The Clear-Cut: ASPE

Disclosure of Carrying Amounts of Categories of Financial Instruments

There is a common practice review deficiency related to financial instrument disclosure that is cited in many practice inspection reports from the CPA practice inspection program that we wanted to address. The comment from practice inspection typically looks something like the following:

> *No disclosure of carrying amounts for categories of financial instruments – items*
>
> *a) Financial assets and liabilities measured at amortized cost*

The applicable disclosure requirement can be found in Part II Section 3856 *Financial Instruments* which reads as follows:

> *3856.38 - An entity shall disclose the carrying amounts of each of the following categories of financial instruments, either on the face of the balance sheet or in the notes:*
>
> *a) Financial assets measured at amortized cost;*
> *b) Financial assets measured at fair value; and*
> *c) Investments in equity instruments measured at cost less any reduction for impairment.*

The intent of the above disclosure requirement is to help users differentiate between items on the balance sheet that are measured at amortized cost, fair value, and equity instruments measured at cost that have been subject to an impairment. When an entity has certain financial instruments that are measured differently this disclosure becomes very relevant to enabling a user to understand the financial statements. However, it is most often the case in simple private enterprises that all of the financial instruments are measured at amortized cost. The reason for this is simple, ASPE was intentionally written to reduce the need for private enterprises to measure assets and liabilities at fair value and it is rare that marketable securities, which are required to be measured at fair value are held inside corporations due to the unfavorable tax position.

Unlike IFRS which often requires fair value measurement of assets and liabilities to help investors, the additional cost of requiring fair value measurements was not considered to be as crucial for ASPE. When all of the financial instruments of an entity are measured at amortized cost the requirement to categorize them in accordance with 3856.38 becomes less important in our view. However, the disclosure is still technically required, so how can it be addressed?

When we examine financial statements that attempt to address the above disclosure requirement we typically see wording such as the following:

> ***Significant Accounting Policies***
>
> *…*
>
> *Financial instruments*
>
> *The company initially measures its financial assets and financial liabilities at fair value, except for certain related party transactions that are measured at the carrying amount or exchange amount, as appropriate.*
>
> *The company subsequently measures all its financial assets and financial liabilities at cost or amortized cost, except for investments in equity instruments that are quoted in an active market, which are measured at fair value. Changes in fair value of these financial instruments are recognized in net income.*
>
> *Financial assets measured at amortized cost on a straight-line basis include cash, term deposits, accounts receivable and notes receivable.*
>
> *Financial liabilities measured at amortized cost on a straight-line basis include the bank overdraft, the bank loan, accounts payable, amounts due to directors and officers and long-term debt.*
>
> *Financial assets measured at fair value include quoted shares.*

While there is nothing technically wrong with the above significant accounting policy and, provided that the carrying amounts of the financial assets and liabilities are presented on the balance sheet, it should satisfy the requirements of 3856.38. However, we find it to be a lot of technical jargon that can confuse clients by mentioning marketable securities which in most cases are not held by the entity. Furthermore, most of the wording is not specifically required by Part II Section 1505 *Disclosure of Accounting Policies*.

An entity need not disclose the way in which it accounts for all transactions. Doing so would likely result in reproducing and disclosing most of the guidance included in ASPE which would result in financial statements that would be too lengthy and detailed. The guidance for the minimum disclosure requirement for accounting policies is as follows:

1505.06 - As a minimum, disclosure of information on accounting policies shall be provided in the following situations:

(a) when a selection has been made from alternative acceptable accounting principles and methods;

(b) when there are accounting principles and methods used that are peculiar to an industry in which an enterprise operates, even if such accounting principles and methods are predominantly followed in that industry.

Based on the above there is no need to disclose how transactions are recorded when there is no alternative provided within ASPE and when the methods are not industry specific. For instance, financial instruments must be initially measured at fair value and thus there is no definitive requirement to disclose this in the financial statements. So, if we assume that the entity has no financial instruments carried at fair value and there has been no election made under 3856 to subsequent measure a financial instrument at fair value, we can remove all of the unnecessary disclosure of accounting policies and edit the above disclosure as follows:

Significant Accounting Policies

…

Financial instruments

~~*The company initially measures its financial assets and financial liabilities at fair value, except for certain related party transactions that are measured at the carrying amount or exchange amount, as appropriate.*~~

The company subsequently measures all its financial assets and financial liabilities at cost or amortized cost~~*, except for investments in equity instruments that are quoted in an active market, which are measured at fair value. Changes in fair value of these financial instruments are recognized in net income.*~~

Financial assets measured at amortized cost ~~*on a straight-line basis*~~ *include cash, term deposits, accounts receivable and notes receivable.*

Financial liabilities measured at amortized cost on ~~*a straight-line basis*~~ *include the bank overdraft, the bank loan, accounts payable, amounts due to directors and officers and long-term debt.*

~~*Financial assets measured at fair value include quoted shares.*~~

As you can see from the above we have simplified the disclosure significantly but we can do better still. Technically, the requirement of 3856.38 is a general disclosure requirement and not specifically an accounting policy disclosure requirement. Furthermore, there is nothing in the standards that states that the term ‘financial instruments’ must be used in the financial statements and we find that such terminology is not readily understood by many users of private enterprise financial statements. So we suggest satisfying the requirements of 3856.38 with a disclosure as simple as the following example:

> *Financial assets include cash, term deposits, accounts receivable and notes receivable and are measured at amortized cost as presented on the balance sheet. Financial liabilities include the bank overdraft, the bank loan, accounts payable, amounts due to directors and officers and long-term debt and are measured at amortized cost as presented on the balance sheet.*

We would recommend that the above wording be included as part of a preamble in the disclosure of risks and uncertainties associated with financial instruments as required by Section 3856.53.

Note that in instances where there are financial instruments measured at fair value or where there are related party transactions in which financial instruments are created the above disclosure would need to be expanded upon.