



Accounting Bulletin

Canadian GAAP for Private Enterprises

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Introduction

Change is in the air as Canadian Generally Accepted Accounting Principles (“GAAP”) will no longer exist for all fiscal years beginning on or after January 1, 2011. Our private company clients will need to make the decision on which accounting standards they will adopt, either Accounting Standards for Private Enterprises (“ASPE”) or International Financial Reporting Standards (“IFRS”). Both standards will be effective for annual financial statements relating to fiscal years beginning on or after January 1, 2011. Canadian private enterprises need to make a choice very soon.

Discussed below, for both IFRS and ASPE, are the following: (1) The differences with Canadian GAAP; (2) What is the best choice; (3) What should a private enterprise do now; and (4) How to transition to the new selected standard.

What are the differences with Canadian GAAP?

ASPE

To begin, ASPE was developed from existing Canadian GAAP. 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 IFRS.

The key differences are as follows:

Disclosures

A considerable number of disclosure requirements have been eliminated or simplified. 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. It also notes that disclosure of information that is not material to the financial statements is not required. Overall, the reduction in disclosures resulting from focusing on the needs of private enterprises is expected to be significant.

Financial instruments

ASPE has consolidated all the financial instruments requirements into a single standard — Section 3856, Financial Instruments.

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.
- Only equity instruments traded in an active market and freestanding derivatives must be measured at fair value. However, a private enterprise can choose to measure one or more of its other financial instruments at fair value if it so wishes. Any gain or loss resulting from the use of fair value is recorded directly in income, although not taxable for CRA purposes.
- 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. Under the current model, impairment losses can not be reversed.
- 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.

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. 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.

Revaluations

When adopting ASPE, there could be a one-time bump up in Property, Plant and Equipment, Investment Property and Intangibles to their respective fair market values.

Differential options

The current Handbook provides certain differential reporting options for private enterprises; these policy options 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.

(i) *Income taxes* — either the taxes payable method or the future income taxes method of accounting may be used.

(ii) *Interests in other entities* — a private enterprise may consolidate a subsidiary, equity account for it or account for it at cost. One difference from the current Handbook is that, if the investee is traded in an active market, then it must be accounted for at fair value and not accounted for at cost.

(iii) *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. The process to measure goodwill impairment has been simplified compared to the current Handbook.

(iv) *Share capital* — disclosures about authorized share capital are not required.

(v) *Disclosure of fair value* — this is not required for financial instruments that are not measured at fair value.

Overall, APSE will simplify the existing financial reporting policies and disclosures regarding the following items:

- Financial instruments; Asset retirement obligations; Subsidiaries and affiliates; Employee future benefits
- Future income taxes; and Goodwill and intangible assets

IFRS

All publicly accountable enterprises (“PAEs”) in Canada must select IFRS standards for their fiscal 2011 financial statements. A Publicly Accountable Enterprise is an entity, other than a not-for-profit or public sector entity, that has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market or an entity that holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

How to decide if whether your business is a PAE?

In making this determination, some questions to be asked include:

- Do I consider my company to be publicly accountable (irrespective of the words used in the definitions)?
- Do I hold and manage financial resources (e.g. deposits or advances) entrusted to me by a broad group of clients, customers or members who are not involved in the management of the entity? If yes:
 - What is (are) my primary business(es)?
 - Is holding and managing such financial resources an integral part of any one of my primary businesses? If I could, the reasons for holding the financial resources might be incidental to the primary business.
 - Has receiving, holding and managing such financial resources created a new primary business, and would holding and managing the financial resources be considered an integral part of that business?

IFRS is similar to Canadian GAAP in that the conceptual framework and the style and form of the accounting standards are similar. A substantial number of the standards are the same including inventories, segmented reporting and accounting changes; this is due to the fact that Canadian GAAP has been converging standards to IFRS during the last number of years.

The key differences are as follows:

Impairment

Under IFRSs impairments will generally be triggered more often; unlike under Canadian GAAP, however, impairments under IFRSs can be reversed.

Revaluations

Some IFRSs including Property, Plant and Equipment, Investment Property and Intangibles allow the re-valuation of assets under certain circumstances. These revaluations could bump up an entity's Property, Plant and Equipment to fair value.

IFRS 1, First-time Adoption of International Financial Reporting Standards

There is no Canadian equivalent for IFRS 1, which provides special one-time options for enterprises converting to IFRSs from their national GAAP. Some items within IFRS 1 are optional and some are required. All companies should review IFRS 1 to determine the options available to them and to assess how they will incorporate these options into their transition.

No Differential Reporting Options

With the end of Canadian GAAP standards, after January 1 2011, differential reporting options will cease for private entities that do not transition to ASPE as IFRS does not consist of any differential reporting accounting policy options. This has a significant impact on the financial statements of private enterprises.

What is the best choice?

The decision on which standard to adopt is based upon who the users of the financial statements are going to be, the financial requirements of the entity and finally, the entity's future intentions.

Most Canadian private enterprises will adopt ASPE, because ASPE is considerably less onerous than IFRS due to the reduced disclosure requirements.

ASPE - Would be attractive to those private companies that the following items apply to:

- Have few users of the financial statements;
- Do not have the resources to make the significant changes that may be required to move to IFRS. ASPE is not significantly different from current Canadian accounting Standards;
- Like to see changes in accounting standards less often. The last few years have resulted in constant change in accounting standards; the Accounting Standards Board has promised to make changes to ASPE less often (every 1 to 2 years);
- Want to see less disclosure in the financial statements;
- Want to keep engagement costs down. Costs should be lower than if you were reporting under IFRS since there are fewer disclosures;
- Like the simpler financial instrument model than the model in use under IFRS; or
- Are interested in having a lot more accounting policy choices (consolidated versus non-consolidated financial statements, taxes payable method versus future income taxes payable method, simplified model for accounting for defined benefit plans etc.)
- Simpler transition from Canadian GAAP than to IFRS
- Unanimous shareholder approval will no longer be required for differential reporting options.

IFRS - Would be attractive to those private companies that the following items apply to:

- Plans to go public in the future or are facing a potential sale to a public company, which will require IFRS reporting;
- Potential debt or equity financing from foreign sources, venture capital funds or pension funds that do business using IFRS;
- Main competitors are public enterprises and using IFRS will facilitate comparisons;
- Suppliers and customers have adopted IFRS
- Foreign parent company uses IFRS; and
- Lenders and other users require use of IFRS

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. 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.

The decision to move forward to ASPE will include 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.

How to transitions to the new standards?

ASPE or IFRS must be adopted for years beginning on or after January 1, 2011 and both standards must be adopted on a retrospective basis.

Assume a private enterprise will adopts one of the new standards (either ASPE or IFRS) 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 their new adopted standard. The notes to the 2011 financial statements will include a reconciliation of the 2010 earnings prepared using ASPE or IFRS 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 the new standard selected.

ASPE

First-Time Adoption (Section 1500 of ASPE), 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.

- You want to make immediate use of one-time transitional adjustments such as:
 - The property, plant and equipment bump up to fair value; or
 - Zeroing out of unamortized actuarial gains / losses and / or cumulative translation adjustments accounts
 - You want to access some of the changes in the new model such as:
 - Recording investments in shares quoted in an active market at fair value;
 - Measuring certain financial instruments at their fair values;
 - Accounting for the conversion option in convertible debt at \$Nil;
 - Applying the simplified defined benefit plan measurement model;
 - Adopting the alternative presentation for callable debt;
 - Using of the easier-to-access hedge accounting model;
 - Your enterprise could not access differential reporting because you could not obtain unanimous shareholder consent.
- Under ASPE, you can freely adopt many accounting policy choices that were previously available under differential reporting

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. These elections may make the transition to ASPE easier and more cost effective for your entity by exempting your entity from having to apply certain accounting requirements retroactively. Also, you may want to talk to us about the effect any changes in accounting policies will have for income tax purposes

Conclusion

Change is here for your private enterprise. You have a lot of decisions to make on your road to IFRS or ASPE and GLM LLP wants to make that transition as easy as possible for your enterprise. If you have any concerns or questions about your transition or making the correct accounting policy choice for your business, please contact us at your convenience.