



# IFRS Perspectives

Update on IFRS issues in the US



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The IFRS and US GAAP requirements are similar for lessees on 'Day One'. However, the 'Day Two' accounting will create significant implementation issues for dual reporters.

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**Note:** *Leases: Top differences between IFRS 16 and ASC 842* in this PDF has been updated in August 2018 to reflect a FASB amendment that removes one of the top differences previously reported. < [Read more](#) >

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The new standard will require fundamental accounting changes to how insurance contracts are measured and accounted for. It also differs significantly from US GAAP.

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## Leases: Top differences between IFRS 16 and ASC 842

**Effective January 1, 2019 for many companies, the IASB's and the FASB's new leases standards<sup>1</sup> require nearly all leases to be reported on lessees' balance sheets as assets and liabilities. The IFRS and US GAAP requirements are similar for lessees on 'Day One'. However, the 'Day Two' accounting will create significant implementation issues for dual reporters.**

The leasing project was a joint project between the IASB and the FASB. As a result, the lease definition and Day One lessee accounting are mostly converged. However, the Boards' views diverged over the course of the project and resulted in significant differences on Day Two lessee accounting and transition provisions.

In particular, lessees no longer classify their leases between operating and finance under IFRS, but will continue to do so under US GAAP.

- IFRS 16 uses a single lessee accounting model that is similar to that of finance leases under current IAS 17. Therefore, from an income statement perspective, the IFRS model treats *all* leases as a financing arrangement.
- However, under US GAAP, only leases classified as finance leases are treated as financing arrangements from an income statement perspective; while the lessee will report an asset and a liability related to all leases on its balance sheet (like IFRS), the Day Two accounting for operating leases will generally continue to produce a straight-line total lease expense.

And in applying those accounting models, one notable difference that will need to be captured in the implementation process is the accounting for lease payments that depend on an index or rate. In a simple real estate lease, suppose that lease payments increase by CPI each year. Under IFRS, the liability is remeasured each year to reflect the latest CPI. Under US GAAP, the liability is not remeasured for changes in CPI unless remeasurement is required for another reason; instead, the additional payments are recognized as incurred. As a result, the liability under IFRS could grow to be significantly greater than the liability under US GAAP, which would exaggerate the income statement difference (because these will often be operating leases under US GAAP).

We believe these and other areas of divergence will cause significant challenges for companies that report under both IFRS and US GAAP. Companies will need to maintain different processes, controls and accounting systems for each framework to comply with the different lessee reporting requirements.

IFRS 16 is effective January 1, 2019 for all calendar-year companies, similar to ASC 842 for public calendar-year companies. Nonpublic entities in the United States may therefore decide not to take advantage of the one year deferral offered by ASC 842 if they are also IFRS preparers.

Here are our top lessee differences between IFRS and US GAAP. This selection is based on the potential effect on earnings that these differences may have, as well as the complexity they may create to comply with both GAAPs. For a more comprehensive listing of differences, including for lessor accounting, see KPMG's publication, [IFRS compared to US GAAP](#).

IFRS 16	ASC 842	Consideration for preparers
<b>Effective date</b>		
The new standard is effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted if the new revenue standard is also adopted.	ASC 842 is effective for annual periods beginning after December 15, 2018 (public business and certain other entities) and after December 15, 2019 for other entities. Early adoption is permitted.	Nonpublic dual reporters may decide to adopt both ASC 842 and IFRS 16 on the same date.

<sup>1</sup> IFRS 16, Leases, issued January 2016; and ASC 842 issued as ASU 2016-02, Leases (Topic 842), in February 2016

IFRS 16	ASC 842	Consideration for preparers
<b>Transition approach and comparatives</b>		
<p>Full retrospective approach, or modified retrospective approach with practical expedients available.</p> <p>The modified retrospective approach is based on leases at the date of initial application and comparative information is not restated. Instead, the effect of adopting the new standard is recognized in opening retained earnings (or other equity component as appropriate) at the date of initial application.</p>	<p>Modified retrospective transition is required for all leases existing at, or entered into on or after, the beginning of the earliest comparative period presented in the financial statements – i.e. comparative information is restated.</p> <p>Practical expedients are available on transition, which are less extensive than those under IFRS.</p>	<p>Dual reporters may need to start implementing the leases standards earlier than companies that only report under IFRS to be able to present comparative information in their US GAAP reporting. They should also consider whether applying the full retrospective approach under IFRS 16 will result in greater comparability in the comparative periods presented.</p>
<b>Leases recognized on the balance sheet</b>		
<p>Lessees may elect to apply the recognition exemption for leases of 'low-value' assets – i.e. underlying assets with a value <math>\leq</math> \$5,000 when new, even if they are material in aggregate.</p>	<p>There is no exemption for leases of low-value assets.</p>	<p>Dual reporters will have to decide whether to use the low-value exemption or recognize leases of low-value assets to maintain consistency between US GAAP and IFRS reporting. When applying the exemption, entities will have to identify leases of low-value assets in the entire lease population to quantify the adjustment between US GAAP and IFRS.</p>
<b>Lease classification</b>		
<p>Lessees apply a single on-balance sheet lease accounting model.</p>	<p>There is a dual classification on-balance sheet lease accounting model for lessees: finance leases and operating leases. Lease classification affects measurement of the right-of-use asset, lease expense and income statement presentation.</p>	<p>Dual reporters will have to separately track leases that have a different classification between US GAAP and IFRS because their accounting will be different.</p>
<b>Remeasurement assessment for leases tied to an index or rate</b>		
<p>Lessees remeasure the lease liability for changes in variable lease payments based on an index or rate on the date when there is a change in the contractually required cash flows.</p>	<p>Adjustments to an index or rate do not constitute a reassessment event.</p>	<p>Dual reporters will have to separately track the remeasurement assessment for leases that are tied to an index or rate.</p>
<b>Sale-leaseback transactions</b>		
<p>If the seller-lessee has a substantive option to repurchase the underlying asset, the transfer is not a sale.</p>	<p>If the seller-lessee has a substantive option to repurchase an underlying asset that is not real estate, the transfer may be a sale under certain circumstances.</p>	<p>Dual reporters will have to separately track the accounting for sale-leaseback transactions.</p>

IFRS 16	ASC 842	Consideration for preparers
<p>The seller-lessee measures the right-of-use asset at the retained portion of the previous carrying amount of the underlying asset (i.e. at cost). Only the amount of any gain or loss related to the rights transferred to the buyer-lessee is recognized.</p>	<p>If the leaseback would be classified as a finance lease by a seller-lessee (or as a sales-type lease by the buyer-lessee), then sale recognition is automatically precluded.</p> <p>The seller-lessee measures the right-of-use asset at the present value of the lease payments in the same way as any other lease. A gain or loss is recognized for the difference between the sale proceeds and the carrying amount of the underlying asset.</p>	
<b>Subleases</b>		
<p>Unless the sublessor for the head lease applies the recognition and measurement exemption applicable to short-term leases, a sublessor classifies a sublease by reference to the right-of-use asset arising from the head lease.</p>	<p>A sublessor classifies a sublease by reference to the underlying asset.</p>	<p>We expect that most subleases under ASC 842 will be classified as operating leases, while most subleases under IFRS 16 will be classified as finance leases by the sublessor.</p>

## Accounting for insurance contracts: IFRS 17, the furthest we can be from IFRS 4

**In May 2017, the IASB issued its comprehensive new accounting model for insurance contracts, IFRS 17 – replacing its 2004 ‘temporary’ standard (IFRS 4).<sup>1</sup> If IFRS 4 was mainly business as usual for insurance accounting, IFRS 17 is anything but. The new standard will require fundamental accounting changes to how insurance contracts are measured and accounted for. It also differs significantly from US GAAP.**

### Overview: IFRS 17

As it was under IFRS 4, the new insurance standard applies to insurance or reinsurance contracts issued and reinsurance contracts held. These may even exist within a noninsurance company.

IFRS 17 brings greater comparability and transparency about the profitability of insurance contracts and gives users more insights into an insurer’s financial health. IFRS 17 introduces the general measurement model (see Figure 1), which is based on a risk-adjusted present value of future cash flows that will arise as the insurance contract is fulfilled. The new measurement

model aims to provide relevant information about the future cash flows.

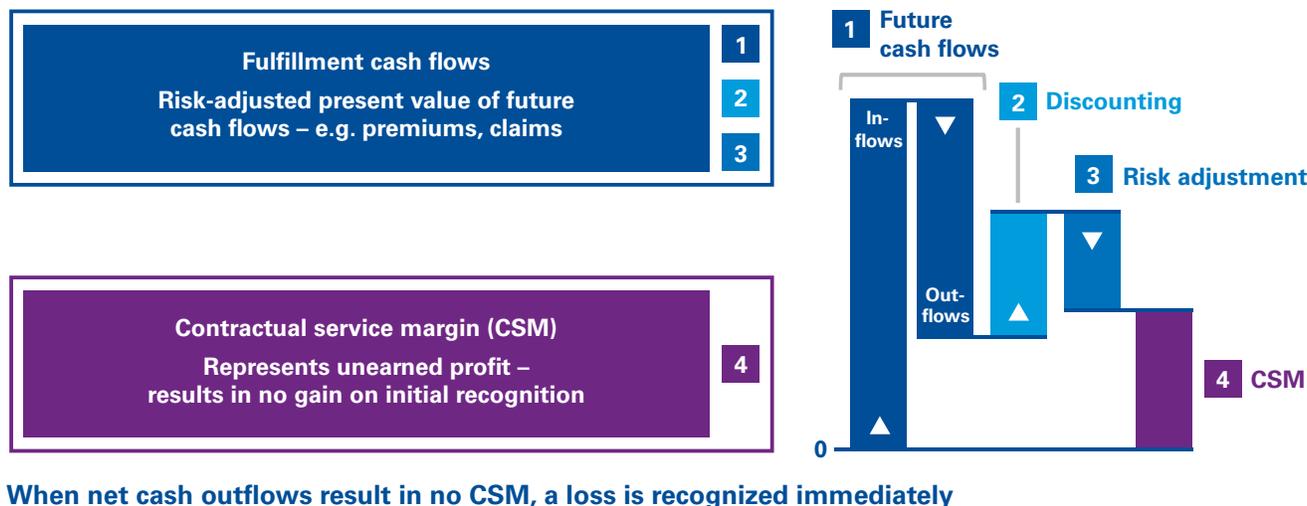
A company applying IFRS 17 will need to remeasure its estimates each reporting period using current assumptions, which could require significant effort and new processes and controls.

The aggregation of contracts into ‘groups’ as defined by IFRS 17 is required at initial recognition and is not reassessed subsequently. Contract grouping is performed in a manner that limits the offsetting of profitable contracts against loss-making ones and cannot include contracts issued more than one year apart; however, exceptions apply in certain circumstances on transition. Generally, this will result in the grouping of contracts for presentation purposes below the portfolio of insurance contracts level as some companies may do now.

While the general measurement model applies to all groups of insurance contracts in the scope of IFRS 17, a simplified approach – the premium allocation approach (PAA) – may be used (optional) to measure contracts that meet certain criteria. Separately, the general measurement model is modified (mandatory) for the measurement of reinsurance contracts held, direct participating contracts and investment contracts with discretionary participation features.

<sup>1</sup> IFRS 17, Insurance Contracts, replaces IFRS 4, Insurance Contracts

**Figure 1: Key components of the general measurement model**



IFRS 17 also includes new disclosure requirements aimed to deliver clarity and transparency for users of financial statements. Companies will have to consider the level of detail necessary to satisfy the disclosure requirements, which may result in some companies disclosing information at a more granular level. The required reconciliations help to explain drivers of change in the contract liability and different types of information about the insurance service results.

IFRS 17 is effective for annual reporting periods beginning on or after January 1, 2021. Early adoption is permitted only when a company applies the new financial instruments and revenue standards<sup>2</sup> on or before the date of initial application of IFRS 17.

### Implementation efforts

Implementation efforts for IFRS 17 will vary depending on the systems, methods and data storage capabilities currently used to measure and track insurance contracts, account for, report and disclose related information.

Being able to group contracts to apply the general measurement model may require significant effort and changes in how insurance contracts are measured and how their results are reported to users. Some companies may currently measure insurance contracts at a level (e.g. portfolio level) that includes both profit-making and loss-making contracts, thereby offsetting losses and gains. When applying the grouping requirements of IFRS 17, these contracts will no longer be able to be grouped. Accordingly, the effect of loss-making contracts will be recognized in profit or loss immediately, but the expected profit from profit-making contracts will be recognized as service is provided (i.e. over the expected life of the contract).

Applying the general measurement model will require companies to track certain historical information to determine the contractual service margin (e.g. tracking of discount rates to determine the present value of estimates of future cash flows). Many legacy systems are still in use and may not be capable of accommodating the new data needs of IFRS 17, resulting in necessary systems and process upgrades. Companies will also have to develop controls around any system and process changes and develop or upgrade existing controls for business as usual after transition. A successful implementation effort will need cross-functional collaboration between IT, actuarial, finance, accounting and operations.

There are benefits for companies that take advantage of this opportunity to gain new insights from data analysis and reporting and to improve process efficiency. With a change of this magnitude, companies should be motivated to invest in solutions that achieve efficiencies.

### Impact: noninsurance companies

While IFRS 17 mostly applies to insurance companies, noninsurance companies may also issue contracts that include insurance risks and are within the scope of IFRS 17.

Fixed-fee service contracts, such as roadside assistance programs and certain financial guarantee contracts, may meet the definition of an insurance contract. However, when certain specified conditions in IFRS 17 are met, a company may exclude such contracts from the scope of IFRS 17. It then accounts for fixed-fee service contracts like other service contracts with customers and financial guarantee contracts under the financial instruments standards.

<sup>2</sup> IFRS 9, Financial Instruments, and IFRS 15, Revenue from Contracts with Customers

This election is made on a contract-by-contract basis and is irrevocable.

The definition of an insurance contract has not changed significantly from IFRS 4. However, noninsurers that issue contracts that meet this definition, and either are required or choose to apply IFRS 17, will no longer be able to apply their preexisting accounting policies as they did under IFRS 4. These companies might need to involve actuarial resources and change their systems, processes and controls to accommodate the new requirements.

**An insurance contract** is a contract under which one party (the issuer) accepts 'significant insurance risk' from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder.

**Insurance risk** is risk, other than financial risk, transferred from the holder of a contract to the issuer.

The scope of IFRS 17 excludes, for example:

- warranties issued directly by a manufacturer, dealer or retailer in connection with a sale of its goods or services to a customer;
- residual value guarantees provided by a manufacturer, dealer or retailer;
- a lessee's residual value guarantee embedded in a lease; and
- financial guarantee contracts – unless the issuer met certain requirements and makes an irrevocable election to apply IFRS 17 to the contract.

### Impact: US companies

Under IFRS 4, a US company that applies IFRS may account for insurance contracts using US GAAP. That will no longer be an option under IFRS 17, which means that dual reporters will need to maintain at least two different sets of financial reporting records upon adoption of IFRS 17 because of the different accounting models.

For example, under US GAAP, there are certain insurance products (such as term life or whole life) that are not required to be measured using current assumptions as mandated by IFRS 17. Discount rates determined under IFRS 17 (the top-down or bottom-up approach) will differ from current US GAAP application. An explicit risk adjustment is required as part of measurement under IFRS 17, but not under US GAAP. And US companies are likely measuring their insurance contracts using groupings that do not meet the IFRS 17 grouping requirements. The disclosure requirements are also key for US companies because the volume and nature of disclosures required by IFRS 17 differ greatly from US GAAP.

The FASB recently revised the disclosures for short-duration contracts, and is working on an ASC 944<sup>3</sup> project to improve, simplify and enhance the financial reporting for long-duration contracts issued by insurance companies (see below). However, those changes are likely to differ significantly from the requirements of IFRS 17. Unfortunately for dual reporters, there are no convergence plans between ASC 944 and IFRS 17.

At this early stage, many US companies that are subsidiaries of foreign companies are waiting on instructions from their foreign headquarters. But with potential implementation issues that may require significant time and resources to address, it is never too early to start the conversations. Additionally, many US insurers may have the extra effort of potential changes to the accounting and disclosures for long-duration insurance contracts under US GAAP, and statutory accounting requirements under principles-based reserving requirements. Ideally, companies should consider these changes and their related effects on their people, processes and systems holistically.

To learn more about IFRS 17, read KPMG's publication, [Insurance Contracts First Impressions](#), which includes our insights and detailed analysis of the effects of IFRS 17.

### The FASB's ASC 944 project

The FASB has identified four areas for improvements in its ASC 944 project:

- timeliness of recognizing changes in the liability for future policy benefits;
- measurement of market risk benefits;
- amortization of deferred acquisition costs; and
- effectiveness of required disclosures.

The FASB issued its **exposure draft** of targeted improvements in September 2016, and is currently redeliberating based on the comments received.

<sup>3</sup> ASC 944, Financial Services—Insurance

## Impairment under IFRS 9: Are US companies (banks and nonbanks) considering the full picture?

**The adoption date of the new financial instruments standard<sup>1</sup> is right around the corner: January 1, 2018 for calendar-year companies. However, the new US GAAP impairment model (current expected credit losses, or CECL<sup>2</sup>) is not mandatory until at least two years later. Both standards focus on expected credit losses, but the models are significantly different. This brings challenges for dual reporters.**

Implementing IFRS 9, and in particular its new impairment model, is the focus of many global banks, insurance companies and other financial institutions in 2017, in the run-up to the effective date.

While both the IASB and FASB have long agreed on the need for a forward-looking impairment model for financial instruments, IFRS 9 and CECL differ significantly in many areas. Some of the main differences are summarized in the comparison below, but a detailed assessment is required to identify those that are relevant to your company.

We are seeing different challenges for:

- US banks adopting IFRS 9 for their foreign operations;
- foreign banks adopting CECL for their US operations; and
- nonbanks, such as captive finance groups, specialty finance companies, treasury activities of large corporations, real estate/hospitality timeshare companies and mortgage REITs holding capital leases.

### US banks adopting IFRS 9 for their foreign operations

Many of the large US banks have dual reporting requirements. When adopting CECL, they may find it desirable to avoid creating a completely independent reporting environment for their foreign branches and subsidiaries that already apply the requirements of IFRS 9. Rather, we envisage that US banks will consider IFRS 9's requirements relative to their expected CECL decisions to limit undue organizational complexity and operational burden for foreign reporting purposes.

Given these considerations, KPMG recommends that US-based dual reporters take a hybrid approach to adopting IFRS 9 and CECL. The majority of the synergies and common components between CECL and IFRS 9 could be addressed by a centralized task force.

### Foreign banks adopting CECL for their US operations

Foreign banks with US operations face different issues. Some may solely focus on IFRS 9 without considering future CECL requirements for their US operations. That approach could be a mistake – by not considering CECL, they may miss the ability to align both US GAAP and IFRS where possible, thereby being unable to realize some of the synergies from CECL adoption and ongoing governance.

In contrast, there may also be instances where following separate approaches may be optimal because it reduces complexity for either the US GAAP or IFRS 9 adoption. For example, IFRS 9 requires the use of multiple scenarios in forward-looking economic forecasts, while US GAAP does not. Consequently, a bank might choose to follow different approaches for the respective implementations.

As the adoption date approaches, foreign banks have the opportunity to work with their US operations to ensure that CECL's requirements are considered when implementing IFRS 9's guidance around staging, multiple economic scenarios and disclosures (see further reading below). Dual compliance may mean applying IFRS 9 while still functioning within the parameters of CECL.

### What about nonbanks?

While IFRS 9 and CECL will mostly affect banks and other financial institutions, their effects stretch into other industries that may not immediately come to mind.

Where banks have been and are increasingly more regulated, nonbanks often are not. As a result, their models, data, systems and processes might need a greater change to comply with IFRS 9. It is therefore key to tailor the level of sophistication of the IFRS 9 impairment model to the size, complexity, structure, economic significance and risk profile of the company. KPMG's newsletter on a white paper of the Global Public Policy Committee (GPPC) provides guidance on the level of sophistication and key factors to consider (see further reading below).

In short, while the general concepts of IFRS 9 and CECL apply equally to nonbanks holding financial assets, each will pose its own specific challenges for companies in different industries.

### High-level differences between CECL and IFRS 9

The following is a high-level summary of some of the differences between CECL and IFRS 9; more detailed information about the concepts under each standard is available in the further reading below.

<sup>1</sup> IFRS 9, Financial Instruments

<sup>2</sup> ASU 2016-13, Financial Instrument—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

	IFRS 9	CECL
<b>Measurement of expected credit losses</b>	12 months if the asset is in stage 1, or life of loan if the asset is in stage 2.	Life of loan.
<b>Staging</b>	Yes. An asset would move from stage 1 to stage 2 if it shows a significant increase in credit risk since origination.	No.
<b>Macroeconomic factors</b>	Multiple probability-weighted scenarios.	Does not specifically require either a single economic scenario or multiple economic scenarios.
<b>Aggregation</b>	Pool or loan level (for IFRS 9 staging).	Pooling required where similar risk characteristics exist.
<b>Discounting</b>	Required.	Permitted.
<b>For periods beyond reasonable and supportable forecast period</b>	May extrapolate projections from available detailed information.	Reversion to unadjusted historical information at the input or output level is required.
<b>Allowance for unconditionally cancellable loan commitments</b>	Required when certain criteria are met.	Not permitted.
<b>Effective date</b>	Annual periods beginning on or after January 1, 2018.	Annual periods beginning after December 15, 2019 for public business entities that are SEC filers; one-year deferral for public entities that are non-SEC filers and all other entities.

### Further reading

The following table provides some helpful resources on IFRS 9.

Resources	Description
<a href="#">Implementing IFRS 9: Considerations for systemically important banks</a>	KPMG's newsletter on the GPPC white paper.
<a href="#">Auditing IFRS 9: Considerations for audit committees of systemically important banks</a>	KPMG's quick guide to the GPPC white paper, to give audit committees and preparers an overview of the key contents and principles.
<a href="#">Q2 2017 IFRS – Global banking newsletter: The bank statement</a>	KPMG's quarterly banking newsletter, which includes a spotlight on IFRS 9.
<a href="#">CECL and IFRS 9: Preparing today to be compliant tomorrow</a>	KPMG's paper identifying steps dual reporters can take to begin their IFRS 9 implementation, including staging, multiple economic scenarios and disclosures.
<a href="#">Credit loss accounting: To centralize or decentralize?</a>	KPMG's Q&A on CECL and IFRS 9 for dual reporters.
<a href="#">IFRS newsletter: IFRS 9 impairment</a>	KPMG's newsletter on the latest developments and status of IFRS 9.
<a href="#">EBA report: Results from the second EBA impact assessment of IFRS 9</a>	The European Banking Authority's report on specific IFRS 9 implementation areas for banks.
<a href="#">ESRB report: Financial stability implications of IFRS 9</a>	The European Systemic Risk Board's report on the financial stability implications of IFRS 9.

## US companies going public in Canada: IFRS considerations

**Some US companies have chosen to raise capital in Canada as an alternative to US public capital markets. While SEC registrants can use their US GAAP financial statements for their initial and ongoing reporting requirements in Canada, private US companies have to adopt IFRS.**

Deciding where to list is a complex decision that encompasses many factors, including liquidity, competitor listings, periodic reporting requirements and ongoing compliance costs. This article explores some of the financial reporting requirements for a company deciding whether to list on a Canadian stock market.<sup>1</sup>

### The TSX and TSXV

Canada has a number of stock exchanges, but here we focus on the Toronto Stock Exchange (TSX), which is the largest exchange, and the TSX Venture Exchange (TSXV), which caters to small and early-stage companies. Since 2015, \$5.5 billion of equity capital was raised on the TSX and TSXV by US companies, and 117 US companies were listed on the TSX or TSXV as of July 31, 2017 (see Figure 2).

### Financial reporting requirements<sup>2</sup>

For a US company that is not an SEC registrant, the basis of preparation of the financial statements is required to be IFRS, as issued by the IASB.

### IPO requirements

For companies listing on the TSX through an initial public offering, a prospectus must be filed. The audited IFRS financial statements to be included in the prospectus comprise:

- statements of comprehensive income, statements of cash flows and statements of changes in equity for **three** completed financial years ending more than 90 days before the date of a TSX listing application, or 120 days for a TSXV listing application;
- statements of financial position as at the end of the **two** most recently completed fiscal years; and
- notes to the financial statements.

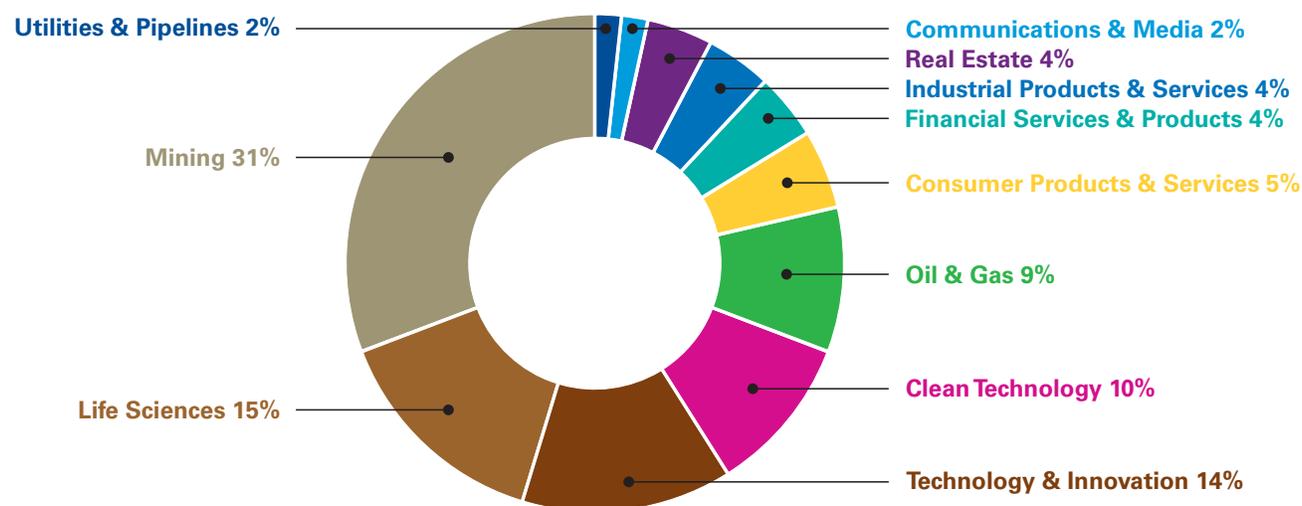
Although there are certain exceptions, the accompanying audit opinions need to be unqualified.

Unaudited quarterly financial statements, prepared in accordance with IAS 34, *Interim Financial Reporting*, are also required if the latest quarter ended more than 45 days before the date of a TSX listing application, or 60 days for a TSXV listing application.

Other required components of the prospectus include (not exhaustive):

- the company's corporate structure;
- description of the company's business;
- use of proceeds;
- dividends or distributions;
- management discussion and analysis;
- executive compensation; and
- risk factors.

**Figure 2: US companies listed on TSX and TSXV, by sector, as of July 31, 2017**



Source: TSX/TSXV Market Intelligence Group

<sup>1</sup> TSX Guide to Listing 2017, available [here](#)

<sup>2</sup> TSX Technical Guide to Listing, available [here](#)

### Ongoing requirements

Once a company is listed on the TSX or TSXV, it becomes a reporting issuer and is subject to ongoing reporting and disclosure obligations, which require the company to file:

- audited annual financial statements and unaudited interim financial statements;
- management discussion and analysis;
- annual information form;
- material change reports;
- material information; and
- business acquisition reports.

### Preparing for a cross-border listing

As a result, any private US company that is contemplating a possible listing on the TSX or TSXV should plan for a potential conversion of its financial reporting from US GAAP to IFRS. An IFRS conversion can be a challenging undertaking that may affect a company's timeline to file its prospectus.

In addition to IFRS financial statement requirements, companies considering a listing should also be aware of other prospectus reporting requirements, including risk factors, management discussion and analysis, and pro forma financial information.

To plan for a successful project, read KPMG's article, [Converting from US GAAP to IFRS](#).

Additional resources on IPO are available on KPMG's resource page, [IPO Readiness](#).

## IFRS vs. US GAAP: R&D costs

**Companies often incur costs to develop products and services that they intend to use or sell. The accounting for these research and development costs under IFRS can be significantly more complex than under US GAAP.**

Under US GAAP, R&D costs within the scope of ASC 730<sup>1</sup> are expensed as incurred. US GAAP also has specific requirements for motion picture films, website development, cloud computing costs and software development costs.

Under IFRS (IAS 38<sup>2</sup>), research costs are expensed, like US GAAP. However, unlike US GAAP, IFRS has broad-based guidance that requires companies to capitalize development expenditures, including internal costs, when certain criteria are met.

Based on these criteria, internally developed intangible assets (e.g. development expenses related to a prototype in the automotive industry) are generally capitalized and amortized under IFRS and expensed under US GAAP. This difference gives rise to two complexities in applying IFRS: distinguishing development activities from research activities, and analyzing whether and when the criteria for capitalizing development expenditures are met.

### Separating development from research

The starting point for companies applying IFRS is to differentiate between costs that are related to 'research' activities versus those related to 'development' activities. While the definition of what constitutes 'research' versus 'development' is very similar between IFRS and US GAAP, neither provides a bright line on separating the two. Instead, a company needs to develop processes and controls that allow it to make that distinction based on the nature of different activities.

### Analyzing when to start capitalizing development costs

Expenditures incurred in the development phase of a project are capitalized from the point in time that the company is able to demonstrate all of the following.

- The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- Its intention to complete the intangible asset and use or sell it.
- Its ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits.
- The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- Its ability to reliably measure the expenditure attributable to the intangible asset during its development.

In our experience, the key factor in the above list is *technical feasibility*. There is no definition or further guidance to help determine when a project crosses that threshold. Instead, companies need to evaluate technical feasibility in relation to each specific project. Projects related to new product developments are generally more difficult to substantiate than projects in which the entity has more experience.

To learn more about the differences between IFRS and US GAAP, see KPMG's publication, [IFRS compared to US GAAP](#).

<sup>1</sup> ASC 730, Research and Development

<sup>2</sup> IAS 38, Intangible Assets

	Research	Development
<b>Definition</b>	Costs related to original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.	Incurring in the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.
<b>Examples</b>	<ul style="list-style-type: none"> <li>— Activities to obtain new knowledge on self-driving technology.</li> <li>— Search activities for alternatives for replacing metal components used in a company's current manufacturing process.</li> <li>— Search activities for a new operating system to be used in a smart phone to replace an existing operating system.</li> </ul>	<ul style="list-style-type: none"> <li>— Design and construction activities related to the development of a new self-driving prototype.</li> <li>— Design and construction of a new tool required for the manufacturing of a new product.</li> <li>— Testing activities on a new smart phone operating system that will replace the current operating system.</li> </ul>

### What about acquired R&D projects?

R&D intangible assets (in-process R&D, or IPR&D) may be acquired rather than developed internally. As a general principle under IFRS, the acquired IPR&D is capitalized. However, the amount capitalized and the differences between IFRS and US GAAP depend on whether a 'business' or a single asset/group of assets is acquired. Under US GAAP, only IPR&D acquired in a business combination is capitalized post-acquisition.

The definition of a business is an area of change under both US GAAP and IFRS.

- The FASB issued ASU 2017-01, *Business Combinations (Topic 805)*, in January 2017. The ASU sets out a new framework for classifying transactions as acquisitions (disposals) of assets or businesses. As a result, fewer transactions are expected to involve acquiring or selling a business. For more information, read KPMG's **Defining Issues**.
- The IASB is continuing its deliberations on the feedback received on its exposure draft, *Definition of a Business and Accounting for Previously Held Interests*, which at the time was similar to the FASB's proposals. The IASB expects to complete its discussions in the first half of 2018.

Expect future articles addressing the definition of a business under finalized amendments to IFRS and any differences from US GAAP, and the accounting for IPR&D.

For more information please contact:



**Kevin Bogle**  
**Principal, Accounting Advisory Services,**  
**IFRS Institute Advisory Leader**  
T: +1 212-872-5766  
E: kevinbogle@kpmg.com



**Valerie Boissou**  
**Partner, Department of**  
**Professional Practice**  
T: +1 212-954-1723  
E: vlesageboissou@kpmg.com



**Holger Erchinger**  
**Partner in Charge**  
**U.S. Germany Corridor**  
T: +1 212-909-5529  
E: herchinger1@kpmg.com



**PK Kalavacherla**  
**Partner in Charge**  
**International Accounting Group**  
**Department of Professional Practice**  
T: +1 415-963-8657  
E: pkalavacherla@kpmg.com

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#### East region

**Erik Lange**  
**Partner, Accounting Advisory Services**  
T: +1 212-872-6654  
E: elange@kpmg.com

**Ingo Zielhoff**  
**Managing Director, Accounting Advisory**  
**Services**  
T: +1 212-872-4423  
E: ingozielhoff@kpmg.com

**Reza van Roosmalen**  
**Managing Director, Accounting Advisory**  
**Services**  
T: +1 212-954-6996  
E: rezavanroosmalen@kpmg.com

#### West region

**Jason Anglin**  
**Principal, Accounting Advisory Services**  
T: +1 415-963-7606  
E: janglin@kpmg.com

#### South region

**Michael Nesta**  
**Partner, Accounting Advisory Services**  
T: +1 214-840-2730  
E: mnesta@kpmg.com

#### Southeast region

**Jack Ingram**  
**Partner, Accounting Advisory Services**  
T: +1 404-221-2398  
E: jtingram@kpmg.com

#### Midwest region

**Marybeth Shamrock**  
**Partner, Accounting Advisory Services**  
T: +1 216-875-8158  
E: mshamrock@kpmg.com