

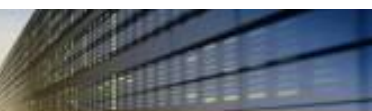
On the road to IFRS in 2011: Disclosure and other legal issues for Canadian companies to consider

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As the Canadian implementation date for the changeover from Canadian generally accepted accounting principles (Canadian GAAP) to international financial reporting standards (IFRS) approaches, the broad potential impact is becoming more apparent. The Canadian Accounting Standards Board (CASB) has adopted a transition plan that requires adoption of IFRS by public companies (and certain others, including non-listed financial institutions and securities dealers) for financial years beginning on or after January 1, 2011. While 2011 may still seem a long way off, given the substantial differences between IFRS and Canadian GAAP, it would not be untimely for issuers to now begin thinking about transition issues and developing a transition plan. As stated in the Canadian Securities Administrators' recent staff notice (discussed in detail below), moving from Canadian GAAP to IFRS is a significant undertaking that may materially affect an issuer's reported financial position and results of operations.¹ Among other things, IFRS-compliant financial statements for fiscal 2010 will also be necessary for comparative purposes. Outside of the official transition from Canadian GAAP to IFRS, Canadian public entities would be wise to start educating their boards and audit committees about these standards and the ways in which they may differ from Canadian GAAP. This has been underscored by the CASB's recent response to the credit crunch with respect to fair value accounting requirements. On October 17, 2008, the CASB announced that it would be amending Canadian GAAP requirements relating to reclassification of financial assets to make them more consistent with IFRS and U.S. standards in this respect. IFRS is a global reality that will soon be coming to Canada, that is, if it isn't already here.

Impact on Business

The transition from Canadian GAAP to IFRS will impact a wide range of activities, including those that may seem to have little connection to a company's disclosed financial position. The first and most obvious impact of the move to IFRS concerns the effect on the presentation of the financial position of an entity as set out in its financial statements. IFRS, like Canadian GAAP, to an extent, represents a statement of principles; principles that must be applied based on judgment and assumptions given the specific facts at hand. With the change to IFRS, not only will many principles change, but arguably, so will many of the more rigid prohibitions or rules that have



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become a part of Canadian GAAP over time (whether through practice or prescription). For example, IFRS allows for more fair value and accounting policy choices and may, as a result, be open to a greater degree of interpretation and professional judgment. New principles underlying the presentation of financial measures suggest potential changes not only to the way in which things are measured, but also changes to what is included in the measurement, when it is measured and in what period it is disclosed. This could impact a variety of financial statement line items and in turn, impact all areas of business that refer or rely on those line items. Further, while IFRS primarily represents a change in Canadian GAAP measures, non-GAAP measures (i.e. EBIDTA, distributable cash, etc.) may also be impacted and these effects will need to be assessed and managed as well.

Transition issues, however, extend beyond simply dealing with changes to financial reporting. Consideration must also be given to terms of existing or new contracts that refer to, or rely on, financial measurements. References in such contracts to commonly occurring phrases such as “in accordance with Canadian GAAP” may, for example, now become contentious interpretive issues. Consideration must also be given to terms of compensation arrangements or plans based on, or connected to, financial targets or measures, internal budgeting and forecasting (including forecasting and modeling for significant acquisitions or similar transactions), changes to compliance procedures, including internal control and disclosure controls and procedures, and tax matters that are derived from Canadian GAAP. If entering into a contract or considering an acquisition today, the IFRS transition should be kept in mind. Will the contracting party make choices consistent with your expectations about financial measures? Will the acquisition target also be moving to IFRS and if so, what policy choices will it make? These are just some of the questions that should come to mind as your company moves towards 2011. The impact on these aspects of business will also affect the nature of the company’s disclosure. To this end, companies must consider how, what and when disclosure will be required, keeping in mind that, as the internal transition continues, external public disclosure must also to be kept current and accurate. Given the broad range of activities connected to the presentation of a company’s financial position and the general requirement that audit committee members be “financially literate”, this also means that boards and audit committees will require education on the new requirements in order to provide the stewardship necessary for a smooth transition.

CSA Notices on Transition and Disclosure

The Canadian Securities Administrators (CSA) have now also issued their guidance on a number of IFRS transition issues as well, including the CSA’s views on transition matters and on the short and long-term impact on MD&A disclosure.

Concept Paper 52-402

On February 15, 2008, the CSA published Concept Paper 52-402 (the Concept Paper) to discuss ramifications for securities laws and rules as a result of the impending transition from Canadian GAAP to IFRS.² The purpose of the Concept Paper was to set out some of the issues that arise as a result of the impending transition, including the options available to address them. The issues on which the Concept Paper focused are limited to early adoption of IFRS by domestic issuers, continued use of US GAAP by domestic issuers and references to Canadian GAAP in securities regulatory materials. But, as the CSA cautioned, the review of issues in the Concept Paper was not exhaustive and the conclusions set out were tentative only.

By way of background, National Instrument 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currency* (NI 52-107), which currently sets out acceptable accounting principles for financial reporting for Canadian and non-Canadian reporting issuers as well as for foreign registrants and other capital markets participants, requires reporting issuers to disclose on the basis of Canadian GAAP. SEC registrants, however, are given the option of using US GAAP and foreign reporting issuers are given the option of using IFRS. Recognizing that domestic issuers may want to move to IFRS prior to 2011, the most significant among the tentative conclusions made in the Concept Paper was that the CSA may allow Canadian domestic issuers to voluntarily move to IFRS before then. Such an action may be of benefit to domestic subsidiaries of foreign-based parents that must comply with IFRS, domestic issuers with significant foreign operations and foreign-based subsidiaries

that must comply with IFRS, domestic issuers that are SEC registrants and that may wish to take advantage of the SEC's recent decision to allow foreign private issuers to comply with IFRS (without US GAAP reconciliation), and Canadian entities considering an IPO in Canada and the U.S. prior to January 1, 2011. For those choosing to adopt early, the CSA indicated they may be inclined to permit adoption as early as the financial year beginning January 1, 2009. Subsequent to the publication of the Concept Paper, on June 27, 2008, the CSA published Staff Notice 52-321 (Staff Notice 52-321), in which they provided more clarity on some of the tentative IFRS issues being considered. Among these issues, the CSA have clarified that they would be prepared to recommend exemptive relief to permit a domestic issuer to adopt IFRS early on a case by case basis. However, in order to recommend such relief the CSA will be looking for evidence that the issuer is prepared for early adoption, which will include the readiness of its staff, board of directors, audit committee, auditors, investors and other market participants (raising the question as to how an issuer might establish their readiness). The CSA will also assess readiness based on preparedness for the implications of early adoption on its securities law obligations, including certifications, business acquisition reports, offering documents and previously released material forward-looking information.

In considering early adoption, however, the CSA caution that issuers should carefully consider the advantages and disadvantages associated with such a move. As the CASB first confirmed in its decision to move to IFRS in 2006, an in-depth knowledge of the new standard is still developing in Canada. This is true of external auditors as well as internal accounting and finance personnel. Issuers wanting to adopt IFRS before 2011 need to ensure adequate deployment of resources to address this gap, as well as adequate education and training for boards and board committees. It is also important to note that the Office of the Superintendent of Financial Institutions has issued a notice indicating that federally regulated financial firms will not be permitted to adopt IFRS early.

With respect to internal resources, issuers should keep in mind that early adoption entails making the transition far in advance of the date that IFRS compliant financial statements will be required. Thus, early adopters will need to prepare both Canadian GAAP and IFRS statements in the years prior to the official adoption date, and related internal control and compliance systems will also need to be modified as necessary. The strain on an issuer's resources may be further exacerbated by the fact that IFRS itself is new, and in many respects, application practices are still being developed. IFRS is also not without its shortcomings, many of which are starting to emerge through the experiences of countries and regions that have already made the transition. While we may have lost a few years in terms of global standardization, we have the opportunity to learn from the transition hurdles faced by others and the value of this hindsight cannot be overlooked. As an illustration, the SEC has recently announced the signing of protocols to allow for the sharing of information among the SEC and a number of European countries with respect to the application of IFRS.³

Although we have much to learn from these experiences, each country will also have its own unique issues based on its characteristics and idiosyncrasies, whether motivated by regional, economic or other concerns. The transition for Canadian issuers in certain types of industries or businesses may, therefore, be more difficult to manage, and for some uniquely Canadian industries and businesses it remains untested. As well, some of the IFRS standards themselves are expected to be modified in the coming years. In this respect, it is also quite likely that the International Accounting Standards Board (IASB) will make some concessions, in the form of further changes to IFRS, in order to accommodate adoption in the U.S. Another issue to consider is the disadvantage associated with reduced comparability of financial statements until other issuers generally move to IFRS in 2011. This may be mitigated if Canadian GAAP statements are concurrently prepared, but would consume added time and expense to duplicate the process. Regardless of these challenges, however, some issuers may still benefit from early transition. For example, a domestic issuer that is a subsidiary of a foreign-based entity may realize substantial cost savings by moving to IFRS early.

As set out in NI 52-107, certain Canadian domestic issuers may currently rely on US GAAP for the presentation of their financial statements. In preparing for the transition to IFRS, the CSA originally indicated in the Concept Paper that they proposed to eliminate such exemptions for financial years in stages beginning on or after January 1, 2009. The CSA would have eliminated the US GAAP option for issuers who had not filed statements in accordance with US GAAP on or before the year ended December 31, 2008. Issuers currently filing US GAAP

statements, however, were proposed to be given an extended transition period that would span from 2009 to 2013. However, according to CSA Staff Notice 53-231, the CSA have decided to retain the option for a domestic issuer that is also an SEC issuer to continue to use US GAAP, without any indication of a cut-off date for the availability of this option. The CSA have also acknowledged that while issuers in certain types of industries may have heightened concerns about how IFRS will impact their financial presentation, ultimately, those issuers may not have a choice with respect to continuing with US GAAP depending on the outcome of the IFRS implementation debate currently underway in the U.S.⁴

Another issue addressed by the Concept Paper regards how the CSA will deal with references to Canadian GAAP in various securities rules, policies and instruments after transition occurs. In Staff Notice 52-321 the CSA have confirmed, as well, that references in securities rules to financial statement requirements will be changed to require issuers to prepare their statements in accordance with IFRS-IASB. This is notwithstanding the fact that the CASB's strategic transition plan proposes to import IFRS into Canadian GAAP and then continue to refer to such standards as Canadian GAAP. What is in a name, one might ask? Consider, however, the documents, disclosures and other materials that refer to, or rely on references to applicable accounting standards. If the IASB and the CSA continue as planned, and given that current Canadian GAAP is expected to continue for private companies, there is a potential for significant confusion if the same standards are referred to by different names. Continued use of different terminology also detracts from the goal of promoting comparability on a global scale.

CSA Staff Notice 52-320

Following publication of its Concept Paper, the CSA also published CSA Staff Notice 52-320 - *Disclosure of Expected Changes in Accounting Policies*. This notice details how disclosure in each of the three financial years preceding January 1, 2011 may be impacted by the implementation of IFRS. Given the potential impact on an issuer's reported financial position and results of operations, as well as certain business functions, the CSA caution that investors and other market participants should be given timely and meaningful information about these matters in the lead-up to the transition date. Specifically, Form 51-102F2 *Management Discussion and Analysis* (MD&A) will be impacted in that it requires issuers to discuss and analyze any changes in the issuer's accounting policies that it has adopted or expects to adopt, including changes due to new accounting standards that an issuer does not have to adopt until a future date.

Changes required in order to transition to IFRS are caught by this disclosure. The CSA advise that disclosure with respect to transition issues should include: a description of the new accounting standard; disclosure of methods of adoption permitted and the method expected to be used by the issuer; and a discussion of the expected effects on the issuer's financial statements and the potential effects on the issuer's business.

The CSA acknowledge that an issuer may only be able to provide limited information on these items in the few years prior to adoption of IFRS. Issuers will, however, be expected to provide more meaningful information in the year immediately prior to adoption, including meaningful quantified information. Thus, detailed IFRS related disclosure requirements will apply for the annual period ending December 31, 2010 and all interim periods in that year. Issuers should, therefore, be prepared to have the capability to produce this information in 2009 or earlier.

Meanwhile, with the implementation of secondary market civil liability in many Canadian jurisdictions, a misrepresentation in the MD&A can form the basis for a claim of misrepresentation from secondary market purchasers. Issuers should, therefore, be mindful of this risk when preparing forward-looking disclosure (regarding items such as expected effects on financial statements and potential impact on business) as recommended in CSA Notice 52-320.

With respect to the three years preceding the implementation of IFRS, CSA Notice 52-320 details the type of disclosure that should be considered for interim and annual MD&A.

Three Years to Go

In the annual period ending December 31, 2008 and all interim periods during that period, if the issuer has developed an IFRS changeover plan, the CSA advise that the issuer should discuss the key elements and timing of such a plan in the interim MD&A and the status of key elements no later than the annual MD&A for the year beginning three years prior to the changeover (for issuers with a December 31 year-end, this means no later than the annual MD&A for the year ended December 31, 2008). Key elements of such a changeover plan may include a discussion of the impact of IFRS on some of the following areas:

- > accounting policies, including choices among policies permitted under IFRS, and implementation decisions such as whether certain changes will be applied on a retrospective or a prospective basis;
- > information technology and data systems;
- > internal control over financial reporting;
- > disclosure controls and procedures, including investor relations and external communications plans;
- > financial reporting expertise, including training requirements; and
- > business activities, such as foreign currency and hedging activities, as well as matters that may be influenced by GAAP measures such as debt covenants, capital requirements and compensation arrangements.

Further, if an issuer is advanced in its changeover plan at the time of preparing its interim and annual MD&A during the 2008 fiscal year, the CSA recommend that the issuer should also discuss the impact on its financial reporting.

Two Years to Go

In the interim periods in the 2009 fiscal year, the CSA recommend that the issuer provide an update of the progress of its IFRS implementation plan and any changes to the plan. For the annual MD&A relating to this period, the CSA recommend that the issuer discuss its preparation to transition to IFRS. In addition to the details outlined above, matters to be discussed could include major identified differences between accounting policies, which may include any differences due to an expected change in accounting policy even though the issuer's existing policy under Canadian GAAP is permissible under IFRS. While the information need not be quantitative, the CSA caution that it should allow investors to understand what elements of the issuer's financial statements are expected to be impacted by the changes. In identifying the accounting policies that an issuer is required or expects to apply under IFRS, the CSA also advise that an issuer should consider policies that exist under IFRS as of the date of the MD&A. This is particularly relevant given that some IFRS standards are expected to be modified prior to 2011. In this respect, the CSA's advice is that if an issuer has considered work that the IASB has in process, it would be well advised to disclose any assumptions made about expected or anticipated future changes to IFRS.

One Year to Go

By fiscal 2010, issuers are expected to provide a more detailed discussion about their implementation plans and the impact on their financial position. For this year, however, the CSA advise that, in addition to the items summarized above, issuers should also discuss decisions about accounting policy choices available under IFRS 1 *First-time Adoption of International Financial Reporting Standards* (IFRS 1) in addition to other relevant IFRS standards. Under IFRS 1, issuers will be required to disclose comparative and reconciliation information in the interim and annual financial statements for the 2011 fiscal year. In order to do this, issuers will need to prepare quantified information regarding the impact of IFRS on each line item presented in the financial statements for the interim and annual periods of the year preceding the changeover (i.e. likely the 2010 fiscal year). The CSA also advise that if quantified information about the impact of IFRS on the key line items is available when an issuer prepares its interim and annual MD&A for the financial year beginning one year before an issuer's changeover date, an issuer should include this information in its MD&A.

Conclusion

The ease or pain associated with transition to IFRS will depend on a number of different factors for different issuers. The industry in which an issuer operates, the nature of its business and the resources invested will all have an effect on the ease with which an issuer is able to make the transition. Transition issues will include potential changes to important contracts containing financial covenants or other measures based on the financial statements and include not only those that are imposed on an issuer by, for example, creditors, but also those that the issuer may be relying on its suppliers, service providers or other counterparties to maintain. Where IFRS makes available options relating to choice of standards or principles, boards may want to consider determining the impact of choosing one over another, and whether they want to get an early start in lobbying for a particular choice where one is available. Companies, as well as their executives and compensation committees may also want to take a closer look at targets or other measures used to calculate components of their compensation and determine whether any changes are appropriate. As planning continues, issuers will also need to seek to ensure that their internal compliance processes, internal controls over financial reporting and disclosure controls and procedures evolve to meet these changing needs. As well, CEOs and CFOs that must provide certifications regarding these controls and procedures, as well as an issuer's annual filings will want to ensure that transition issues are addressed well in advance of the relevant interim and annual filing deadlines. The transition will also be affected by the choices that regulators make. For example, securities regulators will have to determine how to deal with historical and pro forma financial statement disclosure requirements in prospectuses, business acquisition reports and proxy circulars.

Finally, there have been some criticisms of IFRS providing too much management flexibility and, thus, reducing the quality of financial reporting. While it remains to be seen if this is indeed the case, even assuming that critics are correct, there remains an incentive for the sake of better international comparability in a globalizing investment marketplace to effect such a transition. While commentators have also expressed concern that private company Canadian GAAP will atrophy once Canadian private companies have moved to IFRS, this too remains to be seen. Thus, the movement towards implementation continues, and early planning must be considered by issuers to effect a successful transition.⁵

For further information, please contact your Stikeman Elliott representative or any member of our Corporate Finance and Securities Group listed at www.stikeman.com

¹ CSA Staff Notice 52-320 (2008) 31 OSCB 4744 at p. 4744.

² (2008) 31 OSCB 1697.

³ SEC Press Release 2008-95, *SEC Signs Protocols for Sharing Information on International Accounting Standards*, May 23, 2008.

⁴ At the time of writing this paper, the most recent indication from the Securities and Exchange Commission, as contained in its proposed "Roadmap Toward Global Accounting Standards" was that the Securities and Exchange Commission could move to IFRS for U.S. issuers beginning in 2014.

⁵ This paper has been adapted from a version originally published in the journal "Corporate Disclosure", Volume 11, No. 1, 2008.

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