new guidance would be effective for annual and interim financial statements for fiscal years beginning on or after October 1, 2008, with earlier adoption encouraged.

Observation. 40 years ago, the matching principle was in vogue. The idea was to get the income statement to make sense and let the balance sheet bear the consequences. Now, the reverse is true. The matching principle just can't live in this new world – the air's too thin.

Pension Plans

If at first you don't succeed, try, try again. Then quit. No use being a damn fool about it – W.C. Fields

In the last issue of *Financial Reporting Release*, we told you that the Board was proposing to change the rules on accounting by employers for pension and other post employment benefit plans to provide more transparency about their "funded status" in the employer's financial statements. The funded status of a plan is the difference between the fair value of the plan's assets and the actuarial value of its liabilities. For example, if a pension plan set up by an employer had assets worth $100 million and the employer's obligation to provide pensions to employees was $150 million, the funded status of the plan would be a net liability of $50 million. Under the proposed change in rules, the employer would have to adjust the amount reported in its balance sheet for a plan at year-end so that this equals its funded status. Gains and losses resulting from these adjustments would be excluded from net income, but would affect shareholders' equity. This is US GAAP.

In July, the Board abandoned this project, lock, stock and barrel. Why? After reconsideration, the Board decided that Canadian enterprises were better off spending their time figuring out the effect of adopting IFRS on their accounting for these plans.

Observation. We agree with this decision. It does no one any good to introduce a standard that will have a shelf life of only a few years. Why is the Board so worried about the impact that transitioning to IFRS will have on these plans? It's because the transitional rules can really screw you up. You've got two choices. The first is to go back in time, starting at the inception of the plan (that's right, the very start date of the plan) and to figure out what the carrying amount of the plan is at transition assuming you've always been applying IFRS. This means recalculating the actuarial gains and losses arising in the plan from day one, splitting them between the portion that would have been recognized in the financial statements at transition and the portion that would have been deferred for recognition in later periods. The second choice is to adjust the net asset or liability reported in the balance sheet for the plan so that all gains and losses are recognized at transition – potentially much easier than the first alternative, but the question is, can your shareholders' equity take the hit?

Rate-Regulated Enterprises

Bullwinkle: But here, cleverly disguised as a bomb, is a bomb – The Bullwinkle Show

The saga continues. In July, the Board announced its decision to press on with its project to eliminate the special provisions in the Handbook for rate-regulated enterprises. If the project goes through, under Canadian GAAP a rate-regulated enterprise can recognize gains and losses recovered from or paid to customers as assets and liabilities only if the enterprise complies with FAS 71, the US GAAP standard on rate-regulated accounting. Under FAS 71, an entity must apply basic GAAP rules to the recognition of assets and liabilities and can defer the resulting gains and losses only when very strict criteria are met. The Board has observed that under FAS 71 the definition of a rate-regulated enterprise is more restrictive than under existing Canadian GAAP and that this may be a particular concern for certain public sector entities. Which is accounting standards-setter speak, roughly translated, for "Watch out, we may have tossed a bomb into your lap".

The Board expects to decide the fate of rate-regulated enterprises in the fourth quarter of 2007. Any changes it makes to the Handbook would apply to interim and annual financial statements for fiscal years beginning on or after January 1, 2009.

Observation. A huge question here is whether a rate-regulated enterprise can continue to apply FAS 71 if it adopts IFRS. We see little point in establishing a process which might result in publicly accountable rate-regulated entities, and the users of their financial statements, undergoing two potentially significant rounds of accounting changes within a reasonably short period of time.

Going Concern Uncertainty

Seymour Glick Is Alive but Sick – Title of a play by Steve Allen

In April 2007, the Board approved "going concern" amendments to Section 1400, *General Standards of Financial Statement Presentation*. These amendments require management to disclose any uncertainties that cast significant doubt upon the entity's ability to continue as a going concern. In determining whether such uncertainties exist, management must assess all available information about the future. The standard begs the philosophical question of how long "the future" actually is, other than to say it can't be less than 12 months. Drat. Just when we were starting to think that accounting standards-setters had found the key to the universe.

How do you value assets and liabilities if there is significant doubt about the entity's ability to continue as a going concern? The standard says, continue to use valuations appropriate to a going concern unless management intends to liquidate the entity, ceases trading or has no realistic alternative but to do so. In these latter circumstances, change to an appropriate basis of accounting (e.g. liquidation values). You'll also have to disclose the basis of accounting being applied together with the reason why the entity is not considered to be a going concern.

Observation. Of necessity, accountants prepare the financial statements of an entity presuming that if the entity's not on its death bed, it's not sick at all. Potentially fatal maladies affect only the notes to the financial statements.

Not-for-Profit Organizations ("NPO")

If I had some duct tape, I could fix that – MacGyver

In July 2007, the Board issued an exposure draft that proposed an initial series of amendments to standards for not-for-profit organizations. The more important require NPO's to:

- Consolidate controlled entities and make other clarifications relating to identification of control and enhance certain disclosures, and also apply CICA Handbook Section 3055, *Interests in Joint Ventures*, in accounting for interests in profit-oriented joint ventures.
- Apply the guidance on cash flows statements in Section 1540.
- Report certain revenues gross in the statement of operations.
- Prepare interim financial statements in accordance with Section 1751, *Interim Financial Statements*.
- Amortize capital assets reported as assets in the balance sheet, regardless of the size of the NPO.
- When an NPO classifies its expenses by function and allocates some of its fundraising and general support costs to another function, disclose the policy adopted for expenses and amounts allocated from each of these two functions to other functions.

In addition, the proposals would eliminate the requirement to treat net assets invested in capital assets as a separate component of net assets. Instead, NPO's could treat these net assets as a category of internally restricted net assets.

Observation. Not-for-profit organizations are the poor cousins of profit-oriented enterprises, usually getting little attention. These changes are only a quick fix, not a fundamental reconsideration of the principles of accounting by not-for-profit organizations.

Standardized Distributable Cash in Income Trusts

In July, the CICA issued an interpretative release, *Standardized Distributable Cash in Income Trusts and Other Flow-Through Entities, Management's Discussion and Analysis Guidance on Preparation and Disclosure*. The release provides guidance on the measurement and disclosure of cash available for distribution by these entities in the MDA and other filings. The principal recommendations are:

- When a flow-through entity uses a non-GAAP financial measure to report the cash available for distribution to unitholders, that measure should be Standardized Distributable Cash.
- Standard Distributable Cash is the periodic cash flows from operating activities as reported in the GAAP financial statements. It includes the effects of changes in non-cash working capital and operating cash flows provided for or used in discontinued operations, less adjustments for (a) total capital expenditures as reported in GAAP financial statements, and (b) restrictions on distributions arising from compliance with financial covenants restrictive at the date of the calculation and limitations arising from the existence of a minority interest in a subsidiary.
- When cash available for distribution is affected by additional factors outside of Standardized Distributable Cash, these amounts should be disclosed after the computation of Standardized Distributable Cash and the adjusted amount reported as an adjusted distribution base.
- There should be disclosure of additional information to provide the context for assessing Standardized Distributable Cash.

Observation. The CICA release complements revised National Policy Statement 41-201, *Income Trusts and Other Indirect Offerings*, recently issued by the Canadian Securities Administrators. We will review this in our next newsletter.

Emerging Issues Committee ("EIC") Abstracts

EIC Abstracts address the fine points of accounting. Unless you're an egghead, they are, for the most part, interesting only to those who are directly affected by the specific issues being addressed. The rest might have a better time watching paint dry. Don't feel guilty for not reading this section.

EIC 119, Date of Acquisition in a Business Combination

This Abstract was amended to clarify that a buyer of a regulated entity should not apply the special rules in AcG 15, *Consolidation of Variable Interest Entities*, to determine whether to consolidate the entity because of restrictions imposed by a regulatory authority on the buyer pending approval of the transfer of ownership of the entity.

Observation. We warned you not to read this stuff.

EIC 164, Convertible Debt and Other Debt Instruments with Embedded Derivatives

This Abstract interprets the application of the new financial instrument rules to complex convertible debt instruments. It includes guidance on the criteria to use for determining whether the debt contains "embedded derivatives" that must be accounted for separately, how to account for a convertible debt when an embedded derivative has been stripped away from it, and the balance sheet presentation of embedded derivatives.

Observation. The Abstract is a 15-page behemoth. Talk about complexity! Applying it will require the patience of Job and the mind of Einstein. Or maybe the mind of Job and the patience of Einstein.

EIC 165, Accounting by an Investor upon a Loss of Significant Influence

Under the new financial instrument rules, an investor accounting for an investment under the equity method will have to recognize its share of the investee's "other comprehensive income" in a special account in shareholders' equity. The Abstract explains what to do with this accumulated income when the investor loses significant influence over the investee and must stop using the equity method. The answer? Yank it out of shareholders' equity and apply it against the carrying value of the investment.

Observation. If you were an egghead, you might be enraged by this answer.

EIC 166, Accounting Policy Choice for Transaction Costs

Section 3855, the new rules on accounting for financial instruments, requires companies to establish an accounting policy for transaction costs incurred on the acquisition or issuance of financial assets or liabilities measured at cost or amortized cost. The choice is to either expense costs as incurred or to add the costs to the asset or liability. This EIC clarifies that different policies might be used for dissimilar assets and liabilities and provides guidance on when assets and liabilities are similar.

Observation. Expensing transaction costs as incurred is the latest in accounting. This EIC allows you to dip a toe in the water to see whether or not you like it.

D66, Accounting by Pension Plans for Transaction Costs

Pension plans account for investment assets at fair value in accordance with Handbook Section 4100. In order to be consistent with the definition of fair value, this draft Abstract proposes that transaction costs incurred to acquire these assets be expensed as incurred. The Abstract would be applied retrospectively (without restatement of prior periods) to all interim and annual reporting periods ending on or after December 31, 2007, if enacted.

Observation. Historically, practice has accepted factoring transaction costs into the initial determination of the fair value of a property. This is *verboten* under Section 3855, and soon will be under Section 4100.

D69, Determining Whether A Contract for the Purchase or Sale of a Non-Financial Asset such as a Commodity is Routinely Denominated in a Single Currency in Commercial Transactions Around the World

Under Section 3855, you'll have to measure certain contracts for the purchase or sale of non-financial assets that are denominated in a foreign currency at fair value. Alternatively, you can say that the contract has a foreign currency derivative embedded in it that must be measured at fair value. Commodity contracts denominated in a currency routinely used around the world for such contracts (e.g. oil contracts denominated in US dollars) are one type of contract that is exempted from these requirements. This draft Abstract provides guidance on how to interpret the phrase "routinely denominated" and gives examples of items that meet this condition.

Observation. Determining whether and to what extent foreign currency contracts for the purchase or sale of non-financial assets have to be accounted for at fair value is turning out to be one of the biggest headaches in applying Section 3855. Stay tuned. We expect we haven't heard the last on this subject.

D67, Future Income Tax Liabilities – Income Trusts and Other Specified Investment Flow-Throughs

This draft Abstract requires income trusts and certain other flow-through vehicles to recognize a future income tax asset or liability on June 12, 2007 when the tax law imposing income taxes on these entities became substantively enacted. The asset or liability is to be recognized by charging income.

Observation. This consensus is being applied in practice as though it's final. We expect the final consensus will provide more detailed guidance on the recognition and measurement of future income tax assets and liabilities than the draft.

For more information …

This newsletter has been prepared for the clients and friends of PricewaterhouseCoopers by our Professional, Technical, Risk and Quality Department. For further information on any of the matters discussed, please feel free to contact any member of the department, or your PricewaterhouseCoopers engagement leader. This newsletter is available from the PricewaterhouseCoopers LLP Canadian web site, which is located at www.pwc.com/ca.

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