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THE EXCHANGE

SEMINAR SERIES

Annual Financial Reporting Update

Today, we'll be covering...

- Current Economic Conditions & Impacts on Financial Statements
- Accounting Standards Updates
- Assurance Standards Update
- Tax Update

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Current Economic Conditions & Impacts on Financial Statements

Accounting Standards Updates

Topics

- Allocating cost in an asset acquisition
- New standards & amendments
  - Amendments to IAS 16
  - Amendments to IAS 37
  - Amendments to IFRS 9
  - Amendments to IAS 1
- Impact of interest rate changes and inflation

Allocating cost in an asset acquisition

Asset Acquisitions

Why we are talking about it today?

IFRS 3, *Business Combinations* was amended to revise the definition of 'Business'

More transactions being accounted as acquisition of assets

Lack of explicit guidance on accounting of asset acquisitions

Cost of asset acquisition is allocated to the assets and liabilities based on relative fair values

Two scenarios:

- Cost of asset acquisition exceeds fair value
- Cost of asset acquisition is less than fair value

Cost of Asset Acquisition Exceeds Fair Value

Revisit the conclusion:

1. Ensure that all acquired assets (including intangible assets) have been identified and recognized

2. Ensure that the fair values of the assets acquired and liabilities assumed have been appropriately measured

3. Remember to record any settlement of pre-existing relationships (similar to the treatment under business combinations)

Cost of Asset Acquisition Exceeds Fair Value

Cost of asset acquisition may exceed the fair value of the net assets acquired due to synergies

Such excess cost over fair value should generally be allocated to the acquired assets on a relative fair value basis

Not all assets acquired should be allocated such excess, as certain assets could be measured differently, such as:

financial assets	working capital	deferred tax assets

Cost of Asset Acquisition Exceeds Fair Value - ILLUSTRATION 1

Company A acquires equipment, building, land, and technology in exchange for cash consideration of $50 million. Company A also incurs direct transaction costs of $1 million.

Equipment - Fair value (FV) $5 million

Building – FV $25 million

Land – FV $10 million

Technology – FV $5 million

Company A concludes that the acquired assets do not constitute a business and instead represent an asset acquisition.

HOW SHOULD THE ASSET ACQUISITION BE RECOGNIZED AND MEASURED?

Cost of Asset Acquisition Exceeds Fair Value - ILLUSTRATION 1

Analysis:

Company A would allocate total consideration of $51 million (including $1 million of direct transaction costs), to the acquired assets based on their relative fair values.

Cost of Asset Acquisition Exceeds Fair Value - ILLUSTRATION 1

Item	Fair value	% of Fair value (A)	Cost of acquisition (B)	Cost allocated (A x B)
Equipment	$5,000,000	11%	$51,000,000	$5,610,000
Building	$25,000,000	56%	$51,000,000	$28,560,000
Land	$10,000,000	22%	$51,000,000	$11,220,000
Technology	$5,000,000	11%	$51,000,000	$5,610,000
	$45,000,000			**$51,000,000**

Acquired assets may be tested for impairment based on the requirements under IAS 36, *Impairment of Assets*

Cost of Asset Acquisition Exceeds Fair Value - ILLUSTRATION 2

Company A acquires equipment, building, land, and working capital in exchange for cash consideration of $50 million. Company A also incurs direct transaction costs of $1 million.

Equipment - Fair value (FV) $5 million

Building – FV $25 million

Land – FV $10 million

Working capital – FV $5 million

Company A concludes that the acquired assets do not constitute a business and instead represent an asset acquisition.

HOW SHOULD THE ASSET ACQUISITION BE RECOGNIZED AND MEASURED?

Cost of Asset Acquisition Exceeds Fair Value - ILLUSTRATION 2

Analysis:

Company A would allocate total consideration of $51 million (including $1 million of direct transaction costs), to the acquired assets based on their relative fair values.

Working capital items will be measured at fair value.

Cost of Asset Acquisition Exceeds Fair Value - ILLUSTRATION 2

Item	Fair value	% of Fair value (A)	Cost of acquisition (B)	Cost allocated (A x B)
Equipment	$5,000,000	13%	$46,000,000	$5,750,000
Building	$25,000,000	63%	$46,000,000	$28,750,000
Land	$10,000,000	25%	$46,000,000	$11,500,000
Working capital	$5,000,000	N/A	N/A	$5,000,000
	$45,000,000			**$46,000,000**

- Working capital is recognized at its fair value, and accordingly, the remaining cost is allocated to other eligible assets (i.e., equipment, building and land)
- Acquired assets may be tested for impairment based on the requirements under IAS 36, *Impairment of Assets*

Cost of Asset Acquisition is Less Than Fair Value

Cost of acquisition may be less than the fair value of the net assets acquired

Any benefit (fair value less consideration) should reduce the basis of the assets (generally non-monetary)

Not all of the assets acquired should be allocated such deficit, as this could result in an immediate gain, such items could include:

- financial assets
- deferred tax assets

Allocate to eligible assets

Cost of Asset Acquisition is Less Than Fair Value - ILLUSTRATION 3

Company A acquires equipment, building, land, and an investment in common shares, and assumes trade payables in exchange for cash consideration of $40 million. Company A incurs direct transaction costs of $1 million.

Equipment - $5 million

Building - $25 million

Land - $10 million

Investment in common shares (Level 3) - $5 million

Trade payables - $1 million

Company A concludes that the acquired assets do not constitute a business and instead represent an asset acquisition. The financial asset will be accounted for under IFRS 9 subsequent to the asset acquisition.

HOW SHOULD THE ASSET ACQUISITION BE RECOGNIZED AND MEASURED?

Cost of Asset Acquisition is Less Than Fair Value - ILLUSTRATION 3

Analysis:

Company A would allocate total consideration of $41 million (including $1 million of direct transaction costs), to the acquired assets and liabilities assumed based on their relative fair values. No bargain purchase gain should be recognized in an asset acquisition. Accordingly, the benefit would be recognized as a reduction to the relative fair values of the non-monetary assets acquired.

Cost of Asset Acquisition is Less Than Fair Value – ILLUSTRATION 3

Item	Fair value	% of Fair value (A)	Cost of acquisition (B)	Cost allocated (A x B)
Equipment	$5,000,000	13%	$47,000,000	$4,625,000
Building	$25,000,000	63%	$47,000,000	$23,125,000
Land	$10,000,000	25%	$47,000,000	$9,250,000
Investment in common shares	$5,000,000	N/A	N/A	$5,000,000
Trade payables	($1,000,000)	N/A	N/A	($1,000,000)
	$44,000,000			**$41,000,000**

- Investment in common shares and trade payables are recognized at fair value, and accordingly, the remaining cost is allocated to other eligible assets (i.e., equipment, building and land)

Acquisitions under Securities Requirements

- The Commissions generally consider the acquisition of a separate entity, a subsidiary or a division to be an acquisition of a business, and in certain circumstances, the acquisition of a smaller component of a company may also be considered an acquisition of a business

- Definition of a business under IFRS is not considered relevant

- The acquisition of licenses, patents, royalties and intellectual property are "business" acquisitions for securities law purposes

New standards & amendments

Amendments to IAS 16

Property, Plant & Equipment: Proceeds before intended use

Old Requirement

- Sale proceeds deducted from the cost of PPE

New Requirement

Sale proceeds & related cost recognized in profit or loss

Cost measured in accordance with

IAS 2 , Inventories

Meaning of 'Testing' the functioning of PPE

Amendments to IAS 16

Property, Plant & Equipment: Proceeds before intended use

Additional disclosure requirements

Disclose the sale proceeds and related costs recognized in profit or loss along with which line item(s) they are included

Effective date

Annual reporting periods beginning on or after January 1, 2022, with earlier application permitted

Amendments to IAS 37

What is an onerous contract?

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

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Provision:

DR Profit or loss CR Liability

Amendments to IAS 37

UNAVOIDABLE COSTS = COSTS OF FULFILLING A CONTRACT

Paragraph 68A added to IAS 37

Costs of fulfilling a contract comprise costs that relate directly to the contract, which include both:

- Incremental costs of fulfilling the contract (e.g. direct labor & materials)
- Allocation of other costs that relate directly to fulfilling contracts (e.g. allocation of depreciation charge for PPE used in fulfilling the contract)

Amendments to IFRS 9

Effective for annual reporting periods beginning on or after January 1, 2022.

Modification vs Extinguishment accounting based on the '10% test'.

10% test includes present value of the cash flows under the new terms, including any fees paid or received, is at least 10% different from the present value of the remaining cash flows of the original financial liability.

The amendment clarifies that fees included in the 10% test are limited to fees paid or received between the borrower and the lender.

Consequently, fees paid to third parties are excluded from the 10% test.

Amendments to IAS 1 - Convertible Debt

Effective for annual reporting periods beginning on or after January 1, 2024

Amendment will now require that when an entity classifies the host liability as current or non-current, it can ignore only those conversion options that are recognized as equity

Only covenants applicable on or before the reporting date affect the classification. Future covenants do not affect a liability's classification at that date

Amendment has removed the requirement for a right to be unconditional and instead now requires that a right to defer settlement must exist at the reporting date and have substance. Ignore management's intent / expectations

Impact of interest rate changes and inflation

Impact of Interest Rate Changes and Inflation

- Inflation was at its highest peak during 2022
- Substantial increases in the Bank of Canada interest rates
- New financial reporting challenges

Impact of Interest Rate Changes and Inflation

Impairment of non-financial assets

- Indicators of impairment
- Recoverable amount
  - Revised budgets
  - Expected cash flow approach (multiple probability-weighted scenarios)
  - Revised discount rate
  - Terminal growth rate
- Reconciliation to market capitalization
- Impairment Disclosures

Inventory valuation and obsolescence

- Inventory write-downs

Impact of Interest Rate Changes and Inflation

Allowance for doubtful accounts / expected credit losses (ECL)

- Lifetime vs 12-month ECL
- Significant increase in credit risk (SICR)
    - Exposure at default (EAD)
    - Loss given default (LGD)
- Reliance solely on historical loss rates may not be appropriate
- interest rate forecasts and economic outlooks

Impact of Interest Rate Changes and Inflation

Estimates related to revenue contracts

- Significant financing component
- Revenue recognized over time - % completion method
- Variable consideration
- Credit risk – critical factor in Step 1 of IFRS 15

Leases

- Discount rates often based on a lessee's incremental borrowing rate (IBR)
- Revised discount rates to be applied in certain trigger events
- Impact on measurement of lease liabilities and Right of Use assets

Impact of Interest Rate Changes and Inflation

Going concern

- Management's plan for future actions
- Detailed cash flow forecasts
- Reliability of underlying data and support for key assumptions
- Sensitivity analysis
- Credit facilities and repayment terms
- Covenant compliance
- Disclosures

Assurance Standards Update

The Evolution of Standards

New standards affecting audits

2022
- CAS 701 (Key Audit Matters)
- CAS 315 (Risk Assessment)
- CSQM 1 (Quality Management)

2023
- CSQM 2 (Engagement Quality Reviews)
- CAS 220 (Quality Management)

2024
- CAS 600 (Group Audits)

2025 and beyond
- CAS 500 (Audit Evidence)
- CAS 570 (Going Concern)
- CAS 240 (Fraud)
- ESG
- PIE

CAS 701

Communicating Key Audit Matters in the Independent Auditor's Report

Effective for audits of entities listed on exchanges other than the TSX (NEO, CSE and TSX-V), excluding listed entities required to comply with NI 81-106, for financial statement periods ending on/or after December 15, 2022.

What are the requirements of KAMs?

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The auditor's report is required to:

- Identify each KAM;
- Describe the primary reason(s) the auditor designated it as a KAM;
- Describe how each matter was addressed in the audit; and
- Make reference to the relevant financial statement accounts or disclosures.

Types of KAM

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KAMs will generally include matters such as:

- Significant management estimates;
- Areas of high audit risk;
- Areas involving a high degree of estimation uncertainty;
- Significant unusual transactions; and
- Significant changes in the financial statements.

Lessons Learned to Date

- Deciding what was a KAM required significant judgment and was specific to the circumstances of each audit.

- Communicating KAMs that are easily understood by a broad readership can be challenging.

- Sharing draft KAMs with management, audit committees, and legal counsel provided an opportunity to set expectations about KAMs and to reach a common understanding about applying the standard's requirements and how the implementation process and timing may work.

CAS 315 (Revised)

Identifying and assessing the risks of material misstatement

Effective for <u>all</u> audits of F/S of periods <u>beginning</u> on or after December 15, 2021.

Key Changes

More robust risk identification and assessment process;

Modernized to recognize the evolving environment, including information technology (IT);

Enhanced requirements relating to exercising professional skepticism; and

Recognises the use of technology by the auditor in an audit.

Cyber Risks

- CSA Multilateral Staff Notice 51-347 *Disclosure of Cyber Security Risks and Incidents*
- Material fact disclosure (Part 1(f) of MD&A Form, Part 1(e) of AIF Form and National Policy 51-201 *Disclosure Standards*)
- Material change disclosure
- Consider quantitative and qualitative factors
- CSA Staff Notice 11-332 *Cyber Security*

CSQM 1, CSQM 2 & CAS 220

Quality Management Standards

These standards introduce new requirements at the engagement level for:

- Acceptance and continuance of client relationships and engagements
- Relevant ethical requirements
- Engagement resources
- Engagement performance; and
- Engagement quality review

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Overview of Quality Management Standards

CSQM 1

CSQM 2

Engagement Quality Reviews: Applied on certain engagements where required by criteria or firm policy

Audit Engagements

CAS 220 (Revised) *Quality Management at the Engagement Level* and other consequential amendments to CASs

Review Engagements

Reviews of historical financial statements (CSRE 2400) & Section 7060 *Auditor Review of Interim Financial Statements*

Other Assurance Engagements

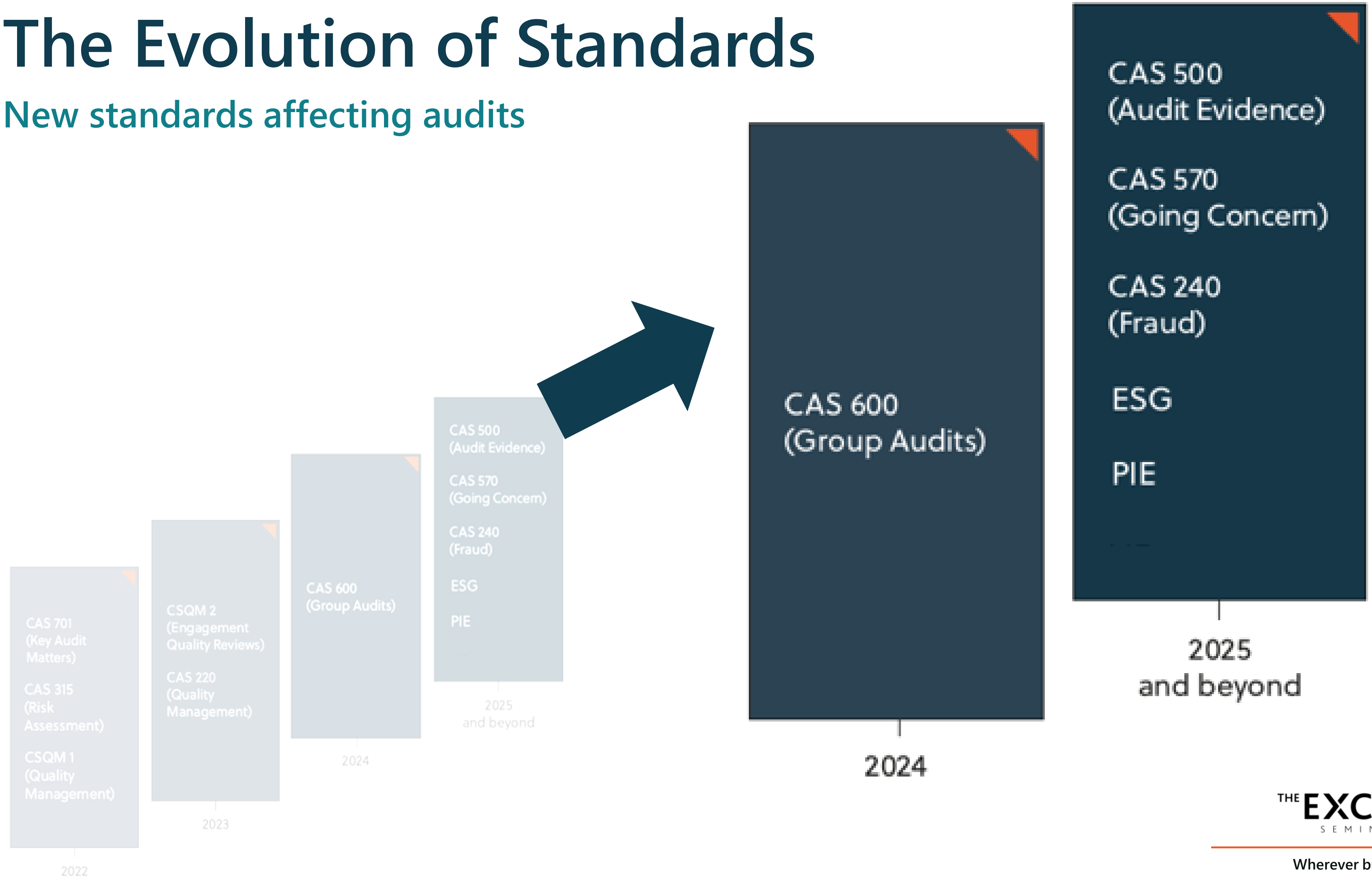
CSAE 3000 series engagements, Audit of Internal Control (Section 5925), and specialized areas (auditor consents and auditor assistance to underwriters and others)

Other Related Services Engagements

Compilation (CSRS 4200), Agreed-upon Procedures (CSRS 4400), and Supplementary Matters arising from Audit/Review (CSRS 4460)

The Evolution of Standards

New standards affecting audits



The Evolution of Standards

New standards affecting audits

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Launching IDA

MNP’s Insights-Driven Assurance

Tax Updates

Excess Interest and Financing Expenses Limitation (“EIFEL”)

2021 Federal Budget & November 4, 2022 Draft Legislation

EIFEL Objectives

- EIFEL regime is to address BEPS issues arising from Canadian tax base erosion
- Restricts deductions for interest and financing costs to an amount that commensurate with the taxable income generated by activities in Canada
  - Limit the amount of net interest and financing cost deduction to no more than a fixed ratio of earnings

EIFEL – Interest and financing expense

- Interest and financing expenses includes
  - Interest and financing expenses capitalised and deduct as capital cost allowances or as amounts in respect of resource expenditure pools
  - Imputed amount of interest in respect of certain finance leases
  - Amounts that are economically equivalent to interest or considered part of the cost of funding; and
  - Expenses incurred in obtaining financing

EIFEL – Adjusted taxable income

- Taxable income adjust for the following items
  - Reverse interest and financing expense
  - Reverse certain tax expenses and CCA/terminal loss
  - Reverse income inclusion for interest and financing revenues, untaxed income and certain other amounts
  - Reverse dividends subject to deductions under S.112/S.113
  - Reduced by losses deducted under S.111, except to the extent they resulted from prior year interest and financing expense

Taxpayers Subject to EIFEL

- Legislation, if passed, will be effective for taxation years beginning on or after October 1, 2023
- Corporations or Trusts reporting income from business or property are subject to the EIFEL unless the Taxpayer is an Excluded Entity
- Excluded Entities include:
  1. CCPCs that, together with any associated corporations have a taxable capital employed in Canada of less than $50,000,000
  2. Eligible group entities (corporations and trusts that are related, affiliated) whose aggregate interest and financing expenses (net of interest and financing revenues) among their <u>Canadian members</u> is $1,000,000 or less; **and**

Excluded Entities Changes

3. Certain standalone Canadian-resident corporations and trusts and groups consisting exclusively of Canadian-resident corporations and trust that carrying on substantially all of their business in Canada
   - No non-resident is a material foreign affiliate of, or holds material interest in any group member, and
   - No group member has any significant interest and financing fees payable to non-arm's length "tax- indifferent investor"(defined in S.248(1))

Taxpayers Subject to EIFEL

If the Taxpayer meets one of the three categories for an excluded entity, then the Taxpayer is not subject to the EIFEL rules. No further analysis is required for the particular taxpayer.

If the Taxpayer does not meet one of the excluded entity categories, then the EIFEL rules will apply.

The EIFEL rules do not apply to Individual taxpayers.

Excluded Interest & Exempt Interest

Excluded Interest

- EIFEL rule allows 2 taxable Canadian entities to jointly elect that one or more payment of interest or financing fee to be excluded from the limitation
  - Among other conditions, the two corporations are related or affiliated

Exempt Interest

- 3rd party interest and financing fees on borrowed amount in respect of an agreement with public sector authority to design, build, and finance real or immovable property owned by public sector authority

Group Ratio Rules

- The group ratio rules allows a taxpayer a deduction for interest and financing fee in excess of the fixed ratio, provided
  - Taxpayer is part of the accounting consolidated group
  - Ratio of net 3rd party interest to EBITDA exceeds the fixed ratio

- The maximum amount of interest and financing expense the consolidated group can deduct is the total of each group members adjustable taxable income multiple by the group ratio

Other Items

- The EIFEL rules apply to include interest and financing expenses of controlled foreign affiliates

- The EIFEL rules apply to include interest and financing expenses of partnerships

- The Taxpayer may carry forward restricted interest and financing expenses indefinitely (previously up to 20 years)

- The Taxpayer may carry forward unused excess capacity for up to 3 taxation years

- The Taxpayer may transfer excess capacity to another eligible group entity in respect of the taxpayer (corporations requires election)

Amendments to IAS12

Deferred tax related to assets and liabilities arising from a single transaction

Background

- Certain transactions result in the recognition of an asset and a liability such as lessee for right of use asset and a lease liability. Would also apply to decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related assets
- In Canada, the lessee would only receive tax deduction when the lease payments are made
- Amendments were issued in response to differing views on whether the recognition exemption applied to transactions, such as leases, that lead to the recognition of an asset and liability

Background (continued)

- There were 2 approaches for deferred tax
  - Considers the lease as a single transaction, asset and liability are integrally linked so no net temporary differences at inception
  - Consider the lease asset and liability separately, in which case the initial recognition exemption would apply
  - Paragraph 15, 22 and 24 are amended. Paragraph 22A and 98J-98L are added

Changes to IAS 12

- Narrow the application of the initial recognition exemption so that it would not apply to such transactions, i.e. resulting in consistency with the two approaches
- IAS 12.15 A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

  a) the initial recognition of goodwill; or

  b) the initial recognition of an asset or liability in a transaction which:

    (i) is not a business combination

    (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

    (iii) at the time of the transaction, does not give rise to equal amounts of taxable and deductible temporary differences

Proposed Changes to IAS12 (continued)

- IAS 12.22A A transaction that is not a business combination may lead to the initial recognition of an asset and a liability and, at the time of the transaction, affect neither accounting profit nor taxable profit. For example, at the commencement date of a lease, a lessee typically recognises a lease liability and the corresponding amount as part of the cost of a right-of-use asset. Depending on the applicable tax law, equal taxable and deductible temporary differences may arise on initial recognition of the asset and liability in such a transaction. The exemption provide by paragraphs 15 and 24 does not apply to such temporary differences and an entity recognised any resulting deferred tax liability and asset

Effective Date

- The amendments are effective for annual reporting periods beginning on or after January 2023
- Earlier application is permitted, however would need to disclose this
- IAS12 98L An entity applying Deferred Tax related to Assets and Liabilities arising from a Single Transaction shall also, at the beginning of the earliest comparative period presented:

Effective Date (continued)

(a) recognise a deferred tax asset – to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised – and a deferred tax liability for all deductible and taxable temporary differences associated with:

(i) right-of-use assets and lease liabilities, and

(ii) decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related asset; and

(b) recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at that date

Example 1

- New lease, asset $100 and liability $100
  - Under old rules, if looking at asset and liability separately
    - Asset accounting basis $100, tax Nil => DTL, IRE applies
    - Liability accounting basis ($100), tax Nil => DTA, IRE applies
    - Subsequent movement in the asset and liability will also be covered by IRE
  - Under new rule, since the transaction gives rise to equal taxable and deductible temporary differences, IRE does not apply. Will not have any DTL/DTA on inception. Subsequent changes will result in DTA/DTL

Example 2

- Same as before, lease asset of $110, lease liability of $100. The asset value includes transaction cost of $10
- Under old rule, same as example 1 and IRE applies
- Under new rule, would be the same as example 1 for the asset and liability of $100, no IRE
    - On the $10 transaction cost, if it's deducted for tax when it was paid, then there is a timing difference between accounting basis of $10 and tax basis of $0 (deduction already taken)

Example 2 (continued)

- If the $10 transaction cost is not deductible immediately for tax, we would expect no timing difference as accounting and tax basis are the same
- Effective date for adoption to be decided after exposure draft finalized. Earlier application is permitted

Ontario Annual Return

Ontario Annual Return

- Effect May 15, 2021, corporations cannot file the Ontario Annual Return with the T2 return
- All Ontario Corporation must file directly online via Ontario Business Registry
- Ontario Annual Returns are due within 6 months after the year end
- Corporation annual return due between May 18-Oct 18, 2021 are exempt from filing for the 2021 year
- There may be penalties for late filing


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