LIPTON
Chartered Accountants

Accounting Standards for Private Enterprises

Executive Summary

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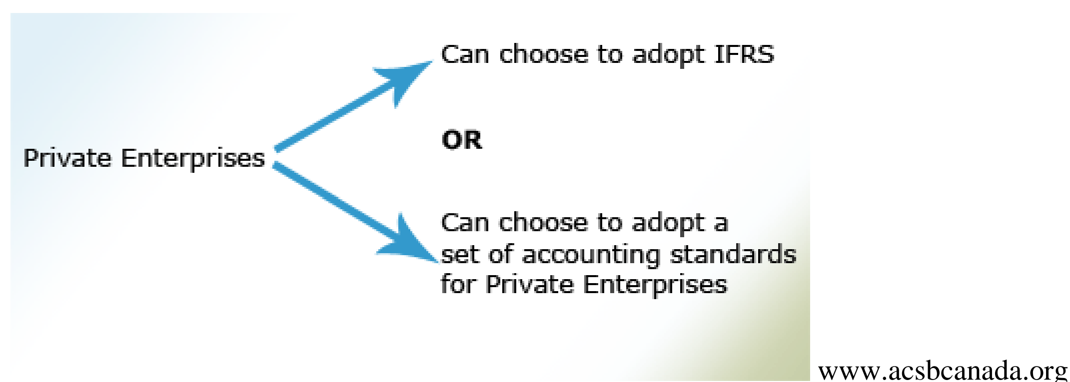
BACKGROUND

In its Strategic Plan, issued early in 2006, the Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants of Ontario ("CICA") noted that "one size does not necessarily fit all" and decided to pursue separate strategies for public enterprises, private enterprises and not-for-profit organizations.

In December 2009, the AcSB approved the final accounting standards for private enterprises in Canada. The new standards have been issued and are available for 2009 reporting for entities that choose to adopt them early.

The private enterprise standards give Canadian businesses the ability to choose to adopt new "made in Canada" standards or International Financial Reporting Standards (IFRSs). Private enterprises must decide which of the sets of standards to adopt for year-ends beginning on or after January 1, 2011.



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Private enterprise standards ("ASPE") were developed from a lengthy consultation process that ensured that private enterprises of all sizes across Canada were able to provide input into the standard-setting process. Consultation was the key to producing new financial reporting standards that respond to the needs of both private enterprises and the users of their financial statements.

Notable changes include simplification of recognition, measurement and presentation in areas that were identified as being overly complex, particularly accounting for financial instruments. The simplified accounting requires less use of fair values. The new standards also significantly reduce the burden of disclosure requirements.

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CHANGES TO CURRENT STANDARDS

The proposed standards have been developed from the existing CICA Handbook. Key differences between ASPE and current Canadian GAAP are as follows:

- recognition, measurement and presentation simplification in the following areas:
    - ➢ asset retirement obligations;
    - ➢ employee future benefits;
    - ➢ financial instruments;
    - ➢ future income taxes
    - ➢ goodwill and other intangible assets;
    - ➢ internally generated intangible assets
    - ➢ investments, subsidiaries, and joint ventures
    - ➢ stock-based compensation;
    - ➢ disclosures
- required disclosures that are appropriate for private enterprises and meet the needs of users — as a result, the number of required disclosures has been reduced; and
- elimination of EIC Abstracts as they currently exist in the Handbook. (Certain guidance that is important to this sector has been embedded in the standards).

A new Section (Section 1500, FIRST-TIME ADOPTION) requires the accounting standards for private enterprises to be adopted retrospectively but provides alternatives for specific situations.

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Asset Retirement Obligations

Existing standards require initial measurement of asset retirement obligations at fair value and provide detailed guidance on how this fair value should be estimated.

Given the assessment of costs and benefits, and a desire for the ASPE standards to be easier to apply and provide scope for professional judgment, asset retirement obligations would be measured at the end of each period at the best estimate of the future expenditures required to settle the present obligation. The measurement does not require credit adjusted discount rates or estimated profit margins.

Employee future benefits

Accounting for defined benefit plans currently involves obtaining an actuarial valuation for accounting purposes in addition to that required for regulatory purposes.

The AcSB understands that the vast majority of private enterprises do not have traditional defined benefit pension plans for their employees. However, in recent years individual pension plans (IPPs) have been used increasingly by private enterprises and the vast majority of IPPs are defined benefit plans. The beneficiaries of such plans are frequently the owner-managers of an enterprise, but it is not uncommon for others such as a key employee or a minority equity owner to be beneficiaries.

The AcSB decided that the amount reported in the balance sheet for a controlling owner plan should be the net of the pension obligation and the plan assets at the balance sheet date, with no amounts being deferred. The full effect of any change in the net plan asset or obligation would be reported in income. Businesses can use the actuarial valuation prepared for funding purposes to measure the plan's obligations, and they can recognize actuarial gains and losses in income when they occur. Actuarial valuation is required every three years. The AcSB noted that a controlling owner plan might be in a net asset position (i.e., the plan assets might be greater than the pension obligation). Consistent with the intent that the proposed standards be more principles based, the AcSB Background Information and Basis for Conclusions — GAAP for Private Enterprises decided to require that a valuation allowance be recognized for any excess of the plan surplus over the amount expected to be recoverable by the entity.

Because these actuarial gains and losses are not included in income for Canadian tax purposes, despite the simplified approach, taxable income should not change, as only contributions made to the plan are deductible for tax purposes. Corporations will continue to determine the adjustment needed to reconcile net income for accounting and tax

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purposes. Corporations using the future income taxes method will also need to consider the effect on the temporary difference for employee future benefits.

Alternative policy choice would be to retain current Canadian GAAP accounting requirements. See First-time Adoption section of this guide.

Financial Instruments

The new Section 3856, FINANCIAL INSTRUMENTS, is intended to capture all requirements in a single Section as opposed to scattered across a number of existing standards. Significant changes have been made to the financial instrument standards.

Financial assets and financial liabilities can be measured at cost or amortized cost with the exception of derivatives, investments in equity instruments that are quoted in an active market, and indexed liabilities. A fair value option will be available permitting an enterprise to elect fair value measurement for any instrument. This election will be made on initial recognition and is irrevocable. Contracts to buy or sell non-financial items do not need to be analyzed anymore for embedded derivatives.

The new Section still requires an entity to classify separately the components parts of a financial instrument that contains both a liability and an equity component, but includes an option to present convertible debt entirely as a liability, measuring the equity component as zero. Preferred shares issues as part of tax planning arrangements can be classified as equity without differential reporting. When redemption is demanded, the issuer shall reclassify the shares as liabilities and measure them at the redemption amount. Any adjustment shall be recognized in retained earnings.

The AcSB decided to include a limited scope hedge accounting model that would not rely on fair value measurement to assist private enterprise. Section 3856 contains qualifying criteria similar to that in existing Section 3865. However, there is no requirement to document a risk management strategy and relate the relationship to a risk management objective because these would be evident by the nature of each relationship. A hedging relationship can only qualify for hedge accounting if the critical terms of the hedging instrument match those of the hedged instrument. This ensures that the relationship will remain effective as long as the terms continue to match. Because the terms match, there is little, if any, difference in the income statement effect between this model and the fair value model in hedging standards for publicly accountable enterprises. The proposed hedge accounting model would recognize the realized gain or loss on the hedging instrument as an adjustment of the carrying amount of the hedged item.

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A single impairment model now exists for all financial assets. Amount to be recognized as a loss should be the difference between the current carrying amount of the asset and the highest of amount the entity expects to collect either through the present value of future cash flows, the sale of the financial asset on the balance sheet date or collection of collateral. Impairment losses can be reversed in specific circumstances.

Transaction costs are to be capitalized for financial instruments measures at amortized cost. All other transactions costs are to be expensed as incurred.

Future Income Taxes

Private entities will have a choice between the taxes payable method and the future income taxes method in accounting for income taxes without the use of differential reporting option. Additional illustrative guidance has been provided in the standard for entities that adopt the taxes payable method to demonstrate what is required for the reconciliation of the income tax rate or expense to the statutory income tax rate or expense.

Goodwill and Other Intangibles

Current Canadian GAAP places considerable emphasis on the impairment testing which is a two-step process.

Testing impairment on an “events and circumstances” basis will now become available without the use of differential reporting option. Impairment will be a one-step process with any shortfall attributed to goodwill. This approach eliminates the need to fair value the individual assets and liabilities in the reporting unit.

Internally Developed Intangible assets

Current Canadian GAAP requires entities to assess whether development costs of identifiable intangible assets meet a number of criteria and, if so, to capitalize these costs.

New standards allow an enterprise to adopt an accounting policy of either capitalizing qualifying development costs incurred on eligible internally developed intangible assets or expensing them as incurred. Depending on your choice, your company will need to analyze these costs to determine whether they should be currently deducted or added to the asset’s cost for tax purposes. Corporations should also consider whether their development costs qualify for tax incentives under Canada’s Scientific Research and Experimental Development (SR&ED) program.

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Investments, Subsidiaries and Joint Ventures

All options previously available under differential reporting are now available under ASPE as policy choices:

Significantly Influenced Investments	Investments in Subsidiaries	Interests in Joint Ventures
1. Cost Method 2. Equity Method	1. Consolidation 2. Cost Method 3. Equity Method	1. Proportionate Consolidation 2. Cost Method 3. Equity Method

Stocked-based Compensation

The current CICA Handbook includes an exception for private companies that allows them to use the minimum value method when calculating the fair value of a stock option (or its equivalent) using an option pricing model. The minimum value method ignores the volatility of the private entity's equity in the option pricing model. The AcSB noted the importance of volatility as an input in calculating the fair value of an option. For an out-of-the-money option, volatility may be the principal element of its fair value. Excluding volatility will generally result in significantly misstating the value of a stock option.

Accordingly, ASPE eliminates the minimum value method from the existing standard. Recognizing that most private enterprises cannot estimate the volatility of their own equity without significant cost and effort, ASPE adopts the calculated value method, which permits an enterprise to use the volatility of an appropriate sector index as a proxy for the volatility of its own equity.

Disclosure

The existing suite of disclosure requirements in the CICA Handbook were developed to serve the needs of both public and private enterprises with many disclosures developed to meet the specific needs of publicly accountable enterprises, particularly equity investors. The proposed new standards would place increased reliance on the general disclosure requirements in general standards of financial statement presentation, Section 1400, in ensuring that enterprises provide sufficient information to present fairly their financial position and results of operations of an enterprise in accordance with GAAP. As a result of

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the increased importance of the overall "fair presentation" requirements, it may be the case that, in practice, there is less reliance placed on disclosure checklists and rote compliance with detailed requirements.

In developing the disclosure requirements in the proposed standards, the existing disclosure requirements were first categorized as follows:

a. accounting policies chosen and any changes thereto;
b. risks and uncertainties (for example, going concern);
c. unusual events (for example, subsequent events);
d. assumptions used in developing an accounting estimate;
e. reconciliations of one financial statement amount to another; and
f. detailed breakdowns of amounts in the financial statements.

Users have noted that the first three are the most important types of disclosures, for the following reasons:

a. accounting policies are necessary to understand and analyze the financial statements;
b. risks and uncertainties are important to evaluate the likelihood of an enterprise meeting its cash flow obligations; and
c. unusual events are important in understanding the financial statements and the changes from prior periods.

The approach in developing the disclosure requirements has resulted in a significant reduction in the number of specific requirements. The proposed standards contain approximately one-half the number of specific disclosure requirements in the existing Handbook.

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OMISSIONS OF CURRENT STANDARDS

As noted above, the proposed standards have been developed from the existing Handbook. There are a number of individual Sections and Guidelines in the existing Handbook that are largely irrelevant to private enterprises. The AcSB proposes not to include these Sections and Guidelines in the proposed set of standards.

Emerging Issues Committee Abstracts of Issues Discussed, as they exist in the Handbook, have been excluded from the proposed standards. Many Abstracts are based on rules-oriented elements of US GAAP and, as a result, are heavily "rules" oriented and very detailed.

Section 1300 DIFFERENTIAL REPORTING, is no longer necessary as the proposed standards for private enterprises replace differential reporting.

Segment information does not appear to have significant value to users in the private enterprise sector and consequently Section 1701 SEGMENT DISCLOSURE, has been omitted from ASPE.

In the course of reviewing the presentation requirements in respect of extraordinary items, the AcSB noted that many financial statement users in the private enterprise sector do not believe there is significant value to the information required by Section 3480 EXTRAORDINARY ITEMS.

Section 3500 EARNINGS PER SHARE and Section 4100 PENSION PLANS, are outside the scope of non-publicly accountable entities and ASPE.

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FIRST TIME ADOPTION

The new Handbook Section 1500, FIRST-TIME ADOPTION sets out specific transitional provisions for first-time adoption of the GAAP for Private Enterprises standards. For a calendar year entity adopting ASPE in 2011, the same accounting policies should be used in the opening balance sheet and all periods presented in the first financial statements prepared using ASPE. All adjustments form events and transactions before the date of transition should be recognized in retained earnings at the date of transition.

Section 1506 ACCOUNTING CHANGES, generally requires retrospective application when new accounting policies are adopted. The AcSB decided that this should be the general principle for enterprises initially adopting the proposed set of standards for private enterprises, but recognized that for certain individual standards this might result in significant difficulties. For example, an enterprise may be unable to recreate the carrying amount of an asset or liability that originated several years ago and for which the enterprise's existing carrying amount is not consistent with the requirements of the Section 3061 PROPERTY PLANT AND EQUIPMENT. Similarly it might be difficult to restate a prior year business combination that was not accounted for in accordance with Section 1582 BUSINESS COMBINATIONS, or to determine the carrying amount in accordance with Section 3840 RELATED PARTY TRANSACTIONS, of an asset obtained through a related party transaction. The AcSB also noted that retrospectively applying certain requirements (for example, hedge accounting per Section 3856 FINANCIAL INSTRUMENTS,), may lead to selective application. Thus similar to IFRS 1, Section 1500, provides relief (optional exemptions and prohibited exceptions) to entities that elect specific exemptions on initial adoption of GAAP for Private Enterprises related to one or more of the following:

- Asset Retirement Obligations
- Business Combinations
- Cumulative Translation Adjustments
- Employee Future Benefits
- Financial Instruments
- Fair Value
- Related Party Transactions
- Stock-Based Compensation

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Asset Retirement Obligations

An entity that has not previously recognized asset retirement obligations on a basis consistent with Section 3110 ASSET RETIREMENT OBLIGATION, may measure the obligation at the date of transition to accounting standards for private enterprises and estimate the amount that shall be included in the carrying amount of the related asset based on the original and remaining life of the asset. The difference between the change in the obligation and change to the carrying amount of the asset is charged to opening retained earnings at the date of transition ASPE.

Business Combinations

A first-time adopter may elect not to apply BUSINESS COMBINATIONS, Section 1582 retrospectively to business combinations that occurred before the date of transition to accounting standards for private enterprises. However, if a first-time adopter restates any business combination to comply with Section 1582, it must restate all subsequent business combinations.

Cumulative Translation Adjustments

A first-time adopter may elect for the cumulative translation adjustments for foreign currency translations for all foreign operations to be deemed zero at the date of transition to ASPE.

Employee Future Benefits

A first-time adopter may elect to recognize all cumulative actuarial gains and losses and past service costs in opening retained earnings at the date of transition to ASPE, even if it uses the corridor approach for later actuarial gains and losses. If a first-time adopter uses this election, it shall apply it to all plans.

Financial Instruments

A first-time adopter may elect not to separate the components of financial instruments that contain both a liability and an equity component if the liability component is no longer outstanding at the date of transition to ASPE.

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Fair Value

An entity may elect to measure an item of property, plant and equipment at the date of transition to accounting standards for private enterprises at its fair value and use that fair value as its deemed cost at that date. A first-time adopter may have established a deemed cost previously for some or all of its assets and liabilities by measuring them at their fair value at a particular date (for example, comprehensive revaluation).

It may use such fair value measurements as deemed cost for accounting standards for private enterprises at the date of that measurement. If the entity did not have a comprehensive revaluation, then it can use the fair value at the date of transition to ASPE (i.e. at date of opening balance sheet) as the deemed cost of its asset. This election can be made on an item-by-item basis. The transition date fair value will become the new cost base of the asset and adjustment are recorded through retained earnings.

Fair value is defined as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction".

Related Party Transactions

Section 3840, RELATED PARTY TRANSACTION, specifies that certain related party transactions shall be measured at the carrying amount and some at the exchange amount. An entity is not required to restate assets or liabilities related to transactions with related parties when the related party transaction occurred prior to the date of transition to accounting standards for private enterprises.

Stock-based Compensation

An entity that previously accounted for stock-based compensation and other stock-based payments using the minimum value method is not required to apply the calculated value method to awards issued prior to the date of transition to ASPE.

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