

June 6, 2012

(by e-mail to commentletters@efrag.org)

European Financial Reporting Advisory Group

35 Square de Meeûs,

B-1000 Brussels

Belgium

Dear Sirs,

Re: Accounting for Business Combinations under Common Control (Discussion Paper)

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB) to the European Financial Reporting Advisory Group's (EFRAG) and Organismo Italiano di Contabilità's (OIC) Discussion Paper, "Accounting for Business Combinations under Common Control" (BCUCC), issued in October 2011.

The views expressed in this letter take into account comments from individual members of the AcSB staff. However, they do not necessarily represent a common view of the AcSB, its committees or staff. Views of the AcSB are developed only through due process.

We appreciate the opportunity to provide comments on the Discussion Paper and we recognize that the Discussion Paper represents a substantial amount of work and analysis of a challenging topic. We acknowledge that the objective of the Discussion Paper is to encourage debate on the accounting for BCUCC. We agree that the current lack of guidance in International Financial Reporting Standards (IFRSs) has resulted in unacceptable diversity in practice in this area.

In formulating its response to the IASB’s *Agenda Consultation 2011*, the AcSB considered the project on accounting for BCUCC. The AcSB did not recommend this project as a priority that should be addressed by the IASB in the next three years. The AcSB did recommend that the IASB should work on updating and improving the conceptual framework in order to provide a better tool for stakeholders to use when applying IFRSs and the IASB to use when maintaining and developing standards. An improved conceptual framework would assist in resolving many of the recognition and measurement issues underlying BCUCC transactions. In addition, not addressing the project in the next three years would provide time to conduct additional research that the AcSB thinks is needed on this topic.

Recommendation

Overall, we think that the accounting for BCUCC should be determined based on what provides relevant information to financial statements users by using methods that faithfully represent the different types of BCUCC that occur. We recommend that EFRAG and the OIC should undertake more research to identify the different types of BCUCC that occur in various jurisdictions and as a result expand the scope of the Discussion Paper to include these types of transactions. More analysis should also be carried out to distinguish the characteristics of business combinations not under common control from ones that are under common control. Different types of users should be consulted to identify what information is most relevant to them about BCUCC and how these transactions should be accounted for and what additional disclosures should be provided.

We think that an analysis from first principles on how to account and report BCUCC would be more appropriate than analyzing the approaches currently used in practice. An analysis from first principles may identify alternate methods not considered previously. The current conceptual framework does provide a starting point to prepare an analysis of BCUCC from first principles.

We think that accounting guidance developed by other standard-setters should be analysed in the Discussion Paper. In order to build on, and benefit from, past research on BCUCC, we encourage EFRAG and the OIC to conduct a thorough review of existing guidance in other

accounting frameworks and literature to identify approaches and key concepts that should be considered.

Distinguishing characteristics of BCUCC

We think that one of the distinguishing characteristics of BCUCC is that these transactions occur in a great variety of forms. Therefore, it may be appropriate to consider a different measurement basis rather than trying to scope all BCUCC into IFRS 3 *Business Combinations* by analogy. Paragraphs 24 and 25 of IAS 16 *Property, Plant and Equipment* provide an example of an IFRS standard that requires a different measurement basis based on a “representational faithfulness” requirement involving a commercial substance test. Analogizing from such examples in IFRSs, we might conclude that different types of BCUCCs should be treated differently.

As you are aware, Canada has a standard on related party transactions, Section 3840, *Related Party Transactions*, that was applied by publicly accountable enterprises before these enterprises adopted IFRSs. It is still being applied by private enterprises. In the early 1990s, the AcSB attempted to develop guidance on common control transactions. The guidance was never completed because stakeholders considered common control transactions to be a subset of related party transactions and concluded that guidance with a broader scope was necessary. Section 3840 was implemented in 1995 and we think that this guidance has resulted in appropriate accounting for related party transactions in Canada.

Unlike IAS 24 *Related Party Disclosures* and many national standards on related party transactions that only address disclosure, Section 3840 also provides requirements for the measurement of those transactions. The measurement requirements differ depending on whether the transactions are carried on in the normal course of business, there is a substantive change in ownership interest of the items transferred and there is commercial substance to the transaction. While we think that some concepts in Section 3840 would be useful to consider, we acknowledge that aspects of the guidance would need to be improved to make it more principle-based and avoid bright-line guidance.

Based on our experience, we think that consideration should be given to distinguishing BCUCC transactions that have no commercial substance and those that do have commercial substance.

Some types of common control transactions would never be undertaken between unrelated parties or may be undertaken for a common purpose, such as to obtain tax or administrative advantages, but would never be agreed to between unrelated parties. Similar to the requirement in paragraph 25 of IAS 16, we think that a BCUCC transaction has commercial substance when the reporting entity’s future cash flows are expected to change significantly as a result of the transaction. Identifying the various types of legal structures and combinations that occur, for example horizontal or vertical amalgamations, would provide a better understanding of how these transactions may differ from transactions between unrelated parties.

Accounting for BCUCC at initial recognition and measurement

We do not support View One or View Two in the Discussion Paper because we think that there is no one basis of accounting that should be applied to all common control transactions. The structure and motivation for BCUCC transactions is not homogeneous. We think that it is necessary to assess the facts and circumstances of each transaction to determine how to account for it.

We think that the information needs of users should be considered first in order to identify the information that is most relevant about these different types of transactions. An assessment of how to represent that information faithfully for each type of transaction can then be done.

Consideration should be given to providing principle-based guidance that would distinguish transactions that warrant the re-measurement of transferred assets and liabilities from those that warrant a carry-over basis. Therefore it would be important to articulate what criteria are required to distinguish the differentiating characteristics between the types of BCUCC transactions, such as commercial substance.

We think that the project should consider whether a transaction may have commercial substance when there is an ownership interest held by, or involvement with, unrelated parties outside of the common control transaction. When there is such outside involvement, it may warrant a change in the measurement basis of the transferred assets and liabilities from the transferor’s carrying amount. The degree of outside involvement or influence (for example, the role of regulators and

board of directors) in determining the terms of the transaction and its price would provide reliable support for the agreed upon price or the amount exchanged.

We think that the project should consider whether BCUCC transactions that are determined to have no commercial substance should be recorded on a carry-over or book value basis.

Accounting for the transaction on this basis would alleviate the concern that a common control transaction might be conducted to achieve the appearance of a significant change in economic substance when, in fact, there is none. The consequences of reporting a non-substantive transaction as a transaction of substance and, accordingly, accounting for it at fair value could be the recognition of a gain or loss in the income statement. Also, some assets (for example, some internally generated intangibles, goodwill or deferred tax assets) and some liabilities (for example contingent liabilities) might be recognized when otherwise they could not be.

We do not agree that the accounting method should be a free accounting policy choice (i.e., between the IFRS 3 acquisition method and a carry-over or book value basis) because this leads to a lack of comparability between BCUCC with similar attributes. Rather, the method applied should be dependent on the facts and the circumstances of each BCUCC transaction.

Importance of disclosures

Regardless of the accounting method applied, we think that an entity should provide information that enables users of the financial statements to assess “the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity” (paragraph OB3 of the *Conceptual Framework*).

Currently entities are required to identify the relationship with related parties and information about transactions undertaken (in accordance with IAS 24). As BCUCC are scoped out of IFRS 3, entities are not required to provide information about the acquiree (transferee) and pro-forma information about the amounts of revenue and profit and loss of the acquiree since acquisition or of the combined entity as though the acquisition occurred at the beginning of the annual reporting period. Consequently, the most relevant information that enables users of the financial statements to assess the entity’s future cash flow prospects subsequent to the BCUCC transactions may not be provided.

Securities regulators in Canada have expressed concern that important financial information may be omitted about BCUCC, based on their review of financial statements. For example, the Ontario Securities Commission has stated publicly¹ that important financial information may be omitted about the acquiree in a BCUCC such as current period pre-acquisition information as well as comparative period information.

We think that in evaluating the additional information that should be disclosed, the need for the following disclosures about BCUCC transactions should be assessed:

- When a BCUCC is measured on a carry-over basis, the entity should provide historical comparatives.
- When a BCUCC results in the re-measurement of the transferred assets and liabilities, the entity should provide the type of pro-forma information required by IFRS 3.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me at +1 416 204-3276 (email peter.martin@cica.ca), or Rebecca Villmann, Principal, Accounting Standards at +1 416 204-3464 (email rebecca.villmann@cica.ca) or Nicky Lahner, Principal, Accounting Standards at +1 416 204-3348 (email nicky.lahner@cica.ca).

Yours truly,



Peter Martin, CA

Director

Accounting Standards

¹ See OSC Staff Notice 52-720 page 2, dated February 2012 at http://www.osc.gov.on.ca/documents/en/Securities-Category5/sn_20120223_52-720_oqa-fin-rpt.pdf