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PSAB Public Sector Accounting Board
CCSP Conseil sur la comptabilité dans le secteur public

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Re: Comments on Exposure Draft 41 – Entity Combinations from Exchange Transactions

Thank you for the opportunity to comment on Exposure Draft 41 (ED 41). Please note that the comments below are views of PSAB staff and not those of the Public Sector Accounting Board (PSAB).

Scope of ED 41

PSAB staff support IPSASB's approach to limit converging IFRS 3, *Business Combinations*, to entity combinations from exchange transactions in public sector because IFRS 3 is not intended to address entity combinations from non-exchange transactions.

Differences between ED 41 and PSAB Standards

PSAB staff noted two differences between ED 41 and the Public Sector Accounting (PSA) Handbook, that is, the treatment of a gain on bargain purchase arising from acquisition of a non-cash generating operation and the acquisition related costs. Given the objective of ED 41 is to converge with IFRS 3, IPSASB's position on these two issues is understandable. PSAB staff found no compelling reason to object to IPSASB's proposal on these two issues. PSAB's position and rationale on these two issues are included below for your reference.

> <u>Gain on Bargain Purchase</u>
> ED 41 proposes recognition of gains on bargain purchases arising from acquisitions in surplus or deficit at the date of acquisition. PSA Handbook is silent on the accounting treatment for bargain purchase arising from acquisition of government business enterprises but requires gains on bargain purchase arising from acquisition of a government unit be eliminated through adjustment to the value of non-monetary assets acquired. This treatment is based on PSAB's view that net assets acquired should not be recorded at amounts higher than the purchase costs to the government.

Acquisition Related Cost

ED 41 proposes recognition of acquisition related costs as expenses in the periods the costs are incurred and the services are received. PSA Handbook treats acquisition related costs as part of the purchase cost, consistent with the treatment of acquisition costs of tangible capital assets (similar to treatment of directly attributable costs in IPSAS 17, *Property, Plant and Equipment*).

Goodwill Arising From Acquisition of a Non-Cash Generating Operation

PSAB staff support the accounting treatments for goodwill arising from acquisitions of cash-generating operation and non-cash generating operation proposed in ED 41. With the different purposes of acquiring a cash and a non-cash generating operation and the different nature of the acquirees, the different accounting treatments for goodwill proposed in ED 41 reflect the different economic substance of the acquisitions (as described in PS 2510, *Additional Areas of Consolidation*, paragraph 24, quoted below).

> "*A purchase premium arising on acquisition of a governmental unit would be charged to expenses in the period of acquisition because the future net cash flows associated with a governmental unit, by definition, are unlikely to indicate that the purchase premium has been paid for anything but policy reasons. Governmental units receive funding from the government in order to pursue their activities and meet their debt requirements. Consequently, it is unlikely that the portion of the purchase cost related to the purchase premium could be tied to projected future profits from revenues received from sources external to the government reporting entity and so should be a cost of the period of acquisition*."

However, PSAB staff is concerned where the accounting treatment for goodwill arising from acquisition of a **non-cash** generating operation is presented in ED 41. This accounting treatment is addressed in the Application Guide (paragraph AG 41), rather than in the Standard itself (for example, under the section "Recognizing and measuring goodwill or a gain from a bargain purchase"). No reference is made for this departure from the general goodwill recognition principle (which is stated in paragraph 38) or from IFRS 3, except that a sentence "*paragraphs AG40-AG45 provide related application guidance*" is included at the end of paragraph 39. Readers of this Standard who do not see the need to go to the more detailed Application Guidance will likely assume that goodwill arising from all acquisitions (regardless of the nature of acquirees) will be recognized. Though the "expense" treatment for "purchase premium" represents a deviation from IFRS 3, it is not mentioned in the "Basis for Conclusions", which addresses major differences between IFRS 3 and ED 41.

The wording in paragraph AG 41, "*Occasionally, an acquirer will make an acquisition of a non-cash-generating operation, in which the aggregate of the amounts in paragraph 38(a) exceeds the amount in paragraph 38(b)*", appears to imply that most entity combination transactions in the public sector are acquisitions of cash-generating operations. PS 2510.11 also recognizes that only “*in the rare circumstances when a government acquires a government unit, the acquisition is normally made for policy reasons.*” Though occurred occasionally, in PSAB staff’s view, the “expense” treatment of “purchase premium” arising from an acquisition of a non-cash-generating operation is a significant deviation from IFRS 3 and the general recognition principle for goodwill and should be addressed in the Standard.

Bargain purchase, is also recognized in ED 41 as arising from entity combinations occasionally, the treatment of which is addressed in the Standard (in paragraph 40, quoted below) and not the Application Guidance.

> “*Occasionally, an acquirer will make a bargain purchase, which is an entity combination in which the amount in paragraph 38(b) exceeds the aggregate of the amounts specified in paragraph 38(a).*”

While the Application Guidance is an integral part of the Standard, not addressing this differential treatment in the Standard and the Basis for Conclusions can be potentially misleading. If there is an acquisition of a non-cash generating operation and goodwill arises, the possible impact of the different accounting treatments on a public sector entity’s financial statements can be significant. PSAB staff recommend that paragraph AG 41 be included in the Standard to ensure that it gets the necessary attention, similar to exceptions to the recognition and measurement principles which are described in the Standard. It is also recommend that this difference be highlighted in the “Basis for Conclusions”.

Other Private Sector Issues and Terms
PSAB staff found that ED 41 is unnecessarily cumbersome as its content is packed with private sector issues that are either irrelevant to or uncommon in most entity combination transactions in the public sector. For example:

- accounting issues related to entity combinations achieved in stages, contingent consideration, indirect acquisition, pre-existing relationship or arrangement before negotiations for the entity combinations;

- references made to “individuals” and “a group of individuals” that control each of the combining entities; and

- examples of franchise agreement and marketing-related intangible assets.

These transactions rarely happened in the public sector. According to the GAAP hierarchy in IPSAS 3, public sector entity can go to IFRS for guidance in areas not addressed in IPSAS. ED 41 can be streamlined and simplified to focus on entity combination (from exchange transactions) issues that are common in the public sector. Doing so would not compromise the “Rules of the Road” for modifying IFRSs for application to public sector entities as stated in paragraph BC2 in the Basis for Conclusions, “*Accrual basis IPSASs that are converged with IFRSs maintain the requirements, structure and text of the IFRSs, unless there is a public sector specific reason for a* *departure*", but would enhance the understandability and relevancy of the Standard to public sector entities.

We hope that you find our comments and observations in this letter useful.

Yours truly,

Tim Beauchamp

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