

November 08, 2005

Peter Martin, C.A.
Director, Accounting Standards
Accounting Standards Board
277 Wellington Street West
Toronto, Ontario M5V 3H2

Dear Peter,

Re: Business Combinations Exposure Draft

The Committee on Corporate Reporting of Financial Executives International Canada (“FEI Canada”) is writing to provide its views on the Business Combinations Exposure Draft issued in August 2005.

FEI Canada is an all-industry professional association for senior financial executives, with eleven chapters across Canada and more than 1,700 members. Membership is generally restricted to senior financial officers of medium to large corporations, as well as senior financial officers in public sector organisations.

The Committee on Corporate Reporting (“CCR”) is one of two national advocacy committees of FEI Canada. CCR comprises more than 20 senior financial executives representing a broad cross-section of the FEI membership and of the Canadian economy who have volunteered their time, experience and knowledge to consider and recommend action on a range of issues related to accounting, corporate reporting and disclosure. In addition to advocacy, CCR is devoted to improving the awareness and educational implications of the issues it addresses, and is focused on continually improving the areas it addresses.

The remarks contained in this submission are made by members of CCR and do not necessarily represent the views of all FEI Canada members or its Board.

CCR recognises the challenges of developing harmonised accounting standards in conjunction with the IASB and FASB. CCR appreciates the efforts of the Accounting Standards Board and its staff in developing this exposure draft.

CCR believes that the current accounting standard is not sufficiently broken to justify such an extensive redrafting. The current exposure draft is overly complex, proposes fundamental changes in accounting principles and introduces concepts that are at odds with existing accounting standards. All of this will, we believe, lead to difficulties and inconsistencies in the application of the standard which will not be in the best interests of the users of financial statements which we believe need to be fully established before such fundamental changes are made.

The exposure draft proposes some fundamental changes in accounting principles:

- recognition of assets and liabilities for contingencies that are not probable of being realised or incurred and incorporating the uncertainty over whether cash will be realised or paid into the measurement
- marking to fair value certain types of contingencies and contingent consideration through earnings post-acquisition
- requiring transaction costs to be expensed
- prohibiting recognition of liabilities for exit costs in purchase accounting
- prohibiting recognition of previously unrecognised acquirer tax assets

The implications of these proposals for the future shape of the financial reporting model are significant. CCR recognises that once issued as a final standard, extension of these principles to similar circumstances that occur outside of a business combination is inevitable. CCR therefore believes that proposals to change such fundamental accounting principles impact the whole basis of accounting and therefore require greater visibility and debate than is likely to happen with this exposure draft.

We provide below our comments on these proposed fundamental changes:

Contingencies, including Contingent Consideration

Valuing and accounting for contingencies and contingent consideration will be extremely difficult as we have seen in the application of other standards such as the valuation of conditional asset retirement obligations. The major difficulty in valuing contingencies is usually due to the existence of diverse views. Indeed, contingent consideration is frequently the compromise solution that results from differences of opinion between buyer and seller regarding the value of a business. As such, it is not intuitive that these arrangements should be presumed to be reliably measurable at the date of acquisition.

Transaction Costs

The current exposure draft specifically excludes transaction costs from the determination of fair value for an acquired business. CCR struggles to understand how costs paid to a third party or incurred solely in transacting the exchange are not part of the fair value of the exchange. In most cases, parties to the business combination lack the expertise to fully consummate a transaction without specialists. These costs, paid to third party specialists, are not unlike organisation costs incurred at the inception of a loan or transportation and installation costs related to equipment. CCR would view a business combination or acquisition as a basket of productive assets and transaction costs as being those necessary to bring them to a state in which they can begin producing revenues. In addition, most economic analysis of a proposed business combination would include such transaction costs in the determination of the value a willing buyer would be willing to pay and therefore CCR believes should be included in the determination of fair value and not expensed as incurred.

Restructuring and Exit Costs

Similar to the discussion on transaction costs, CCR believes a buyer's assessment of the fair value of an acquired entity also includes costs that will be incurred to integrate the acquired business and achieve synergies. Such costs and related benefits are an integral component of the acquisition economics, and the fair value of a target business must be believed to be sufficient to cover both these and the transaction costs.

CCR believes a model which capitalises such costs is consistent with the existing model for other assets (ie. fixed assets) where the amount capitalised is equal to the amount paid to acquire and place the asset in service.

Recognition of Acquirer Tax Assets

CCR believes that a buyer's assessment of the fair value of an acquired entity also includes the benefits of previously unrecognised tax losses which become usable and therefore recognisable as a result of a business consideration. The accounting for a business consideration should reflect the underlying economics and, therefore, fair value should include such future tax benefits if applicable.

In conclusion, we believe that the principles underlying accounting standards should endeavour to reflect the underlying economics of transactions and events in accounting results. In addition, accounting standards also need to provide the most relevant information for the effective decision making of financial statement users.

CCR does not agree that the exposure draft on Business Combinations as currently drafted meets these two key tests and will be extremely difficult to implement consistently in practice leading to worse not improved information for users of financial statements.

We have provided our detailed response in Appendix A of this letter. We would be pleased to meet with the Accounting Standards Board and staff to discuss our concerns in more detail.

Sincerely,



Alister Cowan
Chair, Committee on Corporate Reporting
FEI Canada

Appendix A: Response to the Business Combinations Exposure Draft

- 1. Are the accounting and reporting objective and the definition of a business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?**

Response

- We understand that one of the AcSB's main objectives with this exposure draft is to provide more comparable and transparent financial statements through the application of one single method for the accounting of all business combinations, the acquisition method
- However, we are concerned that the fundamental changes in accounting principles that are being proposed compromises the understandability of financial results
- Due to its complexities, this proposal poses complex practical issues for financial statement preparers and related complications for auditors in their attestation role
- As one of the key objectives of financial statements is to communicate information that is useful to investors, creditors and other users, there should be a balance in the reporting objective of any proposed accounting standard that results in financial information that is not unduly complex to financial statement prepares and users

- 2. Are the definition of a business and the additional guidance appropriate and sufficient for determining whether the assets acquired and the liabilities assumed constitute a business? If not, how would you propose to modify or clarify the definition or additional guidance?**

Response

- The definition of a business and the additional guidance provided appears to be comprehensive

- 3. In a business combination in which the acquirer holds less than 100 percent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognize 100 percent of the acquisition-date fair value of the acquiree, including 100 percent of the values of identifiable assets acquired, liabilities assumed and goodwill, which would include the goodwill attributable to the non-controlling interest? If not, what alternative do you propose and why?**

Response

- We do not agree with the proposed accounting treatment as the application of the acquisition method may result in inconsistencies in how acquisitions are accounted for
- The purchase would typically include a control premium which would be allocated, under the proposed standard, on a pro-rata basis to the minority interest if the acquisition price is extrapolated to be the fair value of a 100% interest
- This would lead to imprecise balances being recorded for goodwill, including the portion allocated to the minority interest
- Inconsistencies would also arise when an acquisition is completed in steps as opposed to in one single transaction due to fluctuations in fair value
- This accounting treatment would also present practical issues relating to the allocation of subsequent impairment provisions relating to goodwill

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4. **Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?**

Response

- Proposal and implementation guidance provided appears reasonable

5. **Is the accounting for contingent consideration subsequent to the acquisition date appropriate? If not, what alternative do you propose and why?**

Response

- We do not agree with this proposal
- Contingent consideration classified as liabilities that are not within the scope of Section 3855 are measured at fair value with changes in the fair value recognized in income in each reporting period
- This results in the immediate recognition of potential contingent liabilities even when the likelihood of occurrence is remote under certain circumstances
- Subsequent fluctuations in the fair value of contingent liabilities due to underlying circumstances and/or changes in fair value would result in continuing volatility in earnings until the contingency is ultimately settled

6. **Do you agree that the costs that the acquirer incurs in connection with a business combination should be excluded from the measurement of the consideration transferred for the acquiree and, with the exception of issue costs, that they should be expensed? If not, what alternative treatment do you propose for the acquirer's costs (other than issue costs) and why?**

Response

- We do not agree with this proposal as it is difficult to understand the support for the proposed treatment of acquisition costs as period costs as they are incurred on an incremental basis to the business acquisition
- These costs would be analogous to amounts incurred to place a physical asset into use (e.g. installation), in which case, they would be eligible for capitalization as part of the cost of the related asset purchased

7. **Do you believe that the proposed changes to the accounting for business combinations for the assets acquired and liabilities assumed as part of the business combination, which are detailed in paragraphs 1582.28-41, are appropriate? (The most significant changes include identification of the assets acquired and liabilities assumed as part of the business combination, and accounting for contingencies and restructuring costs.) If not, which changes do you believe are inappropriate, what alternatives do you propose, and why?**

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Response

- With respect to the accounting for contingencies, we do not agree with the recognition of an asset or liability for those contingencies acquired in a business combination that do not meet the recognition criteria in Contingencies, Section 3290
- Similar to our comments surrounding the treatment of contingent consideration, this results in the immediate recognition of potential contingent assets or liabilities even when the likelihood of occurrence is remote under certain circumstances
- Subsequent fluctuations in the fair value of contingent assets and liabilities due to underlying circumstances and/or changes in fair value would result in continuing volatility in earnings until the contingency is ultimately settled
- With respect to liabilities associated with restructuring or exit activities, the requirement that these items be recognized as part of the combination only if they meet the criteria in EIC-134 and EIC-135 appears to be too restrictive
- Current guidance that allows for the inclusion of other liabilities and commitments such as restructuring costs that are incidental to the acquisition is more reasonable as they are incremental to the business acquisition

8. Do you believe that the limited exceptions to the fair value measurement principle proposed in this Exposure Draft (see paragraphs 1582.42-.51) are appropriate? What exceptions, if any, would you eliminate or add, and why?

Response

- The exceptions to the fair value measurement principle have been limited to those assets and liabilities that are implicitly recognized at fair values based on existing guidance provided by other sections
- To that end, we find these exceptions to be reasonable based on ensuring consistency between how these assets and liabilities are being recorded for transactions that do not arise from a business combination
- However, we reiterate our overall concern over the implications of the fair value measurement principle as it leads to the potential compromise of the understandability of financial statements as previously explained

9. Is it appropriate for the acquirer to recognize in income any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?

Response

- We do not agree with this proposal as the accounting treatment would be inconsistent with current revenue recognition principles whereby gains or losses are generally not recognized until realized
- Current guidance provided for the accounting of equity investments whereby increases in market or fair value are not recognized until realized should continue to apply

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10. Do you agree with the proposed accounting for business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest? If not, what alternative do you propose and why?

Response

- We do not agree with this proposal relating to the accounting of a bargain purchase
- The assessment of fair values of the acquiree and the consideration transferred are subject to significant variability based on valuation procedures and techniques used
- Although the proposal specifies that considerable effort should be made to ensure that fair values have been properly measured, there leaves sufficient variability to the interpretation of appropriate valuation processes
- We believe that current guidance provided for the accounting of negative goodwill is appropriate whereby any such excess amounts are allocated as a pro rata reduction in the amounts that would otherwise be assigned to other assets acquired

11. The AcSB acknowledges that an acquirer might overpay to acquire a business, but concluded that it is not possible to measure such an overpayment reliably at the acquisition date. Can you identify any circumstances in which the amount of an overpayment could be reliably measured at the acquisition date?

Response

- No circumstances identified in which an overpayment would be reliably measured. Practically, we do not see how you could argue that an overpayment existed at the acquisition date when you have assessed the transaction at fair value which generally is the value an acquirer is prepared to complete a transaction.

12. Do you agree that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments? If not, what alternative do you propose and why?

Response

- We do not agree with this proposal as the measurement period could extend well into the subsequent reporting period, resulting in adjustments that may be based on subjective evidence
- Furthermore, financial statement users typically associate restatements with incorrect accounting treatment being applied in prior periods and also questions the reliability of previously reported financial results
- We believe that current guidance provided under Accounting Changes, Section 1506, is appropriate in accounting for any adjustments that may be required to comparative financial statements

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13. Do you believe that the guidance provided is sufficient for making the assessment of whether any portion of the transaction price or any assets acquired and liabilities assumed (including consideration linked to continued employment) are not part of the exchange for the acquiree? If not, what other guidance is needed?

Response

- The guidance provided would appear to be sufficient based on the three criteria provided, those being: (a) the reasons for the transaction or event, (b) who initiated the transaction or event; and (c) the timing of the transaction or event

14. Do you agree with the disclosure objectives and the minimum disclosure requirements? If not, how would you propose amending the objectives or what disclosure requirements would you propose adding or deleting, and why?

Response

- Disclosure requirements appear to be overly onerous
- The level of detail specified would require a demanding level of disclosure to be provided in addition to current requirements under Section 1581

15. Do you believe that an intangible asset acquired in a business combination that is identifiable can always be measured with sufficient reliability to be recognized separately from goodwill? If not, why? Can you provide any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics?

- (a) The intangible asset cannot be sold, transferred, licensed, rented or exchanged individually or in combination with a related contract, asset or liability.**
- (b) Cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole**

Response

- Numerous examples of intangible assets that could be recognized separately from goodwill are provided in the implementation guidance, paragraphs 1582 A27-A61
- Examples of intangible assets that cannot be reliably measured - none determined at this point

16. Do you agree that any changes in the acquirer's future income tax benefits that become recognizable because of the business combination are not part of the fair value of the acquiree and should be accounted for separately from the business combination? If not, what alternative treatment do you propose and why?

Response

- We do not agree with this proposal as future income tax benefits that become recognizable because of the business combination are typically included in the acquirer's assessment of the fair value of the acquiree
- In certain cases, the available tax losses that may be made available to the acquirer are significant

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- As a result, we believe that these benefits should not be accounted for separately from the business combination

17. Do you agree that a future tax asset of the acquiree that was not recognized at the date of acquisition and that is recognized after one year from the acquisition date should reduce income tax expense and not adjust the accounting for the acquisition? If not, what alternative treatment do you propose and why?

Response

- This proposal would be reasonable as it is likely that the future tax asset arose through the normal course of operations as a result of post-acquisition activities or transactions that may have not been contemplated at the time of acquisition

18. Do you agree with the proposed transitional requirements? If not, what alternative do you propose and why?

Response

- The transitional requirements of adopting the proposal on a prospective basis appear to be reasonable

19. Do you believe that there are unique Canadian circumstances for particular issues related to accounting for business combinations that justify treatment that differs from the converged FASB/IASB proposals? If so, please identify these unique circumstances and your suggested treatment.

Response

- The proposals will have the greatest impact on companies that are publicly traded
- In Canada, our capital markets operate on a less complicated and much smaller scale than our counterparts in the US and Europe, and may not necessitate the requirement for further complexities in accounting for business combinations; especially as current standards appear appropriate

20. Do you believe that the proposals, taken as a whole, are understandable? If not, what aspects are difficult to understand and why?

Response

- Taken as a whole, the proposals are understandable from the perspective of the desire to implement a fair value approach to the accounting for business combinations
- However, it is difficult to understand some inherent contradictions the proposals entail which impinge upon current guidance provided by other accounting standards
- As an example, it is difficult to acknowledge the grounds for prohibiting the inclusion of acquisition costs with the business combination, which are incrementally incurred, but at the

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same time, permitting the recognition of contingent assets and liabilities when there can be significant uncertainty surrounding their ultimate settlement

- Other concerns relate to the overall understandability of financial statements and the related presentation
- The inclusion of the NCI balances within equity creates confusion with respect to the reporting and calculation of operating results of the controlling shareholders
- This results in the reporting of financial results within equity that are separated between those of the NCI and controlling interests
- Further distortions include the impact to equity related ratios which will be affected by the inclusion of NCI balances within total shareholders equity

21. Do you agree that after control of a subsidiary is obtained, changes in ownership interests in that subsidiary that do not result in a loss of control should be accounted for as capital transactions and recognized in equity, and that, accordingly, no gain or loss should be recognized in consolidated net income? If not, what alternative do you propose and why?

Response

- We do not agree with this proposal as the accounting treatment is inconsistent with the view that since minority interests do not have an ownership interest in the parent company, transactions involving minority interests should not be reflected within the equity balance of the parent company
- This could also result in the inconsistent treatment of dispositions that are undertaken based on the potential accounting treatment
- If a company intends to dispose of a subsidiary at a loss, it can do so by first selling a portion that would still provide a controlling interest after the sale (e.g. retaining 51%), and then selling the remaining controlling interest, or a portion thereof, in a subsequent transaction
- This would allow for the loss relating to the first sale to be reflected directly in equity; while only the losses relating to subsequent dispositions would be required to be reflected in operating earnings

22. Do you agree that when control of a subsidiary is lost and a non-controlling equity investment is retained, that retained interest should be remeasured to its fair value on the date control is lost and any gain or loss should be recognized in consolidated net income? If not, what alternative do you propose and why?

Response

- We do not agree with this proposal based on a similar argument presented for the proposed recognition in income any gain or loss on previously acquired non-controlling equity investments on the date control of the acquiree is obtained
- This accounting treatment would be inconsistent with current revenue recognition principles whereby gains or losses are not recognized until realized

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23. Do you agree with the proposed requirements for attributing net income or loss and the components of other comprehensive income to the controlling and non-controlling interest based on relative ownership interests unless a contractual arrangement requires otherwise, and that the NCI's share of losses should be attributed to the NCI even when they exceed the interest of the NCI in the equity of the subsidiary? If not, what alternative do you propose and why?

Response

- The new proposal is consistent with current guidance whereby the net income or loss is attributable to the NCI owners except where the NCI's share of losses exceed the interest of the NCI in the equity of the subsidiary, current guidance requires the excess to be allocated to the controller shareholder
- On the assumption that NCI is classified as equity, we agree with the new proposal of attributing the pro rata portion of net income or loss to NCI owners even when it exceeds the interest of the NCI balances so as to properly reflect the equity interest of each respective party
- However, as we disagree with the treatment of NCI as equity (see response to 24. below) we disagree with the proposal on the basis that it would essentially require the creation of a receivable from the NCI which may never be recovered and therefore the current guidance should be maintained

24. Do you agree that the NCI is part of the equity of the consolidated entity and should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity? If not, what alternative treatment do you propose and why?

Response

- We do not agree with this proposal as NCI owners lack the same rights as controlling shareholders and do not meet the current definitions of either liabilities or equity
- NCI balances should therefore be separated from the equity balances of controlling shareholders
- Furthermore, NCI owners would typically have limited interest in the consolidated financial statements as they would normally have other financial information available to them (e.g. the financial statements of the subsidiary)
- We believe that a separate classification of NCI balances outside of equity is most appropriate

25. Do you agree with the proposed additional disclosure requirements?

Response

- Additional disclosure requirements appear to be overly onerous
- Level of detail specified, such as the continuity of contingent consideration and impact of the acquisition, would require a demanding level of disclosure to be provided