CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

The Changeover to IFRSs

PREPARERS' AND AUDITORS' FIRST IMPRESSIONS OF THE CANADIAN EXPERIENCE

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INTRODUCTION

Canada's Accounting Standards Board (AcSB) made the decision to adopt IFRSs for publicly accountable enterprises following extensive consultation with stakeholders. The changeover puts Canadian public companies on the same accounting framework as the over 100 countries that have now adopted IFRSs and has eliminated the need for cross-listed companies to provide U.S. GAAP reconciliations. But the changeover was a major undertaking that involved considerable time and effort.

In view of the significance of the changeover for Canada's capital markets, CICA's Canadian Performance Reporting Board (CPRB) determined to undertake a review of the transition and obtain views of preparers and auditors. A separate study by the CPRB is considering investors' views on the usefulness of financial reporting after the changeover to IFRSs.

BASIS FOR THE REPORT

This report is based on interviews with senior representatives of 15 entities publicly listed in Canada, primarily consisting of larger TSX-listed entities; 2 management entities with responsibilities for a number of smaller publicly-listed entities; and of 6 of the largest Canadian audit firms. These interviews began in late 2011 and were completed in September 2012, although interviews with the audit firms all took place between April and September 2012. In each case, we asked specific questions about IFRS conversion experiences, and others designed to obtain a broad perspective on the effectiveness of the conversion and on the ongoing impact of having adopted IFRSs.

This report summarizes the information we obtained, based solely on these conversations. While we interviewed only a small number of publicly listed companies compared to the total population, their perspectives were broadly aligned with the observations of the 6 largest audit firms that collectively audit a large proportion of Canadian public companies. We acknowledge, however, that if we had carried out a greater number of interviews, then the overall impressions conveyed below might have differed. Some of the entities we approached chose not to participate in this project.

OVERALL COMMENTS

Overall, interviewees described the IFRS conversion as a challenging exercise, but one which they implemented successfully, reflecting sound planning, control and individual commitment. Our conversations did not identify any cases of major reporting failures, nor of adverse stakeholder reactions to the impact of IFRSs. Although interviewees inevitably differed in their assessments of the overall benefit of the transition to IFRSs and of its merits relative to previous Canadian GAAP, the overall tone of our conversations was positive and forward-looking. However, we did identify various recurring concerns, as set out below.

Most of the interviewees started planning their conversion early, usually in 2008. They identified the majority of the significant issues early in the planning process and resolved them substantially as anticipated, although many interviewees expressed some degree of surprise at the extent of the detailed differences existing between IFRSs and previous Canadian GAAP. None of the interviewees reported being subject to major resource constraints, and none reported any lack of support from other areas of the organization. They often described how they drew on industry forums or other groups to share information and ensure a consistent approach to key issues. One interviewee mentioned that the expectations set out by the Canadian Securities Administrators (CSA) for disclosures in the Management's Discussion and Analysis (MD&A) during the transition period assisted in ensuring the project's overall rigour (the CSA most recently commented on these disclosures and on other financial reporting matters in CSA Staff Notice 51-337 *Continuous Disclosure Review Program Activities for the fiscal year ended March 31, 2012)*. The one-month filing extension allowed by the CSA for the initial IFRS filing was also helpful, in particular for smaller entities.

OPPORTUNITY TO IMPROVE PROCESSES

Some interviewees (although a minority) talked about the project as an opportunity to address issues not strictly necessary for the conversion. These included reexamining, simplifying or bringing greater consistency to existing processes or to the accounting policies across all group companies, reallocating work within the organization (one interviewee talked about how lower-level staff are now carrying out a greater range of tasks), and implementing a better internal focus on certain project costs. For example, one interviewee described how the IFRS policy of recognizing any new vested past service costs arising on defined benefit plans immediately in income (rather than amortizing them over an estimate of average remaining service lives, as under previous Canadian GAAP) increases the focus of the company's pension negotiators on the real economic cost of changes to benefit plans. Another talked about how the combination of a change in accounting policy for exploration costs, expensing some amounts that were previously capitalized, and more extensive internal cost allocation to specific projects, has generated broader value for the business by promoting a better focus on the amounts and benefits of costs incurred.

COMMON ISSUES

Many interviewees had a few issues that they resolved later in the process than they anticipated. These most commonly related to financial instruments — in particular, a number of interviewees did not initially realize that IFRSs might compel them to reclassify some instruments previously treated as equity (most commonly trust units) as liabilities. Ultimately however, the great majority of interviewees stated that the conversion did not have a material impact on the measures they regard as their key performance indicators, such as measures of operating cash flow.

A number of interviewees noted that their auditors were also increasing their detailed understanding of IFRSs during this period and that in some cases entities experienced unexpected delays in obtaining their auditors' concurrence on their approach to a particular matter. Sometimes, these delays reflected differences of opinion between audit firms. Some of these issues continue to exist at the time of writing. Most interviewees, at least in hindsight, took a philosophical approach to these difficulties, commenting that they ultimately reached a workable consensus with their auditors on the issues in question.

SPECIFIC AREAS

We asked interviewees about areas of IFRSs where in their view the standards and accompanying material do not contain sufficient guidance on practical issues; or where it is challenging to apply aspects of the standard as written; or where the cost of complying with certain aspects of a standard outweighs any related benefit. Most interviewees cited only one or two areas, if any. Even if aspects of IFRSs had caused them difficulties at various times in the process, they were usually reluctant to cast this as an inherent "problem" with IFRSs. Several interviewees noted that even if IFRSs might lack sufficient guidance on a particular matter, injecting a greater degree of specificity on these matters might also bring its own difficulties.

Many of the specific areas mentioned by interviewees have already been widely identified elsewhere, including the AcSB's IFRS Discussion Group.

The issue most commonly cited was the determination of discount rates for purposes of measuring asset retirement obligations and other provisions at present value in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

Several interviewees mentioned difficulties in determining the appropriate "cash-generating units" for purposes of testing assets for impairment in accordance with IAS 36 *Impairment of Assets.* For some interviewees, this difficulty was exacerbated because they disagreed with the fundamental approach of IAS 36 (which in some cases, in effect, requires testing for impairment at a lower level of asset grouping within the organization than previous Canadian GAAP, and consequently in recognizing impairment losses that would not previously have been recognized).

Several interviewees mentioned differences between the firms on how to apply IFRIC Interpretation 14 *IAS 19 — The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction.*

Two of the interviewees represented entities in the extractive industries that changed their accounting policies to expense some exploration and evaluation costs they previously capitalized, and encountered difficulties in defining certain aspects of this new policy.

Some feeling existed among the interviewees that it is more difficult to maintain a practical approach under IFRSs in some respects — for example, an interviewee described how the requirement to disclose a reconciliation of changes in the carrying amount of each class of property, plant and equipment and intangible assets made it impossible to maintain the entity's previous practice of accumulating costs of projects under construction in a single category, and transferring them to the relevant classes on completion.

No other issues were cited by more than a single company, and these other issues were nearly always characterized as fact-specific challenges, again not indicating an inherent "problem" within the standards (or at least not one carrying a high priority).

OTHER IMPACTS

Inevitably, all interviewees commented that their financial statements were longer as a result of adopting IFRSs, although some stated that the majority of the increase was attributable to the disclosures about the transition itself and should not recur in future periods. Many interviewees doubted whether the additional information provided significant additional value for readers.

Some issuers commented that their results are more volatile under IFRSs. This is an inevitable consequence of various changes in accounting policy — for instance, to recognize impairment losses that might not have been recognized under previous Canadian GAAP and then subsequently to reverse those losses if the recoverable amounts of the underlying assets or cash-generating units increase.

The transition to IFRSs inherently entailed a certain amount of inconsistency between adopters, reflecting the first-time adopter exceptions and exemptions available, and — for some industries — explicit choices provided by the standards. However, the impact of these differences is usually prominent in the financial statements (one interviewee expressed some concern that the impact of first-time adoption is not disclosed in subsequent periods). These matters aside, interviewees felt for the most part that their particular industry had adopted IFRSs fairly consistently. Where differences existed, interviewees often saw this as an inevitable consequence of the complexity of the industry (for example, reflecting the multitude of financing and participation structures existing within the extractive industries). An exception to this again related to determining cash-generating units, which some interviewees cited as an area where application is likely inconsistent.

We asked about the impact of the conversion on other aspects of disclosure and regulatory compliance, such as the process for preparing the MD&A. Other than citing the changes necessary to reflect the impact of the conversion itself, interviewees had few other comments.

They usually felt that their financial reporting staff had succeeded in becoming fluent in IFRSs to the extent required, and that their audit committee members had attained a level of financial literacy relative to IFRSs comparable to that attained for previous Canadian GAAP.

We asked whether the changeover to IFRSs generated any challenges in the CSA's National Instrument 52-109 requirement to report on the design and effectiveness of controls or on overall "fair presentation." Other than citing the incremental controls necessary to respond to changes in accounting policies, or the controls put in place around the transition process itself, most companies had relatively little to report in this area. Only one of the interviewees talked at greater length about the impact of IFRSs on relative risk assessments and the increased possibility of errors resulting from less familiarity with the standards (which did not however lead to any material changes in controls to an extent requiring external reporting). We should note that some of the interviewees were more directly involved than others in this aspect of things.

ADEQUACY OF SUPPORT AND GUIDANCE

A majority of interviewees felt that the volume of support and guidance available under IFRSs is at least comparable to what previously existed under previous Canadian GAAP, and many judged it to be superior. Apart from the material issued by the International Accounting Standards Board (IASB) itself, interviewees frequently cited the publications issued by the major accounting firms. As noted though, these publications are not always consistent in how they address a particular issue, and some interviewees believed their auditors were overly rigid in adhering only to the views contained in the literature of their own firms, even when the publications of other firms demonstrated that an alternate approach could also be regarded as a well-reasoned application of IFRSs.

COMMUNICATIONS WITH STAKEHOLDERS

A majority of the interviewees had carried out some form of proactive communication with analysts or other stakeholders about the anticipated impact of IFRSs, over and above the information they provided in their MD&A for periods leading to the transition. However, once the conversion was effected, most interviewees reported receiving few if any questions from the users of their financial statements about the impact of IFRSs, and no one at this stage believed the conversion had had an impact on the entity's stock price. Some saw the lack of questions as evidence of the clarity of their disclosure; others as indicating that their users focused only on key performance measures (which, as noted above, were usually not materially affected by the conversion) and devoted little attention to the overall impact of IFRSs on the financial statements. However, interviewees did provide some examples where analysts responded positively to various changes—for example, one interviewee mentioned that the amended presentation of its income statement to reclassify expenses consistently by their function, with supplementary information in the notes on their nature, resulted in a greater volume of information overall.

A separate review of professional investors' perceptions about financial reporting, not yet finalized, aligns with preparers' observations about investor views of the changeover. Investors feel more comfortable about IFRSs now than before the changeover occurred and believe companies adequately communicated IFRS changes. Views are mixed, however, about the relative complexity of IFRSs and whether IFRSs improve understanding of corporate performance.

COST

We asked interviewees about the cost of conversion, but the responses varied too greatly to provide meaningful information. The interviewees had not usually tracked internal project costs, and varied on the extent to which they had tracked external costs. Some entities made greater use of external advisors than others—a point also noted by representatives of the audit firms in our conversations with them (see **Perspective of auditors** below) — and of course even one or two complex issues might cause the overall cost to vary greatly between otherwise similar entities. Interviewees also expressed different views on whether they regarded the expenditure as money well spent.

FUTURE DEVELOPMENTS

The great majority of interviewees had limited enthusiasm for further changes to standards in the foreseeable future. Even when interviewees represented an entity for which a particular project might in some sense be beneficial, these benefits were generally outweighed for them by a sense of "IFRS fatigue." Interviewees overwhelmingly felt the collective focus should be on maintaining and improving the standards as they currently stand. They made only limited observations about the standards already finalized and to be implemented starting in 2013, but they consistently criticized the ongoing projects on revenue and, in particular, leasing. Several interviewees commented in strong terms that the leasing project in its current form would entail an enormous cost and demand on their resources in return for little benefit to the financial statements—or in some cases, to a perceived *reduction* in the usefulness of the statements; no one spoke of the project in broadly positive terms.

RATE REGULATION

One of the entities we interviewed operates in a rate-regulated industry. As is well known, the conversion to IFRSs presents particular challenges for such entities, because IFRSs do not currently allow recognizing the regulatory assets and liabilities created under previous Canadian GAAP. As a consequence, the AcSB has allowed rate-regulated entities the option of deferring their changeover to IFRSs until financial years beginning on or after January 1, 2014.

In 2009, the IASB issued an exposure draft of a proposed standard addressing this area that would have allowed recognizing such assets and liabilities under defined circumstances. Work on this project has been paused, and although the IASB has recently expressed its support for giving priority to this area, it has not clearly established a plan or timetable for further progress. Some Canadian rate-regulated entities have adopted U.S. GAAP, which also allows recognizing such assets and liabilities. This alternative is only available on a long-term basis for entities that have reporting obligations under U.S. securities laws. However, Canadian securities regulators have issued decisions to allow several rate-regulated entities to prepare financial statements in accordance with U.S. GAAP without qualifying as an SEC registrant. At present, this relief is scheduled to expire at the end of 2014.

An entity adopting IFRSs, and therefore ceasing to recognize regulatory assets and liabilities in its formal financial reporting, can present adjusted earnings measures preserving its previous accounting treatment, as long as it meets all the expectations of Canadian securities regulators for presenting such adjusted measures.

Against this background, the experience of the interviewee in the rate-regulated entity clearly differed in some key respects from that of the other interviewees. Although the entity ultimately adopted a form of reporting that met its own needs and those of its stakeholders, it believes that the fragmented situation in this area is inherently unsatisfactory.

PERSPECTIVE OF AUDITORS

As noted above, we also talked to representatives of the 6 largest Canadian audit firms. These conversations largely confirmed the overall impression summarized above. Although of course experience differed greatly across the entirety of their client bases, the firms agreed that while the major issues were usually identified later in the process, they sometimes took longer than anticipated to resolve. Overall, several of the firms commented that their clients, in the aggregate, had requested less conversion assistance during the course of the process than the firm initially expected, and most of the firms stated that clients not already engaging the firm to review their interim statements on an ongoing basis seldom engaged it to conduct a review of the first interim financial statements prepared under IFRSs. None of this, however, appeared to increase the volume of issues identified in the course of the year-end audit. Several of the firms also mentioned that the previous experience of other jurisdictions reporting under IFRSs was ultimately less helpful than initially anticipated, potentially indicating a degree of pragmatism that would have been difficult to justify in the Canadian regulatory environment.

More than our corporate interviewees, the auditors believed that the conversion process often had value as a comprehensive examination of existing practices, prompting beneficial changes in various areas beyond what was required solely for the conversion.

Issues mentioned by auditors either as areas of recurring difficulty or as areas of perceived differences between firms included the following:

- Analysis of trust units as debt or equity;
- Determination of discount rates, and other issues in applying IAS 37;
- Determination of cash-generating units for impairment testing purposes;
- The application of IFRIC 14 (and various other matters relating to employee benefits);
- Implementing "componentization" and related concepts contained in IAS 16 *Property, Plant and Equipment*, especially earlier in the process — in general, a more balanced approach to this area evolved over time;
- The detailed application of the principles for capitalizing borrowing costs contained in IAS 23 *Borrowing Costs;*
- The challenges of implementing the various areas of difference in accounting for income taxes under IAS 12 *Income Taxes*, such as the exemption from recognizing deferred tax balances arising on initially recognizing certain assets, or in determining the standard's scope of application, for example, whether a particular tax is asset- or income-based;
- Issues in applying IFRS 3 *Business Combinations,* including whether a particular transaction constitutes an acquisition of a business or of assets, and the extent to which linking contingent consideration to subsequent performance causes it to constitute a compensation arrangement;
- Issues in applying the IFRS 1 "use of fair value as deemed cost" election;
- Common control transactions, for example, the circumstances in which the initial financial statements of an entity created in a spin-off transaction may be prepared on the basis of fair values versus pre-existing carrying values;
- Numerous issues attaching to IFRIC 12, *Service Concession Arrangements;*
- Related party disclosures, in particular in determining what constitutes "key management personnel."

Compared to the other interviewees, the auditors (reflecting their involvement with a broad range of entities and issues) more often expressed concerns about the absence of an active body comparable to the Emerging Issues Committee that existed for purposes of previous Canadian GAAP. They often commented that the broadly equivalent entity for purposes of IFRSs, the IFRS Interpretations Committee, addresses far fewer issues that have broad applicability.

Several of the auditors stated that their relationship with their global office has strengthened in various ways over the course of the conversion, and that the relative prominence of Canada within the global firm has increased. Several of them also mentioned that the multiplicity of financial reporting frameworks now accepted in Canada potentially creates "silos" with different risk and control issues attaching to each, so that it is increasingly more difficult for professional staff to move between them.

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