Non-Monetary Transactions — Background Information and Basis for Conclusions

Section 3831

Foreword

The pre-changeover standards in Part V of the CPA Canada Handbook – Accounting, which included this Basis for Conclusions document, have been removed from the Handbook. This Basis for Conclusions was developed to accompany the pre-changeover standard and, since that standard was fully converged with Part II of the Handbook, it remains relevant.

Background Information and Basis for Conclusions documents are primary sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100. 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 the conclusions in NON-MONETARY TRANSACTIONS, Section 3831, and related amendments to other Sections. It sets out the reasons the AcSB undertook the project to develop this material, 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 understand how the AcSB reached its conclusions in developing the Section and the AcSB's intent with respect to its interpretation and application.

BACKGROUND

3 In January 2003, the AcSB commenced an Accounting Standards Improvements Project to amend and improve certain parts of the Handbook that are no longer relevant, are incomplete, contain unjustified inconsistencies with US Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) standards, or that warrant reconsideration due to style, lack of specificity, or ineffectiveness. The AcSB identified Section 3830 as one of the Sections that should be improved as part of this project.

4 The FASB and the IASB worked together as part of their joint short-term convergence project to amend and improve their requirements for non-monetary exchanges. Section 3831 is based on FASB's Statement of Financial Accounting Standards No. 153, "Exchanges of Productive Assets — an amendment of APB Opinion No. 29" (FAS 153 and APB 29, respectively). It is similar to equivalent parts of the IASB's improved International Financial Reporting Standards IAS 16, "Property, Plant and Equipment," IAS 38, "Intangible Assets," and IAS 40, "Investment Property."

5 The consequential amendments to other Sections achieve consistency with Section 3831.

SCOPE

6 The scope of Section 3831 is based on that of Section 3830 with the amendments described in paragraphs 7-11 below.

7 RELATED PARTY TRANSACTIONS, Section 3840, provides the accounting for non-monetary transactions between related parties except for non-reciprocal transfers to owners that represent a spin-off or other form of restructuring or liquidation (see paragraphs 3831.14-.15, formerly 3830.11-.12). Accordingly, the scope exception for related party-transactions has been expanded from that in former Section 3830 to eliminate duplication.

8 Business combinations are excluded from the scope of Section 3831 as they are dealt with in BUSINESS COMBINATIONS, Section 1581. Stock-based transactions are also excluded as they are dealt with in STOCK-BASED COMPENSATION AND OTHER STOCK-BASED PAYMENTS, Section 3870.

9 CONTRIBUTIONS — REVENUE RECOGNITION, Section 4410, and CAPITAL ASSETS HELD BY NOT-FOR-PROFIT ORGANIZATIONS, Section 4430, provide not-for-profit organizations with alternatives for recognizing and measuring contributed assets and services. To avoid possible confusion, these transactions are excluded from the scope of Section 3831.

10 Comments on the Exposure Draft suggested adding the FAS 153 scope exception for transfers of financial assets to Section 3831. The AcSB decided not to include this change because financial assets are excluded from the scope of Section 3831 (and former Section 3830) by definition as monetary assets. Further, ACCOUNTING GUIDELINE AcG-12, Transfers of Receivables, does not correspond directly to Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 140), so the reference in FAS 153 to FAS 140 would not be analogous to a reference in Section 3831 to AcG-12.

11 Some respondents requested an explanation of why replacements of non-monetary assets that are lost, destroyed or expropriated are considered monetary transactions. This provision is unchanged from former Section 3830 and consistent with APB 29, which states that such transactions are considered monetary because the recipient is not necessarily obligated to reinvest any monetary consideration in other non-monetary assets.

DEFINITIONS

12 The Exposure Draft introduced a number of new terms and many respondents requested that these terms be defined. The AcSB considered the clarity of these terms as follows:

(a) Commercial substance — The AcSB decided that this term was better explained in the context of the decision process as set out in paragraph 3831.11 and the Illustrative Examples.

(b) Configuration — The AcSB inserted paragraph 3831.12 to clarify the meaning of configuration of the future cash flows and how it is used in determining whether a transaction has commercial substance.

(c) Entity-specific value — Despite the definition in paragraph 3831.05, respondents requested clarification of this concept and guidance that distinguishes it from fair value. The AcSB added paragraph 3831.13 and Illustrative Examples in response to these comments.

The Exposure Draft included a reference to after-tax cash flows in the guidance on the entity-specific value test. The AcSB removed it for consistency with the wording of FAS 153. However, as illustrated in the examples and as stated in IAS 16, IAS 38 and IAS 40, tax cash flows are included in determining entity-specific value. Some respondents were concerned that inclusion of tax cash flows conflicts with paragraph 21A of FAS 153, which addresses a specific US anti-avoidance concern. The AcSB was not convinced that paragraph 21A was intended to preclude the consideration of legitimate tax differences in assessing whether a transaction changes entity-specific value.

13 Former Section 3830 was modelled on APB 29 but contained a few distinct differences. One of these was in regard to the existence of partial monetary consideration in the transaction — "boot". APB 29 requires that any transaction with greater than 25 percent boot be classified as monetary and measured at fair value. When a transaction has less than 25 percent boot, APB 29 requires gain recognition on the asset given up to the extent of the proportion of boot received to the total consideration. Gain recognition for a non-monetary transaction under former Section 3830 was only permitted when the boot exceeded the carrying value of the asset given up. However, a transaction with greater than 10 percent

boot was deemed to be monetary resulting in gain or loss recognition for any differential between the carrying amount of the item given up (the consideration in the transaction) and the fair value of the item received.

14 The definition of non-monetary exchange in Section 3831 has been amended from that in former Section 3830 to remove the reference to boot. Since commercial substance occurs when there is a significant difference in cash flows, the AcSB believes that it is not necessary, and would be potentially confusing, to incorporate boot specifically into the definition. No difference between Canadian and US accounting, other than the different gain recognition noted above, is intended as a result of this change; both standards are based on the same assessment of commercial substance.

NON-MONETARY ASSET EXCHANGES

15 Former Section 3830 required fair value measurement for all non-monetary exchanges of assets or services except for exchanges that did not represent the culmination of the earnings process. The Section defined exchanges of inventory or "similar productive assets" as not representing the culmination of the earnings process. In practice, it was difficult to determine whether assets were similar. Several interpretations of Section 3830 and APB 29 had been provided, but problems persisted.

16 The AcSB decided that an approach that focuses on whether a transaction has commercial substance as reflected in projected future cash flows more closely captures the intent of the Section — it is more consistent with the underlying fair value principle, it will produce financial information that more faithfully reflects the economics of the exchange and it will be easier to apply consistently.

17 An assessment of cash flow projections is less subjective than assessing the earnings process and the similarity of the items exchanged. Cash flow projections are often part of the decision-making process to enter into a transaction. When it is not possible to measure reliably the fair value of either the asset given up or the asset received, the transaction is measured at the carrying amount of the asset given up.

18 There is a general but rebuttable presumption that the consideration in arm's length transactions represents the fair value of the item or items exchanged. Section 3830 used the culmination of the earnings process test to evaluate exchanges of both non-monetary assets and services. The AcSB decided that including services in the test was potentially confusing. Contracts for services to be received in the future are non-monetary assets and contracts to provide such services are non-monetary liabilities. Exchanges of current services need to be evaluated against the criteria in REVENUE, Section 3400, to determine their disposition.

19 The AcSB and the FASB continue to exclude exchanges of product or property held for sale in the ordinary course of business for product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange from fair value measurement under Section 3831 and FAS 153, respectively. IASB standards also continue to require entities to measure inventory exchanges at carrying amount. The AcSB is monitoring a joint FASB/IASB project to develop more robust revenue recognition standards. Revenue recognition standards continue to refer to an "earnings process", a concept that has been eliminated from the standards for non-monetary exchanges. It is possible that the treatment of inventory exchanges will be revised as a result of the FASB/IASB project.

COMMERCIAL SUBSTANCE

20 Commercial substance might be assessed by analyzing the attributes of one or more of:

(a) the reporting entity making the exchange;

(b) the assets being exchanged;

(c) the counterparty to the exchange; and

(d) the terms of the exchange.

21 The most useful perspective is that of the reporting entity as it focuses on information required by users of the financial statements. Users are interested in the amount, timing and risk of cash flows generated by the entity. By applying the reporting entity perspective, the financial statements objectively capture the impact of changing cash flow expectations both in measuring the asset received and in recognizing any gain or loss on the asset given up.

22 Former standards focused on the attributes of the assets being exchanged. They first required the entity to determine whether "the earnings process" was complete without defining the point where this occurred. They did state that culmination had not occurred if the transaction involved an inventory exchange or an exchange of "similar" productive assets. These standards then required the entity to assess subjectively whether the exchanged items were similar without necessarily assessing their impact on the entity. Only when the items were declared dissimilar was the impact of the exchange quantified. This risked failing to meet users' needs in a rational and consistent manner. While the approach had some merit, the AcSB believes that the numerous problems noted cannot be adequately resolved without addressing revenue recognition in general.

23 It is inappropriate to use the attributes of the counterparty to determine the accounting model for non-monetary transactions. This information is generally not available in an arm's length transaction. It is also of limited use to the users of the reporting entity's financial statements.

24 An evaluation of the terms of the exchange is inappropriate in the context of improving the standard on measurement of non-monetary transactions, because such an evaluation has implications for revenue recognition that are beyond the scope of Section 3831.

25 Commercial substance occurs when a transaction causes an identifiable and measurable change in the economic circumstances of the entity. A transaction has commercial substance when it results in a change in either the configuration (risk, timing and amount) of the cash flows directly associated with the exchanged items or the entity-specific value of the exchanged items. Only one of the tests needs to be satisfied to conclude that a non-monetary transaction has commercial substance.

26 The configuration test in paragraph 3831.11(a) is a comparison of the risk, timing and amount of the cash flows before and after the transaction. A significant change in any of these parameters is sufficient evidence of commercial substance. It should generally be possible to observe whether the configuration test is met without performing calculations and the AcSB added a clarification to this effect. As noted by Exposure Draft respondents, the AcSB also recognized that it is illogical for the change in configuration to be compared to the fair value of the items exchanged and clarified the test accordingly. Examples 1-3 have been provided to illustrate the cash flow configuration test.

27 The entity-specific value test is necessary when there is no apparent significant change in the configuration of the asset's cash flows. Entity-specific value is calculated as the net present value of the net cash flows the entity expects to receive from use of the exchanged asset, including its disposal at the end of its useful life. The test in paragraph 3831.11(b) captures any relevant change in synergies between the asset received and the entity. Commercial substance occurs when the change in entity-specific value is significant relative to the fair value of the items exchanged. In response to Exposure Draft comments, the AcSB also added a clarification to explain that entity-specific value is not equivalent to fair value.

28 The AcSB agreed with Exposure Draft respondents that the reference to "portion of the entity's operations" in the proposed entity-specific value test was confusing. The AcSB decided on redeliberation that it is not necessary to refer to "portion" in this context; the acquired asset either has a different value to the entity from the asset it replaces or it doesn't. The key distinction between the configuration test and the entity-specific value test is that the latter includes indirect cash flow changes which are not reflected in the configuration test. Examples 4-6 illustrate the entity-specific value test.

29 In each test, the change must be significant to merit fair value measurement. The determination of significance requires the application of professional judgment.

RELIABLY MEASURABLE FAIR VALUES

30 The AcSB decided to base the fair value exception on whether fair value is "reliably measurable". Recent AcSB pronouncements have used this term. 1 The FASB used "determinable within reasonable limits", but notes that this description is intended to mean the same as "reliably measurable" as used by the IASB. The description of "reliably measurable" in Section 3831 is the same as that in FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, Section 3855. The FASB has stated that it will revisit the phrase on completion of its Fair Value Measurement Project.

31 Several Exposure Draft respondents requested the addition of fair value measurement guidance to the Section. Between the date of the Exposure Draft and the release of Section 3831, the AcSB released considerable guidance in the Appendix to Section 3855, in addition to that already existing in the Appendix to Section 1581. The AcSB is also monitoring and participating in various international projects dealing with aspects of measurement. Additional material on fair value measurement is expected to be released at the conclusion of these projects.

DISCLOSURES

32 Disclosure requirements apply to all non-monetary transactions — previously, disclosure was only required for non-monetary transactions that did not represent the culmination of the earnings process. The AcSB believes that the disclosures adequately provide the information that is essential to users' understanding of an entity's non-monetary transactions.

TRANSITIONAL PROVISIONS

33 Section 3831 is to be applied to all non-monetary transactions initiated in fiscal periods beginning on or after January 1, 2006. It may be applied to transactions initiated in periods beginning on or after July 1, 2005. This date should permit affected entities to avoid potential US GAAP differences since FAS 153 applies to transactions in fiscal periods beginning after June 15, 2005. Balances arising as a result of transactions prior to the application date are not restated. The AcSB does not believe it is possible in most cases to determine retroactively, without the benefit of hindsight, the assumptions necessary to assess whether a previous exchange had commercial substance at the date of the exchange.

CONSEQUENTIAL AMENDMENTS

34 There were three Handbook Sections that referred to "culmination of the earnings process": BUSINESS COMBINATIONS, Section 1581, INTERESTS IN JOINT VENTURES, Section 3055, and RELATED PARTY TRANSACTIONS, Section 3840. In addition, DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475, contained references to exchanges of similar productive assets.

Business combinations

35 The AcSB deleted the reference to "culmination of the earnings process" from paragraph 1581.22, which required that the more reliably determinable of the fair value of consideration given or share of the fair value of net assets or equity interest acquired be used to determine the cost of an acquisition. The former provision was also inconsistent with

comparable US GAAP and International Financial Reporting Standards. Further changes to Section 1581 are expected as projects to review accounting for business combinations progress. The AcSB concluded that all business combinations, including those that are non-monetary transactions, should be accounted for in accordance with Section 1581 and that Section 3831 does not apply.

Interests in joint ventures

36 Consistent with the changes to Section 3830, transfers of products or property held for sale in the ordinary course of business to facilitate sales to customers are accounted for at their carrying amount. Transfers of other assets to joint ventures by venturers who are not related parties have commercial substance because relinquishing control of the assets transferred in exchange for rights and responsibilities determined by the joint venture agreement alters the configuration of the cash flows in a manner that is presumed to be significant. In many cases, the transfer will also result in a significant change to the venturer's entity-specific value. No analysis of cash flows is required; these transfers are accounted for at fair value provided fair values are reliably measurable. However, when the venturers are related parties, non-monetary transfers to the joint venture are accounted for in accordance with Section 3840.

37 Due to ongoing projects to re-examine revenue recognition and the accounting for business combinations, FAS 153 excludes exchanges of non-monetary assets for an interest in an entity from the scope of APB 29. The consequential amendments to Sections 1581 and 3055 are not intended to presuppose any conclusions from these projects.

Disposal of long-lived assets and discontinued operations

38 The AcSB amended Section 3475 to delete references to "exchanges of similar productive assets". The amendments clarify that a non-monetary exchange recorded at carrying amount is a disposal other than by sale, and that a non-monetary exchange that has commercial substance and is reliably measurable is a disposal by sale. These changes provide the same degree of objectivity as the changes to Section 3830. The FASB has made comparable changes to Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

Related party transactions

39 Changes to Section 3840 reflect the belief that commercial substance is a better test of whether something has changed for the party making the transfer than culmination of the earnings process. Accordingly, a non-monetary transaction in the normal course of operations, except for an exchange of a product or property held for sale in the normal course of operations to facilitate sales to customers, is measured at exchange amount when the transfer has commercial substance. In this context, the change in the entity-specific value of the asset must be significant relative to the exchange amount. Likewise, a non-monetary transaction not in the normal course of operations, but that has commercial substance, is measured at the exchange amount provided the additional criteria for transactions that are not in the normal course of operations are met.

40 The AcSB decided to use the phrase "normal course of operations" throughout Section 3840 to maintain consistency, but notes that it has the same intended meaning as "ordinary course of business" as used in Section 3831.

DIFFERENTIAL REPORTING

41 The amendments to Section 3830 have been reviewed by the Differential Reporting Advisory Committee. The Committee has not recommended, and the AcSB did not identify, any differential reporting options to be incorporated into the Section.

REPORTING BY NOT-FOR-PROFIT ORGANIZATIONS

42 The amendments to Section 3830 have been reviewed by the Not-for-Profit Organizations Advisory Committee. The Committee believes the proposals are appropriate for not-for-profit organizations. The AcSB adopted the suggestion of this committee to clarify that donations received by not-for-profit organizations are accounted for in accordance with either Section 4410 or Section 4430.

CONSISTENCY WITH US AND INTERNATIONAL REQUIREMENTS

43 The AcSB believes the provisions of Section 3831 are not in conflict with US generally accepted accounting principles or with International Financial Reporting Standards, except as noted above.

Footnotes

1. "Reliably measurable" is used in BUSINESS COMBINATIONS, Section 1581, and in STOCK-BASED COMPENSATION AND OTHER STOCK-BASED PAYMENTS, Section 3870, as well as FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, Section 3855, and HEDGES, Section 3865.