

Transcript

Non-Monetary Transactions – New Handbook Section 3831

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This presentation provides an overview of Section 3831, *Non-Monetary Transactions*, published by the Accounting Standards Board on June 1, 2005. Nothing in this presentation overrides the Section, which contains details not covered in the presentation.

In addition to the information in this presentation, you may find it useful to read the Board's rationale for publishing the standard and the requirements it contains which are included in its "Background Information and Basis for Conclusions" document.

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The Non-Monetary Transactions project is part of the AcSB's Accounting Standards Improvements Project. It was undertaken to ensure harmonization with the FASB's Statement of Financial Accounting Standards FAS 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29*, and with the IASB's recently released revisions to International Financial Reporting Standards IAS 16, *Property, Plant and Equipment*, IAS 38, *Intangible Assets*, and IAS 40, *Investment Property*.

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The previous standard, Section 3830, used a culmination-of-the-earnings-process test to invoke fair value measurement of non-monetary transactions. Section 3830 linked culmination of the earnings process to a test of whether or not the assets exchanged are similar – exchanges of similar productive assets were deemed not to represent the culmination of an earnings process. In practice, this test has been difficult to apply. Several interpretations had been issued to attempt to define similarity. The new standard will alleviate these interpretation difficulties while retaining the spirit of the original standard – fair value measurement is appropriate when something has changed.

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Section 3831 replaces the culmination-of-the-earnings-process test for fair value measurement of a non-monetary transaction with a test that assesses whether the transaction has commercial substance.

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Because the commercial substance test requires an assessment of all cash flows, inclusion of monetary consideration, or "boot", in the definition of non-monetary exchange is redundant. A transaction with a significant boot component has commercial substance and will be measured at fair value.

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The standard contains three exceptions to fair value measurement in addition to lack of commercial substance:

- an exchange of a product or property held for sale in the ordinary course of business to facilitate sales to customers, referred to hereafter as inventory exchanges;
- fair value is not reliably measurable; or
- non-monetary, non-reciprocal transfers to owners.

Inventory exchanges are deemed to not represent culmination of the earnings process under Section 3830. Because they have revenue recognition implications which are beyond the scope of a standard on non-monetary transactions, Section 3831 requires that they continue to be measured at carrying amount.

The exception for non-reciprocal transfers to owners is unchanged from Section 3830.

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Commercial substance occurs when a transaction causes an identifiable and measurable change in the economic circumstances of the entity. Satisfaction of either of two tests determines that a transaction has commercial substance.

The first test compares the configuration of the asset-specific cash flows before and after the transaction; the second compares the entity-specific values of the exchanged assets. Commercial substance occurs when either there is a significant difference in cash flow configuration or the change in entity-specific value is significant relative to the fair value of the assets exchanged.

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Cash flow configuration looks at three elements of the cash flows associated directly with the exchanged assets. A transaction has commercial substance when there is a significant difference in any of the risk, timing or amount of the cash flows. It is not necessary to perform any calculations – the test is a simple comparison of the cash flows.

If, for example, an entity is considering exchanging an asset expected to produce certain cash flows within the next year for an asset expected to produce higher cash flows at later dates, the exchange will have commercial substance simply because the amounts and timing of the cash flows are significantly different even if the net present values of these cash flow streams are equal or nearly equal.

Section 3831 includes three examples illustrating commercial substance due to a change in cash flow configuration.

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Entity-specific value is defined as the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life, or expects to incur when settling a liability.

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It is important to note that in the entity-specific value test, all cash flows attributable directly or indirectly to the exchanged item are considered. This is broader than the cash flow configuration test and results in a measure of the relative synergism of the exchanged items with the entity's other assets and liabilities. The transaction has commercial substance when the change in entity-specific value is significant relative to the fair value of the assets exchanged.

Under the entity-specific value test, an exchange might have commercial substance even though the risk, timing and amount of the cash flows are the same. An example might be the exchange of a parcel of land intended for construction of a rental apartment building for another parcel contiguous to an existing owned building such that the ability to combine certain amenities on the larger combined property will allow the enterprise to raise rents on the existing property.

Three examples illustrating commercial substance due to a change in entity-specific value are included with Section 3831.

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Section 3831 provides guidance on determining the reliability of fair values for the assets exchanged. When comparable market transactions do not exist, fair values are reliably measurable using estimates under two circumstances. The first is when the variability in the range of estimates is not significant. The second is when probabilities can be reasonably assigned to each of the estimates. The fair value of the asset given up is used to measure the transaction unless the fair value of the asset received is more reliable. Additional guidance on fair value measurement is provided in the Appendices to Sections 1581, *Business Combinations*, and 3855, *Financial Instruments – Recognition and Measurement*.

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Certain non-monetary transactions are covered by specific Handbook sections and are excluded from the scope of Section 3831:

- Business combinations under Section 1581;
- Employee future benefits under Section 3461;

- Related party transactions under Section 3840 except non-reciprocal transfers to owners that represent a spin-off or other form of restructuring or liquidation; and
- Stock-based compensation or other stock-based payments under Section 3870.

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Four Handbook sections required amendments as a result of Section 3831:

- The reference to culmination-of-the-earnings-process in *Business Combinations*, Section 1581 has been removed.
- *Disposal of Long-lived Assets and Discontinued Operations*, Section 3475, has been amended to remove the reference to an exchange of similar productive assets.

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- The changes to *Interests in Joint Ventures*, Section 3055, reflect the fact that a significant change in cash flow configuration takes place when a venturer exchanges non-monetary assets with a joint venture and the venturer is not related to the other venturers because the risk of the cash flows changes. When the venturers are related parties, as defined in Section 3840, the exchange is accounted for as a *Related Party Transaction* in accordance with that section.

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- References to culmination-of-the-earnings-process have been replaced with commercial substance for both normal course transactions and transactions not in the normal course of operations. Consistent with Section 3831, inventory exchanges are measured at carrying amount.

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Section 3831 will be applicable to all non-monetary transactions initiated in periods beginning on or after January 1, 2006. It may be applied to transactions in periods beginning on or after July 1, 2005. Balances relating to transactions initiated prior to transition may not be restated and the section may not be applied retroactively.

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Any questions that aren't answered in the Basis for Conclusions or on the AcSB's website, www.acsbcanada.org, may be directed to Kate Ward at 416-204-3437 or by email to kate.ward@cica.ca.