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Keeping your head above water

Recent issues in financial reporting

Financial Reporting Release

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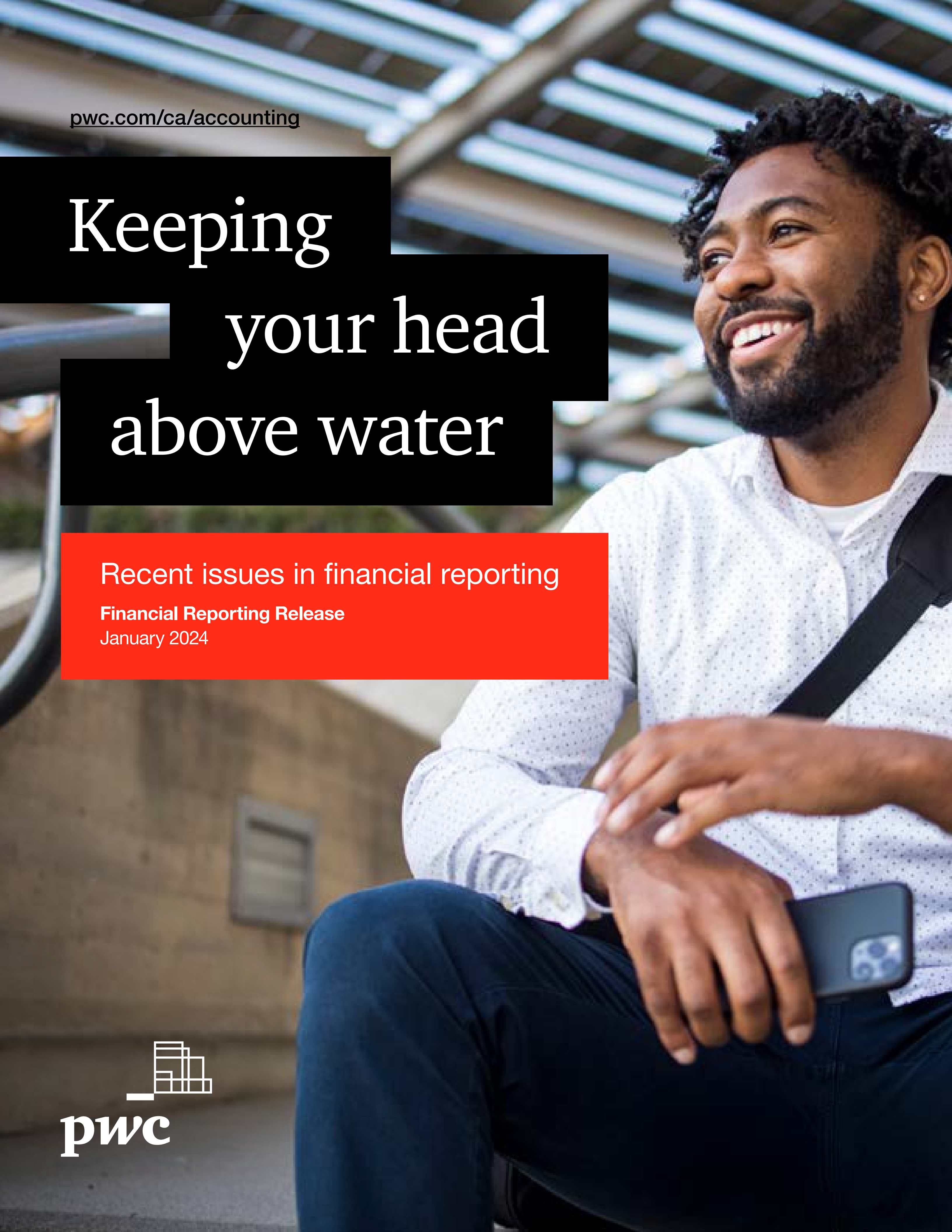

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In this issue

Long ago there used to be a TV show called Dragnet that featured a deadpan Jack Web as sergeant Friday, a humour-free police detective, whose favourite punchline was “Just the facts”. And so, in the spirit of Jack, we report herewith just the facts relating to recent major developments in financial reporting developments affecting Canadian public companies. Well, maybe with the odd observation or two tossed in.

We begin with an overview of global initiatives relating to the development of sustainability reporting disclosures by management. It will come as no particular surprise for you to read that jurisdictions often are establishing reporting regimes keeping an eye firmly fixed on local priorities, perspectives, aspirations and politics. The operative watchword often seems to be, “Align with global reporting standards if possible, but not necessarily.” The consequence is that regional and jurisdictional requirements frequently overlap but don’t fully converge. For example, the introduction of climate-related disclosure rules in Canada on a basis similar to what the SEC has proposed wouldn’t come close to complying fully with International Sustainability Standards Board standards or European ones. Many Canadian companies expecting to be subject to those two latter sets of requirements thus are already considering what if any changes are necessary to their sustainability infrastructure and disclosures to be able to comply with them. How different Canadian public company reporting rules will be remains to be seen because Canadian securities regulators and the SEC have yet to finalize their respective requirements. One thing you can be sure about is that Canadian securities regulators won’t be in a rush to finalize theirs before the SEC does, considering Canadian regulators’ determination to preserve Canadian SEC registrants’ US filing privileges on the one hand and not to expose them unduly to US litigation risk on the other.

On the financial reporting front…

Things are changing too. While the waves of accounting changes in the past few years have only been gently lapping on the shores of companies’ financial statements, the wind is starting to blow and dogs are starting to whine in anticipation of a coming storm. We’ve chosen to highlight the following developments that are likely to be the chief causes of disturbances.

- IFRS clarifications and amendments that will cause you to delay the timing of reporting the collection of your receivables and settlement of your payables in your financial statements.
- A newly approved standard addressing the presentation of the primary financial statements that will fundamentally change the look, taste and feel of your income statement, and also…
- Require you to explain and reconcile your favourite non-GAAP income measures in your interim and annual financial statements.
- A series of regulatory and standard-setting initiatives designed to expand the reporting of climate-related effects and uncertainties in financial statements, and
- New rules finally coming into force regarding the classification of debt as current or non-current.

And there you have it. Happy reading.

Sustainability Regulatory Reporting Developments

"Found a box in the attic filled with very short pieces of string. The label on the box, 'String too short to be saved'."

– Donald Hall, String too Short to be Saved, Recollections of Summers on a New England Farm

We summarize below recent sustainability global regulatory reporting developments, supplemented in some cases with additional information to provide background and context.

International Sustainability Standards Board and European Commission

- Theses authorities published their respective sustainability reporting standards in the summer. These both will ultimately require the disclosure of all sustainability-related risks and opportunities (e.g., climate, water resources, biodiversity, pollution, consumers, own workforce, communities, etc.) but there's a fundamental difference – European standards require disclosure of any information that's material to diverse groups of stakeholders while the ISSB limits disclosures to information that's relevant only to investors. European requirements are, by any measure, the world's most detailed and comprehensive. ISSB standards take second place.

- The difference between the two standards can perhaps best be summarized by the following quote from the European Commission about the application of its climate-related disclosures – These will "provide additional information on impacts relevant for users other than investors such as business partners, trade unions, social partners and academics". As a general rule, companies complying with European standards should be able to meet ISSB requirements without difficulty, but the reverse is definitely not true. GRI, keeper of voluntary sustainability reporting standards, is also broadcasting that companies presently applying GRI standards are well placed to meet European ones. GRI and the ISSB have signed a memorandum of understanding to work together and recently established an "Innovation Lab" to advance capabilities for dual reporting of GRI and ISSB standards.

- Reporting under European standards can be required as early as 2025, in respect of the 2024 financial year for companies with EU listings. However, for European subsidiaries of global companies it will likely be for the 2025 financial year that reporting is required. Reporting under ISSB standards depends on the timing that jurisdictions adopting them decide, unless a company elects to adopt the standards voluntarily, in which case, it can be as early as 2025, for the 2024 financial year.

- Various jurisdictions have decided or are deciding on their pathways to adopting ISSB standards or basing their local reporting requirements on them. These include the UK, Japan, Turkey, Brazil, Switzerland, Australia and, according to the ISSB, dozens of others. Nevertheless, the ISSB has been sufficiently concerned about the lack of overall uptake of its standards by jurisdictions that it has announced various special measures to encourage more participation, including personally visiting recalcitrant jurisdictions to advance the adoption of the standards. The Board has also emphasized the "scalability" of its standards and is also about to release application guidance for jurisdictions that are considering adopting ISSB standards that apparently will contemplate a multi-step implementation that involves the adoption of its climate-related requirements as a first step.

- Both European and ISSB authorities are prioritizing the development of implementation and application guidance of their existing standards, so beware. The ISSB has also consulted on its future agenda including what further non-climate related sustainability thematic standards should be developed.

Canada

- The Canadian Sustainability Standards Board (CSSB), charged with the responsibility of advancing the introduction of ISSB standards in Canada, is expecting to issue an exposure draft of Canadian standards in March and final standards in the fall. These will be available to any legislator, regulator or company that wants to make use of them.

- Canadian Securities Administrators are likely to consult with the public on mandating the standards issued by the CSSB. Previously, the CSA announced that it will consider SEC developments as well.

- The timing of the publication of a proposed CSA rule is conditional on the CSSB finalizing its standards and, presumably, the SEC doing the same. If the rule is finalized in 2025, it will need to provide some time for companies to prepare for adoption before it mandates application of the standards. The risk of delaying further though is that some Canadian companies subject to sustainability reporting obligations in other jurisdictions may have to begin reporting in those jurisdictions earlier.

Sustainability Regulatory Reporting Developments (continued)

- Modern Slavery Act – Canada recently enacted modern slavery legislation ("Fighting Against Forced Labour and Child Labour in Supply Chains Act"). The Act will apply to most public companies in Canada and many private entities as well and requires that entities file their first Modern Slavery report publicly by May 2024 (or possibly earlier where federally incorporated). There is limited official implementation guidance available, but the stated penalties for non-compliance are severe (criminal and monetary penalties). Furthermore, such reports have to be approved by an entity's board and officers and directors can be held liable for non-compliance. The required reporting is extensive and requires analysis of a company's value chain which may require gathering information from outside sources. Meaningful compliance with the standards is likely to require cross-functional teaming with the organization's procurement, sustainability, legal, internal audit and finance functions and appropriate oversight from corporate governance bodies.

United States

- The SEC has now scheduled the final release of its climate-related rules for April. It's missed these deadlines before but the US elections later in the year puts pressure on the Commission to act.
- Approval in 2024 would most likely mean initial reporting beginning in 2026.
- California has enacted legislation requiring disclosure by US-based companies doing business in the state to disclose a Task Force on Climate-Related Financial Disclosures (TCFD) type report once every two years and report their Scope 1, 2 and 3 GHG emissions every year. The thresholds for reporting are based on revenues earned in the US – more than US $500 million in the former case and US $1 billion in the latter. Note that the revenues do not actually have to be earned in California and so these rules are likely to capture many companies operating in the US, even if they are operating primarily outside of California. The legislation applies to US-based subsidiaries of Canadian companies that meet these scope criteria. Reporting begins in 2026, in respect of the prior year, except for Scope 3 GHG emissions, which begin a year later.
- There are two rumours floating about in the US concerning the development of climate change reporting standards. The first is that a lawsuit challenging California's authority to require climate-related disclosure is imminent. The second is that the SEC has decided to backtrack from its original proposal to require disclosure of Scope 3 GHG emissions due to the prospect of lawsuits. The dropping of Scope 3 emissions may have knock-on consequences for the Canadian rule. Both ISSB and European standards require Scope 3 disclosures (subject to some transitional reliefs).
- There are concerns both practical and political that if the US doesn't publish a final standard that Europe will be the de facto standard setter and indirectly capture potentially thousands of US companies. The Chair of the SEC has promised to hold conversations with the European authorities about allowing US companies to use the SEC rule as a substitute for complying with European standards.

PwC observation. How Canadian companies will react to climate developments will depend on their individual facts and circumstances. We expect that some companies, especially smaller ones in less impacted industries, may decide to sit on the sidelines until the picture clarifies. Other companies, particularly those in industries with high levels of investor focus or that now have reporting responsibilities in Europe, California, or expecting to have reporting responsibilities to jurisdictions requiring full compliance with ISSB standards, have already begun identifying and preparing for any additional disclosures and reporting systems that will have to be made, either by the top company or affected subsidiaries and associates, including improving their sustainability reporting infrastructure. It often will be a tough job to string everything altogether and having a solid implementation plan that is flexible enough to adapt to changing regulation is critical.

Financial Accounting Developments

Derecognition of Receivables and Payables

"If I was meant to be controlled I would have come with a remote."

– Anonymous

You may recall that last year the IFRS Interpretations Committee issued a tentative decision summary concerning the timing of derecognition of receivables, in effect on the basis that companies have been inappropriately accelerating the removal of receivables and payables from their balance sheets. As is so often the case with IFRIC decisions, that particular one went over like a lead balloon. Seeking to prevent revolution in the streets, the IASB put the Committee's decision on hold but late in 2023, the Board concluded that, yes, by gum, companies' accounting has to change. You can expect to see the resulting clarifications and amendments to IFRS that will force this to happen being published this year. Dates for transitioning to the new regime are still to be decided.

The root cause of the issue relates to the long-standing IFRS principle that derecognition of a receivable or a payable is appropriate when, and only when, the holder's rights to receive cash and the payer's obligation to deliver it are extinguished. In practice, companies often have taken the practical view that extinguishment occurs before that happens, e.g., as soon as the payer issues an instruction to the bank or the holder receives a notice that an instruction has been made in transactions settled via electronic payment systems, or upon the writing, mailing, or receipt of a cheque. That fact left the Board with an unhappy choice – change the principle to align with what companies were doing or change what companies were doing to align with the principle. The Board chose a sort of middle ground, at least for payables. When a payer settles a payable via an electronic payment system, the payer can deem the payable as having been settled at the notification date, as under existing practice, but only if certain conditions are met. There is no relief being offered for transactions that are settled by cheque. Or for receivables.

PwC observation. Affected contracts will have to be reviewed and perhaps lawyers consulted to determine exactly when their extinguishment occurs for transactions that don't qualify for the Board's exception for electronic cash payments. For those that do, companies still will have to interpret and document why they do qualify. Systems also may have to change. Given the prevalence of electronic payment systems, the changes may drag out the settlement of payables if the payer can't or elects not to use the early settlement option. Of course, everything depends on the system. Settlements via cheque, are of course, another matter altogether – the payer will have lost any control over the timing of their recognition. Keep an eye on the possible impact on key performance ratios. And compliance with debt covenants.

Primary Financial Statements

“Always remember that you are absolutely unique. Just like everyone else.” – Margaret Mead

After ten years (ten long years) the IASB approved a major new standard called *Primary Financial Statements* late in 2023. The principal objective is to revamp the look, taste and feel of the income statement and make targeted changes to the statement of cash flows. Making good on the curse of a former Chair of the Board, the standard also requires companies to include certain non-GAAP measures, now known as “management-defined performance measures”, in the notes to the interim and annual financial statements. More about these requirements in the following section.

The new requirements are scheduled to be released next year, are effective for annual periods beginning on or after January 1, 2027, and must be applied retrospectively.

The new income statement rules:

- Require revenues and expenses to be classified into operating, investing, financing, income taxes and discontinued operations categories.
- Define each of these categories and establishes principles to be used in determining which income statement line items belong in which category (there are special rules for financial institutions).
- Establish two new mandatory subtotals – operating profit or loss and profit or loss before financing and tax. The categories would be presented thus on the statement:

Revenue	xxxx
Operating expenses	xxxx
Operating profit or less	xxxx
Income from investments	xxxx
Profit or loss before financing and income tax	xxxx
Financing	xxxx
Profit or loss before tax	xxxx
Income taxes	xxxx
Profit or loss	xxxx

- Specify that operating expenses should be classified in the income statement based on either their nature or function but permits a mixed presentation when this provides the most useful information (you’ll have to justify why this is so). If by function, an analysis of the expenses by nature must be included in a single note.
- Establish principles for the aggregation and disaggregation of line items and expenses.
- Permit the use of an operating profit or loss before depreciation and amortization and specified impairments subtotal but cautions that describing it as EBITDA would rarely be a faithful presentation of the subtotal.
- Limit the use of the “other” caption.
- Don’t address the identification or presentation of unusual items.

The new cash flow statement rules:

- Require the use of operating profit or loss income statement subtotal as the starting point in calculating cash flow from operating activities.
- Provide that interest and dividends paid are financing activities, and that interest and dividends received are investing activities for non-financial institutions.

PwC observation. The objective of the new classification requirements is to standardize income statement presentations to enhance comparability and, hopefully, reduce the need for non-GAAP measures (hah!). Implicit in the adoption of this straight-jacket approach, of course, is the sacrifice of the long-standing view that management is in the best position to decide what’s the most meaningful and appropriate presentation is for its financial statements. The new rules affecting the classification of interest and dividends differs from US GAAP and therefore will lead to another significant difference in comparability between cash flows.

Primary Financial Statements – Management Defined Performance Measures ("MDPMs")

"It's absolutely impossible but it has possibilities."

– Samuel Goldwyn

The second part of the Primary Financial Statement project addresses the required disclosure of qualifying non-GAAP measures, ahem, management defined performance measures, in the notes to the financial statements. Many of the disclosure requirements will already seem familiar to you because of their similarity to well-established regulatory requirements.

- Disclose in a single note in the financial statements (may be included in the operating segment note in certain circumstances).
- Include only subtotals of income and expenses that communicate management's view of the performance of the entity and may include the numerator or denominator of a ratio. Why does the standard apply only to income-related measures and not, say, cash flow measures as well? Because the Board is only concerned with performance measures. To the Board, performance means income.
- Explain why a MDPM communicates management's view of performance.
- Provide a reconciliation between a MDPM and the most directly comparable subtotal or total under IFRS.
- Disclose the tax and non-controlling effects for each item included in the reconciliation.
- Require MDPM disclosure in interim financial statements.

PwC observation. The Board introduced non-GAAP measures into the GAAP statements, notwithstanding the apparent contradiction, primarily to improve the discipline with which the measures are prepared. As a result, these disclosures will now be subject to fair presentation requirements, financial statement internal controls and processes and within the scope of a financial statement audit, including, key audit matters. In a sense, the requirements can be viewed as an extension of operating segment disclosure requirements that sometimes have already incorporated these measures.

Climate-Related Disclosures in IFRS Financial Statements

"Few things are harder to put up with than the annoyance of a good example."
– Mark Twain

We want to draw two things to your attention. The first is that in October the European Securities and Markets Authority issued a publication, *The Heat is On: Disclosures of Climate-Related Matters in the Financial Statements*. If you can get past the rather dreadful pun, you'll find that the document provides a useful basis for understanding regulatory expectations for the disclosure of climate-related effects in financial statements. Granted, this isn't a source that Canadian preparers refer to every day, but, hey, Europe uses IFRS too and no one's claiming that Canadian reporting in this area is currently world class. The publication provides real-life examples of disclosures by European non-financial corporate issuers and cross-references and discusses the IFRS requirements and educational guidance, including "To keep in mind" reminders about important factors to address in applying the requirements. It covers the following topics:

- Significant judgements, major sources of estimation uncertainty and accounting policies
- Impairments of non-financial assets
- Useful lives of tangible and intangible assets
- Provisions, contingent liabilities and contingent assets
- Share-based payments
- Events after the reporting period.

The second is the IASB's new project, Climate-related and Other Uncertainties in the Financial Statements, which has the same purpose as the ESMA publication – to improve the reporting of climate-related uncertainties in IFRS financial statements. Among other things, the IASB is exploring the possibility of developing illustrative examples to show how to apply IFRS in reporting climate-related effects, clarifying or enhancing specific IFRS requirements, developing an article on the role of financial statements and improving the accessibility of reference sources. You can also look forward to a very interesting decision by the IFRS Interpretations Committee, expected to be finalized next year, on whether a commitment to reduce carbon emissions to net zero constitutes a constructive obligation should result in the recognition of a liability as soon as the commitment is announced. Tentative decisions have been reached which appear to align with our previously published views on the matter and likely results in not requiring a liability prior to the beginning of the entity's compliance period (e.g., if the promise starts in say 2035) but nothing is final, so we'll leave you quaking in your boots as to what the final answer is. Furthermore, we expect entities will still need to think about some of the incidental implications of such commitments on things like asset impairment and useful lives and we expect that the IASB may pull together some more comprehensive examples in this regard.

PwC observation. All of the attention being focused on sustainability and climate-change disclosure outside the financial statements may have diverted attention from issues concerning the disclosure of climate-related effects and uncertainties within the financial statements. Nevertheless, investors continue to take a jaundiced view about the quality of companies' reporting. The initiatives being spelled out above are only the beginning, we suspect. Already standard-setters and regulators are musing about the need for connectivity between climate-related reporting inside and outside the financial statements. Don't forget, too, that the US proposed rule specifies mandatory climate-related financial statement footnote disclosures which, if finalized, may impact IFRS statements filed with the SEC.

Classifying Liabilities as Current or Non-Current

"David, what does burning smell like?"

– Schitt's Creek

Reminder! The IASB's new rules regarding the classification of liabilities between current and non-current are mandatory for annual reporting periods beginning on or after January 1, 2024. Among other things, the new rules provide that:

- Non-current classification is appropriate if and only if the entity has the right to defer settlement of the liability for at least 12 months after the reporting date.
- That right must exist at the reporting date.
- A debt with covenants that must be met within 12 months of the reporting date should be classified as non-current if and only if the covenants are met at the date (even if compliance is tested later).
- A company must disclose information that enables users to understand the risk of a long-term liability becoming repayable within 12 months due to covenant violations. This information includes the nature of the covenants, when an entity is required to comply with them, the carrying amount of the related liabilities, and facts and circumstances, if any, that indicate that the entity may have difficulties complying with the covenants.
- Agreements that provide the ability for a counterparty to convert or exercise for equity within one year of the balance sheet date will impact classification unless they are compound instruments, that is with a component of the instrument recognized in the entity's equity section. For example, convertible debts that allow for immediate exercise and are treated entirely as liabilities containing an embedded derivative (i.e., because they violate the "fixed for fixed" rules) will be classified as current whereas previously many based the classification on the maturity date of the host liability ignoring the potential for conversion. Similarly warrants or options that are treated as liabilities may be impacted where they can be exercised within a one year period.

PwC observation. The biggest impact for Canada will likely be for liability classified instruments that could require issuance of equity instruments. Where an entity is impacted by the classification of those liabilities, they should also consider whether this will cause covenant violations (e.g., where the current ratio is a covenant). We expect that the biggest disclosure challenge will be expanding the notes to address the risk of long-term debt becoming repayable in the next 12 months due to covenant defaults. This will include developing internal controls to ensure that facts and circumstances that may result in difficulties in complying with covenants are appropriately flagged in disclosures. Note the emphasis on "may". The principle here is that management disclosures should be warning about the possibility of fire happening even where it is expected to be doused once it happens and not ultimately lead to a going concern issue.

For more information

This newsletter has been prepared for the clients and friends of PwC by Corporate Reporting Services (CRS). For further information on any of the matters discussed, please feel free to contact any member of CRS, or your PwC engagement leader. This newsletter is available from the PwC Canada web site, which is located at https://www.pwc.com/ca/en/services/accounting-advisory-services.html.

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- Advice on alternatives

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- Diagnostic summary of key impacts on transition
- Evaluation and development of accounting policies
- Training development
- Support in analyzing and documenting technical accounting issues

Accounting Standard Adoption

- Adoption of new standards under IFRS, US GAAP and Canadian GAAP for Private Enterprises
- Diagnostic summary of key impacts on adoption
- Evaluation and development of accounting policies
- Training development and implementation
- Support in analyzing and documenting technical accounting issues

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- PwC IFRS Manual of Accounting

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