

## **Challenges and Changes**

# **MD&A Disclosures Regarding IFRS Conversion**

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In 2011, the accounting principles under which financial statements in Canada are prepared for all publicly accountable enterprises (PAEs) will change to International Financial Reporting Standards (IFRS). Generally accepted accounting principles (GAAP) in Canada, as we currently know them, will be replaced by IFRS for PAEs. To ensure references to Canadian GAAP that remain in regulatory and legal contexts remain valid after the changeover, IFRS will be incorporated into the Canadian GAAP Handbook.

A considerable challenge facing directors is ensuring that their organization is prepared for this 2011 transition. As part of their responsibility to oversee their organization's financial reporting, directors should ensure that they understand the issues relating to disclosures regarding IFRS conversion, and that their organization has an appropriate plan in place.

In May 2008, the Canadian Securities Administrators (CSA) published Staff Notice 52-320, *Disclosure of Expected Changes in Accounting Policies Relating to Changeover to International Financial Reporting Standards*. At a high level, the Notice addresses the key elements of the changeover plan and the disclosures that should be expected in Management's Discussion & Analysis (MD&A) in each reporting period up to the date of the conversion.

The Canadian Performance Reporting Board (CPRB) of the Canadian Institute of Chartered Accountants is developing in-depth guidance entitled *Pre-2011 Communications About IFRS Conversion*, which sets out recommended practices and elaborates on the CSA's expectations. It advocates a proactive and transparent communication strategy to serve both preparers' and investors' needs and to maintain analysts' following through the transition.

### ***Why Communication is Critical Throughout the Transition***

Investors need to be able to differentiate reported performance changes caused by the adoption of different accounting standards from those caused by business activities. The inability to do so will cause uncertainty as to the company's financial performance. Investors will also want to know whether companies have an appropriate plan in place to deal with the conversion and what to expect from the conversion before it takes place.

Transition to IFRS has taken place in many areas of the world including Europe, where the changeover experience demonstrated that entities that provided significant information about the effects of conversion in the period leading up to the changeover were able to maintain analysts' following without significant distress, while poor communication about the conversion process had a negative impact on the views of an entity's analyst community.

Each company must consider its stakeholder community and the particular communication challenges that IFRS conversion poses.

## ***Communicating the IFRS Conversion Process***

A changeover plan is a statement of the process that an entity will follow in executing its conversion to IFRS. It provides a basis for monitoring and communicating all aspects of the conversion.

The CSA suggest a number of key elements that an issuer's plan may address:

- 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 other matters that may be influenced by GAAP measures such as debt covenants, capital requirements and compensation arrangements.

The changeover plan may also define the process to be followed in determining whether a material change has occurred that requires a Material Change Report to be filed in accordance with securities regulations.

The CSA Notice encourages discussion of the key elements and timing of the changeover plan in interim 2008 MD&A reporting and states that in annual 2008 reports, entities should discuss the status of the key elements and timing of the plan, with quarterly updates thereafter. This discussion should include an assessment of the resources needed to execute the plan. The plan's milestones should also be communicated, and the MD&A should report whether the project is progressing according to plan, and, if not, identify steps being taken to correct the situation.

## ***Communicating the Impact of IFRS Conversion on Financial Reporting***

### ***Impact on Financial Statements***

Conversion to IFRS will result in differences in recognition, measurement and disclosure in the financial statements. The extent and significance of the differences will depend on the industry in which an entity operates and the entity's specific circumstances.

Issues which may need to be addressed include disclosures about assumptions used and accounting policy choices made on transition, and the possibility of greater volatility in reported results. This may increase the need for explanation of such changes in the MD&A, so that the implications are properly understood by investors.

### ***Impact on Key Performance Indicators***

Investors commonly focus on an entity's Key Performance Indicators (KPIs), which may be financial, non-financial, or a combination of both. The impact of the conversion on KPIs must be considered from both the application of IFRS generally and the application of IFRS 1, the special standard which applies at the date of transition.

It is possible that the conversion may not affect KPIs at all, as, for example, when a KPI is non-financial. When KPIs are affected, the impact of the conversion on them may not align with the impact on the financial statements.

Investors will want to understand the reasons for any changes to KPIs, the impact of the change on historical trends and on comparability with key competitors, and the possible implications for future periods under different sets of economic conditions.

### ***Communicating the Impact of IFRS Conversion on Other Aspects of the Business***

#### *Impact on agreements*

Various agreements may be affected by the conversion to IFRS such as covenants in debt agreements and executive compensation agreements. Material agreements affected by the conversion should be identified in the MD&A, together with the nature of the impact. Once they are finalized, significant changes in these agreements should be explained.

#### *Impact on internal controls over financial reporting*

An entity's internal controls over financial reporting (ICFR) should include systems and processes to address changes resulting from applying new accounting standards. The CEO and CFO certification of the design of a non-venture issuer's ICFR has been extended to evaluate the effectiveness of the operation of ICFR for years ending after December 15, 2008. Accordingly, at a certain point, if a non-venture issuer's system of ICFR is not IFRS-compliant, then a material weakness in ICFR will exist that should be reported in the MD&A.

The CEO and CFO certification also requires non-venture issuers to report changes in ICFR in the annual and interim MD&A. Consequently, commencing in 2009, an entity should discuss in its MD&A progress towards changes in its ICFR to be IFRS-compliant.

### ***An Incremental Approach to Disclosure***

The major challenge in communicating the impacts of the conversion to IFRS is that, while some differences between Canadian GAAP and IFRS measures will be immediately identifiable and quantifiable, there are also circumstances in which a difference is identified but its impact is uncertain, and others in which differences may not be identifiable or quantifiable until close to the conversion date.

As a result, preparers may be reluctant to disclose their expectations of the impact of IFRS conversion on their KPIs or on the financial statements as a whole. However, investors are likely to want such information as soon as possible.

The CSA has recognized that an issuer will likely be able to provide only limited information while still two or three years away from the conversion date, and has set out an incremental approach to disclosure, suggesting more detailed information on the impact of IFRS on the financial statements as an issuer moves closer to its changeover date.

The CPRB recommends similar disclosure regarding the impact of IFRS on KPIs, and proposes a two-step disclosure process involving both narrative and quantitative disclosure. Under this process, the MD&A would initially identify and discuss an entity's conversion issues, including the possible effects on KPIs. As the consequences of likely choices become more certain, the MD&A should discuss the nature and rationale of any change contemplated. These disclosures should be made in the MD&A on a cumulative basis, commencing with 2009 interim reporting, consistent with the CSA guidance. This qualitative discussion could focus on the impact on financial reporting in the entity's industry as well as the entity's specific circumstances. Further on in the conversion process, once the impact on KPIs has been determined, disclosure of more quantitative information is recommended.

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Directors should ensure that their company is ready with a proactive and transparent communication strategy that will serve both preparers' and investors' needs and maintain analysts' following throughout the transition to IFRS.

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