PUBLIC SECTOR
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Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
277 Welling Street West
Toronto, ON M5V 3H2 Canada

Re: Exposure Draft 60 "Public Sector Combinations"

Thank you for the opportunity to comment on the proposed IPSAS on Public Sector Combinations.

Scope

We support addressing public sector combinations between entities under common control in this proposed IPSAS because they are common transactions in the public sector. However, another common type of government restructuring that involves splitting an existing department/entity into two or more is outside the scope of the proposed IPSAS. We wonder if it was a conscious decision of IPSASB to exclude this type of common control transactions from the scope of the proposed IPSAS.

IFRS convergence

Though this is not an IFRS convergence project, we observe from the exposure draft (ED) that the proposed accounting for acquisitions and the consequential amendments in other IPSASs are similar to an IFRS convergence project. This illustrates that more IFRS convergence would be achieved when the proposals in this ED become part of the IPSASB Handbook.

Accounting methods

The modified pooling of interests and the acquisition methods proposed in the ED are based on well-established practice in accounting for entity combinations. For this reason, we do not have major concern with these proposed methods.

Key issue

The key to a public sector combination accounting standard is identifying which types of combination should be accounted for following the modified pooling of interests method and which should be accounted for using the acquisition method.

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These two methods would result in different accounting outcomes. It is therefore important that the standard or its basis for conclusions demonstrate why certain nature and characteristics of a public sector combination would be more faithfully represented if the assets acquired and liabilities assumed are measured initially at their fair values. This information seems lacking in the ED.

We wonder if classifying or labelling public sector combinations into amalgamations and acquisitions are necessary. Ultimately, it is not the classification, but the accounting method used to account for a public sector combination, that can faithfully represent the economic substance of a combination.

We are concerned that the proposed IPSAS has placed the emphasis on classification and labelling. We note that combinations that would be labelled as amalgamations based on guidance in the ED may not line up with common understanding of amalgamations. The description of amalgamations in many dictionaries is similar to the proposed definition of public sector combinations in the ED. The indicators proposed in the ED are not referred to in the description of amalgamations in the dictionaries.

Classification approach

We have reservations with the classification approach and related guidance proposed in the ED. We question if it would result in:

- consistent accounting treatment for similar combinations; and
- accounting of public sector combinations reflecting their economic substance.

Consistent accounting treatment

As acknowledged in the ED, some indicators relating to consideration and the decision-making process are inconclusive in determining the classification of a combination. These may be signs that such indicators do not represent the economic substance of amalgamations. Leaving them in the guidance can be confusing and potentially result in arbitrary and inconsistent conclusions.

Accounting reflecting economic substance

We agree that change in control, presence of consideration and how consideration is determined can represent the economic substance of a combination. However, they need to be defined more precisely to:

- become unambiguous criteria that reflect the economic substance of a combination; and

- justify why the prescribed accounting method would better reflect the economic substance of combinations with these characteristics.

We believe that assets and liabilities should generally be valued at their costs to the reporting entity. Acquisition accounting should be applied to account for combinations that are of a purchase nature. That is, the consideration provided (by the resulting entity or acquirer) is primarily based on the fair value of the assets acquired and liabilities assumed.

We find applying the control criterion (whether one or none of the combining entity gains control of the combined entity) to combinations that involve combining entities of different sizes challenging. Determining whether a new entity is formed or one of the combining entities takes over the new entity if one of the combining entities is much bigger than the others may not be clear-cut. Different conclusions can be reached.

We do not agree that who makes the decision about the terms and conditions of a combination is the economic substance of a combination. Rather, it is the terms and conditions resulting from the combination decision that represent the economic substance of a combination, regardless if they are imposed or negotiated.

A simplified approach

It appears that the design of the three-level classification assessment is to limit the types of combination that should follow acquisition accounting to a few specific ones. A more clear-cut approach that could achieve similar outcome would be to simply direct specific public sector combinations to follow acquisition accounting. The other combinations would apply the modified pooling of interests method.

Based on the guidance and related illustrative examples in the ED, it seems that IPSASB intends to ensure that the following combinations are accounted for using acquisition accounting:

- there is a controlling entity and a controlled entity relationship between parties in a combination (paragraph AG23);
- a combination that has commercial substance (paragraph AG24);
- there is a payment of consideration that is intended to compensate those with an entitlement to the net assets of the transferred operation for giving up that entitlement (paragraph AG27);
- a donation of the net assets of an operation (paragraph AG30);
- an uncompensated seizure or nationalization (paragraph AG30); and

- public sector combinations not under common control (paragraph AG37).

We believe that this transaction-based approach would improve the understandability and applicability of the standard for more consistent accounting treatment.

However, given our views on the key issue that should be addressed in the proposed IPSAS and what constitutes the economic substance of public sector combinations (discussed above), we do not necessarily agree that accounting for the above listed transactions using the acquisition method would result in more faithful representation of those combinations.

Please note that these are views of staff and do not represent the views of the Public Sector Accounting Board. Our more detailed comments are provided in the attached Appendix.

Sincerely,

Lydia So

Lydia P. So

APPENDIX: RESPONSES TO IPSASB SPECIFIC MATTERS FOR COMMENT EXPOSURE DRAFT (ED) 60: PUBLIC SECTOR COMBINATIONS

Specific Matter for Comment 1

Do you agree with the scope of the Exposure Draft? If not, what changes to the scope would you make?

We support addressing public sector combinations under common control in this proposed IPSAS because they are common transactions in the public sector.

However, another common type of government restructuring that involves splitting an existing department/ministry/entity into two or more would be outside the scope of this proposed IPSAS. These transactions would not meet the proposed definition of public sector combinations. We wonder if it was a conscious decision of IPSASB to exclude this type of common control transactions from the scope of the proposed IPSAS.

Though the proposed title of the new IPSAS is public sector combinations, it only addresses the accounting for the recipient, that is, the resulting entity and the acquirer. It does not address the accounting for the transferor, that is, the combining entity that transferred assets and/or liabilities to the resulting entity and the acquirer. Expanding the scope of the guidance to include transferors would promote consistent and transparent reporting of the effects of a public sector combination in the transferor's financial statements.

Specific Matter for Comment 2

Do you agree with the approach to classifying public sector combinations adopted in this Exposure Draft (see paragraphs 7–14 and AG10–AG50)? If not, how would you change the approach to classifying public sector combinations?

We have reservations with the classification approach and related guidance proposed in the ED. We question if it would result in:

- *consistent accounting treatment for similar combinations; and*
- *accounting of public sector combinations reflecting their economic substance.*

Consistent accounting treatment

As acknowledged in the ED, some indicators relating to consideration and the decision-making process are inconclusive in determining the classification of a combination. These may be signs that such indicators do not represent the economic substance of amalgamations. Leaving them in the guidance can be confusing and potentially result in arbitrary and inconsistent conclusions.

Accounting reflecting economic substance

We agree that change in control, presence of consideration and how consideration is determined can represent the economic substance of a combination. However, they need to be defined more precisely to:

- *become unambiguous criteria that reflect the economic substance of a combination; and*
- *justify why the prescribed accounting method would better reflect the economic substance of combinations with these characteristics.*

We believe that assets and liabilities should generally be valued at their costs to the reporting entity. Acquisition accounting should be applied to account for combinations that are of a purchase nature. That is, the consideration provided (by the resulting entity or acquirer) is primarily based on the fair value of the assets acquired and liabilities assumed.

We find applying the control criterion (whether one or none of the combining entity gains control of the combined entity) to combinations that involve combining entities of different sizes challenging. Determining whether a new entity is formed or one of the combining entities takes over the new entity if one of the combining entities is much bigger than the others may not be clear-cut. Different conclusions can be reached.

For example, Municipality A of 80,000 populations is combining with Municipality B of 20,000 populations. The new governing board of Municipality AB has two members representing Municipality B and the eight members of the governing board of Municipality A. It can be considered that the governing board of Municipality A has the power to govern Municipality AB.

We do not agree that who makes the decision about the terms and conditions of a combination is the economic substance of a combination. Rather, it is the terms and conditions resulted from the combination decision that represent the economic substance of a combination, regardless if they are imposed or negotiated.

A simplified approach

It appears that the design of the three-level classification assessment is to limit the types of combination that should follow acquisition accounting to a few specific ones. A more clear-cut approach that could achieve similar outcome would be to simply direct specific public sector combinations to follow acquisition accounting. The other combinations would apply the modified pooling of interests method.

Based on the guidance and related illustrative examples in the ED, it seems that IPSASB intends to ensure that the following combinations are accounted for using acquisition accounting:

- *there is a controlling entity and a controlled entity relationship between parties in a combination (paragraph AG23);*
- *a combination that has commercial substance (paragraph AG24);*
- *there is a payment of consideration that is intended to compensate those with an entitlement to the net assets of the transferred operation for giving up that entitlement (paragraph AG27);*
- *a donation of the net assets of an operation (paragraph AG30);*
- *an uncompensated seizure or nationalization (paragraph AG30); and*
- *public sector combinations not under common control (paragraph AG37).*

We believe that this transaction-based approach would improve the understandability and applicability of the standard for more consistent accounting treatment.

Specific concerns with the proposed guidance in the ED

Economic substance

Not all the descriptions under the economic substance section in paragraphs AG20-AG25 are unique to acquisitions. In some cases, they may represent the circumstances under which acquisitions may generally occur in the public sector.

For example, we do not agree that "one of the parties to the combination continues to exist provides evidence that its economic substance is an acquisition" (the last sentence of paragraph AG 22). A combining entity can transfer an operation to a resulting entity and continue to exist without the transferred operation. This situation does not provide evidence about the nature of a public sector combination.

Also, combinations entered through mutual agreement can be amalgamations or acquisitions (paragraph AG24).

The second sentence of paragraph AG24 states that where an "entity gaining access to economic benefits or service potential that are similar to those that could have been obtained by mutual agreement, it is probably that the economic substance of the public sector combination is that of an acquisition." We do not understand why gaining access to economic benefits or service potential needs to be obtained through a voluntary *transaction, and why this is an indicator of an acquisition. We also find the example in this paragraph not helpful.*

Indicators relating to consideration

There is insufficient guidance in the ED to help determine whether consideration is paid to compensate the former owners for giving up the net assets of an operation or for reason other than to compensate (paragraph 12(a)). It is unclear how the intent of providing consideration can be objectively assessed. Without further guidance, it can be subject to different interpretations for a desired accounting outcome.

Indicators relating to the decision-making process

Whether a public sector combination is subject to approval by each party's citizens through referenda can equally support both classifications (based on guidance in paragraph AG36). It may be a sign that it should not be included as an indicator.

It is almost certain that all public sector combinations between parties under common control would require the approval of the controlling entity (paragraphs AG37-AG39). That means, the acquisition presumption would always be rebutted in public sector combinations between parties that are under common control. The first sentence of paragraph AG 37 (which states that a public sector combination between parties that are under common control ***may*** *provide evidence that the presumption could be rebutted) should be revised to reflect this certainty.*

Guidance for paragraph 14

The guidance for paragraph 14 in paragraphs AG40-AG50 was not helpful. It focuses on the information provided under each method and the principal users of that information. Rather, it should focus on when measuring the assets acquired and liabilities assumed in a combination at fair value would better meet the objectives of financial reporting and satisfy the qualitative characteristics, and when it would not.

The questions listed under paragraph AG49 are, in certain cases, not answerable. It is not the "classification", but the accounting method used to account for a public sector combination, that can faithfully represent the economic substance of a combination. In fact, this proposed IPSAS should provide answers to these questions rather than asking them.

Specific Matter for Comment 3

Do you agree that the modified pooling of interests method of accounting should be used in accounting for amalgamations? If not, what method of accounting should be used?

As indicated in our answer to Specific Matter for Comment 2, we have reservations with the classification approach proposed in the ED. We therefore do not agree that all the combinations that will be labelled as amalgamations based on the proposed guidance should be accounted for using the modified pooling of interests method.

The new IPSAS should identify the nature and characteristics of public sector combinations that would not be faithfully represented if the assets acquired and liabilities assumed are measured initially at their fair values. We believe that combinations that are of a non-purchase nature would fit into this category.

We find the following guidance regarding the modified pooling of interests method confusing:

- *Guidance on income taxes in paragraph 33 does not seem to reflect the guidance in paragraphs AG57-58.*
- *It is unclear what the second half of paragraph 20 intends to clarify about the amalgamation date.*

Specific Matter for Comment 4

Do you agree to adjustments being made to the residual amount rather than other components of net assets/equity, for example the revaluation surplus? If not, where should adjustments be recognized?

Do you agree that the residual amount arising from an amalgamation should be recognized:

(a) In the case of an amalgamation under common control, as an ownership contribution or ownership distribution; and
(b) In the case of an amalgamation not under common control, directly in net assets/equity?

If not, where should the residual amount be recognized?

We agree that the adjustments to conform to the accounting policies of the resulting entity should be made to the residual amount.

We agree that the residual amount related to combinations between entities under common control should be recognized as ownership contribution or distribution.

For other amalgamations, one can probably argue that the residual amount should be recognized in net assets if the resulting entity is a new entity without history prior to the date of combination. However, there is also conceptual reason to support recognizing the residual amount as in-year gains or losses.

Specific Matter for Comment 5

Do you agree that the acquisition method of accounting (as set out in IFRS 3, *Business Combinations*) should be used in accounting for acquisitions? If not, what method of accounting should be used?

As indicated in our answer to Specific Matter for Comment 2, we have reservations with the classification approach proposed in the ED. We therefore do not agree that only combinations that will be labelled as acquisitions based on the proposed guidance should be accounted for using the acquisition method.

The new IPSAS should identify the nature and characteristics of public sector combinations that would be more faithfully represented if the assets acquired and liabilities assumed are measured initially at their fair values. We believe that combinations that are of a purchase nature would fit into this category.

Since this is not an IFRS convergence project, we believe that the new IPSAS can be simplified if material that is not relevant to public sector is removed.