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March 1, 2005

Sir David Tweedie Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom Mr. Robert H. Herz Chairman Financial Accounting Standards Board 401 Merritt 7 P. O. Box 5116 Norwalk, CT 06856-5116 U. S. A.

Dear David and Bob,

I am writing regarding the tentative conclusion of the IASB/FASB project on Business Combinations which would require that any excess of the net fair value of identifiable assets and liabilities of an acquiree on the date of its acquisition over the fair value of consideration transferred to acquire it be credited immediately to income. The AcSB believes that treatment as income is not justified conceptually except in very narrow circumstances. We debated whether to send this letter now because, to some extent, we may be second-guessing debates not yet concluded by your boards and, perhaps more importantly, the bases for conclusions not yet fully developed. We decided, however, that it would be more constructive to share our views and significant concerns now in order that both the IASB and the FASB could take them into account in developing the draft standard and the accompanying basis for conclusions and invitation to comment. This letter and the accompanying staff paper have been prepared at the request of the Canadian board. Although expressed as the views of staff, the issues have been discussed with my Board and I believe the Canadian Board is near unanimous in its misgivings not only as to the conceptual underpinnings of the current proposals but also the potential damage to the credibility of financial reporting.

The AcSB recognizes that there is no fully satisfactory solution to the treatment of negative goodwill in the context of the existing developed principles, and the need to finalize the Business Combinations exposure draft without undue delay. It recognizes and accepts that trade-offs must be made based on existing information and knowledge. The AcSB believes, however, that the weight of existing information and knowledge supports the "default" being a balance sheet (asset valuation allowance) treatment rather that a credit to income.

The AcSB is concerned that the proposed income treatment of negative goodwill would give the wrong message, resulting in reporting income where no income exists. Further, it may provide an incentive for some acquirors to use the subjectivity of fair value estimates to create and report

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non-existant income on acquisitions. This is unlikely to improve the usefulness and credibility of financial reporting to the investing public.

The AcSB recommends that "negative goodwill" should be recognized as income only when there is persuasive evidence that the fair value of an acquired business taken as a whole exceeds the fair value of consideration transferred, and that the fact that the estimated net fair value of an acquiree's assets and liabilities exceeds the fair value of consideration transferred is not sufficient evidence of this. The reasons for our position and an explanation of one possible balance sheet alternative treatment are elaborated upon in the attached staff paper. In brief:

- There is a fundamental unit-of-account issue here. The governing unit of account for the purpose of determining any income on acquisition is, as acknowledged in paragraph 18 of the FASB proposed ED, the acquired business as a whole, and the objective is to measure its fair value. The fair value of the acquired business is presumed to be the fair value of the consideration transferred, absent evidence to the contrary. The identifiable assets and liabilities of the acquiree represent a different unit of account. Any excess of the net fair value of these individual assets and liabilities on the acquisition date over the fair value of the consideration transferred could be justified as income on acquisition only if the above presumption could be overturned-that is, only if it can be demonstrated that the fair value of the acquired business as a whole happens to equal the net fair value of its individual assets and liabilities.
- The AcSB believes that it may not be uncommon for the fair value of an unprofitable business to be less than the net fair value of its identifiable assets and liabilities. The fair value of consideration given to acquire such a business may be expected to be discounted for expected losses or below market returns to be incurred by the acquiree, that is, on the expectation that the acquiree will not realize the fair value of its identifiable net assets. The AcSB finds the arguments that it has seen for rejecting this possibility unconvincing, for reasons set out in the attached staff paper.
- The AcSB notes that recognizing that the fair value of a business could be less than the net fair value of its identifiable assets and liabilities conflicts with current IASB and FASB (and also Canadian) standards on the impairment of long-lived assets. The AcSB believes that these impairment standards need to be reconsidered, and that consistency with these standards should not be used to justify the recognition of income on the acquisition of a business.



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Given the somewhat unsatisfactory current state of developed principles and conceptual framework, the AcSB believes it is particularly important that the Basis for Conclusions provide a full discussion of the issues and arguments for and against income treatment and that the views of respondents be requested on those points. Stakeholders hopefully would understand that a full and final resolution of the underlying issues is dependant on further development of the Framework.

The Canadian board remains fully committed to the objective of a single high quality global standard on the accounting for business combinations and the application of the purchase method. If you would like to discuss these matters further, please contact Mark Walsh [416 204 3453], Peter Martin [416 204 3276] or me [416 204 3456].

With very kind regards,

Paul G. Cherry

Chair

Accounting Standards Board

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Enclosure

