ONTARIO SECURITIES COMMISSION

# OSC Staff Notice 52-720

## Office of the Chief Accountant
## Financial Reporting Bulletin

February 2012

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## INTRODUCTION

During the course of 2011, most publicly accountable enterprises transitioned from previous Canadian accounting standards to International Financial Reporting Standards (IFRS). The Office of the Chief Accountant (OCA) of the Ontario Securities Commission is publishing this bulletin to highlight selected financial reporting areas of interest that we have observed from our experiences with IFRS during 2011, and to identify topics that we are interested in examining more closely during 2012. The objective of this bulletin is to provide information to market participants that may be useful in preparing financial reports during 2012.

## BUSINESS COMBINATIONS – IFRS 3

During the course of 2011, Staff in the OCA (we or Staff) have been interested in looking more closely at the application of accounting standards that contain different recognition, measurement and disclosure requirements under IFRS compared to pre-changeover Canadian generally accepted accounting principles (GAAP). IFRS financial reporting requirements for business combinations as prescribed by IFRS 3 *Business Combinations* (IFRS 3) may be similar to pre-changeover Canadian GAAP in some respects, however, there are differences between the two reporting standards – the significance of the differences will vary from one issuer to the next depending on the facts and circumstances. As such, Staff undertook an examination of selected Canadian interim financial reports filed in 2011 to determine the level of compliance with certain features of these standards that are "new" to our capital markets. Our objective was primarily to assess whether issuers complied with IFRS 3 requirements during this important year of IFRS implementation.

### Findings

Overall, issuers complied with the IFRS 3 recognition, measurement and disclosure requirements that were similar to those required under pre-changeover Canadian GAAP. However, Staff noted the following recognition and measurement issues that had not been fully reflected in financial statements in all instances:

- *Step acquisitions* – requirement to remeasure previously-held interests at fair value at the date of acquisition, and recognize the resulting gain/loss;
- *Method of acquisition accounting* – requirement to recognize identifiable assets acquired and liabilities assumed at full fair value (with limited exceptions) even when the acquirer's interest in the acquiree is less than 100%;
- *Transactions outside of the business combination* – requirement to identify, measure and appropriately disclose how certain transactions such as "payouts to employees of acquiree" or extension of an existing contract with the acquiree were accounted for separately from the acquisition of assets and assumption of liabilities in the business combination.

In addition, the following deficiencies were noted in areas of **new disclosure requirements** such as:

- Qualitative description of what makes up goodwill
- Revenue and profit or loss of the acquiree since the acquisition date
- Pro-forma revenue and profit or loss for the combined entity
- Reason for the business combination

- Gross contractual amounts of acquired receivable and an estimate of the contractual cash flows not expected to be collected

The significant accounting policy note (related to business combination) that was included in the interim financial reports provided limited information in some instances, and some issuers did not appear to have updated their accounting policy note to be in accordance with IFRS 3.

Our examination of IFRS 3 compliance included a sample of interim financial reports that were subject to auditor review as well as those that did not have auditor involvement. In general, we noted that interim financial reports that were subject to auditor review had fewer deficiencies than those without auditor involvement.

> - Preparers need to provide important *new* disclosure for business combinations – **more extensive** under IFRS than previous Canadian GAAP
> - Do investors understand ***what*** has been acquired, ***how*** it was acquired and ***why***?

## COMMON CONTROL BUSINESS COMBINATION TRANSACTIONS

Business combinations under common control are combinations whereby businesses are ultimately controlled by the same party or parties both before and after the business combination transaction. Accounting for business combinations under common control is a complex area because of the wide array of such transactions that occur in practice.

IFRS currently does not provide guidance on accounting for common control transactions, and as a result, financial statement preparers look to IAS 8 *Accounting Policies, Changes in Estimates, and Errors* to determine an accounting policy that is appropriate for its specific circumstances. In Canada and in other jurisdictions, we have noted the following financial reporting approaches for the "acquired" business that is, in essence, a transfer between entities under common control:

(i) Book value (carry-over basis) accounting of the assets and liabilities acquired for current and comparative years – the financial statements of both entities are combined together at book value for the current and comparative years to account for the entities as though they had always been combined together as one entity,

(ii) Book value (carry-over basis) accounting of the assets and liabilities acquired from the date of acquisition – the financial statements of both entities are combined together at book value only from the date of acquisition without restatement of comparative years; or

(iii) Purchase accounting analogous to IFRS 3 on the basis that the acquirer is a separate entity in its own right.

> ***Consider*:**
> - Is **complete** information about the acquiree being provided?
>   - **with comparative information**?
>   - **without gaps** in periods in the current year?
> - Is the selected accounting policy resulting in **useful information** to an investor?

Staff have encountered instances where the accounting approach outlined in (ii) and (iii) above can result in the omission of important financial information about the acquiree. Such information includes current period pre-acquisition information, as well as comparative period information. Staff are of the view that it is important for investors to have financial information about the acquiree that relates to periods both **before and after** the common control transaction, **without gaps** in the periods being presented. In many of these transactions, there has often been no substantive change regarding the ultimate ownership structure or ongoing operations of the acquiree, and therefore it is important that investors are provided with the current period pre-acquisition as well as comparative financial information for making an investment decision.

Accounting for a common control business combination transaction only from the date of acquisition forward can also result in the omission of information that may otherwise not have been available to the users of the financial statements, for example, when the business combination takes place at a time between reporting periods. To illustrate, a business combination under common control takes place on December 1, 2011. The most recent financial statements of both the acquirer and the acquiree are available for the quarter ended September 30, 2011. If the acquirer accounts for the transaction from the acquisition date forward, the operating results of the acquiree for the period from October 1 to November 30, 2011 may not otherwise be available to the investor group. **Staff are concerned that the absence of such information may not result in complete financial information that is important for the investment decision-making needs of users**.

In summary, common control business combination transactions can take various forms, and facts and circumstances will inevitably be different in each situation. When determining an accounting approach for such transactions, issuers and their advisors should carefully consider whether the resulting publicly available financial reporting and disclosure will provide investors with information about the acquiree that is complete with comparative period information and without gaps in the periods being presented. We would encourage issuers and their advisors to consult with us regarding proposed accounting treatments for these types of complex common control business combination transactions in advance of filing financial statements. Please refer to the OCA consultations procedures discussed at the end of this bulletin.

## IMPAIRMENT

There are significant differences between the requirements of IAS 36 *Impairment of Assets* (IAS 36) and pre-changeover Canadian GAAP with respect to the recognition and measurement of impairment. The application of these requirements that are new to Canada are of a particular interest to Staff given the current local and global economic environment. Key areas of interest are as follows:

- disclosures for each material impairment loss or reversal including the following:
  - events and circumstances that led to the recognition or reversal of the impairment loss;
  - a description of the cash generating unit (CGU);
  - whether the recoverable amount is fair value less costs to sell or value in use;
  - if recoverable amount is fair value less costs to sell, the basis used to determine fair value less costs to sell;
  - if recoverable amount is value in use, the discount rate(s) used in the estimate;
- disclosures required for estimates used to measure recoverable amounts of CGUs containing significant goodwill or intangible assets with indefinite useful lives, irrespective of whether there has been an impairment or not:

  If recoverable amount is based on **value in use**:

  - description of key assumptions that management has based its cash flow projections on;
  - description of management's approach to making these determinations;
  - the period over which management has projected cash flows, and the growth rates used

If recoverable amount is based on **fair value less costs to sell**:

- the methodology used to determine fair value less costs to sell;
- If fair value less costs to sell is not determined using an observable market price for the CGU(s), a description of the key assumptions and management's approach;
- If fair value less costs to sell is determined using discounted cash flow projections, disclosures about the period over which management has projected cash flows, and growth rates;

IAS 36 is a complex standard that involves numerous judgements and estimation uncertainties. As a result, IAS 36 disclosure requirements are aimed at providing users with useful information for evaluating the reliability of the impairment tests. IAS 36 requires these disclosures to be provided appropriately, when applicable, in the annual financial statements.

> ***Consider*:**
>
> - Are financial statement disclosures providing the necessary information to allow investors to **easily understand** how 'recoverable amount' was determined?

## Indicators of impairment

Similar to 2011, 2012 continues to be a year of global economic uncertainty and issuers may experience the impact of these events in their global operations as well as through direct and indirect international debt and equity holdings. As the European sovereign debt crisis continues to impact the global economy, issuers should remain alert of the impacts of the crisis locally. Although sovereign debt concerns may not be significant for Canadian issuers who do not hold debt instruments of affected countries, there may be considerations for reporting issuers who hold debt or equity investments in entities that operate in or are impacted by a jurisdiction experiencing sovereign debt issues. Guarantees of third party investments in entities operating in or who hold debt instruments of affected Eurozone countries may also create increased exposures to a Canadian guarantor.

> ***Consider*:**
>
> - Indicators of impairment as a result of the current economic environment?
> - Indirect impact of European sovereign debt crisis on investments held in affected entities?

Staff remind issuers to carefully assess whether the impact of these exposures:

- are indicators that the recoverable value of an asset/CGU may be lower than its carrying value, and
- are appropriately reflected in the valuation of investments in affected debt or equity instruments accounted for in accordance with IAS 39 *Financial Instruments*.

When applying IAS 36, various sources of information are required to be considered in assessing whether an indicator of impairment exists. In the current economic climate, the market capitalization of some reporting issuers may be less than the carrying amount of the issuer's net asset. In this situation, **investors will benefit from disclosure that explains the shortfall and why the carrying value of the net assets is supported**.

This area of impairment, as well as other indicators identified in IAS 36, will be examined more closely by Staff as we review this area of IFRS during 2012.

## Discounted cash flow calculations

In the past, Staff have encountered filings where issuers have been overly optimistic in establishing assumptions used to determine the fair value of their reporting units (under pre-changeover Canadian GAAP). Problems include incomplete or unrealistic cash flow forecasts that reflect excessive growth rates, unproven sales trends, or insufficient consideration for working capital or capital expenditure requirements going forward.

Staff have also encountered filings where the discount rate incorporated in discounted cash flow calculations did not appropriately reflect current market assessments of the time value of money and the risks specific to the asset.

> ***Consider*:**
>
> - Are cash flow projections based on **reasonable and supportable** assumptions?
> - Do discount rates reflect current market assessments and specific risk of the asset or CGU?

This will continue to be an area of interest for Staff in 2012 given the current economic environment and the areas of judgement and/or estimates when assessing impairment. It is the responsibility of issuers to ensure they are not **unduly inflating fair value determinations** by incorporating overly optimistic assumptions in discounted cash flows calculations.

## CRITICAL JUDGEMENTS AND SOURCES OF ESTIMATION UNCERTAINTY

### Critical Judgements

IAS 1 *Presentation of Financial Statements* (IAS 1) paragraph 122 requires the disclosure of judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the **most significant effect** on the amounts recognized in the financial statements. IAS 1.BC77 notes that the disclosure of **the most important of these judgements** enable users of financial statements to better understand how the accounting policies are applied and to make comparisons between issuers regarding the basis on which management make these judgements. Disclosures of judgements that are immaterial may obscure those that are most important, and may make it difficult for an investor to understand the most important features of the critical judgements disclosures.

> ***Consider*:**
>
> - Do the disclosures focus on the **most significant** judgements?
> - Are disclosures of insignificant (**immaterial**) judgements "cluttering up" the financial statements?

Pre-changeover Canadian GAAP did not have a similar requirement, and therefore this disclosure is likely new to reporting issuers. In our examination of practices of disclosure in this area for interim financial reports, we noted that such disclosures were either **omitted** from the financial statements or were **lacking in substance (boilerplate)**. The purpose of such disclosures is to enable users of financial statements to better understand how the accounting policies are applied and to make comparisons between issuers regarding the basis on which management make these judgements. Some examples of areas of material judgement may include:

- going concern risk assessment;
    - refer to further discussion in the section *Going Concern*
- determination of CGUs;
    - significant judgement may be involved in determining the *smallest* group of assets that generates independent cash *inflows*

- determination of functional currency;
  - significant judgement may be involved where primary and secondary indicators are mixed, and management's judgement should be appropriately disclosed

It is also important to note that IAS 1.132 requires the disclosures of judgements made by management in the process of applying the issuer's accounting policies *separately* from the disclosures of judgements involving estimation uncertainty (see below).

### Sources of estimation uncertainty

IAS 1.125 requires an issuer to disclose information about the assumptions made about the future and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, notes to the financial statements shall include details of their nature and their carrying amount as at the end of the reporting period.

Similar to the disclosure of judgements, Staff noted that disclosures in this area either **lacked substance** (boilerplate) **or included every source of estimation uncertainty**. Staff remind issuers that the disclosure requirements here are for estimates that require **management's *most difficult, subjective or complex* judgements**. The basis of conclusion also stresses that few items are disclosed here [IAS 1.BC81].

***Consider:***

- Do the estimates require management's **most difficult, subjective or complex** judgements?
- Separate disclosures of estimation uncertainty apart from judgements is helpful to an investor's understanding of both of these requirements.

### Examples

Below are examples of estimation uncertainty disclosures that did not meet Staff's expectation, followed by an example of improved disclosure:

***1. Disclosure that did <u>not</u> meet Staff's expectation***

***Problems*:**
- **lacks substance (boilerplate)**
- **does not separate critical judgements from sources of estimation uncertainty**

*The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Estimates and judgements are reviewed on a continuous basis and are based on a management's historical experience, knowledge of current conditions and other factors believed to be reasonable under the circumstances.*

*Material estimates and assumptions are made with respect to establishing the following: depreciation and amortization periods; goodwill and indefinite life intangible assets; the valuation of inventories; allowance for doubtful accounts; impairment of financial assets; customer rebates; current and deferred income taxes; impairment of non-financial assets (if any); fair value and level of financial instruments; and the remeasurement of employee future benefits. Actual results could differ from those estimates under different assumptions and conditions.*

## *2. Improved disclosure*

***Improvements*:**

- **entity specific**
- **separation of critical judgements from sources of estimation uncertainty**

*The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.*

*Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.*

***Critical judgements in applying accounting policies:***

*The following are critical judgements that management has made in the process of applying accounting policies and that have the most significant effect on the amounts recognized in the consolidated financial statement:*

*Determination of a Cash Generating Unit (CGU)* (an excerpt):

*The Company's production facility in London produces the specialized chip that is then transferred to the production facility in Waterloo for use in the final product sold by the Company. The transfer price is determined internally which includes a level of margin for the London production facility.*

*Currently, there is no active market for specialized chip and the cash inflows of the London production facility is dependant on the demand for the final product. As such, management has concluded that the London production facility does not generate cash flows that are largely independent of the cash flows of assets of the Waterloo production facility. The two facilities are managed together and hence, management has treated the two facilities as a single CGU.*

***Key sources of estimation uncertainty:***

*The following are key assumptions concerning the future and other key sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year:*

*Decommissioning liabilities* (an excerpt):

*As part of the long-term lease agreement on the production facility with ABC Company, the Company has recognized a provision for decommissioning obligations associated with the production facility. In determining the fair value of the provision, assumptions and estimates are made in relation to discount rates, the expected cost to dismantle and restore the facility to its original condition and the expected timing of those costs. The carrying amount of the provision at December 31, 2011 is $1,850,000 (2010: $1,600,000).*

*If the estimated pre-tax discount rate used in the calculation had been 10% higher than management's estimate, the carrying amount of the provision would have been $75,000 lower.*

## GOING CONCERN

Many issuers continue to face ongoing challenges as a result of economic conditions and uncertainties stemming from the impact of international events such as the European sovereign debt situation. National growth rates (actual and expected) continue to be low in most countries. As volatile market conditions continue into 2012, Staff remain focused on reviewing financial statements for compliance with financial reporting standards related to the assessment and disclosure of going concern risks. This has been an area of focus in prior years, and further detailed information can be found in OSC Staff Notice 52-719 *Going Concern Disclosure Review* (SN 52-719). Although the notice refers to pre-changeover Canadian GAAP, it is still applicable for issuers reporting under IFRS as the disclosure requirements for going concern under pre-changeover Canadian GAAP were fully converged with IFRS.

Going concern disclosures are important to investors as they provide warnings about significant risks that the issuer is facing and are of critical importance to assist investors when making investment decisions. Therefore, it is important that the assessment issuers make with respect to the going concern assumption is rigorous and that the corresponding disclosure provides a balanced and transparent view of material uncertainties related to events or conditions that may cast significant doubt on the issuer's ability to continue as a going concern.

Staff remind issuers that it is important to differentiate uncertainties that cast significant doubt on an entity's ability to continue as a going concern from uncertainties that do not cast such doubt. This may not be easily determinable if the disclosures provided are "boilerplate" and lack specificity. Therefore, it is important that the going concern disclosures explicitly identify that the disclosed ***material uncertainties may cast significant doubt*** upon the entity's ability to continue as a going concern. The IFRS Interpretations Committee (IFRIC) had considered the need for further guidance on the going concern disclosure requirements in IFRS. While IFRIC decided not to add the issue to its agenda, IFRIC indicated that for the going concern disclosure required by IFRS to be useful, that disclosure **must also identify that the uncertainties may cast significant doubt upon the entity's ability to continue as a going concern**. Staff will continue to monitor going concern disclosures and will look for and expect the explicit use of the words "material uncertainty…casts significant doubt" in disclosures relating to going concern.

In these circumstances, an "emphasis of matter" paragraph is also required to be included in an auditor's report accompanying the annual financial statements. This paragraph should highlight the existence of the material uncertainties which may cast significant doubt upon the entity's ability to continue as a going concern even when adequate disclosure is made in the financial statements. The emphasis of matter paragraph also draws users' attention to the note in the financial statements that discloses the matters. Staff will continue to look for and expect such emphasis of matter paragraph in the auditor's report when appropriate.

***Consider:***

- Can a reader identify going concern disclosures **apart** from those that are associated with other uncertainties / estimation uncertainty?
- Are the words "**material uncertainty** … **casts significant doubt**" explicitly used in the disclosure?
- Does the auditor's report include an "**emphasis of matter**" paragraph highlighting the existence of the going concern risk?

Each of an issuer's management, audit committee and auditors has an important part to play to ensure that investors are provided with timely and accurate information related to going concern risks. Staff remind issuers that this will continue to be an area of focus as part of ongoing financial statement reviews.

Please refer to SN 52-719 for further information and examples on going concern risks disclosures.

## NON-GAAP FINANCIAL MEASURES AND ADDITIONAL GAAP MEASURES

Staff of the Canadian Securities Administrators (CSA) have recently published revised CSA Staff Notice 52-306 *Non-GAAP Financial Measures and Additional GAAP Measures* (SN 52-306). This notice has been revised to provide additional information on Staff's expectations for disclosure of additional GAAP measures presented under IFRS.

The notice describes practices that help issuers and certifying officers address their obligations to ensure that the information they provide to the public is not misleading. The practices contain examples of subtotals that should not be presented in the statement of comprehensive income. These examples include subtotals without labels, "income before the undernoted items", adjusted EBITDA and adjusted EBIT. Staff also remind issuers who include "operating earnings" or similar subtotals to include all items of an operating nature within the subtotal.

The use of additional GAAP measures will continue to be an area of focus as part of ongoing reviews of financial statements.

## AREAS OF INTEREST FOR 2012

We will continue to examine the implementation of IFRS standards that are "new" to the Canadian capital markets, some of which are identified in the table below. The financial reporting areas of focus cited in this bulletin are not an exhaustive list of all areas that will be explored by OSC staff during the course of financial statement reviews in 2012, and application of specific IFRS standards depends on the facts and circumstances of each issuer. Successful compliance with IFRS in all material respects is important in order to provide relevant information for investors to make informed investment decisions.

<table>
<tr><th colspan="3">Areas of Interest for further examination during 2012</th></tr>
<tr><td>Business combinations<br>Critical judgements</td><td>Additional GAAP Measures<br>Impairment</td><td>• See above discussion in this bulletin</td></tr>
<tr><td colspan="3">Provisions<br>• Threshold for recognition (probable) lower under IFRS than under pre-changeover Canadian GAAP (more likely than not)*<br>• Disclosure of whether the discount rate is credit risk adjusted or not<br>• Provisions for loss-making executory contracts<br>• Disclosure of the nature and amount of changes in estimates when an estimate previously reported in an interim period is significantly changed during the final interim period.</td></tr>
<tr><td colspan="3">Fair value measurement<br>• Consideration of the impact of the current economic conditions on the risk adjustments (if any) and discount rates<br>• Reasonable and supportable assumptions, and a rigorous process applied to determining fair value calculations</td></tr>
<tr><td colspan="3">Debt classification<br>• Long-term classification when an issuer has an "unconditional right" to defer settlement of the liability for at least twelve months after the end of the reporting period [IAS 1.69(d)]<br>• Refinancing / rollover arrangements in place at the financial statement date with the same party in order to achieve long-term classification</td></tr>
<tr><td colspan="3">Statement of comprehensive income – presentation<br>• Additional supplementary disclosure 'by nature' when functional approach is utilized<br>• Use of additional subtotals in the statement of comprehensive income (i.e. additional GAAP measures)</td></tr>
</table>

**[*OSC Web Editor's Correction Note dated 2012-02-28: The text of OSC Staff Notice 52-720 Office of the Chief Accountant Financial Reporting Bulletin 35 OSCB Text "(more likely than not)" should have appeared as "(likely)"]**

## QUESTIONS

As part of its on-going efforts to promote high-quality financial reporting, the OCA has established an external consultation process for consultations on unusual or complex technical accounting issues and financial statement disclosures. Click here for the *Guidelines for Requests for Consultations with the Office of the Chief Accountant*. Note that this protocol does not replace and is not a substitute for the existing process for pre-filings and applications made under National Instrument 11-203 – *Process for Exemptive Relief Applications in Multiple Jurisdictions*.

Questions may also be referred to:

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**Guidelines for Consultations with the OCA:**

http://www.osc.gov.on.ca/en/Companies_oca_20111130_rfc-with-oca.htm

ONTARIO SECURITIES COMMISSION

OCA Financial Reporting Bulletin

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Ontario

As the regulatory body responsible for overseeing the capital markets in Ontario, the Ontario Securities Commission administers and enforces the provincial Securities Act, the provincial Commodity Futures Act and administers certain provisions of the provincial Business Corporations Act. The OSC is a self-funded Crown corporation accountable to the Ontario Legislature through the Minister of Finance.