

## New Canadian Accounting Standards for Private Enterprises (ASPE)

*The accounting standards for privately owned business will change and this will create some opportunities for your business. It is important that you understand when these new standards must be applied and how they differ from current accounting standards.*

This article explains how ASPE, the new reporting standards for Canadian private companies, can affect your business. It explains:

- the history of Canadian Accounting Standards for private enterprises;
- who can adopt the new standards and when they must be applied;
- key differences between ASPE and current accounting standards;
- opportunities and requirements related to the initial application of these new standards.

### History of Canadian Accounting Standards for Private Enterprises

In 2006 the Canadian Accounting Standards Board (AcSB) announced that public companies in Canada would be required to adopt International Financial Reporting Standards (IFRS) commencing with periods beginning on or after January 1, 2011. This decision had implications for private companies because the AcSB launched a separate project to look at the needs of users of private company financial statements and evaluated whether it was worthwhile for these entities to prepare financial statements in accordance with IFRS as well.

The AcSB decided that it was not necessarily in the best interest of the users of private company financial statements that those statements be prepared in accordance with IFRS. Instead they created Canadian Accounting Standards for Private Enterprises (ASPE), which were designed to meet the financial reporting needs of this sector. An entity that qualifies to adopt ASPE still has the option to adopt IFRS if it so chooses.

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### What types of entities can adopt ASPE?

A profit oriented entity qualifies to use ASPE as long as it:

1. Has not issued debt or equity in a public market and does not have to file its financial statements with a securities commission such as the Ontario Securities Commission.
2. Does not hold assets in a fiduciary capacity as a primary business. Banks, credit unions and mutual fund companies, are not eligible to apply ASPE as a result of this requirement.

### When do the new standards apply?

An entity must apply ASPE (or alternatively IFRS) to financial statements for periods beginning on or after January 1, 2011. An entity can adopt these standards earlier if they wish.

### What are the key differences between ASPE and existing Canadian generally accepted accounting standards?

The AcSB attempted to address some particularly contentious areas and issues when they created ASPE. Some of the more notable changes are outlined below.

#### *Financial Instruments*

ASPE provided the AcSB with an opportunity to create a financial instrument standard that is simpler than the financial instrument standards contained in IFRS. Under

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ASPE all financial instruments are to be measured at amortized cost except for the following items which will be subsequently measured at fair value:

- Investments in equity instruments whose prices are quoted in an active market.
- Derivatives (unless the company decides to designate the derivative as a hedge and apply hedge accounting.)

ASPE standards also permit an entity to elect to subsequently measure any financial instrument at fair value. This election might be desirable when an entity has a mix of portfolio investments where some investments are subsequently measured at their fair value (e.g. shares in a public company) and others that, in absence of taking advantage of the election, would be subsequently measured at amortized cost (e.g. corporate bonds).

### *Government remittances*

One new requirement under ASPE is that entities are required to disclose the amount payable at the end of the period in respect of government remittances (other than income taxes). Government remittances include federal and provincial sales taxes, payroll taxes, health taxes, and workers' safety insurance premiums.

### *Asset Retirement Obligations*

An asset retirement obligation exists when a company ceases to use an asset and the company is legally obligated to ensure that the asset (e.g. landfill site, pit, mine etc.) is returned to an "acceptable state." What constitutes an acceptable state is usually defined in an agreement or in government regulations.

In Canada we typically think of these types of obligations in the mining and oil and gas industries as companies operating in these industries frequently have environmental obligations once they cease to operate on a certain site. However, these obligations can be found in other industries. Companies that own gravel pits may have asset retirement obligations and some lease agreements may result in asset retirement obligations (e.g. a lessor made changes to a leased building but the lease requires that they return the leased building to its original state at the end of the lease term).

Existing accounting standards related to asset retirement obligations have very detailed and onerous recognition and measurement requirements. As a result, many small private companies concluded it was not practicable to determine asset retirement obligations in accordance with these standards. The AcSB acknowledged this fact and brought forward simpler ASPE requirements to account for asset retirement obligations. Under ASPE, the amount recognized as an asset retirement obligation shall be based on management's best estimate of the costs required to settle the present obligation at the balance sheet date.

### *Impairment Test for Goodwill*

Goodwill arises when one company is purchased by another company and the amount paid for the acquired company is greater than the fair value of that company's net assets (net assets equal the entity's assets less its liabilities). The difference between the amount paid and the fair value of net assets of the acquiree is recorded as goodwill on the acquirer's balance sheet.

Goodwill arises from such factors as a strong management team, a company's excellent reputation etc. Goodwill impairment occurs when there are changes in these factors such as when a key member of the management team leaves the company, the company performs poorly or a product recall damages the company's reputation.

The ASPE standards include a simplified process to test goodwill for impairment. Under ASPE, when the carrying amount of a reporting unit exceeds its fair value, a goodwill impairment loss shall be recognized in an amount equal to the excess. Under existing Canadian GAAP the impairment test is much more involved.

### *Development Costs*

Under existing standards for intangible assets an entity must capitalize development costs when they meet the following criteria:

- The project is technically feasible.
- The company intends on completing the project and has sufficient resources available to do so.
- The company can reliably measure the expenditures attributable to the development project.
- The company can demonstrate how the intangible asset will generate probable future economic benefits (e.g. they can demonstrate that a market exists for the product or they can demonstrate the usefulness of the project if it is being developed for internal use).

Under ASPE, an entity now has the option to expense development costs that meet the criteria outlined above.

Common examples of development costs would be the development of computer software (for sale or for internal use), or the creation of a new web site that would generate identifiable future benefits for the company.

### *Pension Plans and other Future Employee Benefit Plans*

Existing Canadian GAAP requires an organization to use the deferral and amortization approach to account for its defined benefit plans. Under ASPE a company is now provided with the option to adopt the immediate recognition approach.

Under the immediate recognition approach, an entity is permitted to determine the accrued benefit obligation based on an actuarial valuation report prepared for funding purposes. This will enable companies to reduce

the administration costs associated with these plans since current GAAP requires a separate valuation report to be prepared using more conservative assumptions.

The immediate recognition approach is much simpler to apply and easier for users to understand than the deferral method. When determining the amount of the pension liability (or the plan asset) under this approach the entity recognizes the net amount of the actuarially determined accrued benefit obligation and the fair value of plan assets at the balance sheet date. Another key difference that simplifies the accounting process is that actuarial gains and losses and past service costs are expensed in the year they occur.

Those considering adopting the immediate recognition approach should be aware that this method will result in a higher pension liability (or a lower pension asset) and larger fluctuations in expense levels year over year than the deferral and amortization approach.

### *Business Combinations*

The most common form of a business combination occurs when one company acquires another. Amalgamations and mergers of existing companies also meet the definition of a business combination.

For most private companies, the adoption of ASPE will be the first time they apply recently introduced accounting standards to account for business combinations. These new requirements exist under current GAAP but private companies are eligible to defer the adoption of the new standards until they adopt ASPE.

The main difference brought about by the new standard is that business combinations will now be accounted for using the acquisition method. Under the acquisition method, when the acquirer buys less than 100% of the company (other companies or individuals own a portion of the company), the carrying value of assets and liabilities acquired is recorded at 100% of their fair value at the date of acquisition. Under existing standards the purchaser would only record the fair value increase or decrease based on their ownership percentage.

Some of the other differences between the new standards and standards permitted under existing GAAP are:

- Under the new standards costs to acquire a business must be expensed. Under existing standards these costs are capitalized.
- Under the new standards contingent consideration is to be recognized and measured at the time the subsidiary is acquired. Under existing standards an entity would not recognize contingent consideration until the matter in question is resolved.
- Under the new standards, the non-controlling interest (the portion of the subsidiaries value attributable to the non-controlling shareholders) is to be presented as equity. Existing GAAP is silent with respect to how

non controlling interest should be handled.

- Under the new standards an entity can record a gain when it acquires a company at a price that is less than the fair value of the net assets acquired. Under existing GAAP the entity reduces the carrying value of the assets and liabilities acquired by the amount of the gain.

### *Stock Based Compensation*

Volatility is a variable that is used to determine the fair value of a stock option. Under existing GAAP an entity was able to assign a volatility value of nil to a stock that is not actively traded. Under ASPE this option is no longer available. Instead an entity may use the calculated value method which establishes the volatility figure using a value derived from an appropriate industry sector.

## **My company currently uses differential reporting options, are these options available under ASPE?**

The differential reporting accounting policy choices have been incorporated into ASPE. However, they are no longer branded as differential reporting options and financial statements will no longer make any references to “differential reporting.”

Under ASPE, these differential reporting options have become accounting policy choices or, in some cases, the required accounting treatment. It is important to note that management is no longer required to obtain the unanimous consent of its shareholders to adopt them.

The following are differential reporting options that have been incorporated into ASPE:

- An investment that is subject to significant influence can be accounted for using the cost method or the equity method.
- A joint venture can be accounted for using the cost method, the equity method or proportionate consolidation.
- A subsidiary can be accounted for using the cost method, the equity method or it can be consolidated.
- A company can use the income taxes payable method or the future income taxes method.
- Goodwill and intangible assets with indefinite lives are now tested for impairment only when events or circumstances indicate that these assets may be impaired.
- An entity need only disclose the characteristics of issued shares under ASPE. The requirement to disclose the characteristics of authorized shares is no longer required.
- An entity is no longer required to disclose the fair value of its financial instruments, except of course for those items that are subsequently measured at fair value. This goes beyond the existing differential reporting option that enabled an entity to disclose only fair value information that was readily available.

- Preferred shares issued in a specified tax planning arrangement shall be presented in the equity section of the balance sheet at their stated capital amount. The balance sheet presentation shall indicate that the shares are redeemable at the option of the holder and shall identify their redemption amount.

The elimination of the requirement to obtain unanimous consent of a company's shareholders empowers management to make accounting policy choices that will simplify the financial reporting process. However, management must carefully weigh the consequences of these decisions, particularly in widely held corporations, as shareholders who are not active in day to day management may want to see more detailed financial information such as consolidated financial statements.

## How do we report comparative figures when we adopt ASPE?

The ASPE standards must be applied retrospectively which means that all comparative financial statements presented must be prepared in accordance with the ASPE standards.

In the first year that an entity applies ASPE it is required to provide additional information to explain to users of the financial statements the impact of moving from the company's previous standards to ASPE.

A key component of this disclosure is the requirement to provide an opening balance sheet at the "date of transition." The date of transition to ASPE is the beginning of the earliest period for which an entity presents full comparative information under ASPE. For a company that moves to ASPE for its December 31, 2011 fiscal year, it is required to present comparative financial statements for the prior year (December 31, 2010) as well as a transitional balance sheet as at January 1, 2010.

Under the transitional disclosure requirements, the company is also required to provide a comparative income statement and cash flow statement in accordance with ASPE. This would cover the period from January 1, 2010 to December 31, 2010 in the example above. In addition, the company is also required to provide the following transitional disclosures to help users reconcile changes to the comparative figures as a result of applying ASPE to those prior periods:

- An explanation of each transitional change brought about by the adoption of ASPE and the amount charged to opening retained earnings attributable to each change.
- A reconciliation of the net income reported in the entity's most recent previously issued financial statements to its net income under ASPE for the same period.
- If an entity presented a cash flow statement under its previous accounting policies, it shall explain the material adjustments to the cash flow statement.

## This seems like a complicated process, is there any way to simplify it?

Although the disclosure requirements outlined above may seem complicated, for some organizations the transition to ASPE will be straightforward. For instance, the transition will likely be straightforward for companies that do not have:

- investments that are required to be measured at fair value;
- a pension plan;
- asset retirement obligations;
- subsidiaries.

The AcSB has also introduced the following first time adoption optional exemptions to ease the transition to ASPE.

### *Business combinations*

A first-time adopter may elect not to apply the business combinations standard retrospectively to past business combinations (business combinations that occurred before the date of transition to ASPE.)

### *Employee future benefits*

An entity will be able to elect to record any unamortized actuarial gains and losses and past service costs directly to opening retained earnings at the date of transition.

### *Financial instruments*

At the date of transition to accounting standards for private enterprises an entity is permitted to designate any financial asset or financial liability to be measured at fair value. After the transition to ASPE, this election can only be made when a financial instrument is initially acquired or incurred

### *Asset retirement obligations*

Any adjustments made to the carrying amount of asset retirement obligations at the date of transition to ASPE can be charged to opening retained earnings.

### *Related Party Transactions*

An entity may elect not to adjust the measurement of any related party transaction that had occurred before the date of transition and is not in accordance with related party transaction requirements reflected in ASPE.

We believe that this election will be rarely used since ASPE standards are consistent with the current related party transaction standards and the current related party transaction standards were first released in 1995. However, companies that executed corporate re-organizations in the mid nineteen-nineties, or earlier, may not have followed the current related party transaction rules and should take advantage of this election.



### *Stock-Based Compensation*

An enterprise may elect not to re-calculate any stock based compensation items issued prior to the date of transition.

### *Cumulative Translation Differences*

Entities will be able to elect to set cumulative translation adjustments that arose from the consolidation of self-sustaining subsidiaries to zero at the date of transition.

## **Is there any other information about ASPE that we should be aware of?**

One aspect of ASPE that has generated a lot of discussion is the opportunity for an entity to revalue items of land, building and equipment at their fair value when it first applies ASPE. Companies that own commercial properties are often interested in evaluating this opportunity.

An entity may elect to measure any item of land, building 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. An entity taking advantage of this election would record a corresponding adjustment to its opening retained earnings. This is a one time opportunity. If management does not make the election in the year it adopts ASPE, this option expires and is not available to be applied in a future year.

This election will result in the company increasing the value of its assets and its equity position on its balance sheet. However, there are also drawbacks with the election, such as the following:

- An appraisal will likely be required to substantiate the fair value of the asset which will result in incremental costs to the entity.
- If the value of a building is increased then the company's net income for accounting purposes will decrease in future periods since the amortization expense attributable to the asset will increase. This may not be looked upon favorably by the company's creditors.
- Increasing the value of assets could have adverse tax consequences for some companies that you should discuss with your Welch LLP advisor.

Management should carefully evaluate the advantages and disadvantages, and discuss them with their Welch LLP advisor, before they decide to take advantage of this election.

## **Conclusion**

The transition to ASPE is an important junction in Canadian financial reporting. Organizations need to determine the impact it will have on their financial statements as this could have major implications on key financial metrics such as management and employee bonuses as well as debt covenants.

Please contact Shawn Kelso at: [skelso@welchllp.com](mailto:skelso@welchllp.com) or your Welch LLP representative to discuss ASPE and how they will affect your organization.

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