ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES ("ASPE")

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Illustration: Gary Sawyer

ASPE comes into effect for years beginning on or after January 1, 2011 — after that date the existing Handbook standards (now found in Part V of the Handbook) will no longer be Canadian GAAP for either publicly accountable enterprises or private enterprises. Private enterprises can adopt ASPE prior to 2011. In deciding whether to early adopt, a private enterprise should consider factors such as the benefits of the accounting simplifications and reductions in disclosures discussed below and the amount of change required to accounting processes and systems.

After a process that began in 2006 with the recognition that one size does not necessarily fit all, the Accounting Standards Board (AcSB) issued accounting standards for private enterprises (ASPE) in December 2009. They can be found in Part II of the CICA Handbook — Accounting.

What do these new standards mean for private enterprises and their professional advisers? What are the key changes? When do they have to be applied? With ASPE, most of the practices and policies used by private enterprises won't change. There will be differences in key areas though.

The new standards are designed to take into account both costs to preparers and benefits to users of the financial statements. In most cases it will be obvious if an enterprise is private or not, but those that are unclear should refer to the definitions in the preface to the Handbook.

Most private enterprises will use ASPE, but they can choose IFRS instead. Most private enterprises will find ASPE less onerous than IFRS. If a private enterprise chooses IFRS, they must adopt all IFRS, which may result in many more differences from their current reporting and significantly higher training and conversion costs than ASPE. Also, when IFRS is chosen, there will no longer be differential reporting options such as taxes payable, cost method for subsidiaries and equity classification of redeemable preferred shares issued as part of a tax-planning strategy.

Circumstances that may make adopting IFRS attractive include:

- plans to do an IPO, which will require IFRS reporting
- potential debt or equity financing from foreign sources that do business using IFRS
- main competitors are public enterprises and using IFRS will facilitate comparisons
- parent company uses IFRS
- lenders and other users require use of IFRS

Eight Key Differences From Existing Standards
ASPE was developed from the existing Canadian accounting standards. This means that most of the accounting policies and practices used by private enterprises will not change. The changes are focused on those areas that have caused the most difficulties for private enterprises. This should make learning about, understanding and adopting ASPE much easier than, for instance, IFRS.

1. Disclosures
The disclosure requirements in the existing Handbook are often seen as focusing on the needs of investors in public companies, and as excessive and costly for private enterprises. In developing the disclosures in ASPE, key considerations were the needs of users of private enterprise financial statements (primarily lenders) and the effort and cost involved for preparers. The result was the elimination or simplification of a considerable number of disclosure requirements. One significant disclosure has been added: the disclosure of the amount payable at the end of the period in respect of government remittances, other than income taxes. Lenders see this as important information as these amounts usually have priority status in a bankruptcy. A new feature of ASPE is the provision of a compilation of disclosures that brings them together in one place. This is not intended as a checklist of disclosures. Indeed, the compilation notes that, in some circumstances, additional disclosures might be required for fair presentation. It also notes that disclosure of information that is not material to the financial statements is not required.

The amount of reduction in disclosures will vary from company to company depending on the type of transactions and the complexity of the business. Overall, the reduction in disclosures resulting from focusing on the needs of private enterprises is expected to be significant.

2. EIC abstracts
Over the years the Emerging Issues Committee (EIC) abstracts have grown to be a substantial part of Canadian GAAP. Some viewed them as helpful while others disagreed with one or more abstracts or found them burdensome.

ASPE does not include the EIC abstracts. However, some material from 29 of the abstracts has been incorporated into the relevant standards so as to improve the guidance in those standards. One of these abstracts is EIC-122, which addresses the balance sheet classification of callable debt and debt obligations expected to be refinanced. The requirements of EIC-122 have been included in Section 1510, Current Assets and Current Liabilities, together with an example of a presentation format that clarifies the nature of callable debt classified as a current liability.

The result of not including the EIC abstracts is that ASPE is, in some areas, less prescriptive than the current standards. However, guidance in the abstracts that has not been carried forward, while not required to be applied, will generally remain an appropriate accounting choice for private enterprises. This may not be true when changes have been made to a section of the Handbook that affects the issue addressed in the abstract.

3. Financial instruments

Many private enterprises have been using the XFI Handbook, which contains relatively little guidance on financial instruments. Other private enterprises have adopted the financial instruments standards in the current Handbook. ASPE has consolidated all the financial instruments requirements into a single standard — Section 3856, Financial Instruments. The impact of this new standard will vary depending on whether or not the XFI Handbook has been used in the past.

Some key elements of the financial instruments standards are:

- Most financial instruments may be measured at historical cost. Any premium or discount is amortized over the expected life of the item and recognized in net income as interest income or expense. The method of amortization is not specified. Only equity instruments traded in an active market and freestanding derivatives must be measured at fair value. (Derivatives that are part of a hedging relationship and certain other derivatives may be measured at cost.) However, a private enterprise can choose to measure one or more of its other financial instruments at fair value if it so wishes. This choice must be made when the financial instrument is first recorded and cannot be changed subsequently. Any gain or loss resulting from the use of fair value is recorded directly in income.
- Transaction costs are capitalized as part of the cost of a financial instrument unless it is measured at fair value, in which case the costs are recognized as an expense.
- There is a single impairment model for all financial assets that compares the recorded amount of the instrument to the higher of the amounts recoverable by holding the asset, selling it or realizing any security. Impairment losses for a financial asset in one period must be reversed if its recoverable amount increases in a subsequent period.
- Compound financial instruments possessing both a debt and equity component will have to be bifurcated. However a private enterprise may choose to measure the equity component at a zero value.
- The situations where hedge accounting may be used have been restricted to those that are most common for private enterprises such as hedges of an anticipated purchase or sale of a commodity or of an anticipated transaction denominated in a foreign currency; interest rate swaps; cross-currency interest rate swaps; and hedges of net investments in a self-sustaining foreign operation. This narrower focus has permitted simplification of the hedge accounting process.
- Redeemable preferred shares issued as part of a tax-planning strategy must be recognized in equity until a demand for payment is made, at which time the shares will be reflected as debt.

Why use fair value for financial instruments?

- May have a portfolio that includes equity instruments quoted in an active market and want to have all the portfolio measured on the same basis

- May want financial assets and liabilities on the same measurement basis
- May believe it provides more relevant financial information

4. Employee future benefits
The accounting for defined benefit plans can be burdensome because of the requirement for a separate accounting valuation and because of the mechanics of defer and amortize accounting. Traditionally, few private enterprises have had such plans, but in recent years there has been a significant growth in individual pension plans.

ASPE permits a private enterprise to use the regulatory funding valuation for accounting purposes, avoiding the cost of a separate valuation for accounting purposes. Selecting this alternative will also require that all gains and losses are recognized immediately in income. Gains and losses may result from changes in the value of the plan assets or from changes in actuarial assumptions. Immediate recognition of gains and losses may introduce some volatility into earnings. The existing accounting in Section 3461, Employee Future Benefits, may also continue to be used.

5. Intangible assets
Existing standards require the costs of internally generated intangible assets to be expensed during the research phase and capitalized during the development phase. The standards provide criteria for determining which phase a project is in, but applying these criteria is not always a simple task. ASPE permits a private enterprise to choose to capitalize development expenditures or to expense them. The same choice must be applied to all internally generated intangible assets.

6. Asset-retirement obligations
ASPE retains the same requirements for recording an asset-retirement obligation as those in the current Handbook, except that the measurement has been simplified. Instead of requiring the obligation to be measured at fair value, ASPE requires it to be measured at the best estimate of the expenditure required to settle the current obligation at the balance sheet date. This change avoids some of the complications involved in a fair-value measurement.

7. Stock-based compensation
The measurement of stock-based compensation requires the use of sophisticated option valuation models, such as Black-Scholes. These are readily available on the Internet. A key element of the valuation is the expected volatility of the stock price. The current Handbook permits a private enterprise to exclude volatility for practical reasons. However, this is equivalent to setting volatility equal to zero — an impossible value that results in significantly undervaluing stock-based compensation. ASPE replaces this with the ability to use an industry index for volatility. The Appendix to Section 3870, Stock-Based Compensation and Other Stock-Based Payments, provides guidance on how to identify an appropriate index. This will result in recognizing the cost of the services rendered while being cost effective for a private enterprise to calculate.

8. Differential options

The current Handbook provides certain differential reporting options for private enterprises. As noted below, these have been carried forward into ASPE. A major difference is that differential reporting options had to be agreed to in writing by all owners of the enterprise. Under ASPE, these are accounting policy choices made by management and disclosed in the notes to the financial statements.

a) Income taxes — either the taxes payable method or the future income taxes method of accounting may be used. If the taxes payable method is used, a reconciliation of actual taxes to taxes that would result from application of the statutory rate is required consistent with the existing differential reporting option. An example format for that reconciliation has been provided.
b) Interests in other entities — a private enterprise may consolidate a subsidiary, equity account for it or account for it at cost. If the enterprise has significant influence over an investee, it may equity account for it or account for it at cost. An interest in a joint venture may be proportionally consolidated, equity accounted or accounted for at cost. One difference from the current Handbook is that if the investee is traded in an active market then it may be accounted for at fair value but cannot be accounted for at cost.
c) Intangible assets not subject to amortization and goodwill — an impairment test is only required when events or changes in circumstances indicate that the carrying amount may exceed fair value, rather than every year. In addition, the process to measure goodwill impairment has been simplified compared to the current Handbook.
d) Tax-planning arrangements — redeemable preferred shares issued as part of a tax-planning strategy are recognized in equity. The existing differential reporting option permits a choice between equity and debt, although equity classification has been commonly used.
e) Share capital — disclosures about authorized share capital are not required.
f) Disclosure of fair value — this is not required for financial instruments that are not measured at fair value.

Transition to ASPE

ASPE must be adopted for years beginning on or after January 1, 2011 and may be adopted earlier.

ASPE must be adopted on a retrospective basis. Assume a private enterprise adopts ASPE for the calendar year 2011. Its 2011 financial statements will include comparative 2010 financial information as well as an opening balance sheet as at January 1, 2010, all prepared in accordance with ASPE. The notes to the 2011 financial statements will include a reconciliation of the 2010 earnings prepared using ASPE to the earnings in the 2010 financial statements. Also included will be an explanation of the changes between the January 1, 2010 balance sheet prepared using the enterprise's previous accounting policies (i.e., the December 31, 2009 balance sheet from the 2009 financial statements) and the January 1, 2010 balance sheet restated in accordance with ASPE.

Many private enterprises that currently prepare Canadian GAAP financial statements will have relatively few adjustments to make in order to comply with ASPE. However, enterprises that have not prepared Canadian GAAP financial statements due to the cost and effort may now consider doing so and may face greater changes. Some may find it difficult to apply ASPE retrospectively because, for example, certain historical information may not be available or many complex computations may be required. Section 1500, First-Time Adoption, provides several optional exemptions from applying ASPE on a retrospective basis. It is important to realize that all private enterprises adopting ASPE may take advantage of these exemptions. For example, a private enterprise may elect to measure an item of property, plant and equipment at its fair value at the date of transition. This provides a one-time opportunity to revalue one or more fixed assets. However, one consequence would be increased depreciation charges in future years if this is a depreciable asset. Another example is the option to recognize any unrecognized actuarial gains or losses related to a defined benefit plan in retained earnings at the date of transition. Section 1500 also identifies items for which retrospective application is not permitted. Private enterprises intending to adopt ASPE should carefully review Section 1500 so as to understand the first-time adoption requirements and the one-time options available.

Exemptions from retrospective adoption

- Business combinations
- Property, plant and equipment
- Employee future benefits
- Cumulative translation account
- Financial instruments (designation at fair value; bifurcation of a compound instrument)
- Share-based payments
- Asset-retirement obligations
- Related-party transactions

Exemptions from retrospective adoption

- Derecognition of financial instruments
- Hedge accounting
- Estimates
- Noncontrolling interests

The Future of ASPE

ASPE will not be fixed in its current form forever. Changes will be made to address new circumstances and keep ASPE current. To make sure that changes are focused on the requirements of private enterprises and the users of their financial statements, the AcSB has established the Private Enterprises Advisory Committee (PEAC) composed of preparers, professional advisers and financial statement users from the private enterprise sector. Information on PEAC meetings is available on the AcSB website www.acsbcanada.org. PEAC welcomes input on potential changes to ASPE.

What Should a Private Enterprise Do?
The first decision that should be made is, should it be IFRS or ASPE? For most private enterprises the answer will be ASPE. It includes a number of accounting policy choices, both for the transition to ASPE and on an ongoing basis. How to select between these? One approach is to determine which choices best meet the needs of the users of the enterprise's financial statements. This might involve discussion with the key users. Other considerations include the relative work effort and cost of the different options as well as the impact on the income statement, balance sheet, financial ratios and other financial statement-based metrics. The best answer may be a balance between these — which comes back to the principle of cost/benefit that was used in developing ASPE.

This article represents the authors' views and not necessarily those of the AcSB.

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