



# Current Developments: Canadian Securities and Auditing Matters

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## Canadian Securities and Auditing Matters

This edition provides a summary of newly effective and forthcoming regulatory and auditing matters in Canada from July 1, 2018 to September 30, 2018.



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# Canadian Securities: New guidance

## Continuous Disclosure Review Findings

In July 2018, Canadian Securities Administrators (CSA) issued Staff Notice (SN) 51-355 *Continuous Disclosure Review Program Activities for the Fiscal Years Ended March 31, 2018 and March 31, 2017* which summarized information about common areas of deficiencies and highlighted best practices from full continuous disclosure reviews or issue-oriented reviews.

During 2018, 840 (2017 – 1,014) reviews were conducted on which 81% (2017 – 80%) were issue-oriented reviews. The outcomes were as follows (issuers may appear in more than one category):

Outcome	2018	2017
No action required	39%	33%
Prospective changes	25%	24%
Refiling	18%	13%
Referred to enforcement/cease traded/delisted	8%	6%
Education and awareness	10%	24%

The SN highlighted certain common issues.

With respect to financial statement deficiencies the following were highlighted:

- Statement of cash flows: (i) incorrect classification of cash flows as investing or financing activities when they should be operating; and (ii) failure to disclose the reason for reclassifications on the statement of cash flows when changes have been made;
- Fair value measurement for level 3 instruments: (i) insufficient disclosure of the value techniques, processes and policies used in fair value measurements and

(ii) failure to provide disclosure of quantitative information about the significant unobservable inputs used in the fair value measurement and are not providing a narrative description of the sensitivity of the fair value measurement to changes in those inputs; and

- Adoption of new accounting policies: (i) insufficient qualitative and quantitative disclosures regarding the possible impact that the initial adoption of a standard is expected to have on the financial statements in the period of initial application; and (ii) failure to provide entity-specific effects of the new standard on the issuer.

With respect to management discussion and analysis (MD&A) the following were highlighted:

- Investment entities / non-investment entities recording investments at fair value: (i) insufficient qualitative and quantitative information about the investments and (ii) insufficient disaggregation of the investment portfolio;
- Non-GAAP financial measurements (real estate): (i) inadequate transparency about adjustments made in arriving at non-GAAP measures, such as adjusted funds from operations, particularly when the adjustments are management estimates (e.g. maintenance capital); and (ii) some issuers with equity-accounted joint ventures including in MD&A a full set of non-GAAP financial statements unwinding the GAAP equity method accounting and discussing these non-GAAP pro rata financial results, with little to no discussion of the comparable GAAP results, creating prominence issue;
- Disclosure of capital spending and milestones: failure to disclosure sufficient information about significant projects that are in the early stage of development; and
- Related party transactions: (i) failure to disclose the identity of the related person or entity (e.g. naming a director and/or officer) and the business purpose of the transaction (ii) failure to disclose the measurement basis of the transaction.



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The SN included examples of deficient and robust disclosure in MD&A related to forward looking information and non-GAAP measures.

With respect to other regulatory disclosure deficiencies the following were highlighted with respect to mineral project disclosures:

- Technical report content: (i) inadequate disclosure of important criteria the qualified person (QP) used to determine that the mineral resource has demonstrated reasonable prospects for eventual economic extraction (e.g. proposed mining method(s), metallurgical recovery factors, selected metal price(s) including justification for the selection, cut-off grade and how it was determined); (ii) authors of some reports improperly use the provision to rely on other experts for legal, political, environmental and tax matters. Also, authors of some reports disclose reliance on other QP's for scientific and technical information; and (iii) inadequate disclosure of the specific procedures the QP undertook in verifying the data or failure to provide the QP's opinion on the adequacy of the data used in the report;
- Preliminary economic assessment (PEA): potentially misleading PEA if the results after mineral reserves have been determined add, combine, or integrate the PEA outcomes with the economic analysis, cash flows, production schedules, or mine life based on a pre-feasibility, feasibility study, or life of mine plan; and
- Disclosure of historical estimates: disclosure of historical estimates on websites, corporate presentations and other marketing documents without providing information related to the estimate's original source and date, the fact that it is historic and omitting the required cautionary statements creating the impression that the information is a current mineral resource or reserve estimate.

With respect to other regulatory disclosure deficiencies beyond mineral project disclosures the following were highlighted:

- Statement of executive compensation: (i) when executive management services were provided by an external management company some issuers did not disclose the amounts paid to the named executive officers in the Summary Compensation Table; and (ii) failure to meet the filing deadline;
- Non-GAAP measures: excessive prominence of non-GAAP measures in corporate presentations, investor fact sheets, news releases, or on social media;
- Social media: (i) disclosure of material information on social media sites before it is generally disclosed to all investors, which may constitute selective or early disclosure; and (ii) unbalanced information on social media that may be inconsistent with information already posted on SEDAR or exceedingly promotional;
- Climate change related disclosure: (i) boiler plate disclosure or missing disclosure related to risks and opportunities; and (ii) risks disclosed are not sufficiently specific to the issuer and its operations or fail to disclose the potential impact resulting from climate change;
- Disclosure of material relationships: some issuers that disclosed significant transactions with a party with whom there was a familial or similar close relationship failed to disclose the relationship; and
- Change of auditor reporting package: (i) letter from the predecessor auditor is not in the required form and/or is not filed within the deadline; and (ii) lack of clarity in the predecessor or successor auditor's letter whether the auditor agrees or disagrees with the issuer's statements relating to a reportable event.



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## Filing Reports of Exempt Distribution

In July 2018, the CSA issued SN 45-308 (Revised) *Guidance for Preparing and Filing Reports of Exempt Distribution under National Instrument 45-106 Prospectus Exemptions*. The Notice includes four documents to assist issuers, underwriters and their advisors to prepare the report:

- Tips for completing and filing the report;
- Checklist of new information requirements;
- Frequently asked questions; and
- Transition to the report.

## Use of the Rights Offering Exemption

In July 2018, the CSA issued SN 45-323 (Revised) *Update on Use of the Rights Offering Exemption in National Instrument 45-106 Prospectus Exemptions* which provided an update by staff on use of the new streamlined rights offering process and identified areas for compliance improvement.

Prior to adoption of the new requirements, there were approximately 13 prospectus-exempt rights offerings by Canadian reporting issuers each year. As of December 31, 2017, 60 issuers had used the exemption.

The CSA reviewed all the rights offerings conducted and noted three areas where compliance and disclosure could be improved which are discussed below:

- Stand-by commitments: The CSA noted weakness in the disclosure of the relationship between the issuer and the stand-by guarantors;
- Use of available funds: (i) As part of disclosing available funds after the rights offering, an issuer must disclose any working capital deficiency at the most recent month end. If there has been a significant change in working capital

since the most recently audited annual financial statements, even if a positive change, the change in working capital must be explained. Some issuers failed to provide such disclosure. In addition, some issuers that reported a working capital deficiency did not provide the disclosure expected related to discussing how management plans to discharge liabilities as they become due, the minimum amount required to meet short-term liquidity demands and management's assessment of the issuer's ability to continue as a going concern; and (ii) Issuers are required to provide a detailed breakdown of the use of available funds and to describe in reasonable detail each of the principal purposes. In some instances, the detail was insufficient. In general, allocating funds simply to working capital is not sufficient. If an issuer is engaged in mineral exploration, the CSA expects detail of how much is allocated to each exploration program as well as how much is allocated to general and administrative and other expenses; and

- Closing news release: Some issuers that filed a closing news release did not include all the required information: who subscribed to the rights offering, including the amount subscribed for by insiders and stand-by guarantors, distinguishing between the basic and additional subscription privileges.

## Approach to Director and Audit Committee Member Independence

In July 2018, the CSA issued SN 52-330 *Update on Consultation Paper 52-404 Approach to Director and Audit Committee Member Independence* which summarized the feedback received from their consultation paper which facilitated a discussion on the appropriateness of the current approach to determining director and audit committee member independence.

Twenty seven comment letters were received with a variety of viewpoints.



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The CSA concluded that it is appropriate to maintain the current approach to determining director and audit committee member independence.

## Annual Summary Report for Dealers, Advisors and Investment Fund Managers

In August 2018, the compliance and registrant regulation of the Ontario Securities Commission issued SN 33-749 *Annual Summary Report for Dealers, Advisors and Investment Fund Managers*. The report is of relevance to exempt market dealers (EMDs), investment fund managers (IFMs), portfolio managers (PMs) and scholarship plan dealers (SPDs).

The report has four parts:

- Education and registration outreach;
- Regulatory oversight activities and guidance;
- Impact of upcoming policy initiatives; and
- Regulatory conduct activities.

The regulator oversight activities and guidance section grouped deficiencies into seven topics area. Key findings for each of the topic areas discussing the nature of the deficiencies was included in the report.

Topic area	Significant Deficiency	Deficiency	Total
Compliance systems	10%	28%	38%
Client disclosure and reporting	5%	13%	18%
Know your client, know your product, suitability	8%	6%	14%
Marketing	3%	7%	10%
Conflicts of interest and referral arrangements	3%	5%	8%
Financial condition and custody	2%	4%	6%
Registration and commission filings	2%	4%	6%

Staff indicated that looking forward their compliance reviews will focus on the following areas:

- Section 5.6 of NI 81-105 which governs the provision of promotional items and business promotion activities;
- Conflicts of interest created by compensation practices;



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- Firms that participated in the 'Registration as the First Compliance Review' program and have been in operation greater than one year;
- Assessing the accuracy of responses from firms completing the 2018 Risk Assessment Questionnaire (RAQ); and
- High risk registrants identified through the 2018 RAQ process.

## Women on Boards and in Executive Officer Positions

In September 2018, the CSA issued Multilateral SN 58-310 *Report on Fourth Staff Review of Disclosure regarding Women on Boards and in Executive Officer Positions*. The notice highlights key trends observed based on a sample of 648 issuers that had year ends between December 31, 2017 and March 31, 2018. A qualitative assessment of compliance with the disclosure requirements was not conducted.

The following key trends were observed:

### Board seats

- 15% of seats were held by women; however, this number tended to increase with the size of the issuer and varied by industry;
- 66% of issuers had at least one woman on their board; however, 218 issuers (34% of the sample) had no women on their board; and
- 29% of vacant seats were filled by women.

### Executive officer positions

- 4% of issuers had a female CEO;
- 14% of issuers had a female CFO; and
- 66% of issuers had at least one woman in an executive officer position.

### Targets

- 16% of issuers adopted targets for the representation of women on their board; and
- 4% of issuers adopted targets for the representation of women in executive officer positions.

### Term limits and other mechanisms for board renewal

- 21% of issuers adopted some form of director term limits (alone or with other mechanisms of board renewal);
- 32% of issuers adopted other mechanisms of board renewal, but did not adopt term limits; and
- 43% of issuers disclosed that they did not have director term limits nor had they adopted other mechanisms of board renewal.

### Policies

- 42% of issuers adopted a policy relating to the representation of women on their board.

The CSA indicated that they are considering whether changes to the disclosure requirements are warranted and, if so, the nature of those changes and whether the introduction of new or supplemental guidelines regarding corporate governance practices in National Policy 58-201 *Corporate Governance Guidelines* is warranted and if so, the nature of those guidelines.



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# Canadian Securities: Proposed guidance

## Non-GAAP and Other Financial Measures

In September 2018, the CSA issued Proposed National Instrument 52-112 *Non-GAAP and Other Financial Measures* setting out disclosure requirements for non-GAAP financial measures and other financial measures (i.e. segment measures, capital management measures, and supplementary financial measures as defined in the Proposed Instrument). A related companion policy was issued setting out guidance with respect to the requirements. Certain consequential amendments to other rules are also being proposed.

The proposed rule is intended to replace CSA Staff Notice 52-306 (Revised) *Non-GAAP Financial Measures* and complement other CSA financial disclosure requirements.

The CSA indicated that replacing SN 52-306 with a rule will provide CSA Staff with a stronger tool to take appropriate regulatory action when needed.

The definition of a non-GAAP financial measure (NGFM) has been updated. A NGFM means a financial measure of financial performance, financial position or cash flow that:

- Is a measure not presented in the primary financial statements;
- Is a measure not disclosed in the notes to the financial statements;
- Is a measure that is not a disaggregation calculated in accordance with accounting policies used to prepare the financial statements, of a line item presented in the primary financial statements; and
- Is a financial outlook for which no equivalent financial measure is presented in the primary financial statements.

The proposed requirements for historical amounts that are NGFMs align with the previous requirements.

	NGFM	Segment Measure	Capital Management Measure	Supplementary Financial Measure
Labelled appropriately	Yes	Not applicable	Not applicable	Not applicable
Presented with no more prominence	Yes	Yes	Yes	Not applicable
Comparable measure provided	Yes	Yes	Yes	Yes
Labelled as NGFM	Yes, except ratios that meet criteria	Not applicable	Not applicable	Not applicable
States no standardized meaning	Yes	Not applicable	Yes	Not applicable
Explains usefulness of measure	Yes	Not applicable	Yes	Not applicable
Quantitative reconciliation	Yes, more guidance for ratios and outlooks	Yes	Describe how calculated Yes, except ratios	Describe how calculated No quantitative reconciliation
Reasons for change	Yes	Not applicable	Not applicable	Yes



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There are some exceptions in the proposed rule and additional guidance in the companion policy for NGFMs that are historical ratios. For example, gross profit percentage is a NGFM. Ratios are not required to be labelled as such if based on financial components disclosed or presented in the financial statements or if the financial components are dis-aggregations calculated in accordance with the primary financial statements.

For financial outlooks that are NGFMs, the proposed rule also has specific requirements and the companion policy provides considerable detail regarding how to comply with the proposed requirements related to providing a quantitative reconciliation. The level of detail expected appears to exceed current practice.

The disclosures required for segment measures, capital management measures and supplementary financial measures are less onerous than for NGFMs.

The requirements apply to each discrete document that contains such NGFMs and other financial measures.

## Amendments to Mutual Fund Sales Practices

In September 2018, the CSA issued Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices*, *related companion policy* and related consequential amendments.

Comments are due December 13, 2018.

The purpose of the proposed amendments is to implement the CSA's policy response to the investor protection and market efficiency issues arising from the prevailing practice of investment fund managers remunerating dealers and their representatives for mutual fund sales through commissions, including sales and trailing commissions (embedded commissions). The proposed amendments, if

adopted, would restrict the compensation that members of the organization of publicly-offered mutual funds (**fund organizations**) may currently pay to participating dealers, and that participating dealers may currently solicit and accept, under NI 81-105 in connection with the distribution of mutual fund securities.

Specifically, the objectives of the proposed amendments are to prohibit:

- the payment of upfront sales commissions by fund organizations to dealers, and in so doing, discontinue sales charge options that involve such payments, such as all forms of the deferred sales charge option, including low-load options (collectively, the **DSC option**); and
- trailing commission payments by fund organizations to dealers who do not make a suitability determination, such as order-execution-only (**OEO**) dealers.

The discontinuation of the DSC option would render obsolete certain disclosure requirements specific to that sales charge option under Form 81-101F1, Form 81-101F3 and NI 31-103. The consequential amendments propose to eliminate those disclosure requirements.

The CSA anticipates that registrants will require some time to operationalize the proposed amendments. Staff anticipate providing a transition period of 365 days from the date of final publication of the amendments, at the end of which the changes would become effective.



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## Auditing Matters

### Auditor Reporting Model

#### What's new and effective for 2018?

The Auditing and Assurance Standards Board (AASB) in Canada approved the new and revised auditor reporting standards as Canadian Auditing Standards (CASs) effective for periods ending on or after December 15, 2018.

Highlights of the new auditors' report in Canada include:

- re-ordering the contents of the auditors' report (opinion first);
- expanded descriptions of responsibilities of management, those charged with governance and the auditors;
- separate section on "Material Uncertainty Related to Going Concern", if applicable;
- separate section on "Other Information" (e.g. MD&A); and
- disclosure of engagement partner's name (listed entities).

#### Key audit matter reporting

In September 2018 the AASB approved a requirement for Auditors to communicate Key Audit Matters (KAMs) in the auditor's report for audits of complete sets of general purpose financial statements of entities listed on the Toronto Stock Exchange (TSX), other than entities that are required to comply with National Instrument 81-106, *Investment Fund Continuous Disclosure*. Such requirements would be effective for periods ending on or after December 15, 2020.

#### U.S. developments

The Public Company Accounting Oversight Board (PCAOB) adopted their enhanced auditor reporting standards which includes, among other requirements, discussion of critical audit matters (CAMs) (similar to KAMs) and tenure of the auditor.

Highlights and effective dates of the new U.S. standards are:

- New auditors' report format, tenure and other information: audits for fiscal years ending on or after December 15, 2017;
- Communication of CAMs for audits of large accelerated filers: audits for fiscal years ending on or after June 30, 2019; and
- Communication of CAMs for audits of all other companies: audits for fiscal years ending on or after December 15, 2020.

#### Impact to Foreign Private Issuers in Canada

At this time, it is unlikely the SEC and PCAOB will approve a combined report (which many foreign private issuers (FPIs) in Canada issue today) for 2018. If the SEC and PCAOB determine that a combined report is not possible, auditors of FPIs may need to consider whether issuing only a report under PCAOB standards is appropriate for their needs or whether they will need to issue two reports; one referring to the CASs and one referring to the standards of the PCAOB.



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## Auditing Accounting Estimates and Related Disclosures

The International Auditing and Assurance Standards Board (IAASB) approved the final text of ISA 540 (Revised) in June 2018.

This standard:

- enhances requirements for risk assessment procedures to include specific factors related to accounting estimates, namely complexity, judgement, and estimation uncertainty;
- sets a more detailed expectation for the auditor's response to identified risks related to accounting estimates, including augmenting the auditors' application of professional skepticism; and
- is scalable regardless of the size or sector of the business or audit firm.

The revised ISA will be effective for audits of financial reporting periods beginning on or after December 15, 2019. Early adoption is permitted and encouraged.

The IAASB expects to issue the revised ISA in October, and the AASB plans to approve the Canadian equivalent standard shortly thereafter.



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