Accounting Standards for Private Enterprises, Not-for-Profits and Tax Consequences
A disclaimer before we begin...

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Session Objectives

- Accounting Standards in progress;
- Intangibles;
- Customer loyalty programs;
- Employee Stock Options;
- Pensions – Defined Contribution Plans;
- New Not-for-Profit Standards; and
- Not-for-Profit Corporations Act
Accounting standards in evolution

- **Private enterprise standards** – Private Enterprise Advisory Committee of the Accounting Standards Board (AcSB);
  - Exposure Drafts issued or being developed:
    - Variable interest entities;
    - Discontinued operations;
    - Defined benefit plans; and
    - Joint venture.
- **NPO standards** – Joint committee of AcSB and Public Sector Accounting Board (PSAB):
  - Topics under discussions:
    - Contributions, tangible capital assets, intangibles, works of art, etc.
- AcSB recognizes “standards fatigue” as an issue, specifically for IFRS adopters.
Intangible assets
What is an intangible asset?

An intangible asset is an identifiable non-monetary (i.e. not cash or any other asset to be received in fixed amounts of money) asset without physical substance.

Examples: patents, customer lists, copyrights
Recognition of an intangible asset requires two criteria to be met:

- Must meet the definition of an asset; and
- Must meet the recognition criteria.
Definition criteria

All of the following three must be met:

- **Identifiability**
  a. It is separable. This means it can be separated and divided from the entity and sold, transferred, licensed, rented or exchanged; and
  b. Arises from contractual or other legal rights.

- **Future economic benefits**
  May include revenue from the sale of products or service, cost savings, or other benefits resulting from the use of the asset by the entity.

- **Control**
  Power to obtain future economic benefits and restrict access of others to those.
Recognition criteria

The following two must be met:

- It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

- The cost of the asset can be measured reliably. The costs of the asset include all costs directly attributable to preparing the asset for its intended use.
Subsequent Measurement and Impairment Losses

Intangible assets subject to amortization:
- Amortize over estimated useful life;
- Review useful life and amortization method annually; and
- Test for impairment as per impairment of long-lived assets (CICA 3063).

Intangible assets NOT subject to amortization:
- Where useful life is determined to be indefinite, do not amortize until life is no longer indefinite; and
- Test for impairment as per impairment of long-lived assets (CICA 3063).
Example

ABC Limited (the “Company”) acquired a patent for $125,000 cash. The product protected by that patented technology is expected to be a source of cash flows for at least 15 years. The Company has a commitment from a third party to purchase that patent in five years for $75,000 and the Company intends to sell the patent at that time.

How should these transactions be accounted for?
Example – Solution

Is this an intangible asset?

Accounting entry:

- Dr. Patent $125,000
- Cr. Cash $125,000

Should it be amortized?

Accounting entry:

- Dr. Amortization $10,000 ($50,000/ 5 years)
- Cr. A/C Amort – Patent $10,000
Internally Generated Intangible Assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

- Research phase; or
- Development phase.
Example

ABC Limited has developed a new wind turbine technology aimed at generating green energy.

Some of the costs incurred from inception to bring the product to market are as follows:

- Analysis of similar products in the market;
- Interest costs on the loan required to finance the prototype;
- Materials required to build the prototype; and
- Salaries for employees assigned to the feasibility analysis of the project.

Which qualify as research, and which are development related?
Capitalization

An entity has the choice to either expense, or capitalize development activities. However, in order to capitalize, all of the following criteria must be met:

- the technical feasibility of completing the intangible asset so that it will be available for use or sale;
- its intention to complete the intangible asset and use or sell it;
- its ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangibles set or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- its ability to measure reliably the expenditure attributable to the intangible asset during its development.
Definition

- Defined in s.14(5) of the ITA

- A number of conditions must be met, such as
  - a result of a transaction occurring after 1971;
  - relates to the taxpayer’s business;
  - on account of capital; and
  - for the purposes of gaining or producing income from a business.
Common Examples

- Goodwill;
- Customer list; and
- Patents, franchises, or licences.
Customer Loyalty program
Customer Loyalty Programs

- Customer loyalty programs are marketing programs designed to reward customers for using a product or service;
- It aims to create long-term relationships with customers;
- Customer loyalty programs have grown more widespread in recent years; and
- Offered by retailers, airlines, hotels and credit card issuers.
Example

- ABC Limited runs a canoe equipment rental business. In the current year, it has set up a loyalty reward program for its customers. The Company has a POS system that tracks the amounts of points awarded to each customer.

- How should we record this transaction into the books?
Customer Loyalty Programs – Revenue Recognition

The Handbook, *section 3400*, indicates that in a transaction involving the sale of goods and services, revenues are generally recognized when *performance* is achieved and reasonable assurance regarding measurement and collectability of the consideration exists.
Customer Loyalty Programs – Obligation

- An obligation for customer loyalty program meets the three essential characteristics of a liability;

- They embody a duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services or other yielding of economic benefits, at a specified or determinable date, on occurrence of a specified event, or on demand;

- The duty or responsibility obligates the entity leaving it little or no discretion to avoid it; and

- The transaction or event obligating the entity has already occurred.
Example – Cont’d

- For the accounting aspect, we should set up a sales discount account (sales contra account) to break out the expenses incurred from the rewards.

- J/E #1 – to recognize liability (current fiscal year)

  | Dr. Sales Discount | $1,000 |
  | Cr. Deferred Revenue | $1,000 |

- J/E #2 – to recognize redemption rewards (next fiscal year)

  | Dr. Deferred Revenue | $1,000 |
  | Cr. Sales | $1,000 |
Reward Program

- Reserve?
- Contingent?
- Deductible under s.9(1) – promotional expenses
Employee Stock Options
Overview of the discussion

- Stock–based compensation, specifically *stock options*, for *employees* only, to be settled in stock;
- Stock options overview;
- Old GAAP vs. ASPE;
- Transitional considerations;
- General rules;
- Example; and
- Q&A.
Stock options – an overview

“Stock option” – a right given to an employee to purchase or sell a number of company’s shares at a certain price within a specified time period;

Stock options are not just for public companies;

Private companies – can use a valuation; and

Consider cost vs benefit.
**Old vs. New – S.3870**

- ASPE section is substantially the same as the old GAAP, except for one significant difference:
  - Old GAAP allowed a “minimum value” method – for private enterprises only, the effects of stock price volatility could be ignored; and
  - As volatility was ignored, it reduced the calculated value of the stock option.
- ASPE relies on the “fair value” method, as volatility is *clearly* a necessary component of stock option value calculation.
Transition considerations

- Optional election included in ASPE S.1500 First-time Adopters.
- Allows for an exemption of retroactive application of fair value method for options granted prior to the transition date.
- No need to revisit options granted prior to the transition date and valued under the “minimum value” method.
Measurement

- Fair value method used for all stock-based compensation, no exemptions (vs. old GAAP)
- Use a pricing model to calculate FV of a stock option (Black–Scholes or binomial) as of the *grant date*.
- Pricing models use variables such as:
  - Exercise price;
  - Life of the option;
  - Current price of the share;
  - Stock volatility; and
  - Risk-free interest rate.
- Calculated fair value of options is *not* revisited when pricing model variables change in the future.
Recognition

- We measured the FV of the options, what’s next?
  - Determine the period over which related services are rendered.
  - In practice, the service period is often defined by the vesting period.
  - Vested option = option exercisable by the employee.
  - Grant date = agreement reached on the terms of the compensation.
  - If options are vested at the date of the grant, the full value of the options granted should be recognized as an expense immediately.
  - Other variables may apply – awards based on performance, expected forfeitures, etc.
Example

“Cliff” vesting example – all options vest at the same time.

Example:
- Fiscal year end: December 31
- Grant date: January 1, 2009
- Exercise price $10
- Vesting date: December 31, 2011 (3 years from the grant)
- FV of option calculated $3 (calculated using B.-S. model)
- 1,000 stock options granted
- Exercise date: December 31, 2011
- FV of stock at exercise: $15
Example – cont’d

- FV of all options granted (compensation cost) – $3,000. Service period – 3 years. Annual compensation cost – $1,000.
  
  Year 1:
  - DR – Compensation cost $1,000
  - CR – Contributed surplus $1,000
  
  Year 2:
  - DR – Compensation cost $1,000
  - CR – Contributed surplus $1,000
  
  Year 3:
  - DR – Compensation cost $1,000
  - CR – Contributed surplus $1,000
Exercise of option:

Year 3:
- DR – Contributed surplus $3,000
- DR – Cash $10,000
- CR – Share Capital $13,000

Any previously recognized compensation cost is not reversed for vested stock options if they remain unexercised. (ie. balance remains in Contributed Surplus)
Employee stock options

- Options on shares of publicly traded shares exercised after 4:00pm EST on March 4, 2010
- T4 special codes;
- Source deduction; and
- “Cashed out”. 
PENSIONS

DEFINED CONTRIBUTION (DC) PLANS
Employee future benefits are provided under either:

- Defined contribution (DC) plan; or
- Defined benefit (DB) plan
Why Defined Contribution Plans?

- Defined benefit plans are becoming less popular as companies would rather place the onus on the employee of managing their retirement than having to do it themselves.
- “Businesses, especially small businesses, are shifting their group health benefit plans to defined contribution plans as the costs are affordable and clearly defined”. The National Post, May 23, 2012
- “Private companies are increasingly switching over their pension plans to the less–costly defined contribution arrangements in order to reduce the potential cost of their pensions”. Statistics Canada, May 26, 2009.
Employee future benefits

- CICA Handbook, Section 3461 establishes the criteria for recognition, measurement and disclosure of the cost of employee future benefits.

- The objective of accounting for the cost of employee future benefits is to recognize a liability and a cost in the reporting period in which an employee has provided the services which results in this benefit.
An obligation for employee future benefits meets the three essential characteristics of a liability;

They embody a duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services or other yielding of economic benefits, at a specified or determinable date, on occurrence of a specified event, or on demand;

The duty or responsibility obligates the entity leaving it little or no discretion to avoid it; and

The transaction or event obligating the entity has already occurred.
Types of employee future benefits

- Pension or other retirement benefits (e.g. Pension income, health care benefits, life insurance);
- Post-employment benefits after employment but before retirement (e.g. Severance benefits, long and short-term disability);
- Compensated absences (e.g. Parental leaves, sabbaticals, unrestricted time off for past service); and
- Termination benefits.
Employee future benefits – Pension Plan

- Employer sponsors and contributes to a fund, and incurs the cost of the pension plan
  - Accounting for the employer

- Pension plan receives the contributions, administers pension assets, and makes pension payments to the beneficiaries
  - Accounting for the pension plan
Defined Contribution Plan – transaction stream

- Employer contributes a specified sum (either a fixed sum or related to salary) to a third party:
  - plan trustee;
  - ownership of plan assets assumed by trustee; and
  - trustee is responsible for investment and distribution of plan assets.
Defined Contribution Plan – transaction stream – Cont’d

Company

Pension fund

Pension Expense Contribution paid Accrued pension asset/liability

Pension Plan

Retirees (Pension benefits)
Defined Contribution Plan

- Employee assumes the economic risk.
- No guarantee made by employer as to benefits paid.
- Cost of the plan in the current year is known with certainty.
- No actuarial valuation is required to measure the liability or the cost.
Components of Pension Expense

The entity “shall” recognize the following costs:

- The current service cost;
- The interest cost;
- The amortization for the period of past service costs; and
- A reduction for the interest income for the period on any unallocated plan surplus.
Employer Journal Entries

- If contribution made is less than the pension expense:

  Dr. Pension expense  
  Cr. Cash  
  Cr. Accrued Pension liability

- If contribution made is more than the pension expense:

  Dr. Pension expense  
  Cr. Accrued pension asset  
  Cr. Cash
Pension – defined contributions

- One type of registered pension plan – money purchase plan.
- Registration handled by a special division of CRA – the Registered Plans Directorate.
- Deductibility.
New Not-for-Profit (NPO) standards
Basic Information

- For fiscal years commencing on or after January 1, 2012;

- Private sector NPOs have an option to adopt either these new standards or IFRS;

- Part III of the handbook;

- Essentially the adoption of the old 4400 standards; and

- ASPE applies if the new NPO standards are silent on an issue.
Time-Line

Calendar Year-end


- Date of Transition
- First-time Adoption
- Year-end

Non-Calendar Year-end

April 1, 2011  |  March 31, 2012  |  March 31, 2013

- Date of Transition
- First-time Adoption
- Year-end
Transitional provisions

- Standards are to be applied retrospectively with the changes flowing to net assets as of the transition date;

- There are MANDATORY EXEMPTIONS to retrospective application including:
  - derecognition of financial assets and financial liabilities (see 1501.24–.25);
  - hedge accounting (see 1501.26–.27);
  - estimates (see 1501.28–.30); and
  - non-controlling interests (see 1501.31).
There are OPTIONAL EXEMPTIONS (See Part II) to retrospective application including:

- business combinations (see 1501.12);
- fair value (see 1501.13–.14);
- employee future benefits (see 1501.15–.17);
- cumulative translation differences (see 1501.18–.19);
- financial instruments (see 1501.20–.21); and
- asset retirement obligations (see 1501.22).
Transitional provisions – Cont’d

- Comparative amounts to be restated under new standards;

- Similar to ASPE there is a one time election to revalue property, plant and equipment to fair value; and

- Mandatory note disclosure to explain impact on previous fund balances, operations and cash flows.
One time PPE election considerations

- Impact that the one time election to write up PPE to fair value will have on:
  - Funders such as the government and third party (United Way);
  - Donors;
  - Unions, if any;
  - Creditors; and
  - Canada Revenue Agency.
One time PPE election considerations

- The one time election to PPE must be done as of the transition date.
- The election can be done on an item by item basis.

- What is the journal entry required?
  Dr. PPE
  Cr. The appropriate Fund balance (Net assets)
Significant Changes

- Financial instruments:
  - Cash, accounts receivable, accounts payable, lease and loan obligations, investments, etc;

  - ALL financial instruments can be measured at amortized cost except for EQUITIES traded in an active market and FREE STANDING derivatives that are not hedged; and

  - The selection is made on initial adoption of the standards and is irrevocable.
What is an equity instrument?

- An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

- Are the following considered equities traded in an active market?
  - Bonds;  
    - No – debt instruments
  - GICs;  
    - No – debt instrument
  - Treasury Bills;  
    - No – debt instrument
What are the entries required?

- Book value is $120,000, which is the cost of the original investments.

- Marketable securities include 1,667 common shares at $42.00 per share in ABC Ltd. and a $50,000 GIC at BMO (both purchased in July 2010).

- Market value at relevant dates:
  - Transitional date (January 1/11) = $45.00 per share
  - December 31/11 = $39.00 per share
  - December 31/12 = $40.00 per share
The JE required would depend on your current classification of investments (held for trading (FV), available sale (FV) or held-to-maturity (cost/amortized cost)).
Held-for-trading

- Old standards – measured at FV.
- New standards – measured at FV.
- Transition date (January 1, 2011) – No change.
- December 31, 2011 – No change.
- December 31, 2012 – No change to journal entry required.
Available for sale

- Old standards – measured at FV with gain or loss being recorded directly to net assets
- New standards – measured at FV
- Transition date (January 1, 2011)
  - No new entry required.
- December 31, 2011
  - Dr. Loss on investment (stmt of ops) $10,002
  - Cr. Net assets $10,002
- December 31, 2012
  - Dr. Investment $1,667
  - Cr. Gain (stmt of ops) $1,667
Held–to–maturity (cost or amortized cost)

- Shares were not permitted to be classified as Held–To–Maturity under the old standards thus this situation would not arise.
So what about the GICs?

- As the GIC is a debt instrument and not an equity instrument it would not be required to be measured at FV.
- You can elect to carry it at FV.
- There would probably not be a significant difference between cost and FV for a GIC.
- For bonds with either a premium or discount there may be a difference between amortized cost and FV – on transition you should review the FV of bonds held.
In the year of adoption the statement of financial position will show 3 points in time;
- Transition date (January 1, 2011 if a calendar y-e);
- Comparative year (December 31, 2011);
- Current year (December 31, 2012).

Government payables have to be shown separately on the statement of financial position;
Presentation and other changes – Cont’d

- Additional note disclosure in transition year;

- Note disclosure with respect to financial instruments will change; and

- More guidance provided with respect to deferring fundraising events, conferences and radio ads.
New Incorporation Acts for NPO’s

- Affect NPO’s and charities
- Federal:
  - Canada Not-for-Profit Corporations Act came into force October 17, 2011;
  - Corporations will have until October 17, 2014 to transition to the new act; and
  - If Articles of Continuance are not submitted by the deadline, it may be dissolved.

- Provincial:
  - Not-for-Profit Corporations Act passed in 2010;
  - Expected to come into force in early 2013, Corporations will have 3 years to transition subsequent to that date; and
  - If articles of amendment/continuance are not submitted before the deadline, the Province will deem the necessary amendments to have been made.
Not-for-profits vs Charities

- Non-profit organizations defined under s.149(1)(l) of ITA
  - not a charity

- Charities defined under s.149.1(1) of ITA
Not-for-Profit Corporations

Filing requirements:

- T2

- Form T1044 “Non-profit organization (NPO) information return if conditions are met
  - Received or entitled to receive taxable dividends, interest, rentals, or royalties exceeding $10,000 in the fiscal period
Not-for-Profit Corporations – Cont’d

➢ Total assets at the end of the preceding fiscal period exceeded $200,000.

➢ An information return was required for a preceding fiscal period.
CRA started an audit initiative

- Non-profit organization risk identification project – questions and answers

- How many NPOs will the CRA review this year?
- The CRA has identified about 39,000 NPOs that file T2, T3 and/or T1044 returns. It will review 480 NPOs this year, for a total of 1,440 NPOs over three years.
Not-for-Profit Corporations – Cont’d

- CRA has released Tax Window File #0337311E5 reflecting a shift in CRA’s view of what activities can potentially disqualify an entity from claiming NPO status.

- The issue – for-profit objective and accumulating reserve from profit
Consequences of losing NPO status

- Incorporated:
  - Deemed year end at time ceases to be a NPO
  - Deemed to have disposed of all assets at FMV and reacquired them for the same amount

- Unincorporated association:
  - Members could be taxed on the income earned by the unincorporated association
Questions?