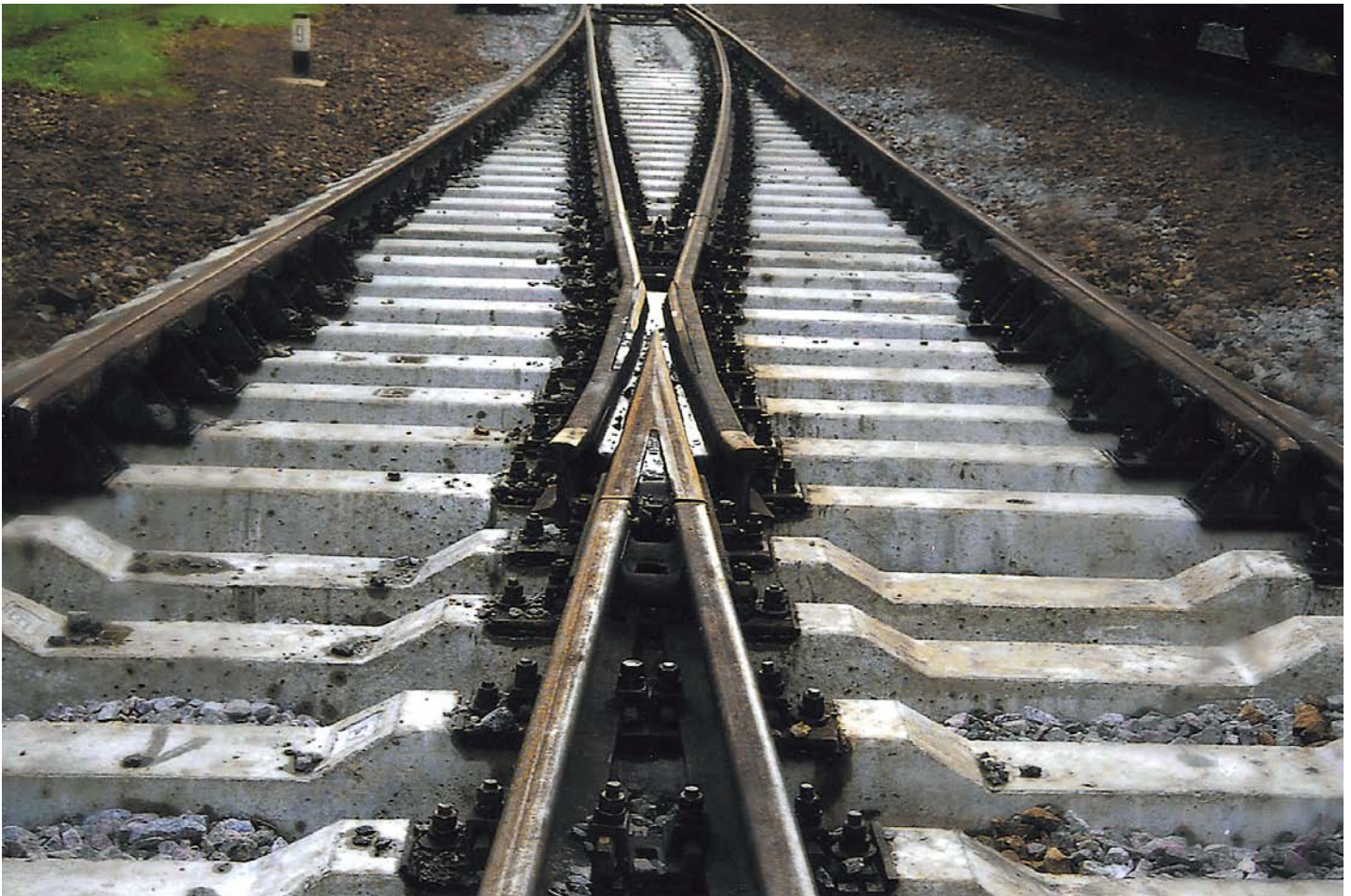


Private Enterprise GAAP

Frequently asked questions on the adoption of Private Enterprise GAAP

For any private enterprise there are changes ahead. The Bermuda and Canada Accounting Standards Board has recently released the new set of standards that will apply to private enterprises (PE GAAP). Here are some frequently asked questions (and answers) that many private entities are wondering about right now.



1. What is a private enterprise?

A private enterprise is defined as:

“A profit-oriented enterprise that is neither a publicly accountable enterprise nor an entity in the public sector.”

This definition means that an entity will be able to apply the PE GAAP standards unless they are a not-for-profit organization, governmental organization, or meet either of the following criteria:

- (i) The entity has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market (a domestic or foreign stock exchange or an over-the-counter market); or
- (ii) the entity holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

2. What are the choices for private enterprises?

Private enterprises in Bermuda have a number of reporting framework options. If Bermuda and Canada GAAP statements are required, then private enterprises should adopt the PE GAAP standards, unless the entity makes a choice to adopt full IFRS as an alternative. Both sets of standards will be Bermuda and Canada GAAP. Entities must decide on one or the other and must adopt the chosen set of standards in full at the selected changeover date. Until a new set of standards is adopted, private enterprises will continue to use existing Bermuda and Canada GAAP.

However, if the entity issues general purpose financial statements that are not required to be in accordance with Bermuda and Canada GAAP, then other acceptable reporting frameworks exist. These may include the newly released IFRS for Small and Medium Enterprises (IFRS for SMEs) or US GAAP and may be used if the selected GAAP meets the needs of all stakeholders.

3. Can individual PE GAAP standards be adopted before a full changeover to PE GAAP?

Individual standards cannot be early adopted. However, private entities will be able to early adopt PE GAAP or IFRS for SMEs in its entirety.

4. How do entities decide which “Canadian GAAP” to use?

Whether to move to IFRS or PE GAAP will depend on much more than just the requirements of the standards. It will generally be a strategic decision based on the entity’s current stakeholder needs, its competitive position in the market, its financing requirements, and its future intentions. For many entities it will not be a clear-cut decision, and the advantages and disadvantages of each option will have to be considered carefully.

Significant factors to consider include:

- Whether plans exist to access public debt or equity markets, or other succession plans. In other words, will there be a need for IFRS statements in the future?
- Whether there is a need to compare or benchmark results with other competitors to measure performance or access credit facilities, and whether these competitors will use IFRS or PE GAAP.
- Users of the company’s financial statements and their informational needs, including any controlling parent entity.
- Accounting resources available to deal with GAAP complexities, as IFRS may be more complex to adopt and maintain than PE GAAP.
- Whether the entity has, or plans to have, a global reach including subsidiaries in other countries. In this situation a common accounting platform will be beneficial.

PwC has prepared a “Decision tree” to help guide decision-makers through these factors. More information can be obtained from a member of the PCS team listed on the last page.

5. When does the decision to adopt IFRS, PE GAAP or IFRS for SMEs have to be made?

A transition to IFRS will almost certainly require more work than a transition to either PE GAAP or IFRS for SMEs. There may be system or informational requirements that need to be in place before the first day of the comparative period of financial statements prepared under a new GAAP (known as the “transition date”), particularly if the entity has complex transactions. Best practice would be to make the decision as early as possible to allow the maximum time to consider new accounting policies and gather information required for the transition to a new GAAP, especially if a move to IFRS is contemplated.

6. How are the final PE GAAP standards different from the exposure draft released in April 2009?

There were some significant changes to the new standards from the exposure draft. For example, the new standards incorporate more EIC guidance, allow for any financial instrument to be measured at fair value upon election (the “fair value option”), require the capitalization of transaction costs for financial instruments not carried at fair value, and increase the scope of the simplified approach proposed for certain defined benefit plans. There have also been changes in disclosures, with the removal of proposed disclosures over government remittances and management compensation.

7. When do entities have to adopt PE GAAP?

For years beginning on or after January 1, 2011, a private enterprise wanting to prepare general purpose financial statements in accordance with Bermuda and Canada GAAP will have to adopt either PE GAAP or IFRS. This timing is consistent with the mandatory adoption of IFRS by publicly accountable entities. Bermuda and Canada GAAP, as is currently in the CICA Handbook, will no longer be applicable after this date.

As noted in question 2, IFRS for SMEs is also an option available to private enterprises incorporated in Bermuda.

Private enterprises also have the choice of early adopting either PE GAAP or IFRS for SMEs reporting frameworks. Entities may choose to adopt either of these reporting frameworks as early as December 31, 2009 for calendar year-end entities. Question 10 below gives more guidance on the transition process to PE GAAP.

8. Why may early adoption be a good idea?

There are an increased number of accounting options available to entities under PE GAAP, compared to current Bermuda and Canada GAAP. Many of the new choices are based on existing differential reporting options, but without the current unanimous shareholders’ consent requirements. For example, the option not to consolidate subsidiaries, meaning that the option to prepare non-consolidated financial statements and account for subsidiaries using either the equity or cost method, can now be chosen by any private entity.

Additional new accounting treatments mandated in the standards may also reduce the amount of information and analysis required to prepare financial statements compared to current Bermuda and Canada GAAP, such as the revised one-step impairment test for goodwill. Where an entity could significantly reduce its financial reporting burden, whether through selecting PE GAAP alternatives or simply due to the reduced disclosure requirements of PE GAAP, early adoption may be appropriate.

Sections where there have been simplified options incorporated into standards or reduced recognition or measurement requirements include the following areas:

- Investments in equity investees, joint ventures and subsidiaries
- Future employee benefits
- Asset retirement obligations
- Financial instruments
- Simplified impairment tests for assets including goodwill
- Research and development costs
- Income taxes.

9. Why would a private enterprise not early adopt?

Transition rules (see questions 10 to 13) mean that adopting PE GAAP requires additional work in the year of adoption, including retrospectively applying many of the new standards. Although in many cases retrospective application should not cause significant difficulties, there are certain areas such as business combinations, and stock-based compensation where having a “transition date” in the past could result in additional work upon adoption.

As the new standards allow for a considerable number of accounting policy choices, and more judgment is encouraged (much of the prescriptive EIC guidance will no longer be included), all private enterprises are encouraged to consider carefully what their options are and the impacts of those options before finalizing their accounting policy choices.

10. What is the Transition Guidance for PE GAAP or IFRS for SMEs?

Transition guidance is covered by a new section – *First Time Adoption*, Section 1500 for PE GAAP and Section 35 for IFRS for SMEs. The standard provides an equivalent to the IFRS transition guidance in IFRS 1, and is very similar in its approach. For example, retrospective application of changes in accounting policies on adoption of either reporting framework - PE GAAP or IFRS for SMEs - is required, except where exemptions are specifically allowed or exception are required. The exemptions and exceptions are set out in Section 1500 for PE GAAP and Section 35 for IFRS for SMEs. The comparative period must also be prepared in accordance with the selected reporting framework and an opening balance sheet must be prepared and presented in the first financial statements under the selected reporting framework.

11. What does retrospective application actually mean?

Retrospective application means that the accounting policies mandated or chosen under the selected reporting framework (PE GAAP or IFRS for SMEs) must be applied consistently to all prior periods. Therefore at the opening balance sheet date, except where an exemption or exception allows or requires otherwise, all assets, liabilities and components of equity should be:

- i) de-recognized if they do not meet recognition criteria under the selected reporting framework;
- ii) recognized if they do meet recognition criteria under the selected reporting framework;
- iii) appropriately classified according to the selected reporting framework standards; and
- iv) re-measured using accounting policies effective under the selected reporting framework as at the opening balance sheet date.

Any differences from the previous GAAP measurements used will be taken as an adjustment to opening retained earnings.

In the periods presented in the financial statements, both comparative and current period transactions will be presented and measured in accordance with the selected reporting framework accounting policies.

12. What about the exemptions to retrospective application under PE GAAP?

There are several exemptions to full retrospective application that allow an enterprise relief from calculating the impact of PE GAAP on transactions that happened prior to the transition date. The most significant ones include:

Business combinations: An entity does not need to apply *Business Combinations*, Section 1582 to business combinations prior to the opening balance sheet date. In other words, the original purchase price allocation or pooling of interests does not need to be recalculated for compliance with Section 1582. However, as at the opening balance sheet date the entity must still recognize existing assets and liabilities, and derecognize those that do not qualify for recognition under the PE GAAP standards. In some cases, these adjustments will affect goodwill.

Stock-based compensation: An entity need not apply changes made to *Stock-based Compensation and other Stock-based Payments*, Section 3870 to awards granted or issued prior to the date of transition.

Asset retirement obligations (ARO): Section 1500 indicates that the ARO can be measured using the PE GAAP standards, and indicates a method for calculating an appropriate carrying value as at the transition date.

The exemptions do not provide any relief for presenting the comparative period under PE GAAP accounting policies.

There are also some provisions that allow for one-time treatments upon transition that may be of interest to certain entities:

Property plant and equipment (PP&E): Although the recognition and measurement guidance in Section 3061 has not changed from current Bermuda and Canada GAAP to PE GAAP, there is still a transitional provision that allows an entity to measure any, or all, items of PP&E at fair value at the transition date, and use that fair value as a “deemed cost” under PE GAAP.

Employee future benefits: Even if an entity does not take advantage of the new options for employee future benefits, there is still an option to recognize all cumulative actuarial gains or losses into retained earnings at the date of transition. In addition any previously existing unamortized transitional asset or obligation must be recognized in retained earnings upon transition.

Foreign currency translation: Guidance in *Foreign Currency Translation*, Section 1651 has not changed significantly in PE GAAP. However, entities may still take advantage of an exemption that allows them to deem the Cumulative translation account (CTA) to be zero at the date of transition.

There are similar exemptions available under IFRS for SMEs for Business combinations, stock-based compensation, PP&E and Foreign currency translation. More information can be obtained from a member of the PCS team listed on the last page.

13. What is the “opening balance sheet” – when will this be?

The opening balance sheet is the balance sheet on the first day of the comparative period for the year in which the selected reporting framework (PE GAAP or IFRS for SMEs) is first adopted. For example, if an entity adopts PE GAAP or IFRS for SMEs for its fiscal year 2011 that ends on December 31, 2011, then 2010 will be the comparative period, and January 1, 2010 will be the opening balance sheet date. The opening balance sheet date is also referred to as the “transition date”. Similarly, if an entity early adopts the standards for a December 31, 2009 year-end, this would mean a transition date of January 1, 2008.

14. Accounting policy choices – when do entities have to decide?

Accounting policies must be based on the selected reporting framework (PE GAAP or IFRS for SMEs) effective as at the end of the year of adoption, e.g. as at December 31, 2011 for a calendar year company adopting for fiscal 2011. Unlike IFRS, however, both PE GAAP and IFRS for SMEs are not expected to change significantly between the release of the final standards and the date of mandatory adoption. Although accounting policies need not be selected until the preparation of the first set of financial statements under the selected reporting framework, an earlier selection of policies is encouraged. This will allow an enterprise to ensure that it has all the information available that is required to prepare financial statements, and also ensure that the impact of the accounting policies has been appropriately considered.

Further, if the entity intends to use the “fair value option” available under PE GAAP to measure certain financial instruments at fair value, or to use the one-time transition exemption to value items of property plant and equipment at fair value on the transition date available under PE GAAP and IFRS for SMEs, one must be aware that these decisions are time sensitive and their use may be curtailed if these accounting policy choices are not made on a timely basis.

15. What is the “fair value option” for financial instruments under PE GAAP?

The fair value option deals with how financial instruments are measured subsequent to their initial recognition. The standards allow an entity to irrevocably designate an individual financial instrument that would otherwise be measured on a cost or amortized cost basis (as defined by the standards), to be measured at fair value with changes in that fair value being recorded in net income. This option may be of use to entities that wish to offset the income statement impact of the volatility of certain items that must be recorded at fair value, or who wish to measure investments, such as debt securities, at fair value if this better represents the way that such investments are managed.

If an entity wishes to take advantage of the option to designate any financial instrument as carried at fair value (the “fair value option”) this designation must be made by the later of the transition date, or the inception of the instrument. (The option may also be used under limited circumstances when certain equity instruments cease to be quoted in active markets). Therefore the fair value option may be used to designate, on transition date, any financial instrument as measured at fair value. Be aware - as many entities intending to adopt PE GAAP had a transition date of January 1, 2010 the impact of this accounting policy choice for such entities will likely be limited to financial instruments where the designation can be documented upon initial recognition.

16. Are there increased documentation requirements under PE GAAP?

Under PE GAAP there are no requirements for additional documentation of accounting policy choices over and above current Bermuda and Canada GAAP, with the exception of documenting where the use of the fair value option (see question 15) is desired. However, if a private enterprise was using, or plans to use, hedge accounting, then the documentation requirements to clearly identify and designate the hedging relationship still apply under PE GAAP, and this must be done *at the inception of the hedging relationship*. In fact the transition rules indicate that transactions entered into before the date of transition to PE GAAP cannot be retrospectively designated as hedges. However, if hedge accounting is appropriately documented under current Bermuda and Canada GAAP, provided the hedging relationship is of a type that qualifies for hedging under PE GAAP, the documentation prepared for current Bermuda and Canada GAAP should be sufficient.

17. Accounting policy choices – does Section 1506 under PE GAAP apply?

Accounting Changes, Section 1506 has been carried forward to PE GAAP, including the requirement that a voluntary change of accounting policy is permissible only if the change is to a more relevant policy that is also reliably measurable. However, exemptions to this requirement have been included that allow an entity free choice in switching accounting policies within specified options. These options reflect the significant areas of accounting policy choice that have been included into the new PE GAAP standards. These are:

- Certain choices over accounting for subsidiaries, joint ventures and significant influence investments.
- Capitalization or expense of expenditures on internally generated intangible assets during the development phase.
- Certain choices over accounting for employee defined benefit plans.
- Measurement of the equity component of a financial instrument that contains both a liability and an equity component.
- Recognition of income taxes under either the taxes payable method or the future income taxes method.

Although changes to accounting policies within these exemptions do not have to be to a more relevant policy, they are still required to be applied retrospectively.

18. Should the planned transition to PE GAAP be disclosed in financial statements under existing Bermuda and Canada GAAP?

The existing Section 1506 disclosures on changes in accounting policies do not relate to a complete replacement of an entity's primary basis of accounting. Accordingly there is no strict requirement for any disclosures to be made about the entity's plans to change to PE GAAP, IFRS for SMEs or IFRS, within the financial statements. However, once an entity has made a decision as to which reporting framework/GAAP to adopt, and has decided when to adopt, then additional disclosures in the financial statements may be useful to users, even if not mandatory under the standards.

19. Top 5 anticipated transition issues to PE GAAP

1. **Selection of accounting policy choices:** PE GAAP has many accounting choices for entities to make. Each choice may have financial reporting impacts that will alter financial results under PE GAAP. When making these decisions enterprises will have to be aware of the impacts of these choices on debt covenants, regulatory requirements and the needs of users of the financial statements. Taking the time to analyze these impacts will be a significant undertaking for some entities. At the same time, some decisions over whether to choose fair value options are time sensitive. It is never too early to start assessing the impact of PE GAAP on an entity's financial statements.
2. **Business combinations:** The Business Combinations section in PE GAAP has significant changes from Section 1581, *Business Combinations*, which is the standard currently used by most private enterprises. Because of the general transition rule requirements to restate the comparative period under PE GAAP, business combinations that occur in the comparative period of an entity's first PE GAAP financial statements (e.g. in 2010) will have to be prepared initially under existing Bermuda and Canada GAAP for 2010 financial statements, but then restated under PE GAAP for 2011 financial statements. This may require a significant level of work. This could be avoided if the entity early adopts Section 1582, *Business Combinations* that is included in the current Bermuda and Canada GAAP Handbook, for their 2010 Bermuda and Canada GAAP statements, as is allowed. If an entity plans to early adopt PE GAAP in 2010 and had significant business combinations in 2009, it may still be possible to early adopt Section 1582, depending on to what extent the purchase price accounting has been finalized when the decision is taken.
3. **Use of fair value option on transition for property, plant and equipment:** Many entities, especially real estate companies, may decide to take the Section 1500 option to use fair value as the deemed cost of all or any items of property, plant and equipment. Although this decision does not need to be taken by the entity's transition date, reliable fair value measurements as at the opening balance sheet date must be available. Obtaining such fair value measurements after the transition date may be difficult, and in some cases impossible. Planning ahead will be essential for an entity that wishes to effectively use this transition option. Remember that for many entities January 1, 2010 was the transition date, and is already in the past.

4. **Use of accounting option to not consolidate**

subsidiaries: If an entity decides to adopt the policy of not consolidating subsidiaries, then this must be applied across all subsidiaries consistently. Where subsidiaries were acquired many years in the past, it may be possible that reliable original cost information may not be determinable. There is no exemption relief under Section 1500 to allow for any deemed cost to be used on transition however. An entity will have to use exhaustive efforts in order to determine this information to apply this accounting policy.

5. **Stock-based compensation:** Under PE GAAP the minimum value method is no longer a permissible method for valuing stock-based compensation. Instead, the calculated value method, which requires an estimation of volatility, must be used. Despite the transition exemption for stock-based compensation to not apply this requirement to stock-based compensation issued prior to the transition date, entities with significant stock-based compensation may still have a significant adjustment to calculate for the prior year comparatives for their first year PE GAAP statements.

Need to talk?

PricewaterhouseCoopers has unparalleled experience in advising private companies on financial reporting matters. We recently presented on the topic “Private enterprise GAAP or IFRS for SMEs - making the best choice for your company”. We are also assisting a number of companies in Bermuda working on full IFRS conversion projects.

So whichever choice you make, or if you need help making the right choice for your company, we can guide you through developing an appropriate decision and conversion strategy and timeframe. Please contact a member of the PCS team listed on the last page.

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