Accounting Standards for Private Enterprises — Background Information and Basis for Conclusions

Foreword

In December 2009, the Accounting Standards Board (AcSB) released Part II of the CICA Handbook – Accounting, which consists of accounting standards for private enterprises. The AcSB has approved for publication the contents of this document setting out its rationale for adopting those standards.

Background Information and Basis for Conclusions documents are sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, in Part II of the Handbook. These documents are intended to help readers understand how the AcSB reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Section or Accounting Guideline.

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INTRODUCTION

1 This document summarizes considerations that were deemed significant by members of the Accounting Standards Board (AcSB) in reaching its conclusions in developing the accounting standards for private enterprises. It sets out the reasons the AcSB undertook the project to develop the standards, the process of research and deliberation, the key decisions made, and the principal reasons for adopting the positions taken and rejecting others. Individual AcSB members gave greater weight to some factors than to others.

2 Nothing in this document is to be taken as overriding the requirements of the CICA Handbook – Accounting. However, the discussion may help readers to understand how the AcSB reached its conclusions in developing the standards and the AcSB's intent with respect to their interpretation and application.

BACKGROUND

3 In its Strategic Plan, issued early in 2006, the AcSB noted, "one size does not necessarily fit all" and decided to pursue separate strategies for publicly accountable enterprises, private enterprises and not-for-profit organizations. These

strategies reflect the different needs of users and different cost-benefit considerations in each sector resulting from the different transactions they undertake and the different circumstances they encounter.

4 Prior to developing the accounting standards for private enterprises, Canadian generally accepted accounting principles (GAAP) included DIFFERENTIAL REPORTING, Section 1300. This Section allowed eligible private enterprises to elect, as an option, to follow different accounting policies in specific areas. Differences included recognition, measurement and presentation issues. The AcSB's decision to adopt International Financial Reporting Standards (IFRSs) for publicly accountable enterprises in 2011 required reconsideration of the appropriateness of differential reporting, because it provided options to the standards and those standards would be withdrawn. In addition, while the differential reporting system provided accounting options for a number of significant issues, many constituents told the AcSB that Canadian GAAP was still too complex and burdensome for private enterprises. These constituents argued that a number of requirements did not meet a cost-benefit test and further modifications were needed to meet the financial reporting needs of private enterprises.

Initial research

5 In the course of developing the strategy for private enterprises, the AcSB undertook a comprehensive examination of the needs of external users of private enterprises' financial statements. This included meeting with a significant number of financial statement users from across the country. Those consulted included a wide range of specific types of users from both the creditor and equity investor perspective. This consultation was completed at the end of 2006. While both internal and external users were consulted, the focus was on external users who rely on financial statements to make decisions as, by definition, general purpose financial statements are designed to meet the needs of such users. Internal users have ready access to information and, accordingly, are able to satisfy their specific needs for financial information without general purpose financial statements. Some have suggested that standards should be developed based on the specific needs of taxation authorities. Similar to internal users, taxation authorities are able to obtain whatever information they require; accordingly, they are not considered users for purposes of developing accounting standards that result in general purpose financial statements.

6 The AcSB's research found no specific demand for a separate and distinct set of accounting standards for private enterprises. However, users generally understood, from a cost and complexity perspective, the problems faced by private enterprises in the preparation of GAAP financial statements. Many users were familiar with differential reporting, as set out in DIFFERENTIAL REPORTING, Section 1300, and accepted the differential reporting model. In general, users were sympathetic to developing a set of accounting standards for private enterprises that would require less effort and cost but still provide them with the information they need.

7 In May 2007, the AcSB published an Invitation to Comment and accompanying Discussion Paper to solicit input regarding the best approach for developing standards for private enterprises. The Invitation to Comment and Discussion Paper included:

(a) the results of the comprehensive review of user needs;

(b) tentative conclusions of the AcSB on a number of fundamental issues; and

(c) three possible approaches to developing private enterprise standards:

 (i) an approach based on the standards for publicly accountable enterprises (i.e., IFRSs) but providing for differences on a number of topics;

 (ii) adoption of the *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs) when finalized, possibly with some modification; and

 (iii) an independently developed set of standards.

8 Late in 2007, The Canadian Institute of Chartered Accountants issued for comment proposals for a Framework for Owner-Managed Enterprises. The Framework for Owner-Managed Enterprises was designed as guidance for enterprises without external users of their financial statement and accordingly do not require their financial statements to be prepared in accordance with GAAP. While the proposals in the Framework for Owner-Managed Enterprises were well received in terms of content and approach, most constituents strongly believed that a "GAAP solution" was needed.

9 The AcSB reviewed the comments on both its Invitation to Comment and the Framework for Owner-Managed Enterprises proposals early in 2008. Comments were received via written responses, as well as through roundtable discussions held across the country. Though the AcSB did not develop the Framework for Owner-Managed Enterprises, the feedback on it proved to be useful to the AcSB's deliberations.

10 Responses to the Invitation to Comment were less supportive of the second approach, the IFRS for SMEs, than the other two options. Concerns expressed included that the IFRS for SMEs was, at that time, still under development and therefore unproven, and that several technical aspects would be unacceptable in Canada.

11 Approximately equal numbers of stakeholders supported each of the remaining two options. Respondents supported the first option, IFRSs with differences, based on the benefits of maintaining relatively close ties between private enterprise and public enterprise reporting, and the difficulties of understanding and maintaining two separate sets of standards.

12 There was also considerable support for a set of standards based on the Handbook, modified to meet the circumstances of private enterprises. Respondents noted that the Framework for Owner-Managed Enterprises had demonstrated the

benefits of this approach. They also stated that such an approach seemed likely to result in the timeliest development of standards for this sector. Virtually all respondents thought that accounting standards for private enterprises were needed in the short term.

Development of the standards

13 After reviewing input from stakeholders, the AcSB decided to develop a set of "made in Canada" accounting standards for private enterprises based on the following approach:

(a) Canadian GAAP 1 should be used as a starting point;

(b) only the issues that had caused significant concern to private enterprises should be considered, with the need for simplification based on an assessment of cost / benefit;

(c) the majority of the recognition and measurement requirements, which did not cause significant concern to private enterprises, should be retained with few, if any, modifications;

(d) the standards should be principles-based and encourage the use of professional judgment; and

(e) disclosure requirements should be re-evaluated based on the needs of external users of financial statements of private enterprises, with the expectation that there would be considerably fewer disclosures.

This approach was discussed at a number of roundtable meetings and other forums held across the country and met with strong support from stakeholders. The AcSB thinks that this approach has resulted in accounting standards that meet the needs of users and preparers of private enterprise financial statements in a similar manner to that in which IFRSs meets those needs for publicly accountable enterprises. The AcSB does not consider the accounting standards for private enterprises as "inferior" to IFRSs or the pre-changeover standards but rather as being appropriate standards for private enterprises.

14 The AcSB noted that the Handbook had existed for some time and had largely met the needs of the private enterprise sector. Respondents to earlier consultations expressed a strong preference for a solution in the short-term while also expressing concerns about the education and training burden of introducing a new financial reporting system. Using the Handbook as a starting point would not require private enterprises to undertake the significant change that publicly accountable enterprises are facing with the transition to IFRSs.

15 The AcSB considered using the proposed Framework for Owner-Managed Enterprises as a basis for developing private enterprise standards. However, the AcSB determined that because of its different focus (i.e., internal users) extensive work would be needed to develop a set of general purpose financial reporting standards with that starting point. Accordingly, the AcSB concluded that using the Handbook as a starting point would be more appropriate.

16 The AcSB set up a special Advisory Committee to provide input with respect to the development of the accounting standards for private enterprises. Committee members included financial statement users, financial statement preparers, public practitioners, business advisors from the private enterprise sector and academe. Two AcSB members were members of the Committee.

17 The Advisory Committee met frequently throughout the second half of 2008 and early in 2009 to develop recommendations to the AcSB on the content of the accounting standards for private enterprises. The AcSB posted working drafts of proposed standards developed by the Advisory Committee to the AcSB website to provide information to stakeholders on the direction of the standards and to provide the opportunity for them to provide input before the Exposure Draft was published.

18 The AcSB issued an Exposure Draft, "Generally Accepted Accounting Principles for Private Enterprises," in April 2009 with a comment deadline of July 31, 2009. The AcSB received 180 responses, the majority from public practitioners and financial statement preparers. Input was also received through public roundtables and other discussion groups held across the country.

19 The vast majority of respondents supported the direction the AcSB had taken in developing the Exposure Draft and the proposed simplifications. However, many respondents proposed specific changes to the proposals. The AcSB discussed the issues raised in the responses to the Exposure Draft at its August, September and October 2009 meetings and reached the conclusions discussed below.

MAIN FEATURES OF THE STANDARDS

Availability

20 Private enterprises reporting in accordance with Canadian GAAP may use the standards applicable to publicly accountable enterprises (IFRSs in Part I of the Handbook) or the accounting standards for private enterprises in Part II of the Handbook.

21 Any private enterprise can use the accounting standards for private enterprises. There is no size test or other qualifier to use these standards. The AcSB set out its rationale for not adopting a size test in the 2007 Invitation to Comment and Discussion Paper, as follows:

(a) all private enterprises are distinguishable from publicly accountable enterprises on the basis of accountability; and

(b) the public policy issue regarding economic significance, which has resulted in large private enterprises publishing their financial statements in certain other jurisdictions, does not appear to be relevant in Canada.

The vast majority of respondents agreed with the AcSB's conclusion and rationale on this issue.

Free choice

22 Use of the accounting standards for private enterprises is a free choice. Unlike the requirements to use differential reporting, unanimous consent of shareholders is not required. Some stakeholders noted that obtaining unanimous consent was a barrier for private enterprises wishing to adopt differential reporting. Others noted that consent was required only from shareholders even though the most significant external users of private enterprises' financial statements are usually lenders. The unanimous consent provisions in differential reporting were, in part, due to differential reporting being a part of standards that applied to public and private enterprises. The AcSB concluded that a set of standards for private enterprises developed with input from all categories of constituents and through full due process should be available to all private enterprises.

23 The accounting standards for private enterprises provide an individual enterprise with a choice of accounting treatments on several topics. Use of each of these options is a free choice, not subject to the requirements in ACCOUNTING CHANGES, paragraph 1506.06(b), to assess the relevance and reliability of the information produced by accounting policy alternatives. The AcSB based this decision on practical considerations. The AcSB thinks that entities should be able to use the simplifications provided by some of the alternative treatments without having to demonstrate relevance and reliability. A few Exposure Draft respondents disagreed with this proposal, arguing that it would allow management to change accounting policies to avoid recognizing or disclosing matters of relevance to a user. The AcSB considered this argument and noted that:

(a) changing policies has inherent costs, which will likely deter private enterprises from changing policies on a frequent basis; and

(b) this exemption is a result of applying cost / benefit considerations underlying the simplified accounting policies. Consequently, when the AcSB has provided an optional simplification, allowing policy choices that may produce less relevant information is similarly acceptable because the costs of achieving greater relevance may outweigh the benefits.

24 Research into user needs indicated that a significant number of users do not favour a "menu" approach that allows entities to choose accounting treatments on particular topics (for example, to consolidate or not consolidate subsidiaries or to follow the taxes payable or future taxes method in accounting for income taxes). These users argued that providing a large number of policy alternatives can make it significantly more difficult to analyze and compare financial statements and voiced support for an "all or nothing" approach. Under an "all or nothing" approach, private enterprises would follow substantially the same accounting policies or would have a restricted set of policy choices.

25 The AcSB noted this view and kept the number of policy choices to a minimum. In several cases, the AcSB required private enterprises to use a simplified method of accounting rather than allowing that method as an alternative treatment (for example, with goodwill impairment testing and classification of preferred shares issued pursuant to specific tax-planning arrangements). However, in other areas, the AcSB concluded that the simplified method should be optional to allow private enterprises to be comparable with public enterprises and to allow individual enterprises to conduct their own cost / benefit assessments in selecting accounting policies. During the course of discussions, several users on the Advisory Committee noted that under the accounting standards for private enterprises, users may need to take a more pro-active approach in indicating which policies they wish individual enterprises to use than has been the case under differential reporting.

Stand-alone standards

26 The accounting standards for private enterprises are a stand-alone set of standards (i.e., they do not require reference to another set of standards to address some issues or for additional guidance on others). Exposure Draft respondents did not favour a system that required significant knowledge and understanding of the standards applicable to publicly accountable enterprises, as this would increase preparers' education and training requirements.

27 The Exposure Draft proposed several changes to GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, largely to modify the GAAP hierarchy to remain internally consistent (for example, to reflect the elimination of Emerging Issues Committee Abstracts of Issues Discussed). Some Exposure Draft respondents noted that the references in Section 1100 to other standards such as IFRSs or US GAAP might give the impression that an enterprise should look to those sets of standards. The AcSB did not intend this interpretation and amended the wording in Section 1100 accordingly.

Conceptual framework

28 After reviewing the attributes of the conceptual framework, the AcSB concluded in the 2007 Discussion Paper that the conceptual framework is relevant to financial reporting by both public and private enterprises. However, differences in the application of the concepts in the conceptual framework might be justified. The AcSB decided that the application of cost / benefit considerations, as set out in the conceptual framework, would result in accounting that was largely similar for the two sectors but appropriately addressed their differences. This proposition was widely accepted by respondents to the Invitation to Comment, who agreed that stakeholders would be confused by fundamental differences in the building blocks of financial reporting for different categories of reporting entities.

29 On these grounds, the Exposure Draft retained the existing conceptual framework in financial statement concepts, Section 1000, which is consistent with the International Accounting Standards Board's *Framework for the Preparation and Presentation of Financial Statements*. The International Accounting Standards Board has a joint project with the US Financial Accounting Standards Board to develop an improved common conceptual framework. Over time, the AcSB intends that Section 1000 will be updated to remain consistent with the International Accounting Standards Board's conceptual framework. Although the AcSB did not ask a specific question in the Exposure Draft about this issue, several respondents commented on it, with a few respondents arguing for a separate and distinct framework for private enterprise standards. The AcSB reviewed the arguments put forth by these respondents but did not change its view on this issue.

Future changes

30 The accounting standards for private enterprises will not be static. Any high-quality set of accounting standards must evolve in order to address current reporting needs in a changing business environment. In comparison to publicly accountable enterprises, private enterprises generally have fewer resources to devote to keeping up to date with standards. The AcSB will update the accounting standards for private enterprises on an annual or biennial basis, with each update potentially consisting of changes to several standards that would all be effective at the same time. The AcSB believes that this bundling of changes will be sensitive to the needs of this sector.

31 In general, the AcSB does not intend to make changes to the accounting standards for private enterprises for some time following their finalization, so that stakeholders in the private enterprise sector have time to absorb and become familiar with them. However, the AcSB will make exceptions for Appendix B of FINANCIAL INSTRUMENTS, Section 3856 (as carried forward from ACCOUNTING GUIDELINE AcG-12, Transfers of Receivables), and AcG-15, Consolidation of Variable Interest Entities. This guidance is based on parts of US GAAP that are recognized as needing improvement and international projects are underway to address these topics. The AcSB will consider changes for these two topics subsequent to finalization of the international projects.

32 Future changes to IFRSs will be considered to determine the extent that they are appropriate for Canadian private enterprises. Input received from stakeholders supported reviewing IFRSs for potential changes to the accounting standards for private enterprises, as this minimizes confusion in the marketplace and the educational and training burden for those who need to work with both sets of standards.

33 Some stakeholders expressed a concern that accounting standards for private enterprises would be a short-term solution and that the AcSB would adopt IFRSs or the IFRS for SMEs for this sector shortly after publicly accountable enterprises complete their transition to IFRSs. The AcSB confirmed that it intends the accounting standards for private enterprises to be a long-term solution that will exist as long as the standards remain appropriate for this sector. Applying the accounting standards for private enterprises for only a few years before adopting a different set of standards would not pass a cost / benefit test for the AcSB or its stakeholders. Consistent with good practice, the AcSB will periodically evaluate whether the accounting standards for private enterprises remain the most appropriate basis of financial reporting for Canadian private enterprises. The AcSB will undertake such an evaluation no sooner than five years after publication of the standards.

RECOGNITION, MEASUREMENT AND PRESENTATION ISSUES

34 The various consultations and feedback received from stakeholders during the research phase of the project indicated that only a limited number of specific issues caused significant difficulty for private enterprises. Accordingly, the AcSB focused on the most critical areas in considering the need for changes from the starting point, and compiled a list of the most significant issues for private enterprises based on:

(a) experience with differential reporting;

(b) input received during the development of the CICA's Framework for Owner-Managed Enterprises proposals and responses to that document; and

(c) input from stakeholders.

35 The significant issues identified were:

(a) asset retirement obligations;

(b) classification of callable debt;

(c) consolidations, joint ventures and significantly influenced investees;

(d) employee future benefits;

(e) financial instruments;

(f) future income taxes;

(g) impairment of goodwill and other intangible assets;

(h) internally developed intangible assets;

(i) leases; and

(j) stock-based compensation.

36 To ensure completeness, the list of significant issues was discussed at various roundtable meetings and during other consultations, and posted on the AcSB website. To complete the initial version of the accounting standards for private enterprises in a timely manner, the AcSB limited substantive changes in recognition, measurement, and presentation requirements to these areas. The Exposure Draft validated this list, in that no broad-based request for additional items to be addressed was received.

37 Changes were considered based on cost / benefit considerations. The AcSB noted that "costs" should include preparation costs, communication costs, specialized expertise costs, and related assurance costs. Costs include not only preparer costs but also the costs to users of receiving inadequate information and having to understand accounting differences across several sets of standards. In addition, the AcSB considered the costs related to education and training, specifically as they relate to the standards that differ from IFRSs.

38 "Benefits" were assessed in relation to user needs, specifically whether the information conveyed under an existing accounting standard benefits financial statement users in this sector. The AcSB relied on the information collected during its previous research into user needs, as well as the perspectives of the users on the Advisory Committee to guide its assessment of benefits. The AcSB's research indicated that creditors are the most frequent user of private enterprise financial statements. Other users, such as minority shareholders and guarantors, are encountered much less frequently in practice. Accordingly, while the needs of all users were considered, the most weight was given to the needs of creditors. A key difference between the private enterprise sector and the publicly accountable enterprise sector is that private enterprises are not subject to the significant requirements and constraints imposed on publicly accountable enterprises concerning the dissemination of information. In general, it appears that many users in the private enterprise sector can get financial information beyond that contained in the financial statements from an enterprise on request.

Asset retirement obligations

39 Some financial statement preparers believed that calculating asset retirement obligations in accordance with the requirements of ASSET RETIREMENT OBLIGATIONS, Section 3110, in the pre-changeover standards, 2 is complex and costly, without commensurate benefit to users. An accretion approach was suggested wherein an enterprise accretes the obligation over time on a straight-line basis, similar to the accounting used prior to the issuance of Section 3110. The AcSB noted that the liability recorded in the balance sheet under an accretion approach is not a faithful measure of the asset retirement obligation. Accretion was considered and rejected in adopting Section 3110. The AcSB agreed that there should not be a different conclusion with respect to the appropriateness of an accretion method based on whether an enterprise is public or private.

40 In the pre-changeover standards, Section 3110 required initial measurement of asset retirement obligations at fair value and provided detailed guidance on how this fair value should be estimated. Some of those requirements created difficulties for many private enterprises. For example, a credit-adjusted risk-free discount rate and a profit margin if the enterprise itself will perform the work to satisfy the obligation are factors that may be difficult to determine. From a benefits perspective, users on the Advisory Committee found little value in the specific requirements regarding measurement of an asset retirement obligation, recognizing that the measurement of the obligation involves significant estimation. The preference of the users consulted was for a measurement based on a less prescriptive "best estimate" approach.

41 Given this assessment of costs and benefits, and a desire for the standards to be easier to apply and provide scope for professional judgment, the Exposure Draft proposed adoption of the relevant provisions of International Accounting Standard IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Under this approach, asset retirement obligations are measured at the end of each period at the best estimate of the future expenditures required to settle the present obligation. This approach does not require credit-adjusted discount rates or estimated profit margins.

42 Only a few Exposure Draft respondents commented on this issue. These respondents agreed with the proposed approach, suggesting clarification in respect of a few specific issues. The AcSB discussed these comments and clarified specific aspects of the Exposure Draft proposals.

Consolidations, joint ventures and significantly influenced investees

43 In the pre-changeover standards, SUBSIDIARIES, Section 1590, included a differential reporting option that allowed subsidiaries to be accounted for on either the cost or equity basis instead of being consolidated. The scope of that differential reporting option extended to other pre-changeover standards. INVESTMENTS, Section 3051, and INTERESTS IN JOINT VENTURES, Section 3055, contained similar differential reporting options for investments in which there is significant influence and interests in joint ventures.

44 The AcSB understood that these differential reporting options had been widely used in practice, and that the cost / benefit arguments considered in creating these options had remained substantially unchanged. Accordingly, the Exposure Draft proposed including these alternatives in the accounting standards for private enterprises.

45 Several Exposure Draft respondents addressed this issue, with a few respondents disagreeing with the alternative of non-consolidated statements. These respondents provided essentially the same arguments that were considered when the differential reporting option was created; accordingly, the AcSB did not change its view with respect to non-consolidation. Other respondents expressed concern with respect to the retention of ACCOUNTING GUIDELINE AcG-15, Consolidation of Variable Interest Entities.

46 The AcSB understood that AcG-15 could be problematic to apply, often requiring significant effort to determine whether an enterprise has a variable interest in another entity and, if so, whether to consolidate that entity. It considered replacing AcG-15 with the corresponding requirements in IFRSs 3 but noted that an international project on consolidations was underway. The AcSB did not believe that implementing multiple changes in the short term would serve the needs of private enterprises. On this basis, the AcSB decided to wait until completion of the international project at which time it will consider whether private enterprise standards should include similar guidance. Given that the issue is not a pervasive concern to all private enterprises, that an enterprise can avoid this issue by preparing non-consolidated financial statements, and that the publication of new standards in this area is imminent, the AcSB retained AcG-15 in the initial set of accounting standards for private enterprises.

Employee future benefits

47 The AcSB noted that most private enterprises do not have traditional defined benefit pension plans for their employees. However, in recent years, private enterprises have increasingly used "individual pension plans." The AcSB was informed that virtually all individual pension plans are defined benefit plans and that the beneficiaries of such plans are frequently the owner-managers of an enterprise. However, beneficiaries can also include key employees, minority equity investors or others. Accordingly, the issue considered was accounting for defined benefit plans of this general type.

48 Accounting for individual pension plans in accordance with the pre-changeover standards can be complex and costly. An actuarial valuation for accounting purposes is required in addition to that required for funding and regulatory purposes. Discussions with actuaries and accounting practitioners indicated that the costs of this additional valuation for a plan could exceed $1,500. Setting up and maintaining the accounting for such plans adds further costs. These costs are often significant in relation to the size of an individual pension plan.

49 Some stakeholders suggested that private enterprises should be allowed to account for individual pension plans on a cash basis (i.e., expense the contributions as they are made). Such an approach would result in not recognizing a pension liability for an underfunded plan that will require future contributions to fund current obligations. The AcSB found such a result misleading and, accordingly, rejected this suggestion. Several Exposure Draft respondents also argued in favour of allowing a cash basis of accounting. The AcSB noted that these responses did not present any facts or information it had not previously considered and, accordingly, did not change its view with respect to the appropriateness of the cash basis of accounting for defined benefit plans.

50 The Exposure Draft proposed a simplified method of accounting for individual pension plans structured for the benefit of a controlling owner (controlling owner plans). Users informed the AcSB that they generally view liabilities for controlling owner plans as different from liabilities for defined benefit plans for employees. An owner can unilaterally extinguish a controlling owner plan without repercussion to the enterprise. In addition, it is common practice that these plans are unwound when there is a change in control. Accordingly, users view these plans as tax-planning arrangements and are generally less interested in understanding the reported amount of the obligation. Users did not believe that plans whose beneficiaries were employees or minority shareholders shared the same characteristics as controlling owner plans.

51 The AcSB received a number of responses to its Exposure Draft proposal on this issue, with many commenting on the scope of the proposed simplification. The majority of these respondents argued for expansion of the scope of the simplification, with several suggesting that it should be applicable to any defined benefit plan. These arguments noted that many private companies have plans that do not meet the proposed definition of a controlling owner plan and that the cost / benefit considerations are applicable to these other plans. The AcSB considered these arguments and, after consulting with accountants and actuaries knowledgeable in this area, as well as financial statement users, agreed to expand the scope of the simplified method so that it is available for any defined benefit plan.

52 The Exposure Draft proposed the following simplifications:

(a) use of the actuarial valuation for funding purposes in place of an actuarial valuation for accounting purposes; and

(b) elimination of smoothing mechanisms.

Private enterprises would be permitted an accounting policy choice between the accounting requirements in the pre-changeover standards and the simplified method. There were no substantive comments from Exposure Draft respondents with respect to the proposed simplifications. Accordingly, the final standards reflect these simplifications.

53 As noted above, the accounting for defined benefit plans required a separate valuation for accounting purposes. As a result of discussions with financial statement users, the AcSB noted that use of the funding valuation for accounting purposes would not result in a significant loss in decision-useful information, and would eliminate the cost of an additional valuation for accounting purposes. The frequency of funding valuations varies by jurisdiction but a pension plan does not necessarily have a valuation each year. The AcSB decided that in the years that an actuarial valuation of the obligation is not performed, the obligation could be estimated under the simplified method and included guidance on how this should be done. However, the AcSB was concerned that it was possible that a plan might not have a funding valuation for several years and, as a result, the estimate of the obligation may become unreliable. Therefore, the AcSB decided to require a funding valuation at least once every three years, with disclosure of the effective date of the most recent actuarial valuation for funding purposes.

54 The AcSB also considered the related costs of accounting for defined benefit plans, specifically as they relate to the deferral of gains and losses. The pre-changeover standards permit the deferral of actuarial gains and losses and past service costs, with the deferred amounts amortized into income over time. This requires accounting effort to keep track of the deferred amounts and to calculate the appropriate amortization each period. Users stated that they use the full pension obligation in their analysis and that deferring actuarial gains and losses and past service costs is not useful. Therefore, the AcSB decided that the amount reported in the balance sheet under the simplified method should be the net of the pension obligation and the plan assets at the balance sheet date, with no amounts deferred. The full effect of any change in the net plan asset or obligation is reported in income.

55 The AcSB noted that a defined benefit 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 standards be more principles based, the AcSB decided to require a valuation allowance be recognized for any excess of the plan surplus over the amount expected to be recoverable by the entity under the simplified method but not to include the specific guidance provided on this issue under the deferral and amortization approach.

Financial instruments

56 The AcSB agreed with stakeholders that the financial instrument standards for publicly accountable enterprises are complex and often require resources that are beyond those cost-effectively available to many private enterprises. Further, financial statement users indicated that their needs with respect to private enterprises are not met by these standards. For these reasons, the AcSB had not required private enterprises to adopt the recognition and measurement requirements for financial instruments in the pre-changeover standards. Concerns expressed by stakeholders, and how they were addressed, include the following:

(a) Obtaining fair value estimates for financial instruments that are not traded in an active market requires sophisticated financial modeling and access to a variety of market price sources. FINANCIAL INSTRUMENTS, Section 3856, avoids the need for modeling to estimate fair value in most cases.

(b) Determining impairment losses on financial instruments is complex due to multiple models in existing standards. Section 3856 specifies a single impairment model that applies to all financial assets that are not measured at fair value.

(c) Hedge accounting is complex in both measurement and determination of effectiveness. Section 3856 avoids this complexity but is more limited in scope than the model available to publicly accountable enterprises.

Therefore, the AcSB decided not to use the pre-changeover standards as the starting point in developing standards for financial instruments but to develop a new Handbook Section (Section 3856) that is comprehensive and consolidates the requirements for financial instruments in one place, making it easier to locate relevant guidance for similar items.

57 The AcSB confirmed that most aspects of the principles underlying the accounting standards for financial instruments for publicly accountable enterprises should apply to private enterprises for the following reasons:

(a) Financial instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.

(b) Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments.

(c) Only items that are assets or liabilities should be reported as such in financial statements.

(d) Special accounting for items designated as being hedged should be provided only for qualifying items.

Modifications to these principles were made only when the cost to apply the principle exceeded the benefit to the users of private enterprise financial statements. Consequently, for many financial instruments, the use of fair value has not been required because the benefit to the users of the financial statements is lower than the cost to obtain the information.

58 Alternative treatments reduce comparability in financial reporting between enterprises in similar businesses. Users incur increased costs to analyze financial statements and draft appropriate agreements. Consequently, users prefer consistency in treatment among similar enterprises. To reduce complexity, the Exposure Draft proposed two alternative treatments for financial instruments. An entity would choose among three possible measurements for the equity portion of convertible debt and would choose whether to apply hedge accounting. Many requests were received for additional optional treatments. The AcSB added the following options in response to these comments:

(a) an entity may elect to measure any financial instrument at fair value when it is initially recognized or when an equity instrument ceases to trade in an active market; and

(b) in addition to providing the ability to measure the equity portion of convertible debt at zero, warrants or options issued with and detachable from financial liabilities may also be measured at zero.

Recognition

59 Section 3856 requires all financial instruments to be recognized on the date the reporting entity becomes a party to a contract to buy or sell a financial instrument. The AcSB concluded that trade date accounting more accurately reflects the economic effects of transactions and is the only recognition date that provides transparency for derivatives.

Initial measurement

Arm's length transactions

60 The AcSB decided that, consistent with the standards applied by publicly accountable enterprises, all financial instruments created in transactions with arm's length parties should be measured at fair value. Some Exposure Draft respondents thought that low interest rate loans should be measured initially at their proceeds because owners and financial statement users need direct information about cash flows. The AcSB disagreed with these comments because cost measurement fails to represent either the nature of the transaction or the relationship between the parties. Appendix A to Section 3856 expands on the definition of fair value and provides guidance on determining the fair value of a financial instrument when part of the transaction price relates to something other than the financial instrument. This guidance is consistent with GOVERNMENT ASSISTANCE, Section 3800. Appendix A also provides the same guidance on measuring the initial fair value of a demand loan as that included in International Accounting Standard IAS 39 *Financial Instruments: Recognition and Measurement* in Part I of the Handbook.

Related party transactions

61 The AcSB concluded that most related party transactions involving financial instruments should be measured in accordance with RELATED PARTY TRANSACTIONS, Section 3840, because it is inappropriate to create gains or losses by transferring financial instruments between related parties. However, the AcSB decided that a financial instrument transaction with an individual or entity related to the reporting entity solely by virtue of a management relationship should be measured at fair value to reflect the true cost of services provided by the related party.

Transaction costs

62 The Exposure Draft proposed that all transaction costs be expensed to simplify accounting. Many Exposure Draft respondents requested that transaction costs be capitalized. The AcSB agreed that transaction costs incurred to acquire or issue financial instruments measured at amortized cost should be included in the initial carrying amount of the related asset or liability. The AcSB noted that capitalization of transaction costs is consistent with standards in Part I of the Handbook and with the IFRS for SMEs. Transaction costs related to financial instruments measured at fair value are expensed in the period the asset or liability is recognized because they are not part of the fair value of the financial instrument and they do not meet the definition of an asset necessary for separate recognition.

63 To simplify subsequent measurement of financial assets and liabilities on which transaction costs have been capitalized, FINANCIAL INSTRUMENTS, Section 3856, does not specify the method to be used to amortize transaction costs associated with interest-bearing instruments. To address concerns about transparency of cash flows, the standard also permits presentation of amortization as a separate component of interest income or expense. The AcSB noted that the cost to use the effective interest method is prohibitive relative to the usually nominal difference in net income between this method and other amortization methods.

Subsequent measurement

64 Stakeholders in the private enterprise sector have repeatedly stressed that reporting fair value information for financial instruments other than those that are traded in an active market requires them to incur significant costs in obtaining prices and rates, calculating fair values and in additional costs of attestation. Accordingly, Section 3856 requires financial assets and financial liabilities to be measured at cost or amortized cost with the exception of:

(a) freestanding derivatives outside qualifying hedging relationships;

(b) equities that are traded in an active market; and

(c) financial instruments that the entity elects to measure at fair value either at initial recognition or when an equity instrument ceases to be traded in an active market.

65 Many respondents requested changes to the measurement requirements proposed in the Exposure Draft (fair value measurement would be applied only to traded equity investments and derivatives outside qualifying hedging relationships). Several respondents preferred that all investments be measured at cost or amortized cost with fair values disclosed. Some noted that cost or amortized cost was necessary for consistency with non-financial investments such as real estate. Others thought that the standard should permit or require more extensive use of fair value measurement. Some thought that fair value measurement should not be required for derivatives. The AcSB's conclusions with respect to the measurement of various types of instruments are set out below.

66 The AcSB did not agree with respondents who argued that the measurement basis for investments in financial instruments should be the same as for investments in non-financial items such as real estate. The values of significant real estate investments tend to be more transparent than many financial instruments.

Interest-bearing financial assets

67 FINANCIAL INSTRUMENTS, Section 3856, permits, but does not require, fair value measurement of debt instruments. Lenders advised the AcSB that the amortized cost of a debt instrument provides more relevant information than its fair value for their analysis of the financial statements of a private enterprise.

68 Exposure Draft respondents noted that some private enterprises invest in debt and equity instruments with a similar objective. The AcSB agreed that requiring the use of different measurement bases for similar financial assets does not always meet the needs of owners or other financial statement users. Some respondents also noted that many debt instruments contain features that alter their payment structure in such a way that amortized cost measurement does not provide appropriate information about the instrument.

69 The AcSB concluded that the ability to elect fair value measurement for any financial instrument at initial recognition allows a private enterprise to report investments on a consistent basis or in a manner that best reflects the nature of the instrument. In some cases, fair value measurement will also be easier and less costly than maintaining amortization schedules.

Indexed debt

70 Private enterprises often issue debt that requires payments determined by factors such as the value of the enterprise's equity or performance measures such as earnings before interest, taxes, depreciation and amortization. FINANCIAL INSTRUMENTS, Section 3856, prescribes a simplified model to account for the potentially negative effect of these indexing terms that avoids fair value measurement. At each reporting date, the enterprise reports the higher of the amortized cost of the debt or the amount that would be payable if the indexing formula were applied at that date. The adjustment for changes in value of the embedded feature are recognized immediately in net income as a separate component of interest expense. The AcSB decided that this measurement, together with disclosure of the terms of the liability, best meets the information needs of financial statement users.

Equity instruments

71 Responses were mixed on the proposed requirement to measure investments in traded equities at fair value. Some argued that, when available, fair value measurement should be permitted for untraded equity investments for consistency with traded securities. Others argued that the requirement for fair value measurement was inappropriate for a variety of reasons including:

(a) the information is out of date by the time the financial statements are prepared;

(b) the volatility in net earnings created by changes in fair value is confusing;

(c) fair value measurement is inconsistent with the measurement of non-financial investments such as real estate; and

(d) fair value measurement is inconsistent with measurement for tax purposes.

72 The AcSB believes that fair value is the most relevant measure for traded equity instruments. The AcSB disagreed with respondents who requested cost measurement for investments in equities. The AcSB noted that cost is rarely an indication of the value of a traded equity instrument to an investor. Unlike debt instruments, equity instruments have no maturity and their fair value is unlikely to return to their cost to the investor. Fair value measurement provides the best indication of the future cash flows that could result from an enterprise's investment in a traded equity instrument. Fair value measurement also more accurately reflects the risk the entity has undertaken in making each investment in a traded equity instrument. Investments in equity instruments that are not quoted in an active market are often difficult and costly to measure at fair value. Users do not rely on estimates of the fair value of untraded equity investments reported in the financial statements of private enterprises. Accordingly, and in common with standards applicable to publicly accountable enterprises, these investments are measured at cost unless the entity elects to report them at fair value.

73 The AcSB noted that judgment is necessary in some cases to determine whether a particular security is an equity instrument that is traded in an active market. For example, the AcSB observed that investments that are conduits for traded securities, such as pooled or mutual fund units, might meet the criteria for fair value measurement if the investments are liquid and prices for the units reflect the net asset value of the underlying pool. The ability to elect fair value measurement for any financial instrument at initial recognition makes it easier to measure investments with similar characteristics in the same manner when some are actively traded and others are not. The fair value option can also be used to continue fair value measurement when an equity instrument ceases to be traded in an active market.

Derivatives

74 The AcSB believes that fair value is the only relevant measure for derivative financial instruments. The cost of a derivative is often zero, yet a derivative generally can be settled or sold at any time for its fair value. If derivative financial instruments are not measured at fair value, they are often invisible on the balance sheet yet have the potential to create significant future cash flows. Gains and losses that may change disproportionately in response to market movements are reported only when the derivative is settled or sold, rather than in the period in which the change in fair value occurred. Information about the value of derivatives and the gains and losses resulting from changes in those values is essential for users of financial statements to understand the nature of the risk exposures associated with derivative financial instruments.

75 Some respondents argued that fair value measurement of derivatives does not provide meaningful or relevant information to the users of private enterprise financial statements. They contended that fair value is not necessarily indicative of the effect derivatives will have on the cash flows of the entity. Some suggested that foreign exchange contracts, in particular, are not used for speculative purposes so the volatility created by fair value measurement would be misleading.

76 The AcSB decided that the cost-based hedge accounting model in FINANCIAL INSTRUMENTS, Section 3856, provides an acceptable alternative to fair value measurement for derivatives that have a predictable effect on future cash flows. In all other circumstances, fair value is the only measurement that reflects the risks and rewards of engaging in derivative contracts. The AcSB concluded that it is reasonable to expect that entities using derivatives other than in qualifying hedging relationships have sufficient sophistication to calculate fair values of those derivatives or to understand fair value information provided by bankers or professional advisors.

77 Derivatives that are based on, and require settlement by, delivery of another enterprise's equity instruments for which fair value cannot be readily determined are measured at cost. When the fair value of these instruments is not reliably measurable or is difficult and costly to estimate, users have indicated that their information needs are adequately met by qualitative information.

Fair value

78 Many Exposure Draft respondents expressed concern with finding information suitable for estimating fair values. To simplify fair value measurement, the AcSB decided to permit the use of the proxies for fair value described in Appendix A to FINANCIAL INSTRUMENTS, Section 3856. Closing prices may be used to measure traded equities. This is the simplest and most accessible price information for these investments. Non-option derivatives may be measured using mid-market prices or rates, consistent with prices that would be supplied by banks. Mid-market prices might also be used for over-the-counter options in place of bid prices for purchased options and ask prices for issued options. The AcSB recognized that option valuation is complex so the standard permits some flexibility, provided the price or rate chosen is applied consistently. However, although Section 3856 permits some practical expedients, the fair value of a financial instrument includes the credit quality of the instrument.

Impairment

79 Under the pre-changeover standards, private enterprises applied one of three standards with differing requirements to determine whether various types of financial asset are impaired. The AcSB concluded that a single impairment model with practical measurement requirements that applies to all financial assets is less costly to preparers and auditors and easier for users to understand.

80 FINANCIAL INSTRUMENTS, Section 3856, requires the impairment loss to be determined on the basis of the difference between the current carrying amount of the asset and the cash flows the enterprise could expect to receive in the most favourable outcome. The standard identifies three possible measures depending on the source of the cash flows. The AcSB concluded that private entities can determine the most relevant measure for their individual assets and circumstances by applying judgment.

81 The AcSB noted that existing procedures for determining an allowance for doubtful accounts receivable were well established and did not need changing. The impairment process in Section 3856 should not create differences from the pre-changeover standards in the calculation of the allowance.

Derecognition

82 Section 3856 includes the guidance on derecognition of financial liabilities previously applicable to all entities. In response to comments received on the Exposure Draft, guidance from Emerging Issues Committee Abstracts EIC-88, Debtor's Accounting for a Modification or Exchange of Debt Instruments, and EIC-101, Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements, was added to Appendix A to assist with the interpretation of the requirements for derecognition of liabilities.

83 Section 3856 includes guidance from International Financial Reporting Interpretations Committee Interpretation 19 *Extinguishing Financial Liabilities with Equity* (IFRIC 19). The requirements of ACCOUNTING GUIDELINE AcG-12, Transfers of Receivables, in the pre-changeover standards, have also been included as Appendix B to Section 3856 to provide guidance in a complex area of accounting. As previously noted, the AcSB will reconsider the guidance in Appendix B when new IFRS derecognition requirements are finalized.

Liabilities and equity

84 The guidance in Section 3856 on classifying financial instruments as either liabilities or equity is based on that in FINANCIAL INSTRUMENTS — PRESENTATION, Section 3863, in the pre-changeover standards. To address concerns raised by stakeholders, the AcSB included the following simplifications:

(a) the equity component of a convertible financial liability and warrants issued with and detachable from a financial liability may be measured at zero; and

(b) redeemable preferred shares issued in a tax reorganization must be classified as equity.

Convertible debt

85 Many private enterprises grant equity options because doing so is a condition of obtaining debt financing. Venture capital lenders use the option both to obtain control over higher risk borrowers, if necessary, and to enhance the potential return from the loan. Section 3856 allows the choice of one of three alternative measurements for equity conversion options attached to financial liabilities:

(a) at zero;

(b) by using the residual value method; or

(c) by using the relative fair value method.

The AcSB agreed to include these alternatives because stakeholders advised that bifurcating and measuring the equity component is expensive for the preparer but does not produce information that is relevant to users of the financial statements.

86 When an enterprise is unable to obtain financing without providing an equity option, there will be no market interest rate available for a loan with similar terms but without the conversion option. In these cases, it is difficult to measure the

value of the option based on the fair value of the debt without a conversion option. Measurement of embedded equity options often requires engaging valuation specialists at a cost that outweighs the benefit of the information produced.

87 In analyzing financial statements, lenders have stated that they add back to the liability the amount allocated to the equity component. Other financial statement users also prefer that the liability be measured at the face amount of the obligation. Public practitioners advised that reviewing or auditing the amount allocated to the equity component is complicated and increases the cost of an assurance engagement.

88 The AcSB confirmed that convertible debt should be bifurcated to reflect the different economic characteristics of the liability and equity components. Further, separate classification is reconsidered only if the terms of the financial instrument are modified. However, the AcSB was persuaded that the equity component might be allocated no value on the basis that the cost to estimate a value exceeds any benefits of performing the calculation or reporting the amount calculated. FINANCIAL INSTRUMENTS, Section 3856, requires disclosure of the nature and terms of the conversion feature.

89 The AcSB agreed with Exposure Draft respondents that noted that the requirements for measurement of warrants issued with, but detachable from, financial liabilities should provide the same options as for conversion options. Stakeholders argued that the circumstances under which detachable warrants are issued are the same as those under which conversion options are included in debt instruments. The AcSB decided that an enterprise could elect to measure these warrants at zero.

90 Guidance was also added to Appendix A to FINANCIAL INSTRUMENTS, Section 3856, from elements of IFRIC 19 *Extinguishing Financial Liabilities with Equity*, and Emerging Issues Committee Abstracts EIC-96, Accounting for the Early Extinguishment of Convertible Securities Through (1) Early Redemption or Repurchase and (2) Induced Early Conversion, and EIC 164, Convertible and Other Debt Instruments with Embedded Derivatives, to clarify the treatment of conversions, induced early conversions and extinguishments.

Preferred shares

91 Stakeholders advised the AcSB that many private enterprises use retractable shares to protect the interests of continuing shareholders on the retirement or death of former employees or shareholders. The guidance in Emerging Issues Committee Abstract EIC-149, Accounting for Retractable or Mandatorily Redeemable Shares had been helpful in distinguishing between retractable shares that should be treated as liabilities and those that are treated as equity. Accordingly, key aspects of that guidance were included in Section 3856.

92 The pre-changeover standards provided a differential reporting option permitting private enterprises to treat as equity mandatorily redeemable shares issued pursuant to a tax reorganization effected under one of several specified Income Tax Act (Canada) sections. The AcSB was informed that many private enterprises elected equity classification using the differential reporting option.

93 Redeemable shares issued in tax planning arrangements meet the definition of a liability. However, their terms are constructed to achieve a particular tax outcome. External lenders usually protect their loans by prohibiting redemption of the shares other than on the death of a shareholder by requiring the shares to be subordinated to all external financing. Lenders advised that they classify the shares as equity for the purpose of conducting their analyses even if the differential option is not chosen.

94 Classifying these shares as equity achieves consistency between enterprises. Lenders also commented that presenting the shares as equity gives a more realistic picture of the enterprise since the shares tend to crystallize the value of the enterprise that is held in unrecognized intangible assets. Solvency and liquidity measures would be misstated if the shares are classified as liabilities.

95 The AcSB considered whether to accord equity treatment to all shares issued without an infusion of cash but determined that only those issued pursuant to the specified Income Tax Act sections behave in a manner analogous to equity. The AcSB also considered whether there were other reorganization structures permitted by the Income Tax Act that create shares that meet the criteria of the listed sections. After further consideration, the AcSB confirmed that redeemable preferred shares issued in tax planning arrangements differ from other redeemable preferred shares in that tax planning arrangements do not involve financings in the traditional sense.

96 The AcSB noted that retaining the option to treat redeemable preferred shares issued in a tax planning arrangement as liabilities would permit comparability with publicly accountable enterprises. However, private enterprises are not precluded from adopting the standards in Part I of the Handbook should comparability with publicly accountable enterprises be desired.

97 Specific disclosures are required to alert financial statement users to the potential for future cash outflows that these shares present, should the preferred shareholders decide to retract them. Disclosure on the face of the balance sheet of the total redemption amount for all such shares outstanding is required to alert users to the special nature of the arrangement.

98 The existence of scheduled redemptions does not alter equity classification of the shares. The AcSB observed that redemption schedules are frequently modified with changes in the economic circumstances of the enterprise. The enterprise discloses scheduled redemptions in each of the next five years.

Presentation of interest, dividends, gains and losses

99 FINANCIAL INSTRUMENTS, Section 3856, permits, but does not require, presenting amortization as a separate component of interest income or expense in such a way that the amounts relating to amortization are shown separately from the cash interest accrued. The AcSB concluded this flexibility will achieve cost savings and provide more useful information for affected enterprises.

100 Section 3856 requires presentation of all gains and losses in net income. Standards applicable to publicly accountable entities require use of other comprehensive income to record certain gains and losses temporarily. Other comprehensive income would increase bookkeeping complexity and would not improve the ability of financial statement users to understand the financial statements. Accordingly, the AcSB decided against adopting an other comprehensive income treatment.

Hedge accounting

101 Hedge accounting provides special accounting treatment for either or both of the item creating a risk and the item providing the offset that neutralizes that risk. Hedge accounting is always optional and is applied only when accounting requirements for the two items create an accounting mismatch. To prevent abuse, hedge accounting requires strict adherence to a number of qualifying conditions.

102 FINANCIAL INSTRUMENTS, Section 3856, provides relief from fair value measurement for derivatives that qualify and are designated as hedging instruments. To qualify for hedge accounting, the derivative must exactly offset a specific risk of the hedged item. Only in this way does the entity mitigate the volatility inherent in either the hedged item or the hedging item. Disclosures are required to alert financial statement users to the existence and effect of each hedging relationship. The limited scope hedge accounting model in Section 3856 is designed to assist entities that:

(a) use forward contracts to offset the terms of purchase and sale contracts or future foreign currency cash flows;

(b) offset interest rate risk with interest rate swaps;

(c) offset both interest rate and currency risk with cross currency interest rate swaps; or

(d) hedge the effect of changes in foreign currency exchange rates on the net investment in a self-sustaining foreign operation with either a derivative or a non-derivative financial instrument.

103 The criteria that must be met to qualify for hedge accounting under Section 3856 are similar to those in IAS 39 *Financial Instruments: Recognition and Measurement* in Part I of the Handbook. However, Section 3856 does not include a 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 qualify for hedge accounting only 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 hedging model in IAS 39.

104 Non-derivative financial instruments are permitted as hedging items only for the foreign currency risk of the net investment in a self-sustaining foreign operation. Foreign exchange gains and losses on non-derivative financial instruments are recognized in net income, other than those relating to a net investment in a self-sustaining foreign operation. Accordingly, there is no income statement mismatch if the terms of a foreign currency asset exactly match those of a foreign currency liability. A non-derivative financial instrument may not be designated as a hedging instrument in a hedge of the foreign currency risk in an anticipated transaction. This is because the AcSB concluded that it is difficult to achieve the degree of matching between foreign currency gains and losses on non-derivative financial instruments and anticipated transactions that is necessary to qualify for hedge accounting in accordance with Section 3856.

105 Foreign currency gains and losses on a net investment in a self-sustaining foreign operation are recognized in equity in accordance with FOREIGN CURRENCY TRANSLATION, Section 1651. Accordingly, special hedge accounting treatment is available to ensure that foreign currency gains or losses on financial liabilities financing these investments can be recognized in net income at the same time as the corresponding foreign currency gains and losses on the investments.

106 The hedge accounting model in FINANCIAL INSTRUMENTS, Section 3856, results in accounting for a hedging derivative on a cash or accrual basis. Realized gains or losses on the hedging item are recorded as an adjustment of the carrying amount of the hedged item. When an interest rate swap is used to hedge periodic cash flows, the enterprise accrues the interest adjustment from each reset date to the settlement date to which it relates. This treatment most closely mirrors the recognition of accrued interest on the hedged item.

107 Many Exposure Draft respondents thought the standard should permit hedge accounting for more complex relationships. Some requested the AcSB to permit the use of futures contracts as hedging instruments. The AcSB confirmed that special accounting for futures contracts and options used as hedging items would not be permitted. Futures contracts rarely match the critical terms of a contract perfectly due to their standardized quantities and settlement dates. An enterprise that hedges with futures contracts must account for those contracts at fair value. Although options can be effective in protecting an entity against unfavourable changes in a market price or rate, the AcSB was concerned that the accounting model that would be necessary to reflect such arrangements would unduly complicate the standard. In particular, certain types of options would provide too much flexibility to qualify as matching the critical terms of the

hedged item. Some AcSB members also noted that the asymmetrical hedging that occurs with options was inconsistent with the concept of neutralizing risk.

108 FINANCIAL INSTRUMENTS, Section 3856, permits hedge accounting when the maturity dates of the hedged and hedging items differ by up to two weeks on the basis that the difference would not have a material effect on the relationship. When an interest rate swap is used as the hedging item, the relationship must be designated at the inception of the swap to ensure the swap is an effective hedge.

109 The AcSB decided that it would be inappropriate to permit an entity to elect to discontinue hedge accounting. Fair value is the most appropriate measurement for derivatives and is waived for qualifying hedging relationships only when the reporting entity is not exposed to the effects of changes in fair value. An entity would be able to influence reported net income inappropriately if the standard permitted discontinuance of hedge accounting as a matter of choice.

Income taxes

110 In the pre-changeover standards, INCOME TAXES, Section 3465, included a differential reporting option allowing entities to use the taxes payable method. From a cost perspective, the arguments supporting the differential reporting option remain largely unchanged — some entities incur significant costs on a recurring basis in accounting for future income taxes. In respect of benefits, views on the usefulness of future income taxes information continue to be diverse. Many users of private enterprises' financial statements believe that accounting for future income taxes produces very little in the way of useful information. Others believe that the taxes payable method produces misleading information because it provides no information on whether cash tax payments will change significantly in future years for reasons other than changes in the level of income. User views in respect of future income taxes appear to be partly situational, depending on the size of the investment, the type of industry and the characteristics of the enterprise. For example, those who lend to industries that commonly use the percentage of completion method for revenue recognition generally dislike the taxes payable method. Based on their experience with differential reporting, users who argued that the future income taxes method provides significant value believed that, in many cases, they would be able to require enterprises they are involved with to follow the future income taxes method. On this basis, these users were supportive of permitting the taxes payable method provided there is note disclosure similar to that applicable under the pre-changeover standards.

111 Some enterprises informed the AcSB that they did not use the taxes payable differential reporting option because they believe that the accompanying disclosures require essentially as much effort as applying the future income tax method. The AcSB noted that this view appears to stem from a misreading of the differential reporting disclosure requirement to reconcile recorded taxes to the amount that would result on application of the statutory tax rate. This reconciliation was between the income tax expense reported and the amount that would result if the statutory rate were applied to reported income before discontinued operations and extraordinary items, not the expense if the future income taxes method was used. The AcSB was advised that this reconciliation can be performed very readily once the enterprise's income tax return has been prepared. To assist financial statement preparers, an example of this reconciliation has been included in Section 3465.

112 Several Exposure Draft respondents addressed this issue, with the majority expressing full support for the taxes payable option. Other respondents disagreed with the taxes payable method on the basis that it provides potentially misleading information. The AcSB discussed these responses and noted that the arguments were the same as those made when the differential reporting option was developed. Accordingly, the AcSB decided to retain the taxes payable method as an option.

113 A few respondents noted several issues related to accounting for income taxes in a business combination. The AcSB discussed these issues and decided to modify INCOME TAXES, Section 3465, to converge with International Accounting Standard IAS 12 *Income Taxes* on these issues.

Impairment of goodwill and other indefinite-lived intangibles

114 In the pre-changeover standards, GOODWILL AND INTANGIBLE ASSETS, Section 3064, required initial measurement of goodwill and intangible assets with an indefinite life at cost, subject to write down for impairment but with no periodic amortization. This treatment placed considerable emphasis on testing the recognized asset for impairment. Private enterprises have often found this treatment difficult because the standard required an annual impairment test and the impairment test can be costly to perform.

115 Some stakeholders suggested that private enterprises should apply an amortization approach to account for goodwill and other indefinite-lived intangibles. The AcSB noted that this approach would reduce the likelihood of impairment the longer the asset is held, as the balance would reduce as a result of amortization; however, amortization does not eliminate the need to test for impairment. The AcSB rejected this alternative because amortizing assets that have an indefinite life would result in misstating income and assets.

116 Others suggested non-recognition of goodwill and other intangible assets on a private enterprise's balance sheet because of the significant uncertainty with respect to their value. Many stakeholders expressed strong disagreement with such an approach, noting that goodwill and other intangible assets meet the definition of an asset and immediate write-off would be inconsistent with the treatment of assets generally. The AcSB agreed with this view and, accordingly, rejected a non-recognition approach.

117 Differential reporting permitted impairment testing on an "events and circumstances" basis in lieu of an annual impairment test. The AcSB understands that this differential reporting option was well accepted by preparers and users, and that the cost / benefit arguments supporting it have not changed significantly since its introduction. On this basis, the Exposure Draft proposed embedding the events and circumstances trigger into the accounting standards for private enterprises as the mandatory approach.

118 The Exposure Draft proposed further simplification in respect of the mechanics of impairment testing. In the pre-changeover standards, GOODWILL AND INTANGIBLE ASSETS, Section 3064, required a two-step approach to determining impairment of goodwill. The first step required a comparison of the carrying amount of the reporting unit containing the goodwill to its fair value. If the fair value of the reporting unit was less than its carrying amount, then the fair value of goodwill was compared to its carrying amount. Determining the fair value of the goodwill could be costly, as it required obtaining fair values for all other assets and liabilities in the reporting unit. (The fair value of goodwill is the difference between the fair value of the reporting unit and the fair value of its net assets, other than goodwill.)

119 The AcSB observed that International Accounting Standard IAS 36 *Impairment of Assets* does not require the second step in order to determine the amount by which goodwill is impaired; it attributes any shortfall first to goodwill. Adopting this approach eliminates the need to fair value the individual assets and liabilities in the reporting unit in order to determine the amount by which goodwill is impaired. The Exposure Draft proposed charging any excess of the carrying amount of the reporting unit over its fair value to goodwill, with the goodwill impairment loss being limited to the carrying amount of goodwill.

120 Only a few Exposure Draft respondents addressed this issue. These respondents suggested that goodwill and indefinite lived assets be amortized, but did not present new arguments in support of amortization. On this basis, the AcSB decided to make no changes on this issue in finalizing the accounting standards for private enterprises.

121 A few respondents argued that impairment reversal should apply to goodwill and indefinite-lived intangible assets as it does to other assets such as investments. The AcSB discussed and rejected this suggestion because it may be difficult to measure an impairment reversal objectively, particularly in the case of goodwill, since it is a residual. The AcSB was concerned that reversal of previous impairment of goodwill or an indefinitely-lived intangible asset could not be distinguished from the creation of a new and possibly different asset.

Internally developed intangible assets

122 In the pre-changeover standards, GOODWILL AND INTANGIBLE ASSETS, Section 3064, required entities to assess whether development costs of identifiable intangible assets met a number of criteria and, if so, to capitalize these costs. Some stakeholders suggested that this evaluation is costly, and that private enterprises should have the option of expensing these costs without evaluating them against the criteria.

123 In discussing this issue, the AcSB noted that internal costs associated with evaluating the criteria set out in Section 3064 were not necessarily burdensome. Management should be able to evaluate these criteria as a result of knowing their business. However, the AcSB also noted that some costs may be incurred related to obtaining assurance on the application of these criteria.

124 From a benefits perspective, some users ascribe little value to so-called "soft assets" such as internally developed intangible assets. Users recognize that these items may meet the definition of an asset and may have economic benefits. Therefore, recognition of these assets does have information value. Nevertheless, many, but not all, users of private enterprise financial statements generally ignore or heavily discount internally generated intangible assets in their analysis of an enterprise's financial position.

125 The AcSB noted that the criteria used to evaluate whether capitalization of internally generated intangible assets is appropriate rely heavily on management judgment and, in practice, many entities expense such costs. As a result, users do not know whether costs are expensed because they do not meet the criteria for capitalization or because the enterprise has, *de facto*, adopted a practice of expensing all internal costs related to intangible assets.

126 Given this cost / benefit assessment, as well as a desire to make an enterprise's accounting policy as transparent as possible, the Exposure Draft proposed a free choice in accounting for internally developed intangible assets. This choice would permit an enterprise either to capitalize eligible costs subject to meeting certain criteria, 4 or to expense all such costs as incurred.

127 The AcSB considered whether this choice should apply consistently to development costs for all internally generated intangible assets or on a project-by-project basis. This issue was raised primarily in the context of the effort and ability of enterprises to restate prior period financial statements should the enterprise change its policy choice in the future.

128 This application issue was discussed at several of the roundtable sessions held across the country, with mixed feedback. The majority of constituents understood the appeal of application on a project-by-project basis but felt strongly that the need for consistency of application called for a uniform policy choice.

129 In addition, the AcSB noted that while the general requirement in ACCOUNTING CHANGES, Section 1506, is to restate prior years when there is a change in accounting policy, the Section permits prospective treatment when restatement is impracticable because the enterprise "cannot determine the cumulative effect of applying the policy to all prior periods." The AcSB concluded that this provision in Section 1506, together with an appropriate application of the

materiality concept, addresses the concerns raised and concluded that this accounting policy choice should apply consistently to all projects.

130 Only a few respondents commented on this aspect of the Exposure Draft, with several expressing full support for the proposals. One respondent commented that comparability and representational faithfulness would be adversely affected by introducing this accounting policy choice. The AcSB noted that any optional treatments affect comparability and concluded that the cost / benefit considerations justified the simplification. Another respondent noted that, for the sake of simplicity and minimization of alternatives, expensing should be the mandatory treatment. The AcSB discussed this alternative but noted that many enterprises would wish to remain comparable to publicly accountable enterprises on this issue. Accordingly, the AcSB decided to retain the option to use either method.

Stock-based compensation

131 The AcSB understands that private enterprises generally find measuring the fair value of stock-based compensation to be costly, primarily in valuing the enterprise's stock as an input to an option valuation model. Some entities note that, for assurance purposes, they find it necessary to engage third-party business valuators to validate the value of the enterprise's stock.

132 Some stakeholders suggested that private enterprises should be allowed to use a "disclosure-only" option wherein the entity would only disclose general information regarding stock-based compensation, (i.e., avoid recognition of stock-based compensation). The AcSB concluded that a disclosure-only approach would not provide useful information to financial statement users as an enterprise would not recognize any cost for compensation that has real value. Recognition of stock-based compensation has gained wide acceptance among stakeholders. The AcSB concluded that there is no basis for differences in the recognition of this cost based on the accountability of the enterprise (i.e., public vs. private).

133 Other stakeholders suggested that private enterprises be allowed to use the intrinsic method to account for stock-based compensation. The AcSB considered, but rejected, the intrinsic method as it would actually increase the burden from a cost perspective. One of the inputs in applying the intrinsic method is the fair value of the underlying equity instrument. The intrinsic method would require remeasurement at each balance sheet date and, consequently, periodic fair value determinations of the underlying equity.

134 The research into user needs noted that creditors generally have little interest in information about the cost of stock-based compensation, unless such plans have significant cash flow implications (for example, under a cash-settled stock appreciation right). However, equity investors, particularly minority shareholders, have expressed interest in the cost of stock-based compensation, largely in understanding the degree of potential dilution. While creditors are the most frequent users in this sector, the AcSB agreed that the standards cannot ignore the needs of equity investors. By the very nature of the transaction, it is much more likely that an enterprise that issues stock-based compensation will have financial statement users who are equity investors.

135 In examining the costs of accounting for stock-based compensation, the AcSB noted that in the pre-changeover standards, STOCK-BASED COMPENSATION AND OTHER STOCK-BASED PAYMENTS, Section 3870, does not require a third-party independent valuation. In addition, in issuing a stock option, an enterprise would normally have assessed the fair value of its underlying equity, even if only at a basic level, to comply with corporate governance requirements and determine whether the option was written in, out, or at the money.

136 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, as allowed in the pre-changeover standards, generally results in significantly misstating the value of a stock option. Accordingly, the Exposure Draft proposed deleting the minimum value method. Recognizing that most private enterprises cannot estimate the volatility of their own equity without significant cost and effort, the Exposure Draft proposed adoption of the calculated value method. This method permits an enterprise to use the volatility of an appropriate sector index as a proxy for the volatility of its own equity. The AcSB noted that such indices are readily available and, accordingly, concluded that private enterprises will have no major cost issues with respect to using the calculated value method. In particular, they should not require the assistance of third-party experts.

137 A significant number of Exposure Draft respondents commented on this issue, with a number of similar responses coming from the technology sector. Many responses suggested use of a disclosure only approach or use of the intrinsic value method but did not present any new arguments or facts in support of those approaches. Accordingly, the AcSB re-affirmed use of a fair value method in accounting for stock-based compensation in the accounting standards for private enterprises.

138 Several Exposure Draft respondents suggested valuing stock-based compensation based on the fair value of employee services. The AcSB considered these suggestions and observed that this approach was considered and rejected in developing the original standard. The AcSB also noted that the Basis for Conclusions to International Financial Reporting Standard IFRS 2 *Share-based Payment* sets out the rationale for rejecting this alternative. On the same basis, the AcSB rejected such an approach.

139 A number of Exposure Draft respondents argued that the minimum value method should be retained, possibly on a fallback basis, should it be impossible to find an appropriate sector index for purposes of calculating volatility. These responses provided both cost and benefit arguments. In respect of cost, respondents argued that the calculated value

method would require more effort than the minimum value method, particularly when it is difficult to find a comparable industry sector to calculate volatility. In respect of benefits, respondents noted that many factors influence the volatility of a public enterprise's shares, some of which are not relevant to a private enterprise. Accordingly, it was argued that the volatility of a publicly traded enterprise may not be a good proxy for that of a private enterprise. The AcSB considered these arguments and re-affirmed the importance of volatility in establishing the value of an option. The AcSB agreed that there may be rare instances when it might be difficult to identify a specific industry subsector and, accordingly, modified the final standard to allow enterprises to use a broad-based index in such circumstances.

Classification of callable debt

140 Emerging Issues Committee Abstract EIC-122, Balance Sheet Classification of Callable Debt Obligations and Debt Obligations Expected to be Refinanced, required debt that is callable at the option of the holder to be classified as a current liability, unless specific conditions are met. The common concern with current classification is the effect on the balance sheet — the financial statements do not reflect management's view of an enterprise's liquidity.

141 A number of stakeholders believed that, in many cases, current classification of callable debt misrepresents the nature of the liability. For example, many demand bank borrowings are accompanied by a non-binding long-term repayment schedule. The borrower expects that the lender will not exercise the call feature as long as repayments are made as scheduled and thus current classification is inconsistent with the expectations of the borrower. Many financial statement preparers suggested classification of such debt based on management's reasonable expectations.

142 Users informed the AcSB that current classification provides the most useful information. This is particularly the case when an enterprise has borrowed from more than one creditor. Some lenders have been surprised at the way amounts owing to them have been classified in a borrower's financial statements, but indicate that they can easily adjust for this in their analysis. The AcSB confirmed that callable debt meets the definition of a current liability and noted that there are no direct costs associated with presenting this debt as current. Some additional communication may be required to inform financial statement users about management's expectations concerning repayments but any effort and cost associated with this should generally be non-recurring and also relatively insignificant. The AcSB concluded that there is no logical basis for classifying callable debt as long term because only the lender can determine whether the debt will be called in the short term.

143 On this basis, the Exposure Draft proposed carrying forward the guidance in EIC-122, Balance Sheet Classification of Callable Debt Obligations and Debt Obligations Expected to be Refinanced, by incorporating it into CURRENT ASSETS AND CURRENT LIABILITIES, Section 1510, with an example of how such debt might be presented in the balance sheet to make the nature of the debt clearer.

144 A number of Exposure Draft respondents commented on this issue, with the majority expressing a view that current classification of callable debt misrepresents the debt because, in their experience, the call feature is rarely exercised. Others noted that creditors have been calling such debt in recent times and, accordingly, agreed that current classification is appropriate. The AcSB did not agree that the frequency of exercise of the call feature should affect the classification of callable debt. No new arguments were advanced on this issue and, accordingly, the AcSB decided to adopt the Exposure Draft proposal in the final standards.

Leases

145 Some stakeholders told the AcSB that it can be costly to account for a lease as a capital lease, suggesting optional treatment of any lease as an operating lease as a solution. Users have repeatedly stated that they find considerable information value in capital lease accounting, with some users advocating capitalization of all leases. The AcSB noted that an "all capital" approach was proposed in the joint International Accounting Standards Board and US Financial Accounting Standards Board Discussion Paper, "Leases — Preliminary Views," issued in March 2009.

146 The Advisory Committee did not believe that the costs associated with accounting for capital leases are overly burdensome. Accordingly, the Exposure Draft proposed making no changes in respect of lease accounting.

147 Only a few Exposure Draft respondents commented on this issue, suggesting an "all operating lease" approach, as such an approach would minimize the adjustments needed to financial statement income to arrive at taxable income. The AcSB noted that this is not an objective in setting accounting standards and not a compelling argument relative to the needs of users. Accordingly, the AcSB rejected the suggestion for optional treatment of all leases as operating leases.

BUSINESS COMBINATIONS

148 BUSINESS COMBINATIONS, Section 1582, CONSOLIDATED FINANCIAL STATEMENTS, Section 1601, and NON-CONTROLLING INTERESTS, Section 1602, were added to the pre-changeover standards in a January 2009 Handbook update, with effect for years beginning on or after January 1, 2011. The Exposure Draft included these new Sections in the accounting standards for private enterprises rather than BUSINESS COMBINATIONS, Section 1581, and CONSOLIDATED FINANCIAL STATEMENTS, Section 1600. If a private enterprise adopted the accounting standards for private enterprises before the effective date, it would have to apply these new business combinations standards. The AcSB made this decision for the following reasons:

(a) The accounting standards for private enterprises is a new basis of reporting. It would be unnecessary, and possibly confusing, to have two sets of standards dealing with the same transaction on initial release of a new financial reporting system.

(b) Business combinations are relatively uncommon transactions within the private enterprise sector and, typically, an enterprise learns the applicable accounting standards for this transaction when the transaction is undertaken. Therefore, it is unlikely that many enterprises will need to learn the new business combinations standards immediately.

(c) In several respects, the new business combinations standards are simpler than the superseded standards.

DISCLOSURES

149 In developing the accounting standards for private enterprises, the AcSB undertook a comprehensive re-evaluation of disclosures based on the needs of financial statement users in this sector. The disclosure requirements in the pre-changeover standards were developed to serve the needs of all types of enterprises, with many disclosures developed to meet the specific needs of publicly accountable enterprises, particularly their equity investors. As a result, some disclosures may not have served the needs of users in the private enterprise sector. Many stakeholders argued that private enterprises suffered from "disclosure overload"; that is, there were so many disclosures that it has become difficult to prepare and understand the financial statements.

150 The AcSB was informed that the most frequent financial statement users in the private enterprise sector (i.e., creditors), often have the ability to request (and generally receive) additional information from the enterprise when needed. On this basis, the goal of the disclosure requirements for the accounting standards for private enterprises was to provide enough information for users to understand the financial statements and to be able to make informed inquiries regarding financial statement items or transactions when they require further details. This approach avoids imposing costs of preparing unnecessary disclosures. Cost / benefit considerations were used as an aid in creating the disclosure requirements. In assessing cost / benefit considerations, the AcSB noted that individual disclosure requirements are only part of the issue. The overall number and extent of disclosures can also be problematic to stakeholders in this sector.

151 Not all financial statement users consulted during the development of the accounting standards for private enterprises embraced this approach. Several users stated that they would like to receive more information rather than less. In addition, some users pointed out that placing the onus on users to seek out information may result in transactions taking additional time. This would result in an increased cost to an enterprise through a delay in completing a transaction or an increase in the cost of capital, or both. The AcSB considered these concerns as it developed the disclosure requirements.

152 Compared to the pre-changeover standards, the accounting standards for private enterprises place increased reliance on the general fair presentation disclosure requirements in GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400. Accordingly, in practice, the AcSB expects preparers and auditors, to place less reliance on disclosure checklists and rote compliance with specific requirements.

153 The first step in developing disclosure requirements for private enterprises was to categorize the existing requirements as follows:

(a) accounting policies chosen and any changes thereto;

(b) risks and uncertainties;

(c) unusual 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.

154 Users indicated that the first three categories are the most important, 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.

155 The Advisory Committee reviewed each of the disclosure requirements in the pre-changeover standards using these criteria. On each topic, user members on the Advisory Committee were asked to consider what information they would need in terms of disclosures. The three types of disclosures listed above provided guidance for developing the disclosure requirements, but they were not applied as hard and fast criteria. Accordingly, several disclosures in the accounting standards for private enterprises are outside of these "critical" categories.

156 This approach resulted in a significant reduction in the number of specific disclosure requirements. The accounting standards for private enterprises contain approximately half the specific disclosure requirements in the pre-changeover standards. However, the Exposure Draft proposed introducing several new disclosure requirements that users identified as being of particular value. The most significant proposed additions included disclosure of the compensation of key management personnel and liabilities for government remittances, including whether any such remittances are in arrears.

157 In respect of compensation of key management personnel, users indicated that they are particularly interested in this information for purposes of evaluating the cash flows of the entity. This information is especially relevant in the case of

private companies as there is a tax incentive to pay sufficient compensation in order to reduce the enterprise's taxable income to a specific amount. Thus, the income statement may not accurately reflect the enterprise's underlying profitability. The preparers consulted during the development of the Exposure Draft stated a reluctance to disclose this information as they did not want it to be widely known. Others responded that private enterprises generally do not distribute their financial statements widely and can control who receives them.

158 This issue attracted significant reaction from Exposure Draft respondents, with the majority of respondents expressing strong objection to this disclosure. Respondents noted that private enterprises wish to keep this information private and users who would like it can ask for it. Respondents also stated that, in many cases, disclosing compensation for management, as a group, results in effectively disclosing compensation of one or two individuals as "key management" for many private enterprises consists of only a few individuals. The result is that the disclosure would create privacy issues. The AcSB agreed with the arguments put forth by respondents on this issue and, accordingly, decided to remove this proposed disclosure requirement in finalizing the accounting standards for private enterprises.

159 In respect of liabilities for government remittances and any amounts in arrears, users noted that some of those liabilities receive super-priority status over other creditors and, accordingly, they are interested in such amounts. The AcSB noted that there is little direct cost associated with disclosing this information and accordingly proposed a disclosure requirement in the Exposure Draft.

160 This issue also attracted significant reaction from Exposure Draft respondents, with the majority objecting to inclusion of this information in the financial statements. Respondents pointed out that lenders can obtain this information on request. Some agreed that disclosure of the total amount of government remittances provided useful information but objected to disclosure of amounts in arrears. These respondents argued that disclosure of the amount of government remittances in arrears at the balance sheet date would not provide meaningful information due to the significant amount of time that often passes before issuance of the financial statements. These respondents also argued that this disclosure goes beyond the objective in creating the disclosure requirements — to give users enough information to decide whether they need to ask for more information from the entity.

161 The AcSB discussed the responses on this issue and, because liabilities for government remittances are analogous to secured debt, agreed to retain the requirement to disclose government remittances payable on cost / benefit grounds. However, the AcSB agreed with the comments that disclosure of amounts in arrears is unnecessary, given the goals of the disclosure requirements, and decided not to include this requirement in the final standards.

EIC ABSTRACTS

162 Emerging Issues Committee Abstracts of Issues Discussed (EIC Abstracts), as set out in the pre-changeover standards, were excluded from the accounting standards for private enterprises. Many EIC Abstracts were heavily "rules oriented" and very detailed. The AcSB concluded that in creating a principles-based financial reporting system for private enterprises, it was not appropriate to include the type of detailed guidance contained in the EIC Abstracts. However, some EIC Abstracts contained significant guidance that is relevant to private enterprises and the key elements of such guidance were incorporated into the standards.

163 The following criteria were used in reviewing the EIC Abstracts to identify elements to be incorporated into the accounting standards for private enterprises:

(a) Retain only significant guidance. The accounting standards for private enterprises should be principles-based and should not contain a significant amount of detailed guidance.

(b) Retain EIC Abstracts, or portions thereof, that address issues of particular importance to private enterprises. The AcSB conducted a significant amount of research into the needs of financial statement users in this sector, and on the issues commonly encountered by private enterprises. The knowledge gained was used to identify EIC Abstracts interpreting issues that are important to private enterprises.

(c) Retain components of EIC Abstracts that fill in gaps in the overall financial reporting framework.

(d) Omit disclosure requirements. Disclosures were separately re-evaluated in developing the accounting standards for private enterprises.

As in the development of the disclosure requirements, these guiding criteria were not applied as hard and fast rules. Accordingly, several elements of EIC Abstracts carried forward into the accounting standards for private enterprises may not meet all of these criteria.

164 In applying these criteria to develop the Exposure Draft, the AcSB identified 17 issues addressed in existing EIC Abstracts for retention in the proposed standards. The Exposure Draft sought comment with respect to the approach of avoiding significant amounts of detailed guidance and interpretations (i.e., not adopting all of the EIC Abstracts). Feedback almost unanimously agreed with the direction taken in developing the Exposure Draft. However, a number of respondents identified additional EIC Abstract issues that they believed should be included in the standards. Individual respondents noted a number of such issues, with very little overlap between respondents. The AcSB revisited each of the issues suggested by respondents. Based on this review, the AcSB decided to add components from an additional 12 EIC Abstracts to the final standards, bringing the total number of EIC Abstract issues incorporated into the final standards to 29. The majority of these issues deal with leases, related party transactions, revenue and current assets and current liabilities.

EXCLUDED TOPICS

165 A number of individual Sections and Guidelines in the pre-changeover standards were largely irrelevant to private enterprises. The Exposure Draft proposed excluding these Sections and Guidelines from the accounting standards for private enterprises.

166 The AcSB observed that guidance on a number of excluded sections and guidelines can be found in IFRSs. In accordance with the hierarchy of GAAP sources identified in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, an enterprise would be able to refer to that guidance should it wish to do so. Exposure Draft respondents generally supported excluding these standards from the accounting standards for private enterprises. However, several respondents identified specific Sections and Guidelines for retention. Their comments, and the AcSB's decisions, are noted below.

Section 1300

167 DIFFERENTIAL REPORTING, Section 1300, was replaced by the accounting standards for private enterprises.

Section 1701

168 SEGMENT DISCLOSURES, paragraph 1701.08, stated:

.08 ♦ *This Section should be applied by public enterprises, co-operative business enterprises, deposit-taking institutions and life insurance enterprises. Public enterprises are those enterprises that have issued debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), that are required to file financial statements with a securities commission, or that provide financial statements for the purpose of issuing any class of securities in a public market.*

Thus, section 1701 was excluded.

169 Historically, segment information has not been of significant value to users in the private enterprise sector. Research into user needs conducted prior to the development of the accounting standards for private enterprises confirms that there was little interest in having entities in this sector report segmented information. In particular, the majority of creditors did not appear to be interested in analyzing cash flows on a disaggregated basis.

Section 1751

170 INTERIM FINANCIAL STATEMENTS, paragraph 1751.02, stated:

.02 This Section applies to all entities that are required by law, regulation or contract to prepare interim financial statements in accordance with generally accepted accounting principles, or elect to do so. This Section does not mandate which entities are required to prepare interim financial statements, nor does it specify how frequently, or how soon after the end of an interim period.

171 Many stakeholders have noted that private enterprises rarely prepare interim financial statements in accordance with GAAP. While many users wish to see interim financial information, the statements they are interested in, and accept, are internal financial statements that are not prepared in accordance with GAAP. Other internal information, such as aged accounts receivable listings and inventory listings, often supplements the internal financial statements. In addition, stakeholders have noted that it is often not practical from either a cost or a timeliness perspective for private enterprises to prepare interim financial statements in accordance with GAAP.

172 A few Exposure Draft respondents suggested retaining Section 1751 because some private enterprises may wish to prepare interim statements to serve the needs of their financial statement users. The AcSB noted this concern and reiterated that enterprises would be able to look to other sources of GAAP for guidance in preparing interim statements. On this basis, Section 1751 was excluded. However, the AcSB noted that the pre-changeover standards included simplification in respect of comparative interim information for entities that did not previously report such information. The AcSB thinks that this simplification would be beneficial to private enterprises and, accordingly, has retained it in the accounting standards for private enterprises.

Section 3500

173 EARNINGS PER SHARE, paragraph 3500.02, stated:

.02 ♦ *An enterprise should present earnings per share information when it has:*

(a) issued common shares or potential common shares that are traded in a public market (a domestic or a foreign stock exchange or in an over-the-counter market, including local and regional markets); or

(b) made a filing or is in the process of filing with a securities commission in preparation for the sale of those securities in a public market.

Thus, private enterprises were not required to present earnings per share information.

174 Users in this sector have not expressed a demand for earnings per share information. Creditors are generally not interested in earnings per share information, as they are typically concerned with aggregate cash flows. Since private enterprises generally have simple capital structures, financial statement users who are interested in this information would be able to calculate earnings per share information, if they so desired.

Section 3480

175 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 did not believe there was significant value to the information required by EXTRAORDINARY ITEMS, Section 3480. Stakeholders consulted agreed that extraordinary items are rare in practice. Given the significant time that often passes between the balance sheet date and issuance of the financial statements, users noted that they would expect to be informed of extraordinary items prior to receiving the financial statements. When the disclosure is of value, stakeholders commented that the "fair presentation" requirements in GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400, are sufficient to require entities to disclose extraordinary or unusual events separately. As a result, Section 3480 was excluded. This decision also achieved harmonization with reporting by publicly accountable enterprises because IFRSs do not include an extraordinary item classification.

176 A few Exposure Draft respondents commented on the exclusion of Section 3480, suggesting that it should be retained on the basis that it provides useful information to financial statement users. The Advisory Committee, which included several financial statement users, discussed these responses and confirmed its view that this Section is unnecessary. On this basis, Section 3480 was excluded.

Section 4100

177 Pension plans are, by definition, publicly accountable enterprises. Accordingly, accounting for pension plans is outside the scope of the accounting standards for private enterprises.

Section 4250

178 The AcSB concluded that FUTURE-ORIENTED FINANCIAL INFORMATION, Section 4250, is not relevant to private enterprises. This Section was developed to meet the needs of the public securities markets (i.e., inclusion of future-oriented financial information in prospectuses and other offering documents). Many users in the private enterprise sector are interested in obtaining future-oriented financial information, and often receive such information in the course of making investment decisions. However, this information is generally not prepared in accordance with Section 4250 due to cost constraints.

179 Several Exposure Draft respondents commented on the exclusion of Section 4250, noting that the standard has been used in the sector and, accordingly, that it may be useful to retain this guidance. The AcSB observed that while Section 4250 contained useful guidance, that guidance is not consistent with the scope of general purpose financial statements as discussed in FINANCIAL STATEMENT CONCEPTS, Section 1000.

Insurance standards (Section 4211, AcG-3, AcG-8 and AcG-9)

180 LIFE INSURANCE ENTERPRISES — SPECIFIC ITEMS, Section 4211, ACCOUNTING GUIDELINES AcG-3, Financial Reporting by Property and Casualty Insurance Companies, AcG-8, Actuarial Liabilities of Life Insurance Enterprises — Disclosure, and AcG-9, Financial Reporting by Life Insurance Enterprises, dealt with insurance enterprises. Insurance enterprises are, by definition, publicly accountable enterprises and, therefore, are required to follow International Financial Reporting Standards.

AcG-7

181 ACCOUNTING GUIDELINE AcG-7, The Management Report, provided the AcSB's views on the minimum content of a management report that acknowledges management's responsibility for financial information, but does not form part of the financial statements.

182 AcG-7 stated that when an enterprise's annual financial statements are distributed widely, a management report should be presented. An enterprise's financial statements are considered to be distributed widely when, for example, its securities are traded in a public market, it is required to file financial statements annually with a securities commission, or its financial statements are distributed to members or policyholders in the case of an enterprise such as a credit union or a life insurance enterprise.

183 The AcSB noted that, in general, the financial statements of a private enterprise are not widely distributed. On this basis, AcG-7 was excluded.

AcG-11

184 During the development of the disclosure requirements, users noted that the existing disclosures in this Guideline are of little informational value to them. In respect of recognition and measurement issues, GOODWILL AND INTANGIBLE ASSETS, Section 3064, covered what is required by ACCOUNTING GUIDELINE AcG-11, Enterprises in the Development Stage. As a result, the Exposure Draft proposed excluding this Guideline from the standards for private enterprises.

185 A few Exposure Draft respondents suggested that AcG-11 should be retained, as it may contain guidance that is helpful to enterprises in the development stage. The Advisory Committee re-affirmed its conclusion that the Guideline is largely redundant. The AcSB also noted that the desire to increase the use of professional judgment has resulted in reducing the amount of detailed guidance in some areas. On this basis, AcG-11 was excluded.

EFFECTIVE DATE

186 The accounting standards for private enterprises are effective for fiscal years beginning on or after January 1, 2011. This effective date is consistent with the date on which publicly accountable enterprises will be required to adopt IFRSs. Earlier application of the standards is permitted.

TRANSITIONAL PROVISIONS

187 The AcSB understands that an enterprise adopting accounting standards for private enterprises may have previously prepared its financial statements on one of several different bases of accounting. Many enterprises will have prepared financial statements in accordance with the pre-changeover standards. However, the AcSB also expects that some enterprises that previously did not prepare GAAP financial statements will adopt the accounting standards for private enterprises. Similarly, some private enterprises that reported using IFRSs will also adopt the accounting standards for private enterprises. In each case, an enterprise will likely need to make accounting policy changes.

188 ACCOUNTING CHANGES, Section 1506, generally requires retrospective application on adoption of new accounting policies. The AcSB decided that this should be the general principle for initial adoption, but recognized that for some individual standards this might result in significant difficulties. For example, an enterprise may be unable to recreate the carrying amount of an asset acquired many years ago and for which the existing carrying amount is not consistent with the requirements of PROPERTY, PLANT AND EQUIPMENT, Section 3061. Similarly, it might be difficult to restate a prior business combination that was not accounted for in accordance with BUSINESS COMBINATIONS, Section 1582, or to determine the carrying amount in accordance with RELATED PARTY TRANSACTIONS, Section 3840, of an asset obtained through a past related party transaction. The AcSB also noted that applying some requirements retrospectively may lead to selective application designed to report a specific result or may require the inappropriate use of hindsight.

189 The AcSB developed FIRST-TIME ADOPTION, Section 1500, to ensure that an enterprise's first financial statements prepared using the accounting standards for private enterprises contain high-quality information that:

(a) is transparent for users and comparable over all periods presented;

(b) provides a suitable starting point for accounting under the standards for private enterprises; and

(c) can be generated at a cost that does not exceed the benefits to users.

Section 1500 was based on the approach in International Financial Reporting Standard IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

190 The AcSB recognized that the transitional issues facing individual enterprises will differ, depending on their previous basis of accounting and the nature of their business (among other factors), and that some enterprises will face only minor transitional issues. However, the AcSB viewed the accounting standards for private enterprises as a new basis of accounting and, accordingly, decided that all first-time adopters should be able to take advantage of the same transitional provisions. This means, for example, that an enterprise that has accounted for defined benefit pension plans in accordance with EMPLOYEE FUTURE BENEFITS, Section 3461, in the pre-changeover standards, would be able to use the transitional provision in Section 1500 to recognize accumulated actuarial gains and losses at the date of transition in the same way as an enterprise that had never previously applied Section 3461.

191 A number of Exposure Draft respondents commented on the proposed Section 1500. Many respondents objected to the option to revalue property, plant and equipment to fair value on the initial adoption, with some suggesting that this option be restricted to situations in which measuring an item in accordance with PROPERTY, PLANT AND EQUIPMENT, Section 3061, is impracticable. Respondents argued that, without restricting this option, a one-time revaluation to fair value would allow entities to manipulate the financial statements and potentially confuse financial statement users. The AcSB discussed this concern and noted that financial statements include similar assets measured at different amounts due to different acquisition dates. It also observed that many financial statement users look to the fair value of property, plant and equipment in making investing and lending decisions. With respect to users being confused, the required note disclosure will make it clear when a private enterprise chooses this option. Accordingly, the AcSB decided to retain this option in the final standards. With respect to restricting this option, the AcSB decided that impracticality is too high a threshold and agreed that the option should be available to all first-time adopters.

192 Several Exposure Draft respondents commented that presenting prior year comparative information on the new accounting basis in the year of initial adoption of the standards would be costly and that enterprises should be able to present comparative information in accordance with the previous basis of accounting. The AcSB understands that there will be some costs incurred in restating financial statements. However, users find it critical to have comparative amounts prepared on the same accounting basis. Accordingly, the AcSB decided to make no changes to this issue in finalizing the accounting standards for private enterprises.

193 A few Exposure Draft respondents suggested elimination of any remaining transitional assets and transitional obligations relating to the initial adoption of EMPLOYEE FUTURE BENEFITS, Section 3461, in the pre-changeover standards, on transition. The AcSB observed that these balances are a holdover from previous transitional provisions and do not represent assets or liabilities in their own right. Accordingly, the AcSB decided to require elimination of these transitional assets and obligations on adoption of the accounting standards for private enterprises.

Footnotes

1. The CICA Handbook – Accounting, as at June 2009, was used as a starting point for development of the accounting standards for private enterprises.
2. The pre-changeover standards refer to Canadian GAAP prior to the issuance of the accounting standards for private enterprises.
3. SIC Interpretation 12 *Consolidation-— Special Purpose Entities*.
4. The criteria for capitalization are set out in GOODWILL AND INTANGIBLE ASSETS, Section 3064. These criteria have been carried forward from the pre-changeover standards.
