MNP LLP

May 14, 2020

Kelly Khalilieh, CPA, CA
Director
Accounting Standards Board
277 Wellington Street West
Toronto, Ontario M5V 3H2

Dear Ms. Khalilieh:

Re: Proposed Section 4449 *Combinations by Not-for-Profit Organizations*

Thank you for the opportunity to provide input to the Accounting Standards Board (AcSB) on the above noted document.

MNP LLP is one of Canada's largest chartered professional accountancy and business advisory firms, with a significant focus on clients in private enterprises and not-for-profit organizations. We believe that we are well-positioned to provide feedback on this exposure draft ("ED").

We have reviewed the ED and have provided our comments below. We support the AcSB's efforts to provide a standard to account for the recognition and measurement of combinations by not-for-profit organizations (NFPOs). There are certain items for which we have concerns, and we have also identified some areas where we believe additional guidance may assist in the consistent application of the finalized standard.

Question 1: Paragraph 4449.02 proposes that this new Section apply to combinations involving two or more related or unrelated NFPOs. The proposed new Section refers to other Sections in the Handbook for instances when a for-profit enterprise is contributed to an NFPO, a for-profit enterprise is acquired by an NFPO, a group of assets not constituting an NFPO is transferred to an NFPO or a joint venture involving an NFPO is formed. Do you agree with this scope? If not, why not?

We agree with the proposed scope.

Question 2: The proposed scope of this Section includes combinations between two or more related NFPOs. However, the proposals do not include specific provisions for such combinations. Do you agree that no specific provisions to the criteria in paragraph 4449.07, or to the guidance on accounting for a merger or an acquisition are necessary for a combination of related parties? If not, why and what specific provisions should be provided?

We have concerns that the absence of specific provisions or guidance on accounting for a combination of related NFPOs could lead to inconsistencies in practice in how to account for a merger or an acquisition for a combination of related parties.

As the proposed Section would not apply in cases where control already exists, the only related party combinations that the proposed Section would cover would be of significantly influenced or other related entities as described in Section 4450 *Reporting Controlled and Related Entities by Not-for-Profit Organizations.*

Conceptually, we believe the guidance on accounting for a merger or an acquisition for a combination of related parties should not be different from the guidance for unrelated parties.

Question 3: The AcSB proposes to refer NFPOs to the guidance in BUSINESS COMBINATIONS, Section 1582, in Part II of the Handbook to account for the acquisition of a for-profit enterprise. This guidance includes the recognition of goodwill, if applicable. Given the rarity of these combinations, the Board also proposes to require the acquisition method be applied without exceptions, regardless of whether the NFPO chooses to subsequently consolidate or equity account for the for-profit enterprise. Do you agree with this approach? If not, why not?

We agree with this approach.

Question 4: Paragraph 4449.07 proposes five criteria to determine whether a combination is a merger or an acquisition. Does each criterion distinguish a transaction that exhibits the characteristics of a merger from that of an acquisition? If not, why not? What amendments to the current criteria or alternatives to the current criteria would you recommend?

We note from the proposed standard and the illustrative examples that have been provided that the criteria are to be evaluated separately on a pass/fail basis – a failure to meet one of the criteria would mean that the combination would not be accounted for as a merger. In contrast, assessments of whether control exists under HB4450 and other accounting frameworks consider the collective impact of multiple indicators. We believe there should be some allowance for judgment to consider the overall fact pattern and circumstances when determining whether a transaction is a merger or acquisition. We therefore encourage the AcSB to consider further refinement of these criteria and inclusion of additional guidance in the final standard.

In our view, certain of the proposed criteria are unclear, which, as addressed below, could lead to difficulties in their application.

Criterion # 3

A combination would be accounted for as a merger if no significant consideration flows to a third party. This implies that if any consideration does flow to a third party, a benefit has been conferred from the combination and therefore, that combination should be accounted for as an acquisition.

The body of the proposed Standard does not explain what would constitute consideration to a third party. Per Illustrative Example 3, payment of liabilities that would have gone unpaid if the acquired entity had wound up is consideration to a third party.

In our view, deciding whether liabilities would not have been paid if the combination had not occurred could be very subjective and give rise to significant variance in practice. We would therefore recommend that this criterion be clarified to reduce its subjectivity and the related example be appropriately modified.

Criterion # 4

A combination would be accounted for as a merger if the combined organization encompasses the purposes of each of the individual predecessor not-for-profit organizations. Minor changes to the purposes of the combining organization are acceptable, but a significant change would be an indicator of an acquisition.

The absence of a definition of the term “significant change” could lead to inconsistencies in practice.

For example, consider a combination where the professed purpose of the combined entity is different from the purposes of its predecessor organizations, but it conducts exactly the same activities as its predecessor organizations for the same client community. In the absence of a definition of “significant change”, some practitioners may take a rules-based approach and assess this criterion as not being met since the expressed purpose has changed. Other practitioners may cite substance over form and assess this criterion as being met (or irrelevant) since the activities remain unchanged.

We recommend including a definition of what constitutes a significant change for this criterion.

Criterion # 5

We agree any significant change in the client communities being served could be a good indicator to distinguish between a merger and an acquisition. However, we think additional guidance would be beneficial.

The absence of a definition of the term “significant” could lead to inconsistencies in practice. We recommend including a definition of what constitutes significant for this criterion.

The Basis for Conclusions considers a decline in the client communities as an indicator of an NFPO being acquired. However, it does not specify what constitutes a decline or at what point a decline would be considered significant. In our experience there could be significant practical difficulties in obtaining the data needed to complete an assessment under this criterion - i.e., an assessment against this criterion based solely on the number of physical locations delivering service or number of people being served could be misleading. A definitive answer might require a detailed analysis of the specific individuals served and the services provided before and after the combination. Depending upon the nature of the services being provided, such an evaluation might be prevented by privacy legislation.

Question 5: Prior to a combination, one or more of the combining entities might have applied the exemption in TANGIBLE CAPITAL ASSETS HELD BY NOT-FOR-PROFIT ORGANIZATIONS, Section 4433, and/or INTANGIBLE ASSETS HELD BY NOT-FOR-PROFIT ORGANIZATIONS, Section 4434, when the average of annual revenues recognized in the statement of operations for the current and preceding period of the organization and any entities it controls was less than $500,000. Once the entities combine, the exemption might no longer be applicable as the threshold might be exceeded.

(a) In a combination accounted for as a merger, the proposals require that a reporting entity applies uniform accounting policies on a prospective basis from the combination date. Do you agree with this proposal to apply uniform accounting policies when the exemption in Section 4433 and/or Section 4434 were previously applied? If not, why not? Alternatively, do you think an option should be provided for organizations to either apply uniform accounting policies for the recognition of capital assets and intangible assets on a prospective basis or on a retrospective basis?

We agree with providing the alternative option to allow organizations to either apply uniform accounting policies for the recognition of capital assets and intangible assets on a prospective basis or on a retrospective basis. Some organizations might find it beneficial to provide comparative information using the uniform accounting policies.

(b) In a combination accounted for as an acquisition, the acquirer might have applied the exemption prior to the combination. To determine whether the threshold has been exceeded, the reporting entity assesses the average of annual revenues recognized in the statement of operations for the current and preceding period by aggregating the revenues of the combining entities and any entities it controls as if the entities were combined in those periods. Do you agree with this approach? If not, why not and what alternative approach should the AcSB consider?

We agree with this approach. However, we believe it would be beneficial to include an option to consider what the planned or budgeted revenues will be going forward. If there will be a significant decrease in the services provided or communities served, aggregating past revenues would not be representative of the revenues of the new combined entity.

Question 6: In a combination, the proposals require a reporting entity to disclose information that enables users of its financial statements to evaluate the nature and financial effect of the combination.

(a) For a combination accounted for as a merger, do you agree the disclosure requirements in paragraphs 4449.19 - .20 meet this purpose?

While we agree with most of the disclosure requirements, we believe that information about the primary reason for a merger is more appropriately included in the management discussion and analysis section of an annual report, rather than disclosed in the financial statements.

(b) For a combination accounted for as an acquisition, do you agree the disclosure requirements in paragraphs 4449.62 - .67 meet this purpose?
If not, which proposed disclosures do not meet this purpose and why? Are there other disclosures the AcSB should consider that meet the purpose?

Similar to our response to the question above, we believe that information about the primary reason for an acquisition is better-suited to the commentary in the management discussion and analysis in an annual report, rather than disclosure in the financial statements.

The disclosure requirement as written in paragraph .64 will not meet the purpose. Paragraph .64 appears to suggest that if a reporting entity does not prepare consolidated financial statements, there would not be a need to disclose a condensed statement of financial position showing the amount recognized at the date of acquisition for each major class of assets acquired and liabilities assumed. We believe a condensed statement of financial position should be disclosed irrespective of whether consolidated financial statements are prepared. The condensed financial information as of the date of acquisition is relevant for the users for the financial statements.

Question 7: In an acquisition, the proposals require disclosure of contingent consideration. How common is contingent consideration in combinations of NFPOs and what is the purpose of contingent consideration?

We have not seen contingent consideration in combinations of NFPOs in practice.

Question 8: To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FINANCIAL STATEMENTS CONCEPTS FOR NOT-FOR-PROFIT ORGANIZATIONS, Section 1001, at the combination date. There are certain exceptions to this recognition principle proposed in paragraphs 4449.36 - .45. Do you agree with the exceptions? If not, why not? What other exceptions do you think the AcSB should consider and why?

We have concerns about the following requirements:

Collections

The wording of paragraph .43, when read in conjunction with the Basis for Conclusions, could give the impression that Collections should be reported at the acquiree's cost, or at nominal value. We suggest that paragraph .43 be revised to clarify that collections should be recorded at either the acquirer's cost (i.e., fair value at acquisition date) or at nominal value.

Contingent liabilities

Paragraph .37 states that the acquirer shall ignore the criteria in HB3290 and recognize as of the combination date a contingent liability assumed in a combination if it is a present obligation that arises from past events and its fair value can be measured reliably. The phrasing being used is very similar to the definition of a liability in Section 1001. If that definition was met, then the acquired liability would not be a contingency. Conversely, if the criteria in Section 3290 were applied, the contingency would only be recorded if it was considered likely that a future confirming event would occur. Because paragraph .37

indicates those criteria are not to be applied, it appears that it could require the recognition of a contingency that would not have been recorded in the absence of the acquisition.

The Basis for Conclusions does not address what the expected benefits to financial statement users would be of adopting a more conservative approach to contingencies in the event of an acquisition than in the course of ongoing operations. Unless the fair value of the contingency is to be recorded as an expected value based on the probability of loss, recording the contingency may result in the consideration paid for the acquisition exceeding the net assets acquired, resulting in a loss on acquisition. This could cause financial statement users to take an adverse view of the acquisition which might not be warranted.

In addition to the potentially inappropriate judgments that financial statement users might reach if contingencies are recorded on this basis, the cost to determine the fair value of contingencies that do not meet the requirements of Section 3290 *Contingencies* may outweigh any benefits derived by the users of the financial statements.

Indemnification assets

Paragraph .41 refers to the acquiree providing indemnification assets. In a for-profit situation, the indemnification is generally offered by the shareholders selling the business. In a not-for-profit situation, it is difficult to imagine what would be remaining of the acquiree to be able to provide the indemnification. The only potential source of indemnification that we could think of would be where a funding agency has requested a solvent not-for-profit assume responsibility for an insolvent not-for-profit to ensure continued provision of needed services. We suggest including examples in the final standard on accounting treatment of indemnification assets in NFPO combinations.

Question 9: The AcSB decided to not provide guidance on how to determine fair value of deferred contributions or deferred capital contributions at the acquisition date. Do you think guidance is necessary on how to fair value these deferred balances? If so, what guidance do you think would be helpful and why?

We expect there to be different approaches in practice used to determine fair value of deferred contributions or deferred capital contributions at the acquisition date. Therefore, additional guidance would be helpful.

Requiring fair values to be calculated for deferred contributions risks effectively imposes the liability method of revenue recognition on these contributions. Rather than attempt to conclude whether or not deferred contributions meet the definition of a liability, and if so, to arrive at fair values based on present values of expected future cash flows, a simple approach would be to deem carrying value to approximate fair value for deferred contributions for which the related expenditure has yet to be made. For deferred capital contributions being amortized over the life of the related capital asset, if the capital asset's fair value is less than carrying value, a write-down of the deferred contribution in proportion to the write-down of the capital asset may be recorded. If the capital asset's fair value is greater than carrying value, the deferred capital contribution would not require adjustment.

Question 10: When an NFPO acquires another NFPO, the Section proposes that goodwill is not recognized. Instead, when the consideration transferred exceeds the net of the acquisition-date values of the identifiable assets acquired and the liabilities assumed, the difference is recognized and presented separately in the statement of operations as an expense. Alternatively, if the consideration transferred is less than the acquisition-date values of the identifiable assets acquired and the liabilities assumed, a gain is recognized and presented separately in the statement of operations. Do you agree with these proposals? If not, why not and how should the excess or deficit be accounted for?

There are certain aspects of the proposals which raise concerns.

For example, NFPO A pays zero consideration and acquires a net asset position from NFPO B. In accordance with the proposal in the ED, NFPO A would recognize a gain in the statement of operations. This could conceivably happen in the case of a small local organization that was sound financially but reliant on volunteers, which chose to turn its operations over to a larger organization that might be able to provide some paid support. Unlike an arm's length commercial negotiation where a bargain purchase might warrant disclosure as a gain generated by the abilities of the acquirer's management, in this case the "gain" might more fairly be presented as a contribution from the acquiree.

Alternatively, if NFPO A pays zero consideration and takes on a net debt position from NFPO B, NFPO A would record an expense in the statement of operations. This financial statement presentation could cause users to question the judgment/stewardship of NFPO A's management/board.

The treatment of a bargain purchase in IFRS and ASPE presumes the purchaser and seller are attempting to maximize their respective returns from the combination transaction. A bargain purchase therefore reflects the purchaser's ability to either take advantage of weaknesses in the seller's negotiating position, or that the acquired business has greater value to the purchaser than the seller because the purchaser expects it can generate a greater return from the acquired business than was possible for its previous owner.

In a not-for profit setting, where there can be no direct benefit from the combination transaction to the members of the acquired NFPO, the purposes of the bargaining are different. In many cases the goal of both parties to the transaction will be to continue the provision of service/indirect benefit to the members/clients of the acquired organization. This could result in the gifting of net assets to the acquirer which would be more appropriately reflected either as contribution revenue in the statement of operations or as contribution of net assets in the statement of changes in net assets.

Question 11: Do you agree that the proposed new Section should apply to combinations for fiscal years beginning on or after January 1, 2022 on a prospective basis, with earlier application permitted? If not, why not?

The standard is expected to be released in the second quarter of 2021; therefore, the proposed effective date of January 1, 2022 will only provide entities with approximately six months to prepare for its implementation. In view of the limited resources available within the NFPOs sector, we recommend providing additional time to prepare so NFPOs are able to develop comprehensive understanding and interpretations of the requirements.

We also note that the AcSB is proposing to issue a consultation paper on *Contributions – Revenue Recognition and Related Matters.* Given the potential impact of this project on deferred contributions, we believe it would be beneficial to have considered the responses to this consultation prior to making decisions on fair valuing deferred contributions. We would therefore recommend the effective date of this new consultation paper be prior to the finalization and issuance of proposed Section 4449.

Additional Considerations:

- The Basis for Conclusions does not address why the AcSB thinks that the benefit of reporting fair values, in the case of an acquisition, would be great enough to warrant incurring the additional costs needed to derive them. Without this information we are unsure whether the benefit of the proposal change is commensurate with its probable cost. If the use of fair values was an option rather than a requirement, this would limit the use of fair values to situations where management or those charged with governance found there to be a benefit that outweighed the costs being incurred by the entity.

- Paragraph .01 refers to Section 4450 *Reporting Controlled and Related Entities by Not-for-Profit Organizations* for how things are to be accounted for subsequent to the combination. Section 4450.14 requires reporting each controlled NFPO either by consolidation or disclosure in the notes. Paragraph .03 presumes there will only be one reporting entity in the case of a merger and combined information will be presented. However, if the predecessor organizations remain separate legal entities, and

Section 4450.14 continues to allow a non-consolidation option for reporting controlled NFPOs, there does not appear to be any reason for combined information to be provided.

- Paragraph .49 *Measurement Period.* We recommend adding example(s) in the final standard to assist with understanding when this would be applicable.

- Example 3

From the case facts presented it is difficult to see this example as representative of a situation that would be likely to be encountered in real life. The reference in the example to Club B continuing as Club AB would appear to indicate that the transaction would include an amalgamation of Club A and Club B. There is no reason provided in the example for why Club B would be motivated to do this. Absent this amalgamation, this situation would be an acquisition. It is not clear what element of judgment in the application of the proposed standard is being illustrated.

We noted difficulties with the example as presented.

3 (a):
"No cash would be paid by Club B to Club A. Instead, Club B would assume the outstanding liabilities of Club A in the transaction. As a step in the transaction, these liabilities would be discharged from the funds made available for the transaction **by the membership of Club A**."

We believe this should read "**by the membership of Club B**."

Criterion (c) – Not Met
"…**While the members of Club B** are not receiving these payments…"
We believe this should read "**While the members of Club A** are not receiving these payments"

Criterion (e) – Met
This concludes the client communities remain unchanged because the geographic communities being served remained unchanged. This assessment might be appropriate in the case of a non-profit that is providing services to the general public and not just to its members. However, in the case of member benefit organizations, it is not clear why the termination of the Club A memberships (albeit with eligibility to purchase memberships in new Club AB) would not constitute a change in the community being served.

- Example 4

This example concludes the combination to be an acquisition on the basis that criterion (e) has not been met. The example states that this is the case because the programs that were terminated or about to be cancelled were not fully compensated for by the new clothing bank location that was being opened. This appears inconsistent with the wording of the second sentence in .07 (e) in the proposed standard, which seems to indicate that any new programs or services arising post-combination would not form part of an assessment of whether or not the client communities had changed.

This example does raise questions as to whether further refinement of the criteria to differentiate between mergers and acquisitions is required. Although the Handbook is clear that economic dependence does not constitute control, in this situation the principal funder of both charities has told Charity A that future funding will not be forthcoming unless it finds another charity to combine with. Conceptually, a combination between two entities economically dependent on the same funder could be seen to be analogous to a transfer of a business between entities under common control, in which case this combination would be reported at carrying values. The expected users of the financial statements are the provincial government and potential private donors. Decisions by the provincial government are unlikely to be influenced by estimated fair values for Charity A's assets and liabilities. In our experience, potential donors would be more concerned with program and administrative costs and information on programs and services provided. Asset values would be a lesser consideration unless there are superfluous assets that could be converted into cash for operations. There seems to be little benefit to the expected users of the financial statements of the combined entity to incur the cost to estimate fair values for Charity A's assets and liabilities.

We would be pleased to offer our assistance to the AcSB in further exploring the issues raised in our response and in helping to find solutions which meet the needs of the financial statement users.

Yours truly,

MNP LLP

Jody MacKenzie

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