FYI accounting standards

ACTIVITIES OF THE CANADIAN ACCOUNTING STANDARDS BOARD AND STAFF

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Accounting Standards Board AcSB CNC Conseil des normes comptables

DECEMBER 2008

AN INTERVIEW WITH PAUL GOODYEAR, CHAIR OF THE AcSB'S NOT-FOR-PROFIT ORGANIZATIONS ADVISORY COMMITTEE

WHO ESTABLISHES NOT-FOR-PROFIT GAAP IN CANADA?

The Accounting Standards Board (AcSB) has the authority to establish standards for private sector not-for-profit organizations. For government not-for-profit organizations, which include schools, universities, colleges and hospitals in some provinces, the authority rests with the Public Sector Accounting Board (PSAB), which has to date directed not-for-profit organizations in that sector to apply the accounting standards issued by the AcSB.

The AcSB is engaged in a strategic process to determine future GAAP financial reporting standards that should apply to not-for-profit organizations. Why is reporting in accordance with GAAP standards important to not-for-profit organizations?

Not-for-profit organizations need to have standards that help ensure quality financial reporting. Regardless of whether a not-for-profit organization is a registered charity or not, it has stewardship obligations to its contributors, members, or other stakeholders, including the public. High-quality financial reporting helps organizations fulfil their need to be accountable for good stewardship. GAAP standards provide that quality in reporting.

What are the options that the AcSB is considering and why are they considering those particular options?

The AcSB is responsible for setting standards for publicly accountable and private profit-oriented enterprises and for not-for-profit organizations in the private sector. The AcSB has determined that publicly accountable profit-oriented enterprises will follow International Financial Reporting Standards (IFRS). While these standards are not developed with not-for-profit organizations in mind, they may be applied by a not-for-profit organization if it considers them to be an appropriate form of reporting to its stakeholders. In fact, not-for-profit organizations in some other jurisdictions are using IFRS.

The AcSB is also developing a made-in-Canada alternative set of financial reporting standards for private profit-oriented enterprises. The AcSB is considering including not-for-profit organization-specific material in this set of standards similar to the material that is contained in the existing CICA Handbook – Accounting. I would expect that many, if not most, not-for-profit organizations will probably find this basis of reporting more useful.

What other options did the AcSB consider?

The AcSB considered and rejected developing stand-alone standards for not-for-profit organizations. The AcSB understands that the current approach to standard setting, in which standards for not-for-profit organizations are aligned with standards for profit-oriented enterprises, seems to have served not-for-profit organizations well for the last dozen or so years. As well, considerations such as the cost of developing and maintaining stand-alone standards for not-for-profit organizations and the impact on both preparers and users of financial statements to have to learn and apply those standards seemed to suggest that this was not a practical alternative.

We understand that the PSAB is considering whether government not-for-profit organizations should continue to follow private sector GAAP or should instead follow public sector GAAP, either with or without some form of specific not-for-profit guidance. Would you care to comment on this initiative?

Given the changes occurring in setting private sector standards, the PSAB decided it would be an appropriate time to examine whether to continue to require government not-for-profit organizations to follow the standards developed for the private sector or to require them to follow standards developed for the public sector. Hence, the Invitation to Comment on the future reporting standards for not-for-profit organizations will be issued jointly by the AcSB and the PSAB.

The Invitation to Comment is expected to be issued soon. Would you like to comment on the importance of not-for-profit organization stakeholders responding to the questions the AcSB and the PSAB are asking?

It is very important that not-for-profit organization stakeholders respond. Given the broad diversity of not-for-profit organizations, it is very difficult for the Advisory Committee, or either Board for that matter, to fully appreciate the circumstances of every possible type of organization and their financial reporting needs. Hearing from stakeholders concerning their views is critically important in ensuring that accounting standards for not-for-profit organizations, both in the private and public sectors, continue to meet the financial reporting needs of these organizations and their stakeholders into the future.

What questions are being posed in the Invitation to Comment?

The Invitation to Comment solicits input on whether not-for-profit organization stakeholders agree that financial reporting for not-for-profit organizations should be closely linked to GAAP standards and, assuming that is the case, whether they support requiring all not-for-profit organizations to follow one set of standards.

If so, the alternatives seem to be either International Financial Reporting Standards, private enterprise standards being developed by the AcSB supplemented by standards specific to not-for-profit organizations, public sector standards, or public sector standards supplemented by standards specific to not-for-profit organizations.

Alternatively, stakeholders are asked if they support making options available to not-for-profit organizations based on an assessment of their users' needs or whether rules or guidance should be developed to narrow use of the options. If stakeholders support making options freely available, the proposed options for private sector not-for-profit organizations would be the ones I outlined earlier.

If one set of standards for all not-for-profit organizations is not supported, the proposed options available for public sector not-for-profit organizations would be to apply public sector standards or public sector standards supplemented by standards specific to not-for-profit organizations.

Mr. Goodyear is a former member of the AcSB and the Accounting Standards Oversight Council. He is the Financial Secretary (CFO) of the Salvation Army Canada.

ACCOUNTING CONSIDERATIONS FOR THE CURRENT ECONOMIC TURMOIL

Consumers and investors today, perhaps more than any other time in recent history, are seeking financial information on the companies they invest in and make purchases from. Sophisticated investors are delving more deeply into companies' financial results and the "average Joe" is attempting to assess whether a retailer will exist long enough to service warranty obligations, or whether the Christmas gift card purchased for a dear friend will be valid in the coming months.

While many accounting standards attempt to portray the current state to a financial statement user, others may require preparers and auditors of financial statements to be somewhat forward looking — for example, to assess an entity's ability to continue as a going concern. Some of these standards are highlighted below. They are particularly relevant in the current economic environment, but should always be considered.

- **Going concern assessments —** Section 1400, *General Standards of Financial Statement Presentation*, requires an assessment of an entity's ability to continue as a going concern for at least a twelve-month period, as well as disclosure of material uncertainties giving rise to significant doubt about an entity's ability to continue as a going concern. The standard also requires disclosure of the basis on which an entity's financial statements are prepared, if they are not prepared on a going concern basis. Consider risk exposures from relationships with significant suppliers, customers, debtors, creditors and others.
- **Impaired loans —** Section 3025, *Impaired Loans*, requires the carrying amount of an impaired loan or a portfolio of impaired loans to be recorded at net realizable value, if reasonable assurance of the timely collection of the full amount of interest and principal recorded by the lender does not exist. In assessing the need to record an impairment charge in the income statement for the period, consider downgrades in the credit status of a borrower or guarantor reported by recognized credit rating agencies as well as independent credit reports. Financial statements that portray a decline in the current financial position of the borrower or guarantor (particularly its liquidity), receivership, bankruptcy or liquidation of a borrower or guarantor are warning signs.
- **Inventories —** Section 3031, *Inventories*, generally requires inventories to be recorded at the lower of cost and net realizable value. Consider whether the demand for, or selling price of, an item of inventory is expected to be lower, which will impact its estimated net realizable value.
- **Property, plant and equipment —** Section 3061, *Property, Plant and Equipment*, requires the amortization charged to an entity's income statement to be the greater of: the cost less salvage value over the life of the asset; and the cost less residual value over the useful life of the asset. Consider changes in the economic environment that may affect consumer styles and tastes or changes in the manner or extent to which an item of property plant and equipment may be used. Amortization methods may need to be revised.
- **Long-lived assets —** Section 3063, *Impairment of Long-lived Assets*, requires the recognition of an impairment loss when the carrying amount of a long-lived asset is not recoverable and exceeds it fair value. Consider whether the recognition of an impairment loss is appropriate.
- **Goodwill and intangible assets —** Section 3064, *Goodwill and Intangible Assets*, requires impairment assessments on intangible assets subject to amortization, intangible assets with an indefinite life and goodwill. Consideration should be given to whether the assumptions used in fair value computations are appropriate in the current market environment or the assumptions used to determine fair value are difficult to predict and additional disclosures are appropriate.
- **Contingent liabilities —** Section 3290, *Contingencies*, requires the recognition of certain contingent losses and disclosure of contingent losses. Consider whether contingent liabilities, including guarantees of the indebtedness of others, have been appropriately identified and adequately disclosed.

- **Employee future benefits —** Section 3461, *Employee Future Benefits*, requires defined benefit plans to disclose (among other items) the current service costs and expected return on plan assets. Consider the impact of falling investment values, investment returns and interest rates on the expense recognized for the period.
- **Deferred taxes —** Section 3465, *Income Taxes*, permits the use of a valuation allowance when recording future income tax assets and requires an annual assessment of whether a future income tax asset should be reduced. Consider whether current conditions mean it is no longer "more likely than not" that a deferred tax asset will be realized. This is particularly important where an entity has incurred cumulative losses in the immediately preceding years or other circumstances exist that may make it difficult to justify deferred tax asset balances.
- **Financial assets —** Section 3855, *Financial Instruments — Recognition and Measurement*, generally requires financial assets to be measured at fair value on initial recognition and subsequently at cost, amortized cost or at fair value depending on whether the financial asset is classified as held for trading, held-to-maturity or available-for-sale. The standard also requires such assets to be written down to their estimated recoverable amount or fair value (depending on their classification), when impaired.

  Consider whether impairment charges are necessary due to falling asset values. For financial assets classified as available-for-sale, also consider whether a cumulative loss recognized in other comprehensive income should now be recognized in net income, if the impairment is considered to be other than temporary. The recognition of such impairment losses in net income cannot be reversed.

  For additional information related to financial assets, see Responses to Financial Turmoil on the AcSB website at www.acsbcanada.org.

The list above is not all-inclusive, but demonstrates the potentially pervasive effects of the current economic climate on financial reporting. These circumstances require an exercise of judgment. The AcSB staff commentary, "Fair Value in Inactive Markets," provides remarks on making judgments based on fair values. The Audit and Assurance Standards Board has also published a Risk Alert on "Auditing Considerations Regarding Fair Values and Financial Markets in a Credit Crisis". Investors, creditors and others need financial statements they can rely on as they make the difficult decisions necessary to bring the global economy out of its current downturn.

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ACCOUNTING FOR RATE-REGULATED OPERATIONS IN AN IFRS WORLD — NO EASY ANSWERS

The impending move to International Financial Reporting Standards (IFRSs) for publicly accountable enterprises in Canada poses a distinct challenge for entities with operations subject to rate regulation, in terms of their ability to continue recognizing assets and liabilities solely as a result of the effects of rate regulation after 2011. This is because, unlike existing US and Canadian GAAP, which explicitly allow for the recognition of such items when certain criteria are met, IFRSs are silent on rate-regulated operations. It is clear that, after the changeover to IFRSs, Canadian entities with operations subject to rate regulation must apply existing IFRSs, including the "Framework for the Preparation and Presentation of Financial Statements" (the Framework). What is unclear is whether the above-mentioned items will qualify for recognition as assets and liabilities under IFRSs. In the interests of brevity, this article focuses only on assets. However, the concepts discussed relate equally to liabilities, even if different IFRSs apply.

The Framework states that an asset is "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." In the case of an asset recognized solely as a result of the effects of rate regulation, the "resource" is the right to charge higher rates in the future as the result of a regulator's action. The "past events" are the incurrence of the cost addressed by the regulatory action and the regulatory action itself. But if the ability to charge higher rates in the future is an asset meeting the Framework

definition, what type of asset is it? Many say that it is an intangible asset as defined in International Financial Reporting Standard IAS 38, *Intangible Assets*.

IAS 38 states that an intangible asset is "an identifiable non-monetary asset without physical substance." As noted in paragraph 10 of the standard, this definition is met only if an asset is identifiable, the entity has control over the resource, and there are future economic benefits. Paragraph 12 of IAS 38 says that an asset is identifiable when it "is separable" or "arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations." Items meeting the definition of an intangible asset can be recognized only if the recognition criteria of IAS 38 are met, that is, it is probable that the expected future economic benefits attributable to the asset will flow to the entity, and the cost of the asset can be measured reliably.

Those of the view that an intangible asset may be recognized as a result of rate regulation say that all of these necessary conditions are met. A regulator's action can clearly provide the entity with additional rights it would not have in the absence of rate regulation. The entity can be said to control the resource, because only it can provide the future services to which the higher rates attach. As noted in the background discussion in the existing Framework, control of the resource is sufficient for an asset to exist, even in the absence of legal control. The future economic benefit associated with the resource is the promise of higher cash inflows as a result of the regulator-approved increase in rates. The parameters set by the regulator for the recovery of the related cost through future rates provide a reliable starting point for measuring the asset. Supporters of this view think it is possible to draw an analogy with the IASB International Financial Reporting Interpretations Committee's Interpretation 12, "Service Concession Arrangements," that requires the recognition of an intangible asset for an entity's right to charge the public for the use of infrastructure.

Those who think rate regulation should not result in the recognition of an intangible asset argue that the resource created as a result of a regulatory action has no benefit separate from the entity's existing ability to provide services at approved rates. They also question the control held by the entity over the resource, when the regulator can reverse a previous decision or its decision may be challenged or overturned by the government. They say that, at most, control over the right to charge higher rates is shared between the entity, the regulator, and the government. The question of control is particularly pertinent when an entity recognizes an asset in advance of obtaining the required regulatory approval, on the assumption that such approval will occur. If the regulatory process in place has substance and is robust, approval is not an inevitable result. Proponents of this view also point out that the entity has limited control over the recoverability of the future economic benefits because it cannot compel the use of its services in the future. Therefore, it cannot say if there will be sufficient demand to recover the asset recognized. However, this argument relates more to the measurement of the benefit than to whether an asset exists, and runs counter to the current thinking of standard setters on what constitutes control.

Regardless of which of these two views is taken, IAS 38 cannot be faulted for not providing a ready answer for entities with operations subject to rate regulation. The application of GAAP to the unique circumstances of rate-regulated operations is complex, and tests the most fundamental concepts of the Framework at a time when the concepts themselves are under review. IAS 38 may provide the tools needed to determine whether a particular regulatory action has created an asset. However, it is advisable to look to other relevant IFRSs (including IAS 11, *Construction Contracts*, and IAS 12, *Income Taxes*), and the tentative conclusions of the IASB and the FASB on certain current projects (for example, the Conceptual Framework and Insurance Contracts) for additional guidance. An inherent challenge is the myriad of regulatory structures and methodologies in place throughout the world. Any solution will necessarily require identifying all relevant facts and circumstances and carefully evaluating their economic effects.

It is important to remember that the answer arrived at for GAAP financial reporting purposes may not also be suitable for special purpose reporting to regulatory

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authorities. As the AcSB and staff have pointed out, accounting standard setters and rate regulators have different mandates and goals. To satisfy its rate-setting objectives, a regulator may require a different treatment for an item than its GAAP treatment. An example is the deferral and amortization of a current period cost for rate-setting purposes to achieve intergenerational equity, that is, a match between the periods in which rate revenues and the costs incurred to produce them are recognized. GAAP does not allow the recognition of an asset solely to achieve such a match when the deferred cost would not otherwise meet the definition of an asset. If rate regulation does in some instances create an asset, it does so by virtue of the future cash flows resulting from the regulatory action, rather than through the deferral of a past cost. This argues for a two-step approach to dealing with the effects of rate regulation. The first step would account for the cost incurred as an expense of the current period. The second would evaluate the economic effects of the regulator's action to determine whether it gives rise to a new asset. If so, an entity would decide if the asset recognition criteria have been met and then measure any asset it recognizes.

The IASB is expected to decide later this month whether to add an item on accounting for the effects of rate regulation to its work plan. The AcSB encourages Canadian entities with operations subject to rate regulation and their auditors to monitor international developments on this topic when considering how to proceed in adopting IFRSs.

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PAUL CHERRY TO CHAIR IASB'S STANDARDS ADVISORY COUNCIL

Paul Cherry, Chair of the AcSB has been appointed Chair of the International Accounting Standards Board's Standards Advisory Council (SAC) for a three-year period, beginning January 1, 2009. Mr. Cherry will step down as Chair of the AcSB at the end of March 2009. Before joining the AcSB in 2001, he served as a partner at PricewaterhouseCoopers and Chief Accountant of the Ontario Securities Commission.

SAC is a formal advisory body to the IASB and provides a forum to consult a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators and professional accounting bodies that are affected by and interested in the IASB's work. It provides advice on individual projects with a particular emphasis on practical application and implementation issues. This includes matters relating to existing standards that may warrant consideration by the International Financial Reporting Interpretations Committee.

For more details visit: www.acsbcanada.org

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