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Navigating financial reporting

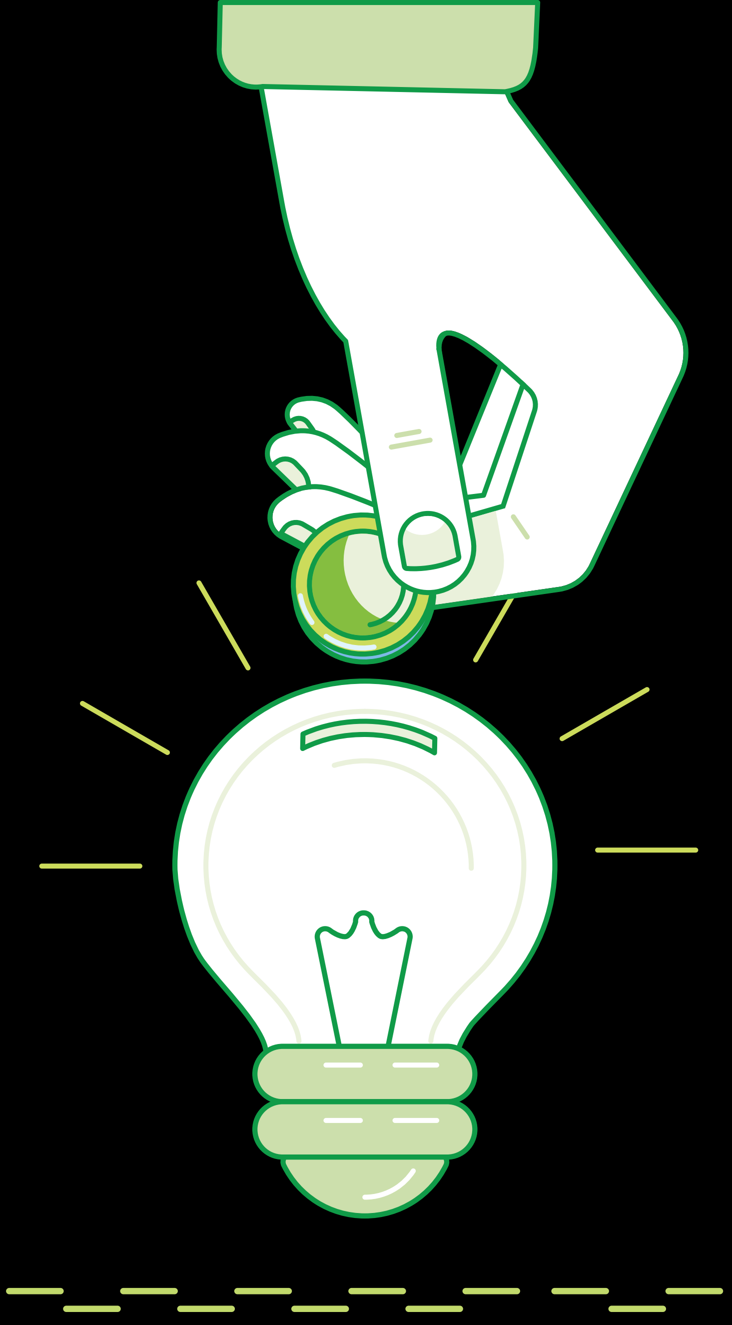
An update on Accounting Standards for Private Enterprises

Audit & Assurance

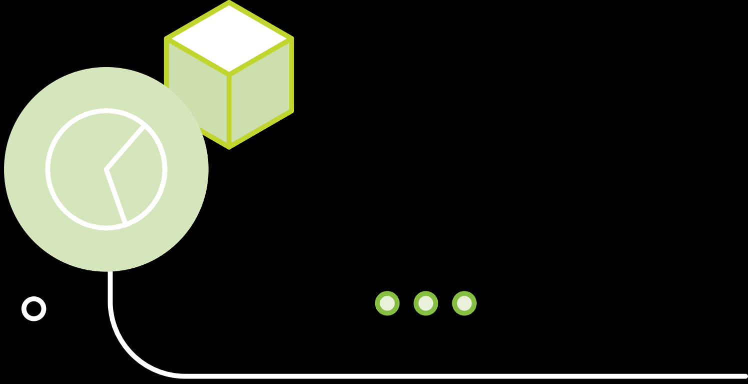
Keeping ahead of all of the changes affecting private companies which apply Accounting Standards for Private Enterprises ("ASPE") can be a challenge. In this guide, we provide an overview of the recently introduced changes to ASPE and how these changes might impact your organization. We also provide insight into expected future changes to ASPE to ensure you are prepared for what's to come.

This guide is organized as follows:

- Preparing for the 2017 year-end
- Amendments effective in 2018
- Looking down the road beyond 2018



Preparing for the 2017 year-end

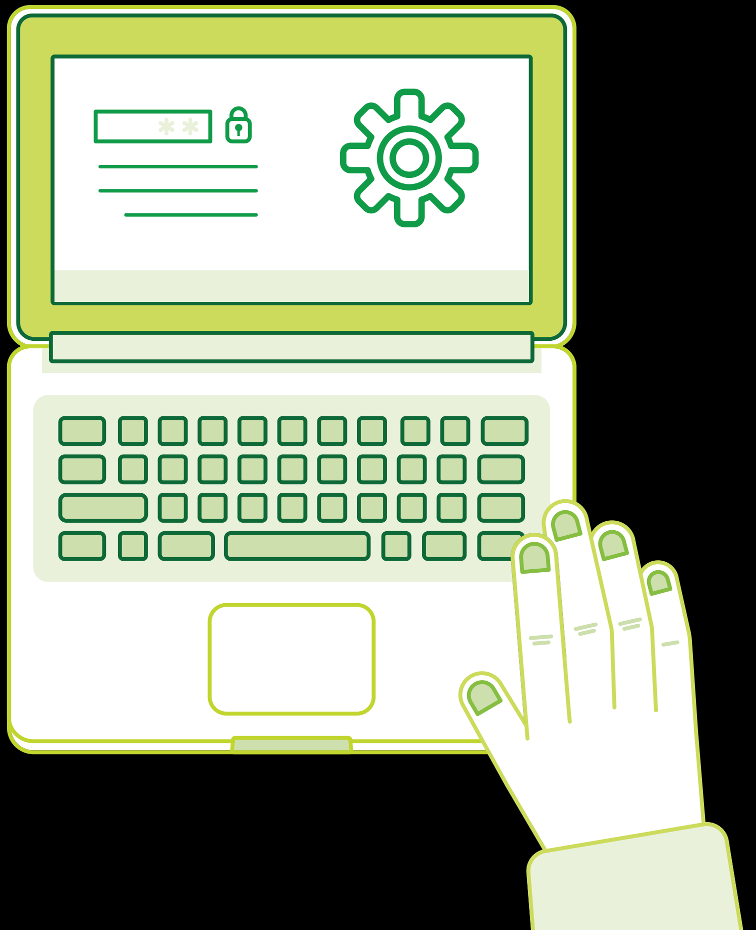


Updates to ASPE that took effect in 2017 are minimal. There were no new standards issued that are effective in 2017 and the only changes made were to clarify minor subtleties in the application of existing standards.

Changes to ASPE effective January 1, 2017 at-a-glance

Amendment	Impact
1. Clarification that the transitional relief in Sections 1591, ***Subsidiaries,*** and 3056, ***Interests in joint arrangements,*** applies only when an enterprise adopts those sections for the first time. Private companies with calendar year-ends were required to adopt these standards in 2016.	Going forward, entities that choose to change accounting policies in relation to investments in subsidiaries or jointly controlled enterprises are required to do so in accordance with Section 1506 *Accounting changes.*
2. Clarification that an enterprise preparing non-consolidated financial statements is not required to assess whether contractual arrangements give rise to control.	Confirmation that a review of contractual arrangements for "control" is only required when consolidated financial statements are prepared.

In short, these changes are not expected to change your approach to your 2017 year-end financial reporting.



Amendments effective in 2018

1. The new cost method

In December, 2016, the Accounting Standards Board ("AcSB") introduced several amendments to Section 1591, ***Subsidiaries,*** and Section 3051, ***Investments,*** to clarify how the cost method should be applied when an enterprise has elected to use such method in accounting for its interests in subsidiaries or investments subject to significant influence.

The amendments represent the most significant change to the cost method in 15 years. The fundamentals of the cost method have not changed, the investment is still initially measured at "cost" and earnings are still recognized when received or receivable. However, the requirements when the cost method is applied have expanded.

In particular, a new principle has been introduced: a subsidiary, which is subsequently accounted for using the cost method, is initially measured on a basis that is similar to other business combinations. This means that the key concepts in Section 1582, ***Business combinations,*** will be applied when a subsidiary is acquired (except, of course, a purchase price allocation would not be performed).

The new cost method—an overview of the requirements

When a subsidiary is accounted for using the cost method, the following requirements would apply (note, this is a summary only):

Initial measurement

- Cost is measured at the acquisition-date fair value of the consideration transferred for the subsidiary.
- If the acquisition involves an exchange of equity interests only, the more reliably measurable of the equity of the acquirer or the acquiree is used.
- Acquisition-related costs are expensed, except for the costs to issue debt or equity.
- When the enterprise and subsidiary settle a pre-existing relationship or enter into an arrangement during negotiations that is separate from the acquisition of the subsidiary (such as the remuneration of employees or former owners of the acquiree for future services), those arrangements are excluded from the cost of the investment.
- A bargain purchase gain is not recognized.
- When control is acquired in stages, the previously held interest is not re-measured.
- Provisional amounts may be used to measure the cost of the subsidiary when the initial accounting is not complete by the end of the reporting period in which the acquisition occurs (for example, because of a working capital adjustment clause).
- When a subsdiary is transferred between enterprises under common control, the transaction is recorded at its carrying amount, unless specific conditions are met.

Subsequent measurement

- Earnings are recognized to the extent received or receivable.
- At the end of each reporting period, each subsidiary is assessed for impairment.
- Contingent consideration is only re-measured when the contingency is resolved, on the same basis as required by Section 1582.
- Provisional amounts must be finalized within one year of the acquisition date in the manner described in Section 1582, except there is no retrospective adjustment.
- Additional guidance is provided when accounting for a change in ownership of a subsidiary. For example, when an enterprise purchases an additional stake in a subsidiary or sells a portion of its interest in a subsidiary, it would need to determine whether the transaction is indicative of an impairment in the subsidiary (i.e. whether the price paid for the additional interest acquired or the price received for the portion of the interest sold is less than its proportionate carrying amount).

Similar, but less extensive, amendments were also made to Section 3051, *Investments*, in respect of the application of the cost method to investments subject to significant influence. While ASPE isn't explicit, it would appear reasonable to apply such amendments to investments in jointly controlled enterprises accounted for using the cost method.

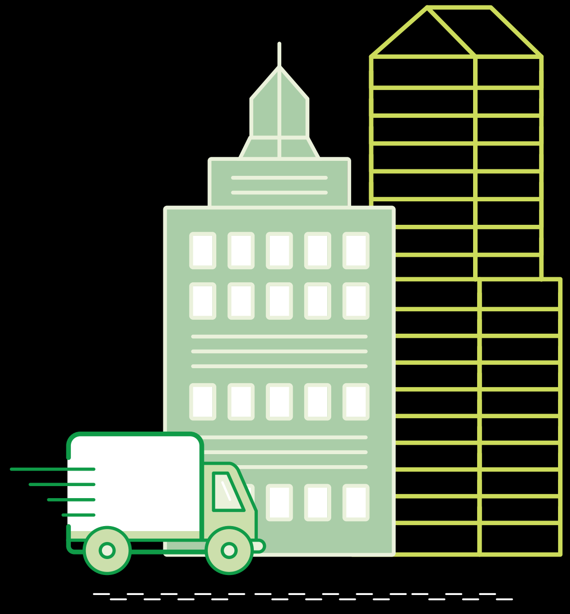
The amendments to Sections 1591 and 3051 are effective for fiscal years beginning on or after January 1, 2018, and are applicable prospectively, with earlier application permitted.

Impacts to your organization?

The amendments will impact companies which acquire interests in subsidiaries or investments subject to significant influence after the effective date (i.e. fiscal years beginning on or after January 1, 2018). The extent of the impact will vary by company and individual circumstances.

Companies which acquire interests in subsidiaries after the effective date may need to apply greater diligence in analyzing those transactions. For example, when a company acquires a new interest in a subsidiary it would need to analyze any arrangements which it enters into with the employees or former owners of the subsidiary, to determine whether amounts payable under such arrangements are part of the cost of the investment or must be accounted for separately. Given that entering into arrangements with former owners of the acquiree is common in private company transactions, this new requirement could result in additional work.

Overall, the cost method remains the simplest method for accounting for investments—but the new requirements highlight that care will be required in analyzing acquisitions. The new requirements are effective for fiscal years beginning on or after January 1, 2018 on a prospective basis, and therefore will impact companies undertaking new acquisitions (and changes in ownership interests) after the effective date.



2. 2017 Annual Improvements Project

In July, 2017, the 2017 Annual Improvements were issued. The annual improvements are summarized below:

Improvement	Impact
Section 1505, Disclosure of accounting policies, has been amended to require disclosure of accounting policies as "one of the first notes" to the financial statements rather than as the first note.	This is not expected to result in a significant change in practice.
Section 1506, Accounting changes, has been amended to require disclosure of the impact of a change in accounting policy "for each of the prior periods(s) presented" in contrast to the current requirement to disclose the impact of a change in accounting policy "for the current period".	This improvement is likely to provide more meaningful information to users.
Section 1521, Balance sheet, has been amended to clarify those assets and liabilities that must be presented separately on the balance sheet versus those which could be disclosed in the notes to the financial statements.	Companies are encouraged to compare their existing balance sheet format to the revised standard, to determine if any changes to their current presentation are necessary.
Section 1651, Foreign currency translation, has been amended to remove the inconsistency with Section 3031, ***Inventories,*** relating to the reversal of write-downs of inventory from the translated financial statements of integrated foreign operations.	Enterprises with inventory in integrated foreign operations will need to adjust their translation models to allow reversals of previous write-downs of inventory.
Section 3065, Leases, has been amended to require disclosure of only the amount of the allowance for impairment, not the carrying amount of impaired operating lease receivables.	This should simplify the disclosures for enterprises with impaired operating lease receivables.

These improvements are effective for fiscal years beginning on or after January 1, 2018, with earlier application permitted.

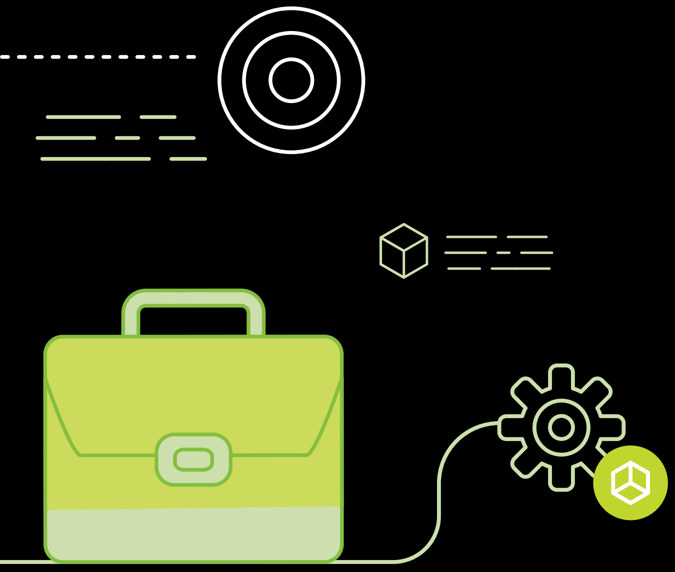
Looking down the road beyond 2018

In this section, we will review two recently issued Exposure Drafts and the AcSB's project on ***Agriculture,*** which could impact companies in the next few years.

1. Exposure Draft—Retractable or mandatorily redeemable shares issued in a tax planning arrangement

Companies which issue redeemable preferred shares in a tax planning arrangement under certain specified sections of the Income Tax Act are currently exempt from classifying these shares as liabilities, pursuant to paragraph 23 of Section 3856, ***Financial Instruments***. The AcSB has been revisiting this exemption with concern that the exemption was being applied to transactions beyond those originally intended, such as commercial financing arrangements.

In 2014, the AcSB issued an Exposure Draft which proposed to eliminate the Section 3856.23 exemption entirely. After some reflection, the AcSB has revisited this position. In September, 2017, the Board issued a new Exposure Draft which proposes to retain the exemption but tighten the conditions under which shares issued in a tax planning arrangement would be allowed to be classified as equity. The conditions reflect the notion that nothing of substance has changed.



Under the new Exposure Draft proposals:

Retractable or mandatorily redeemable shares issued in a tax planning arrangement are classified as **equity** only when the following 3 conditions are met:

1. Control of the enterprise is retained by the shareholder receiving the shares;
2. No arrangement exists, explicit or implicit, that requires redemption of the shares in a fixed or determinable period; and
3. No consideration other than shares are exchanged.

If all three conditions are met, the shares would be classified as equity and measured, at their par, stated or assigned value (which is generally nominal). In addition, shares which are initially classified as equity would need to be reassessed when a subsequent event or transaction occurs that indicates one or more of the conditions for equity classification are no longer met. When the conditions for equity classification are no longer met, the retractable or mandatorily redeemable shares would need to be reclassified as financial liabilities.

If all three conditions are not met, the retractable or mandatorily redeemable shares would be classified as a financial liability and measured at their redemption amount (i.e. the amount payable on demand), with the offsetting charge presented as a separate component of equity. As the shares are called for redemption, amounts would be reclassified from the separate component of equity into retained earnings. Retractable or mandatorily redeemable shares that are initially classified as financial liabilities are prohibited from being reclassified to equity even if conditions change.

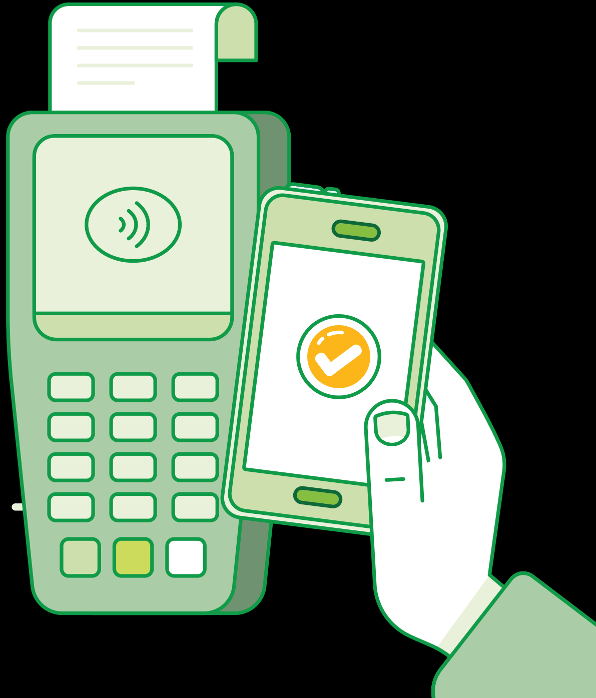
The amendments would be effective for fiscal years beginning on or after January 1, 2020. An enterprise would be required to assess whether the conditions for equity classification are met at the date the enterprise applies the amendments for the first time. Transitional relief would allow preparers the option to not restate comparatives.

Which transactions will not qualify for equity classification?

- **Estate freeze transactions** that meet the required conditions should qualify for the classification exception. However, not all estate freeze transactions are expected to qualify. For example, several shareholders which jointly control an enterprise undertake an estate freeze in which they exchange their common shares for mandatorily redeemable shares, after which each jointly controls the enterprise. The mandatorily redeemable shares would not qualify for equity classification as the 'control' condition is not met: no individual controlled the enterprise on his or her own before or after the transaction.

- **Asset rollover transactions** will not qualify for equity classification. If an individual transfers an asset (or group of assets) to an enterprise in a tax planning arrangement in exchange for mandatorily redeemable shares, the addition of assets to the enterprise will change the cash flows of that enterprise as opposed to "freezing" the value. The mandatorily redeemable shares would not qualify for equity treatment as the condition requiring that the transaction consideration involves only a share for share exchange is not met.

Asset rollover transactions will not qualify for equity classification.

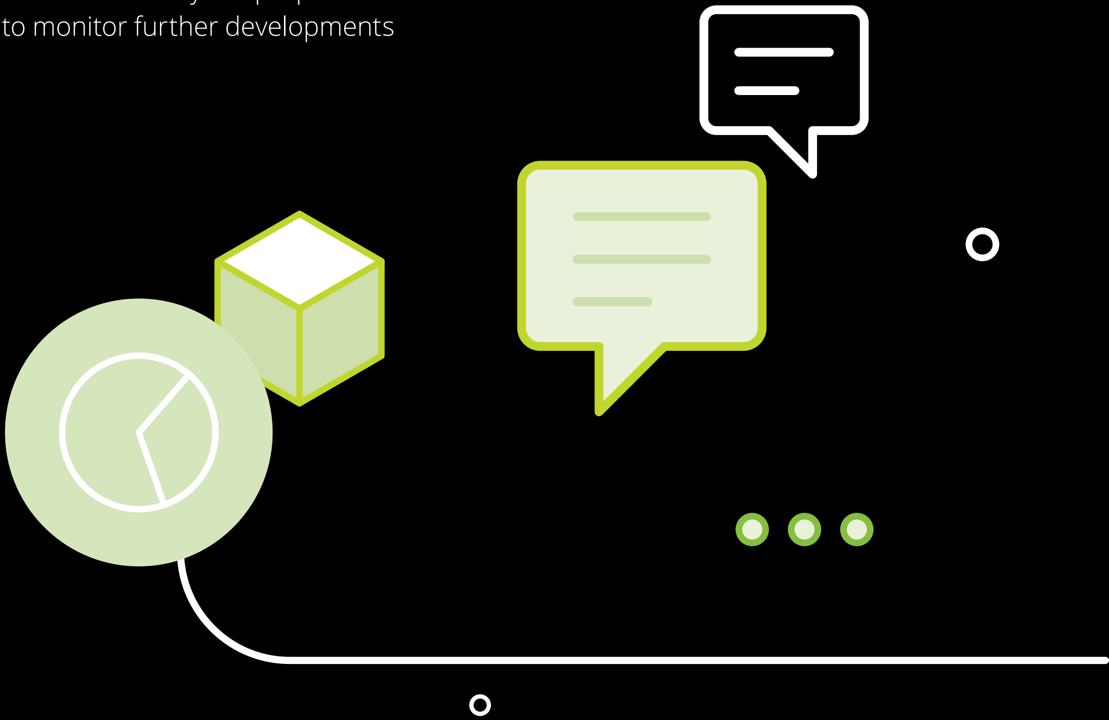


Exposure draft for shares issued in a tax planning arrangement—impacts to your organization

Impacts to your organization?

- For tax planning arrangements for which the shares do not qualify for equity classification:
  - The shares will need to be reclassified from equity to liabilities, and measured at their redemption amount. The shares would need to be classified as current liabilities (as the shares are redeemable on demand).
  - The reclassification of the shares may adversely impact financial metrics, such as the current ratio and the debt to equity ratio, necessitating the renegotiation of debt covenants and other contractual arrangements.
  - For companies which apply the future income taxes method, consideration would need to be given to the impact on future income taxes.

Enterprises which have undertaken tax planning arrangements involving the issuance of retractable or mandatorily redeemable shares, or plan to undertake such tax planning arrangements in the future, are encouraged to read the Exposure Draft, to determine the impact of the proposals on their particular transaction. Enterprises which are affected by the proposals are encouraged to monitor further developments on this project.



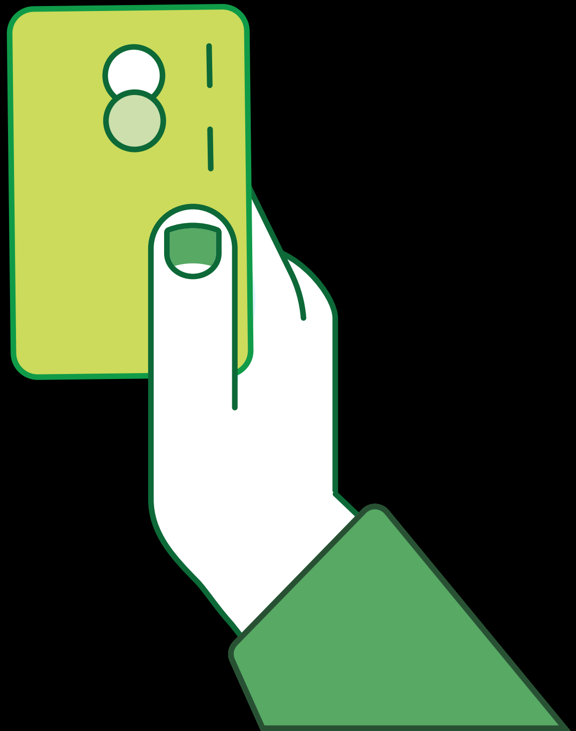
2. Exposure Draft—Accounting for related party financial instruments and significant risk disclosures

In October 2017, the AcSB issued an Exposure Draft which aims to address specific challenges raised in the Post Implementation Review of Section 3856, *Financial Instruments,* with respect to the accounting for related party financial instruments.

One of the most significant challenges is how related party financial instruments should be measured on initial recognition and thereafter.

The Exposure Draft proposes the following:

- Equity instruments quoted in an active market and derivative contracts are measured at **fair value**.
- All other related party financial instruments are measured at **cost**.
- The **cost** of a related party financial instrument depends on whether it has repayment terms:
  - **Instruments with repayment terms** are measured using the undiscounted cash flows of the instrument, excluding interest and dividend payments.
  - **Instruments without repayment terms** are measured using the consideration transferred by the enterprise.
- Enterprises would be prohibited from electing to measure related party financial instruments at fair value.
- These proposals are intended to simplify the measurement of related party financial instruments, by limiting the circumstances when related party financial instruments would be required to be measured at fair value.



The Exposure Draft proposes retrospective application with simplifying transitional provisions.

The Exposure Draft also provides other simplifications, such as:

- An enterprise is required to assess for, and recognize in net income, any impairment of a related party financial asset before forgiveness of the financial asset is recognized. Any forgiveness is recognized in equity when the original transaction was not in the normal course of operations; otherwise, it is recognized in net income.
- All modifications of a related party financial liability are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
- An enterprise which issues a related party compound financial instrument is permitted to measure the equity component as "zero".
- The disclosure requirements would be modified to permit disclosures about significant risks arising from derivatives to be included with risks arising from other financial instruments.

The proposals would be effective for fiscal years beginning on or after January 1, 2020, and would be applicable retrospectively with simplifying transitional provisions.

3. Agriculture

If your company engages in agricultural activity—ranging from traditional farming activities to the production of cannabis—you will be interested in the AcSB's ***Agriculture*** project. The project is focused on developing authoritative guidance for ASPE on the recognition and measurement of living plants and animals, and the harvested produce from those assets.

In December, 2015, the AcSB issued its Discussion Paper, ***Agriculture,*** which set out the key proposals for accounting for agricultural activity. Since then the AcSB has spent considerable time evaluating responses received to the Discussion Paper, conducting outreach and forming an Agriculture Advisory Group to better understand the issues affecting entities operating in various agricultural sub-sectors.

If you are a company with agricultural activities, you are encouraged to monitor this project and watch out for an Exposure Draft which is expected to be issued by the third quarter of 2018.

Contacts

If you have questions, we encourage you to reach out to your Deloitte advisor, or any of the professionals listed below.

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