2011 Improvements to Accounting Standards for Private Enterprises — Background Information and Basis for Conclusions

Foreword

In October 2011, the Accounting Standards Board (AcSB) released the 2011 annual improvements to accounting standards for private enterprises. The AcSB has approved for publication the contents of this document setting out its rationale for making these improvements.

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 approving the 2011 annual improvements to accounting standards for private enterprises. It sets out the reasons the AcSB undertook the project to improve 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 Accounting standards for private enterprises will be changed periodically through two processes: major improvements and annual improvements. Major improvements will result in significant changes to accounting standards for private enterprises. Major improvements will not be included in the annual improvements process.

4 The purpose of this annual improvements process is to amend accounting standards for private enterprises to clarify guidance or wording and to correct for unintended consequences, conflicts or oversights. These changes are "bundled" together to reduce the number of individual changes to the standards.

5 The AcSB released an Exposure Draft, "2011 Improvements to Accounting Standards for Private Enterprises," in May 2011. The Exposure Draft proposed amendments to a number of Sections as discussed in this document. The proposed

amendments were largely in response to issues submitted to the AcSB by stakeholders. In deliberating the individual issues, the AcSB also considered input from its Private Enterprise Advisory Committee.

6 A few respondents expressed concern over the length of the comment period, noting that more time should have been provided. The AcSB decided on the 60-day comment period on the basis that it was important for the amendments to be included in the Handbook early in the fourth quarter of 2011. A number of stakeholders suggested that there was a strong need to make the proposed improvements available for use in time for the first mandatory application of accounting standards for private enterprises.

7 The majority of respondents were from public accounting firms. A significant number of respondents expressed agreement with the proposals set out in the Exposure Draft.

8 The specific issues addressed in this improvements project, including substantive comments received on the Exposure Draft and any changes made in response to these comments, are as follows.

MULTIPLE SETS OF FINANCIAL STATEMENTS

9 The pre-changeover standards in Part V of the CICA Handbook – Accounting included DIFFERENTIAL REPORTING, Section 1300. Paragraph 1300.16 required that an enterprise have only one set of general purpose financial statements in any particular period, and that additional sets of financial statements should refer to the general purpose statements. Section 1300 was excluded from accounting standards for private enterprises as they have been developed to meet the particular needs of the private enterprise sector, making differential reporting unnecessary. Accordingly, the guidance in paragraph 1300.16 was inadvertently excluded in the initial version of accounting standards for private enterprises.

10 An enterprise may prepare more than one set of financial statements in accordance with accounting standards for private enterprises, using different accounting policy options. Stakeholders noted that, in such circumstances, it is important for users to know whether or not the financial statements they receive are the enterprise's general purpose financial statements. They also noted that assurance standards no longer require an auditor to identify different sets of financial statements prepared under accounting standards for private enterprises as being general purpose or special purpose. Accordingly, without the guidance in Part V, there would be no indicator that a financial statement reader is viewing an additional set of financial statements. The Private Enterprise Advisory Committee, in particular the user members, expressed strong support for incorporating the requirements in paragraph 1300.16 into Part II. On this basis, the Exposure Draft proposed including this material in GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400 in Part II.

11 A significant number of respondents commented on this proposal, with the majority being in agreement. One respondent noted that this requirement is unnecessary as financial statement users should be able to understand the basis of presentation from reading the financial statements. The AcSB did not agree with this view, noting that unless additional sets were identified as special purpose, a reader would likely presume that the financial statements they were reading were the general purpose financial statements.

12 Several respondents agreed with the proposals and further argued that all financial statements should be identified as either general purpose or special purpose. The AcSB discussed this suggestion and decided that such a requirement would be impractical as, in many cases, an enterprise does not know that it will issue additional sets of statements at the time that it issues its general purpose financial statements. The AcSB also concluded that it is reasonable for a reader to assume that, unless otherwise identified, financial statements are general purpose. This conclusion is consistent with the pre-changeover standards as set out in Part V. On this basis, the AcSB decided not to require identification of the general purpose financial statements.

13 A few respondents suggested that the requirements refer to Part II of the Handbook specifically. These respondents noted that, without specific reference, some may interpret the requirement as precluding the preparation of general purpose financial statements for a given period under Part I of the Handbook as well as under Part II, as may be the case if an enterprise is becoming, or ceasing to be, publicly accountable. The AcSB agreed with this suggestion and, accordingly, the proposed requirement was amended to refer to Part II of the Handbook explicitly.

14 Several respondents suggested defining "general purpose financial statements". One respondent suggested the term be defined as the statements that are prepared to meet statutory reporting obligations. The AcSB noted that the term "general purpose financial statements" has existed in the Handbook for a significant period of time and there does not seem to be an issue in practice. In respect of the suggestion that the general purpose statements be defined as those prepared to meet statutory reporting obligations, the AcSB noted that such a definition would not work for unincorporated enterprises, or enterprises in jurisdictions that had no statutory reporting obligations. On this basis, the AcSB decided to make no changes in respect of that suggestion.

15 In developing the proposals, the AcSB noted that this issue was also applicable to the not-for-profit sector. Accordingly, the Exposure Draft proposed adding the same requirements to GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1401 in Part III of the Handbook. Respondents agreed that this issue is applicable in the not-for-profit sector and that the requirements in Part III should be the same as in Part II. On this basis, the AcSB decided to include this material in Section 1401 as well.

BALANCE SHEET – PRESENTATION REQUIREMENTS

16 A few stakeholders noted that the requirements in BALANCE SHEET, paragraph 1521.05, were inconsistent with the requirements in CURRENT ASSETS AND CURRENT LIABILITIES, Section 1510. Section 1521 was developed specifically for Part II of the Handbook. Its purpose is to set out in one place all of the significant presentation requirements in respect of balance sheet items, similar to INCOME STATEMENT, Section 1520, for the income statement.

17 The specific issue was in respect of the presentation of current liabilities. Section 1510 states that current liabilities should be segregated between major categories. Prior to amendment, paragraph 1521.05 was being interpreted by some as requiring a presentation that was not fully consistent with Section 1510. The Exposure Draft proposed removing this inconsistency such that Section 1521 reflects the requirements of Section 1510.

18 Respondents all expressed support for the proposed amendments to Section 1521. Some respondents suggested minor changes to the proposals to eliminate duplication between the two Sections. The AcSB agreed with these suggestions and amended Section 1521 accordingly.

INTANGIBLE ASSETS – PROMOTIONAL ACTIVITIES

19 Several stakeholders noted a significant amount of diversity in practice among not-for-profit organizations in respect of accounting for promotional material. The AcSB observed that similar diversity is likely to occur amongst private enterprises. In response to these concerns, the Exposure Draft proposed amending GOODWILL AND INTANGIBLE ASSETS, Section 3064, to clarify that the requirements with respect to expenditures on advertising and promotional activities apply to mail order catalogues and other similar documents intended to advertise goods, services or events to customers. The AcSB also noted that Section 3064 was developed from, and is consistent with, IAS 38 *Intangible Assets*. The proposed amendments are consistent with amendments made to IAS 38.

20 There was substantial support for the proposed amendment among respondents. However, some respondents indicated that there may still be a view that certain expenditures on advertising and promotional activities should be capitalized, specifically mail order catalogues and other similar documents that have yet to be distributed by an enterprise (i.e., they are physically on hand). This view suggests deferring production costs of these items as a prepaid expense until such time as the documents have been distributed. The AcSB rejected this view, noting that the amendment to Section 3064 requires the expensing of catalogues immediately upon incurring the expenditure and that an entity cannot account for such items as prepaid expenses or inventory. Consequently, the AcSB decided to add further guidance on this matter in finalizing the amendment to Section 3064.

SUBSEQUENT EVENTS – CUT-OFF DATE

21 SUBSEQUENT EVENTS, Section 3820, requires management to identify and consider subsequent events up to the date at which the financial statements are "complete". Prior to amendment, Section 3820 did not provide guidance on how to determine when the financial statements are "complete".

22 In the past, the cut-off date for subsequent events under Section 3820 was generally considered to be a date that was consistent with the then-existing auditing standards (i.e., the date of "substantial completion" of the audit). This date was often determined to be the last day of work by the public accountant at the client's location (i.e., last day of fieldwork). This cut-off date was generally before final adjusting journal entries were prepared, such as for owner compensation and income taxes, and the financial statements, including all note disclosures, were fully drafted.

23 Stakeholders noted that new Canadian Auditing Standards require auditors to consider subsequent events to the date that the full financial statements, including the notes, have been prepared and "those with the recognized authority have asserted that they have taken responsibility for those financial statements." The AcSB noted that the new auditing standards resulted in a significant change in practice because an auditor is required to consider subsequent events to a much later date than had been the practice. The AcSB also noted that, although the review engagement assurance standards were not updated to be consistent with the new auditing standards, the Auditing and Assurance Standards Board had decided to issue a guideline requiring that the new dating convention apply to review engagement reports as well.

24 From a practical perspective, an auditor must be able to rely on the fact that an enterprise's management has considered subsequent events up to the same date as the date the auditor considers them. An auditor cannot audit something that management has not identified. As a result, the AcSB decided that Section 3820 should be clarified so that management's consideration of subsequent events is substantially aligned with the requirement in the new auditing standards.

25 The AcSB noted that this clarification would have the following benefits:

(a) better information to users because the financial statements will reflect adjustments or disclosures as required by Section 3820 for any events occurring between the last day of field work for the auditor and the date the financial statements are finalized (compared to previous practice where events were generally only considered to the last day of field work for the auditor);

(b) clear guidance that preparers can apply in a reasonably consistent manner;

(c) application of Section 3820 as originally intended; and

(d) reduced potential for conflict between preparers and practitioners because both the accounting standard and the assurance standard have changed (as a result preparers will be more likely to work with their assurance provider in a co-ordinated manner in determining the appropriate cut-off date for management's review of subsequent events under Section 3820).

26 The AcSB concluded that these benefits exceed the costs that an entity will incur to identify and consider subsequent events to a later date. Also, the incremental costs of clarifying Section 3820 will be minimal because auditors are already required to change their past practice in order to adopt the new auditing standards.

27 A significant number of respondents addressed this proposal, with a majority expressing support. Several respondents recommended revising the proposed amendment to use the same words as the Canadian Auditing Standards, specifically with respect to the determination of when the financial statements are approved. This approach had been considered and rejected in developing the Exposure Draft. The AcSB decided that different wording was necessary with respect to an enterprise's approval process so that the requirement will meet the needs of the wide range of types of private enterprises applying the standard. Further, the AcSB considers the amendments to be merely a clarification of the original intent of Section 3820, and did not intend to pick up verbatim the wording in Canadian Auditing Standards. Consequently, the AcSB decided that no changes should be made in response to those comments.

HEDGE ACCOUNTING

28 The Exposure Draft included the following amendments to FINANCIAL INSTRUMENTS, Section 3856, in respect of hedge accounting:

(a) adding requirements to permit concurrent hedging of commodity price and currency risk in a hedge of an anticipated commodity purchase or sale;

(b) extending the number of days between the date on which an anticipated transaction occurs and the date on which the forward contract that hedges its foreign currency exposure or its commodity price exposure from 14 days to 30 days;

(c) modifying the requirement that a prepayment option in a hedged financial asset or liability be matched with the ability to cancel or terminate a hedging interest rate or cross-currency interest rate swap;

(d) replacing the requirement to match the location parameter of a commodity forward contract with that of the anticipated commodity purchase or sale it hedges with a requirement that the grade or purity specified in the derivative be similar to that of the contract it hedges; and

(e) clarifying that groups of contracts can be hedged with a single hedging instrument and that a percentage of a hedging instrument may be designated in a qualifying relationship.

29 These amendments are intended to respond to concerns that many private enterprises would not be able to apply the existing hedging provisions in Section 3856 while maintaining the overall hedge accounting principles.

30 In considering the responses to the Exposure Draft, the AcSB disagreed with comments that the hedge accounting model should be expanded to allow hedge accounting for more sophisticated hedging strategies. The provisions for hedging anticipated transactions in Section 3856 minimize hedge ineffectiveness by requiring that the critical terms of the hedging instrument match those of the hedged item. While there are many hedging relationships that could be devised that would have minimal ineffectiveness, many of these are not permitted on the basis that the standard would become overly complex if it included provisions for ensuring effectiveness. Section 3856 deals with the relatively straightforward hedging arrangements seen more commonly in practice amongst private enterprises. Adding guidance to address more complex hedging arrangements would likely make the standard too complex for many private enterprises to apply.

31 In response to stakeholder enquiries, the AcSB clarified the permissible mismatch in maturity dates for items giving rise to foreign currency risk or commodity price risk and hedges of these risks. The amended standard requires that a derivative contract hedging currency risk must mature within 30 days of the settlement date of the hedged item because the exposure to changes in exchange rates continues during the period between the date the anticipated foreign currency denominated transaction takes place and the date the resulting payable or receivable is settled. The AcSB also clarified the treatment of gains or losses when the hedging item matures before the hedged item by requiring temporary recognition as a separate component of equity. Any such balances are transferred to the carrying amount of the hedged item when it is recognized.

32 The AcSB confirmed the existing requirements that payments on an interest rate swap or cross-currency interest rate swap must occur within 14 days of the cash flows they hedge to qualify for hedge accounting because it is usually possible to match swap payment dates exactly to the item it hedges. The AcSB decided that the proposed changes, which would have required matching of prepayment terms between the swap and the hedged item, were too restrictive. Prepayment terms rarely match between a swap and the item it hedges. The AcSB decided that it is unnecessary that these terms match; hedge accounting should be available as long as it is probable that the hedged item will not be prepaid.

33 Some commentators noted that dynamic hedging strategies for commodity risk would not be eligible for hedge accounting under Section 3856 unless the matching requirements were removed or reduced. The AcSB noted these concerns but confirmed that matching is required in lieu of proving the effectiveness of each hedging relationship because the hedge accounting model delays recognition of the derivative hedging instrument. Relaxing the requirements for matching would require adding provisions to prove hedge effectiveness and, consequently, a more complicated standard.

34 The AcSB confirmed that entities adopting Part II of the Handbook may not elect to adopt the hedge accounting provisions in Part I as proposed by some respondents; an entity adopts either Part I or Part II in their entirety.

OTHER ISSUES

35 Several respondents noted other issues that should be considered in terms of improvements to accounting standards for private enterprises. The AcSB noted these issues and decided to consider them in the next annual improvements project.

EFFECTIVE DATE AND TRANSITIONAL PROVISIONS

36 On the basis of input from a wide range of stakeholders, the AcSB understands that the majority of private enterprises are planning on adopting accounting standards for private enterprises for years beginning on or after January 1, 2011, which is the mandatory effective date for the standards. The AcSB noted that the amendments are to address issues that stakeholders are facing in applying the standards and, accordingly, decided to make the amendments effective from the mandatory effective date of the standards.

37 The AcSB approved a special transitional provision in respect of the amendments to FINANCIAL INSTRUMENTS, Section 3856, as a result of the effective date. This provision allows an entity to designate any hedging relationship initiated before December 31, 2011 retrospectively, provided that the relationship will have met all of the requirements for hedge accounting, other than designation and documentation at inception, and is still in existence at the next reporting date following inception.
