

# Torys on Corporate and Capital Markets

C&CM 2008-15  
August 7, 2008

## Canada to Adopt International Financial Reporting Standards: An Update

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Earlier this year, the Canadian Accounting Standards Board confirmed January 1, 2011 as the date that International Financial Reporting Standards (IFRS) will replace Canadian generally accepted accounting principles (Canadian GAAP) for all Canadian publicly traded companies as well as for non-listed financial institutions, securities dealers and many cooperative enterprises that qualify as “publicly accountable enterprises.” Canadian private enterprises will be permitted, but not required, to adopt IFRS.

The adoption of IFRS, which is the collection of financial reporting standards developed by the International Accounting Standards Board, is consistent with a trend toward global convergence of accounting standards. Over 100 countries, including the United Kingdom and other countries in the European Union, Australia, New Zealand and India, either permit or require the use of IFRS for public company reporting. Although the United States has not adopted IFRS, the U.S. SEC recently revised its rules so that foreign private issuers that report under IFRS will no longer have to reconcile financial statements to U.S. generally accepted accounting principles (U.S. GAAP). The SEC has also solicited public comment on whether IFRS should replace U.S. GAAP for domestic U.S. issuers and is expected in the near future to propose a timetable for permitting U.S. issuers to adopt IFRS on a voluntary basis.

Although current Canadian GAAP and IFRS are both principles-based and generally similar, some significant differences between the two sets of standards exist. Issuers can therefore expect to see differences in their reported results of operations and financial position when they transition to IFRS; in some cases, the differences may be material.

### Early Adoption

Some issuers may wish to adopt IFRS for financial periods before the mandatory changeover on January 1, 2011. Early adoption may be particularly attractive to (i) issuers in a consolidated group with other entities that are required to use IFRS; (ii) issuers with significant foreign operations that use IFRS; (iii) issuers that want to eliminate U.S. GAAP reconciliations from SEC filings; and (iv) issuers considering an IPO in both Canada and the United States before the mandatory changeover date.

Staff of the Canadian securities regulators have indicated that they are prepared to recommend exemptive relief on a case-by-case basis to permit early adoption of IFRS. A few issuers have applied for relief to adopt IFRS effective January 1, 2009. Issuers applying for relief must demonstrate their overall readiness to transition to IFRS, including the readiness of their staff, board of directors, audit committee, auditors, investors and other market participants to deal with the change. They must also demonstrate that they have considered the implications of early adoption on their

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obligations under securities legislation, including those relating to CEO and CFO certifications, business acquisition reports, offering documents and previously released material forward-looking information.

## Public Disclosure

In May 2008, staff of the Canadian securities regulators published guidance on the disclosure that a reporting issuer should provide regarding its changeover to IFRS. The guidance emphasizes that, given the potential effect on an issuer's reported financial position and results of operations and other aspects of its business, investors and other market participants will need timely and meaningful information leading up to the changeover.

In its management's discussion and analysis (MD&A), an issuer must discuss and analyze any changes in its accounting policies that it has adopted or expects to adopt after year-end, including changes due to a new accounting standard that the issuer does not have to adopt until a future date. Since changes to an issuer's accounting policies relating to the changeover to IFRS will be due to new accounting standards, an issuer must include relevant disclosure in its MD&A.

The guidance indicated that an issuer should begin providing general disclosure about its changeover to IFRS in its MD&A for the interim periods of the financial year beginning three years before its changeover date and provide more detailed information as the changeover date approaches. For most issuers, this will mean including disclosure about the changeover to IFRS in interim MD&A during 2008.

An issuer's MD&A should discuss the status, key elements and timing of its changeover plan and, over time, address the impact of IFRS on

- accounting policies, including policy and implementation decisions the issuer has made or will have to make;
- 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;
- business activities, such as foreign currency and hedging activities, as well as matters that may be affected by the changeover, such as debt covenants, capital requirements and compensation arrangements; and
- key line items presented in the issuer's financial statements (including quantified information when available).

Issuers that wish to adopt IFRS before the mandatory changeover date will be required to provide disclosure on an accelerated timeline.

## Implications

Many issuers have already begun or will shortly begin to develop their changeover plans. Although responsibility for executing the changeover will rest with management, the audit committee has an important oversight role and should receive regular updates from management on the status and effectiveness of the plan's implementation. The changeover could have many implications beyond financial reporting, including the following:

- **Financial covenants.** An issuer should assess how the changeover to IFRS will affect its financial covenants. For example, differences in reported results of operations and financial position arising from the changeover, particularly if they are material, could negatively affect the issuer's financial ratios and even trigger a default. Alternatively, an issuer may find that the changeover will improve its ratios, which may make the prospect of early adoption more attractive. If an issuer's compliance with its covenants is likely to be materially affected by the changeover, consultation with lenders may be appropriate.
- **Reporting obligations.** An issuer should assess its financial reporting obligations under contractual arrangements. For example, under a loan agreement with a "frozen GAAP" provision, an issuer would be required, absent a waiver, to maintain records in both Canadian GAAP and IFRS (a frozen GAAP provision is one under which the borrower undertakes to ensure that either all financial statements provided to the lenders apply the same GAAP as were used in the financial statements delivered when the loan agreement was entered into or, if a change in GAAP occurs, to provide the lenders with a reconciliation to the original GAAP).
- **Effect on reported financial results.** The adoption of IFRS is expected to lead to increased volatility in reported financial results because more categories of financial instruments (assets and liabilities) will be subject to fair value accounting. An issuer should assess the appropriateness of its existing guidance and other forward-looking disclosures in light of expected changes to results of operations and financial position. Dividend policies that are calculated on the basis of results of operations or financial position should also be reviewed.
- **Compensation metrics.** To the extent that adopting IFRS causes changes in earnings and financial position, the performance metrics that an issuer uses to compensate executives and other employees may no longer be appropriate.
- **Controls and certification requirements.** Management should consider the impact of the changeover to IFRS on internal control over financial reporting and disclosure controls and procedures, the changes that may be necessary to address new and additional disclosures required under IFRS, and how to maintain adequate controls and the integrity of information disclosed to investors through the transition period. An issuer's control systems may also be affected by the decision of the Auditing and Assurance Standards Board to adopt International Standards on Auditing, which are issued by the International Auditing and Assurance Standards Board. It is currently expected that ISAs will come into effect in Canada for audits of historical financial information for periods beginning on or after December 15, 2009.
- **Financial literacy.** Audit committee and other board members will need to be able to read and understand a set of financial statements prepared under IFRS. Audit committee members in particular need to be sufficiently knowledgeable about IFRS so that they can evaluate management's assessments and selection of accounting policies, including the sensitivity analysis that led to management's decisions.
- **Corporate and securities laws.** The financial reporting requirements of the *Canada Business Corporations Act* (CBCA) and Ontario's *Business Corporations Act* (OBCA) were amended in 2005 to allow for the use of U.S. GAAP by public companies with U.S. reporting obligations as permitted by securities laws. Since the Handbook of the Canadian Institute of Chartered Accountants will contain the full body of IFRS in effect from time to time, both statutes will permit reporting in IFRS when it replaces Canadian GAAP on January 1, 2011. However, companies incorporated under the CBCA will not be able to adopt IFRS earlier without an amendment to the Handbook or an amendment to, or exemptive relief from, the CBCA regulations. Public companies incorporated under the OBCA that adopt IFRS before the mandatory changeover date under an exemption from the securities regulators will comply with the OBCA requirements. Issuers that are subject to laws or professional standards of

other jurisdictions, or that have financial reporting obligations under their constating documents (e.g., income funds), should determine whether the changeover to IFRS raises any issues.

Canadian securities regulators are in the process of developing necessary changes to securities law rules, policies and guidance that currently require that Canadian issuers use either Canadian GAAP or, in the case of registrants with the SEC, U.S. GAAP.

The changeover to IFRS will present many challenges. Issuers should assess the impact of this change on their organization and external stakeholders, and develop a comprehensive changeover plan with input from their audit committee, auditors and legal advisers. Careful planning will help to avoid negative surprises and ensure a smooth transition.

Further information can be found at the following websites:

- the Transition to International Standards section of the CICA's website at [www.cica.ca](http://www.cica.ca)
- [www.acsbcanada.org](http://www.acsbcanada.org)
- [www.aasb.ca](http://www.aasb.ca)
- [www.iasb.org](http://www.iasb.org)
- [www.ifac.org](http://www.ifac.org) 