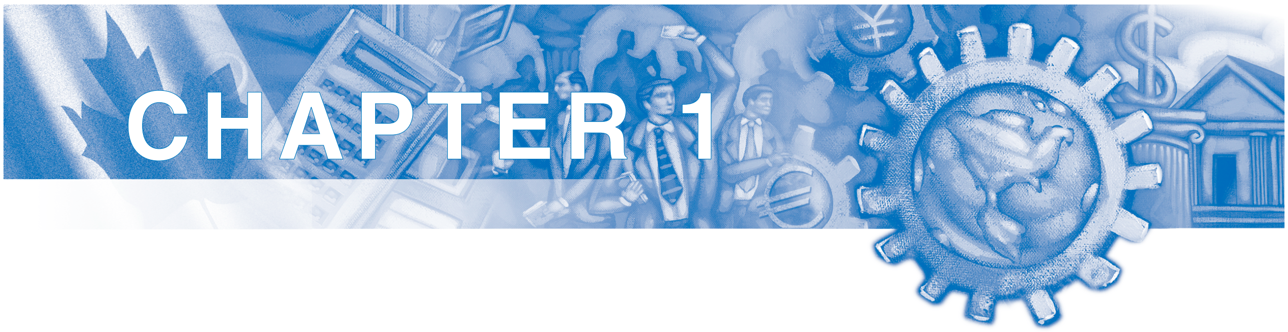
Detailed Contents Of Chapter 1

Introduction



Introduction

Abbreviations Used In This Text

The abbreviations used in this Chapter and all subsequent chapters are described in the Preface.

International Convergence

The Problem

Canada

1-1. At one point in time, the AcSB focused its efforts almost entirely on the development of effective accounting standards for use in the Canadian reporting environment. The use of these standards was required by all of the bodies responsible for securities regulation in Canada, as well as by the legislation that provided the basis for federally chartered corporations. In fact, many analysts fervently believed that a unique set of Canadian accounting standards was essential to the maintenance of effective financial reporting in the Canadian environment.

1-2. A number of trends have served to alter this situation. We are all aware of the increased importance of international trade. This has resulted in a situation where it is rarely appropriate to view any of our large, publicly traded companies as a "Canadian" company. These companies sell their product and acquire their resources throughout the world, in some cases with only a small proportion of their activity within this country's borders.

1-3. Such multi-national companies operate in a great variety of economic environments. In addition, they are subject to differing legal requirements, including those related to the assessment of taxes. Given this, it is difficult to argue effective reporting by these companies requires a set of accounting standards that is unique to Canada.

1-4. Of even greater importance is the fact that our large, multi-national companies do not restrict their fund raising activities to Canadian capital markets. In actual fact, Canadian capital markets are relatively small, compared to the size of many Canadian companies. This means that these organizations sell their securities in New York, London, and other venues on a regular and ongoing basis. As these alternative venues have differing regulatory bodies, Canadian companies commonly must prepare multiple sets of financial statements in order to comply with the requirements of these foreign capital markets.

Other Countries

1-5. This situation is not unique to Canada. Regardless of their home jurisdiction, multi-national companies are encountering difficulties dealing with the oft-times conflicting requirements of operating and raising capital in multiple jurisdictions. They are having to incur the not insignificant costs of preparing multiple sets of financial statements.

1-6. Further, as differences can be material, the users of financial statements are often confused as to which presentation they should be using to make investment decisions. For example, in 2003, Canadian Pacific Railway reported a Net Income based on Canadian GAAP of $401 million. In the same annual report, they also reported that, under U.S. GAAP, the result would have been a Net Income of $358 million. To further muddy the waters, in the U.S. GAAP results, they reported a Comprehensive Income Figure of $204 million (at this time, there was no Canadian requirement to report Comprehensive Income amounts).

The Canadian Response

1-7. Not surprisingly, the situation described in the preceding paragraphs has led to demands, from both financial statement preparers and financial statement users, for a single set of international accounting standards. At this point in time, these demands are being met in a number of jurisdictions by the adoption of the IFRSs that are produced by the International Accounting Standards Board.

1-8. Canada is one of these jurisdictions. After a lengthy strategic planning process, the AcSB has concluded that it will, at least for publicly accountable enterprises, adopt IFRSs as the primary source of Canadian GAAP. This strategic planning process, as well as the implementation plan for converging with international standards, will be given detailed consideration in the next section of this Chapter.

The Road Ahead: The AcSB's Strategic Plan

Background

1-9. A first draft of the Strategic Plan was published by the AcSB as an invitation to comment in March, 2004. This draft provided an overview of the Canadian standard setting environment and asked readers to comment on whether the Board should continue with the status quo, adopt U.S. standards, or adopt international standards. Comments were also invited on the need to develop alternative standards for different types of entities.

1-10. The AcSB received a wide range of views on the various issues raised in this initial draft of the Strategic Plan. After taking into consideration the feedback that it received on this draft, the Board issued a second invitation to comment in March, 2005.

1-11. The response to this second draft was generally supportive and, as a reflection of this, its content was largely incorporated into the final version which was approved by the AcSB in January, 2006. The Strategic Plan involves a multi-track approach to standard setting, with separate attention being given to the financial reporting needs of:

- publicly accountable enterprises;
- non-publicly accountable enterprises; and
- not-for-profit organizations.

1-12. The term "publicly accountable enterprises" is not directly defined in the *CICA Handbook*. However, its meaning can be determined by referring to Section 1300's definition of "non-publicly accountable enterprises":

> **Paragraph 1300.02(a) Non-publicly accountable enterprises** are enterprises other than public enterprises, co-operative business enterprises, regulated financial institutions and regulated financial institution holding companies, rate-regulated enterprises, government business enterprises and government business-type organizations as defined in the CICA Public Sector Accounting Handbook.

1-13. The Strategic Plan notes that the term "publicly accountable enterprise" is used substantially in accordance with the terminology and definitions in Section 1300. Given this, it encompasses public companies plus some other types of enterprises that have relatively large or diverse classes of financial statement users.

Basis For A Multi-Track Approach

1-14. The Strategic Plan describes the need for a multi-track approach as follows:

> The AcSB will pursue separate strategies for each of the major categories of reporting entities - publicly accountable enterprises, non-publicly accountable enterprises, and not-for-profit organizations. The AcSB recognizes that "one size does not necessarily fit all"; it may not be possible to address the divergent needs of different categories of reporting entities properly within a single strategy. Each category deserves a strategy that specifically addresses the particular needs of the users of financial statements of entities in that category, even though the outcomes of some of the strategies may be the same or similar for all categories.

1-15. This conclusion reflects the fact that the universe of Canadian reporting entities is quite diverse and it is unlikely that a single, monolithic set of standards could meet the needs of all of the members of this universe. As expressed in the comments made, the major concerns with this multi-track approach are:

1. The possibility that identical transactions would be given different treatment in the financial statements of different entities.
2. The possibility that the application of this approach could result in the need to prepare multiple sets of financial statements.
3. Difficulties associated with clarifying which set of standards should be used in particular circumstances.

1-16. The AcSB concluded that these problems were manageable. While the strategies for all three defined categories will be based on the same conceptual framework, they will differ when such differences can be justified by the needs and cost-benefit considerations of the different categories.

1-17. As an additional point here, we would note that it is not uncommon to see the group that the AcSB has referred to as "publicly accountable enterprises" referred to as either public enterprises or public companies. Since the majority of publicly accountable enterprises are, in fact, public companies, this terminology is close to being accurate. However, in this text, we will consistently reflect the intentions of the AcSB by using the correct designation — publicly accountable enterprises.

Implementation Plan

1-18. In June, 2006, the AcSB released *An Implementation Plan For Incorporating IFRSs into Canadian GAAP*. This fairly lengthy document provides a *Handbook* Section by *Handbook* Section analysis of how the AcSB expects IFRSs to be incorporated into Canadian GAAP.

1-19. The Implementation Plan specifies a "changeover date" of January 1, 2011. This is the date that the first year of reporting by publicly accountable enterprises under IFRS-based standards is expected to begin. The changeover will certainly not take place before this date. In fact, most analysts would expect the date to be deferred by at least one year.

1-20. For the *Handbook* material that is covered in this text, we will look at the detailed provisions of this Implementation Plan at the end of the relevant Chapter.

> **CD-ROM Note** If you are interested in additional information on this Implementation Plan, see our *Guide To Canadian Financial Reporting* which can be found on the CD-ROM which accompanies this text. Each Chapter of this *Guide* begins with a discussion of how international convergence will apply to the *Handbook* Section covered in the Chapter.

Strategy For Publicly Accountable Enterprises

A Change In Direction

1-21. In its original deliberations on the approach to be used for dealing with accounting standards for publicly accountable enterprises, the AcSB was faced with a choice between two discrete alternatives:

> **Harmonization With U.S. GAAP** This would require the elimination of significant unjustifiable differences with U.S. standards. While this does not involve copying all elements of U.S. GAAP or even all elements of a particular U.S. standard, it does involve developing standards that do not conflict with U.S. GAAP but may also permit other policies in some cases.
>
> **Convergence With International Standards** This would require replacing Canadian GAAP with the IFRSs issued by the IASB.

1-22. In its first version of a strategic plan for publicly accountable enterprises, the AcSB focused on harmonization with U.S. GAAP. This approach was based on the fact that the U.S. was Canada's most important trading partner, as well as the fact that most large Canadian companies required access to U.S. capital markets. Further supporting this approach was the acceptance by Canadian securities regulators of financial statements based on U.S. GAAP.

1-23. This changed dramatically with the October, 2002 signing of the Norwalk Agreement between the FASB and the IASB. The basic content of this agreement is as follows:

Norwalk Agreement

> At their joint meeting in Norwalk, Connecticut, USA on September 18, 2002, the FASB and the IASB each acknowledged their commitment to the development of high-quality, compatible accounting standards that would be used for both domestic and cross-border financial reporting. At that meeting, both the FASB and the IASB pledged to use their best efforts to:
>
> (a) make their existing financial reporting standards fully compatible as soon as is practicable and
> (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.
>
> To achieve compatibility, the FASB and IASB (together, the "Boards") agree, as a matter of high priority, to:
>
> (a) undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and International Financial Reporting Standards (IFRSs, which include International Accounting Standards, IASs);
> (b) remove other differences between IFRSs and U.S. GAAP that will remain at January 1, 2005, through coordination of their future work programs; that is, through the mutual undertaking of discrete, substantial projects which both Boards would address concurrently;
> (c) continue progress on the joint projects that they are currently undertaking; and
> (d) encourage their respective interpretative bodies to coordinate their activities.
>
> The Boards agree to commit the necessary resources to complete such a major undertaking.
>
> The Boards agree to quickly commence deliberating differences identified for resolution in the short-term project with the objective of achieving compatibility by identifying common, high-quality solutions. Both Boards also agree to use their best efforts to issue an exposure draft of proposed changes to U.S. GAAP or IFRSs that reflect common solutions to some, and perhaps all, of the differences identified for inclusion in the short-term project during 2003.

As part of the process, the IASB will actively consult with, and seek the support of, other national standard setters and will present proposals to standard setters with an official liaison relationship with the IASB, as soon as is practical.

The Boards note that the intended implementation of the IASB's IFRSs in several jurisdictions on or before January 1, 2005, requires that attention be paid to the timing of the effective dates of new or amended reporting requirements. The Boards' proposed strategies will be implemented with that timing in mind.

Note This Norwalk Agreement was reinforced by the two Boards signing a Memorandum Of Understanding (commonly referred to as MOU) in February, 2006.

1-24. This Agreement, along with the supporting Memorandum Of Understanding, constituted a fairly dramatic change in the U.S. approach to globalization of accounting standards. In prior years, there appeared to be a belief in the U.S. that the standards of other countries simply did not measure up to the quality that was inherent in the work of the FASB and should not be given serious consideration. In contrast, this agreement provides a clear indication that U.S. standard setters believe that there is a pressing need to work with other standard setters towards establishing internationally acceptable rules for financial reporting.

1-25. Given this change in the U.S., it no longer made sense for Canada to work towards harmonization with U.S. standards. This was reinforced by the fact that in several jurisdictions, most importantly the European Union and Australia, local standards were being eliminated in favour of the IFRSs. As a consequence of these developments, the AcSB's strategic plan for publicly accountable enterprises is based on convergence with international standards.

The Strategy

1-26. The AcSB's description of its strategy for publicly traded enterprises is as follows:

1. The AcSB will direct its efforts primarily to participating in the movement toward the global convergence of accounting standards. The AcSB has concluded, given the increasing globalization of capital markets and other recent developments, that it is timely for publicly accountable Canadian enterprises to adopt globally accepted high-quality accounting standards by converging Canadian GAAP with International Financial Reporting Standards (IFRSs) over a transitional period. At the end of that period, a separate and distinct Canadian GAAP will cease to exist as a basis of financial reporting for publicly accountable enterprises.

2. The AcSB's general approach to achieving convergence will include:

   (a) Adopting standards newly developed by the International Accounting Standards Board (IASB) that are converged with standards issued by the U.S. Financial Accounting Standards Board (FASB), as these new global standards are issued.
   (b) Replacing other Canadian standards with corresponding IFRSs already issued, in accordance with a separate convergence implementation plan to be developed in consultation with affected stakeholders.
   (c) Working with both the IASB and the FASB to ensure that the Canadian perspective is taken into account in their deliberations.
   (d) Working to promote the further convergence of IASB and FASB standards.

   In taking on a role in the development of global standards, the AcSB will cease to make final decisions on most matters affecting the technical content and timing of implementation of standards applied in Canada.

3. The AcSB's object is to achieve convergence of Canadian GAAP with IFRSs at the changeover date at the end of the transitional period, which is expected to be approximately five years (the currently stated goal is five years). The AcSB believes that by providing reasonable lead time and a clear transition plan, the costs and disruption to affected stakeholders will be minimized.

1-27. There are two other points that should be made with respect to this strategy:

> **References To Canadian GAAP** While a distinct Canadian GAAP will no longer exist as of the changeover date, as a practical matter, IFRSs will be imported into Canadian GAAP and will need to be described as Canadian GAAP for some period of time subsequent to the changeover date. The reflects the fact that, at present, many federal, provincial, and territorial laws, regulatory rules, and other such requirements related to financial reporting, make reference to Canadian GAAP.

> **AcSB Powers Unchanged** In adopting this strategy for publicly accountable enterprises, the AcSB is retaining all of its powers and responsibilities. For example, the AcSB could add disclosure requirements to an IFRS or, in cases where an IFRS provides alternative treatments, specify that only one of these treatments is acceptable in Canada. The resulting financial statements would still meet the convergence goal of compliance with international standards. However, the Strategic Plan indicates that the AcSB's intention is to exercise its powers in such ways only when necessary. In general, it is expected that IFRSs will be adopted without modification.

Strategy For Non-Publicly Accountable Enterprises

Current Situation

1-28. Most analysts believe that, for enterprises that do not have a significant number of external users, the full application of GAAP would not survive any reasonable cost/benefit analysis. As most of you are aware, the current CICA approach to dealing with this problem is to provide differential reporting options for non-publicly accountable enterprises.

1-29. Under this approach, these enterprises can choose not to apply some of the more complex provisions of current Canadian GAAP. For example, a non-publicly accountable enterprise can account for income taxes on a taxes payable basis, rather than becoming involved with the intricacies of Section 3465's tax allocation procedures.

> **CD-ROM Note** If you are interested in a complete discussion of Section 1300's differential reporting provisions, see Chapter 4 of our *Guide To Canadian Financial Reporting* which can be found on the CD-ROM which accompanies this text.

International Convergence

1-30. The Strategic Plan makes clear the AcSB's continuing belief that non-publicly accountable enterprises have different needs. Given this, the AcSB is currently doing research with respect to how these needs can be met in the context of international convergence.

1-31. Current IFRSs make no provision for non-publicly accountable enterprises. If this situation does not change, the AcSB would have three choices:

1. Requiring non-publicly accountable enterprises to use the same IFRSs as publicly accountable enterprises.
2. Continuing with a differential reporting model based on specified exemptions from IFRSs.
3. Developing and maintaining a distinct Canadian GAAP for this sector.

1-32. It appears, however, that the AcSB will not have to choose one of these alternatives. In November, 2006, the IASB issued an Exposure Draft, *International Financial Reporting Standard For Small And Medium-Sized Entities*. The Exposure Draft indicates that "small and medium-sized entities are entities that (1) do not have public accountability, and (2) publish general purpose financial statements for external users. While there are some differences, the IASB term "small and medium-sized entities" would largely include the same group of companies that are covered by the Canadian term "non-publicly accountable enterprises".

1-33. In contrast to the Canadian differential reporting approach, this document proposes a separate set of standards for small and medium-sized enterprises. That is, instead of listing specific exemptions from compliance with individual IFRSs, the Exposure Draft is a 243 page document which includes 28 separate standards covering issues such as “Financial Assets And Liabilities”, “Investments In Joint Ventures”, and “Impairment Of Non-Financial Assets”.

1-34. Given the issuance of this IASB Exposure Draft, it would be our expectation that the differential reporting model will remain in place until the date of the changeover to international standards. At the changeover date, the AcSB will likely adopt whatever final IFRS results from the Exposure Draft on small and medium-sized entities.

Strategy For Not-For-Profit Organizations

Current Situation

1-35. At present, not-for-profit organizations apply many *CICA Handbook* Sections without modification. However, Sections 4400 through 4460 provide guidance in areas where the AcSB has concluded that these organizations have financial reporting needs that are different from those of profit oriented enterprises (e.g., the treatment of pledges).

International Convergence

1-36. At present, IFRSs do not provide any special provisions with respect to not-for-profit organizations. Further, unlike the situation with standards for non-publicly accountable enterprises where there is an Exposure Draft dealing with the needs of these organizations, the IASB’s work plan makes no mention of any efforts to provide standards to meet the special needs of not-for-profit organizations. If this situation continues until the January 1, 2011 changeover date, the AcSB will have three choices:

- Require the application of all IFRSs to not-for-profit organizations.
- Allow not-for-profit organizations to use the IFRS that is being developed for non-publicly accountable enterprises.
- Continue the current practice of providing guidance in areas where they believe that these organizations have special needs.

1-37. It would be our guess that the last alternative will be selected. Not-for-profit organizations clearly have unique features. It seems unlikely to us that applying a set of standards developed for application to profit-oriented organizations would provide appropriate financial reporting results.

Writing Textbooks In This Brave New World

The Problem

1-38. There was a time when a financial reporting text could be published with the expectation that its content would be reasonably current for a period of three to five years. In fact, the normal revision cycle for the leading financial accounting texts was three years.

1-39. Even before the AcSB announced its plan to incorporate IFRSs into Canadian GAAP, this situation had changed. For several years, there have been near-monthly revisions to the *CICA Handbook*. Further, some of these revisions have been extremely complex as well as far-reaching in their implications. Examples of this latter problem include the new standards on financial instruments and stock-based compensation.

1-40. The decision to incorporate IFRSs into Canadian GAAP, as well as the AcSB’s approach to the convergence process, has exacerbated this situation. In particular, their decision to introduce components of international standards into the *CICA Handbook* on a piecemeal basis over the period leading up to the changeover date means that there will be significant changes in Canadian standards in all of the years leading up to that date.

1-41. We are now living in a world where, given the lead times required between the author’s completion of text material and its actual publication, any new financial reporting text will be at least somewhat out-of-date before it is put into the hands of students.

The Advanced Accounting Dilemma

1-42. This is a particularly difficult issue in preparing a text on advanced financial accounting subjects. While the parameters of this area vary considerably, the two subjects that appear to be common to all advanced financial accounting courses are business combinations and the preparation of consolidated financial statements. At least one-half of most advanced courses deal with this complex and extremely technical subject.

1-43. Because of the content of the existing IFRSs and work being done by the FASB and IASB in this area, we are virtually certain that the procedures used to prepare consolidated financial statements are going to change significantly. This change is likely to occur in 2009. Given this, we are faced with two choices:

- We can base our material on existing Canadian standards on business combinations and the preparation of consolidated financial statements. This means that we will be forcing you to learn some very complex procedures which, by the time you will be applying them in practice, will be largely irrelevant in the Canadian environment.

- We can base our material on what we expect to be the content of the IFRSs on business combinations and the preparation of consolidated financial statements. As the IFRSs are currently undergoing revision, there is the possibility that our expectations will not be correct. Further, for those of you writing professional examinations prior to the adoption of the IFRSs, you will not have an understanding of the Canadian statements that are likely to be applicable to these examinations.

Our Compromise Solution

1-44. Neither of the choices described in the preceding paragraph is satisfactory. In fact, no completely satisfactory solution exists. Given this, our compromise approach will be as follows:

- We will include complete coverage of the requirements of the current (1st Quarter, 2007) *CICA Handbook* with respect to the subjects covered in this text.

- In presenting this coverage, we will place extra emphasis on the concepts which underlie the procedures required by the current *CICA Handbook*. This will help you deal with the changes in procedures which we know will be coming in the near future.

- Throughout the text, we will describe the procedures that we expect to be required when IFRSs are converged into the relevant Canadian GAAP. This will include coverage of both current IFRSs, as well as changes that we anticipate as a result of revisions that are currently underway.

- In all chapters where we expect that IFRSs will produce significantly different results than those produced under the current *CICA Handbook* requirements, we will provide detailed examples of the alternative IFRS results.

- As we move closer to the adoption of IFRSs in the relevant subject areas, additional examples of their application will be provided on the web site for this text.

1-45. Also of possible assistance in this area is our *Guide To Canadian Financial Reporting*. This CICA publication provides detailed coverage of the international convergence process for all of the accounting Sections of the *CICA Handbook*.

CD-ROM Note Our *Guide To Canadian Financial Reporting* is available on the CD-ROM which accompanies this text.

1-46. While we would prefer a more satisfactory solution to this problem, we believe that this is the best approach that is currently available.

An Overview Of Investments In Equity Securities And Business Combination Transactions

Our Objective

1-47. Chapters 2 through 7 of this text deal with a group of related subjects which typically constitute the core material of most advanced financial accounting courses. These related subjects are:

- Investments In Equity Securities
- Business Combinations
- Consolidated Financial Statements

1-48. Some business combinations do not involve an investment in equity securities. Correspondingly, some investments in equity securities do not involve a business combination transaction. However, there are business combination transactions in which the combined business is carried on in the form of two separate legal entities, with one of the entities holding a continuing investment in the equity securities of the other entity. In this type of situation, the rules related to the preparation of consolidated financial statements come into play.

1-49. Given this situation, the objective of this section of our introductory Chapter is to provide a description of each of the individual subject areas listed, along with a general explanation of how the subjects are related. While the content of this Chapter is non-technical in nature, a familiarity with the individual subjects, as well as with the basic relationships between them, is essential to an understanding of the more technical material which follows in Chapters 2 through 7.

Investments In Equity Securities

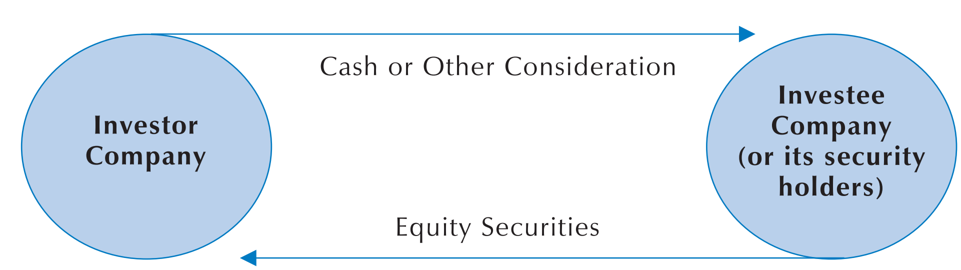
Separate Legal Entities

1-50. A corporation can invest in another corporation either by acquiring assets or, alternatively, by acquiring securities. When the asset approach is used, the assets are recorded on the books of the acquiring company and accounted for as per the other assets of the corporation. While an investment has been made, there would be no separate disclosure of an investment balance.

1-51. Alternatively, when equity securities are acquired, there is a continuing investment relationship between two separate and distinct legal entities. This is depicted in Figure 1-1.

1-52. As can be seen in Figure 1-1, the enterprise that has paid the consideration and acquired the securities will be referred to as the investor company. This enterprise can either acquire the other company's securities directly from the other company or, alternatively, the securities can be acquired in secondary markets from other investors. Regardless of the route chosen, the company whose securities are held will be referred to as the investee company.

Figure 1-1
Separate Legal Entities



1-53. In the preceding paragraphs, we have referred to the investor "company" and the investee "company". There are, of course, many situations in which the investor, the investee, or both, may be unincorporated business entities. In those cases where such business entities must apply GAAP, the *CICA Handbook* Recommendations are clearly applicable. However, in order to avoid the additional complications associated with other forms of business organizations, we will generally focus on equity investment situations in which both the investor and the investee are incorporated businesses.

Strategic Vs. Non-Strategic Equity Investments

1-54. While this term is not defined in the *CICA Handbook*, we find it useful to classify equity investments into two groups — investments that are a component of the operating strategy of the investor company, and investments that are not part of that operating strategy. We will refer to this latter group as non-strategic investments.

1-55. Within the category of strategic investments, the AcSB and the IASB have found it useful to identify three different ways in which the investor company may relate to the investee company:

Control Some investments in equity securities, generally those involving a majority holding of investee voting shares, give the investor control over the operating and financing decisions of the investee. In such situations, the investor is referred to as the parent, with the investee being referred to as the subsidiary.

Significant Influence Some investments in equity securities, generally those involving a holding of more than 20 percent, but less than 50 percent, of the outstanding voting shares of the investee, give the investor influence but not control over the operating and financing decisions of the investee. In such situations, the investee is referred to as a significantly influenced company.

Joint Control Some investments in equity securities allow the investor to share control of the investee with other investors. The investee in these situations is referred to as a joint venture, with the investors being referred to as joint venturers.

1-56. With respect to non-strategic investments in equity securities, the AcSB and the IASB divide this group into two categories:

Held-For-Trading Investments In general, these investments are held with an objective of generating a profit from short-term fluctuations in price or dealer's margin. However, as will be discussed in more detail in Chapter 2, management has the discretion of classifying any non-strategic investment as held for trading.

Available-For-Sale Investments This category would include any non-strategic investments that are not classified as held for trading.

1-57. Each of these classifications will be given more detailed consideration in Chapter 2, Investments In Equity Securities.

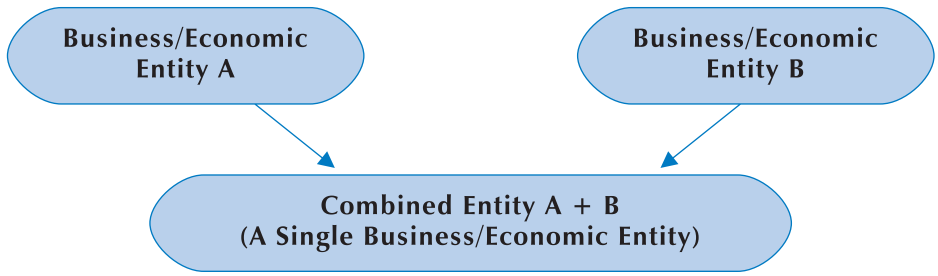
Current Vs. Non-Current

1-58. At an earlier point in time, the *CICA Handbook* contained separate sections titled Temporary Investments and Long-Term Investments. As this is no longer the case, investments in equity securities will have to be classified as current or non-current on the basis of the guidance in Section 1510, "Current Assets And Current Liabilities".

1-59. With respect to strategic investments in equity securities, except in very unusual circumstances, these assets will be classified as non-current in a classified Balance Sheet.

1-60. As to non-strategic investments, classification would depend on the intent of management. If management intends to hold such investments for more than one year from the date of the Balance Sheet, they would be classified as non-current. Otherwise, they would be included in the current assets.

Figure 1-2
Single Business Entity



Business Combinations

Defined

1-61. The term "business combination" is defined in Section 1581 of the *CICA Handbook* as follows:

> **Paragraph 1581.06(a)** A business combination occurs when an enterprise acquires net assets that constitute a business, or acquires equity interests of one or more other enterprises and obtains control over that enterprise or enterprises.

1-62. This definition is illustrated graphically in Figure 1-2. In examining this Figure, it is important to understand that there is a difference between the legal and the accounting meanings of the term, business combination. In some situations, the economic unification of two businesses will be accompanied by an actual legal amalgamation of their assets.

1-63. For example, if Entity A pays cash to acquire all of the assets of Entity B, the combined assets of the two entities will wind up on the books of a single legal entity. A similar result would occur if the assets of both Entity A and Entity B were transferred to a new entity established for this purpose. In such situations, the economic and legal entities coincide, and this serves to clearly establish the appropriate accounting entity.

1-64. However, as is indicated in the definition of the term, a business combination may be accomplished through one business entity gaining control over the other through an acquisition of shares. For example, Entity A might acquire 100 percent of the outstanding voting shares of Entity B. In this case, the combining enterprises, Entity A and Entity B, retain their separate identities and, from a legal point of view, no business combination has taken place.

1-65. In substance, however, this situation is no different from the previous one. The assets of both entities are now under common control and, from an economic point of view, a business combination has occurred. In situations such as this, the entity assumption requires that accountants focus on economic substance rather than legal form.

1-66. This means that the accounting procedures will focus on the fact that there has been an economic amalgamation which has resulted in a single economic entity. The resulting financial statements, which ignore the separate legal existence of the two companies, are referred to as consolidated financial statements.

Classification

1-67. In most business combination transactions, one of the combining companies will be clearly identifiable as dominant in the ongoing operations of the combined company. For example, if Company A with 10 million shares outstanding, issues an additional 1 million shares to the shareholders of Company B in return for all of their outstanding voting shares, it seems clear that Company A will be in control of continued operations of the combined company. In the context of business combinations, this dominant company is referred to as the acquirer.

1-68. If an acquirer can be identified, a business combination transaction can be viewed as an acquisition of assets. While this type of acquisition is far more complex than the purchase of a drill press, the basic concepts underlying the relevant accounting principles are not significantly different than those applicable to the purchase of a single asset.

1-69. At one point in time, Canadian, U.S., and international standards provided for the possibility that there might be business combinations in which an acquirer could not be identified. If this was the case, the business combination transaction could not be viewed as an acquisition of assets and other accounting procedures would be appropriate. In particular, a procedure referred to as "pooling-of-interests" could be applied. While this procedure was not widely used in Canada, it was very widely used in U.S. practice.

1-70. At this point in time, the AcSB, the FASB, and the IASB have concluded that an acquirer can be identified in all business combination transactions. This means that in the jurisdictions where these Boards make the rules, all business combination transactions must accounted for as an acquisition of assets.

1-71. The required method of accounting for these transactions is currently referred to as the "purchase method". However, it appears that the FASB and IASB are currently moving toward designating this method the "acquisition method". This will be discussed in more detail in Chapter 3.

The Overlap

1-72. In reading the preceding material, it probably occurred to you that the acquisition of equity shares in another corporation could be a business combination transaction. It is likely that you also noted that, in some business combination transactions, the combining companies may continue as separate investor and investee companies. In an effort to ensure your understanding of this situation, Figure 1-3 (following page) graphically depicts the relationship between business combination transactions and holdings of investments in equity securities.

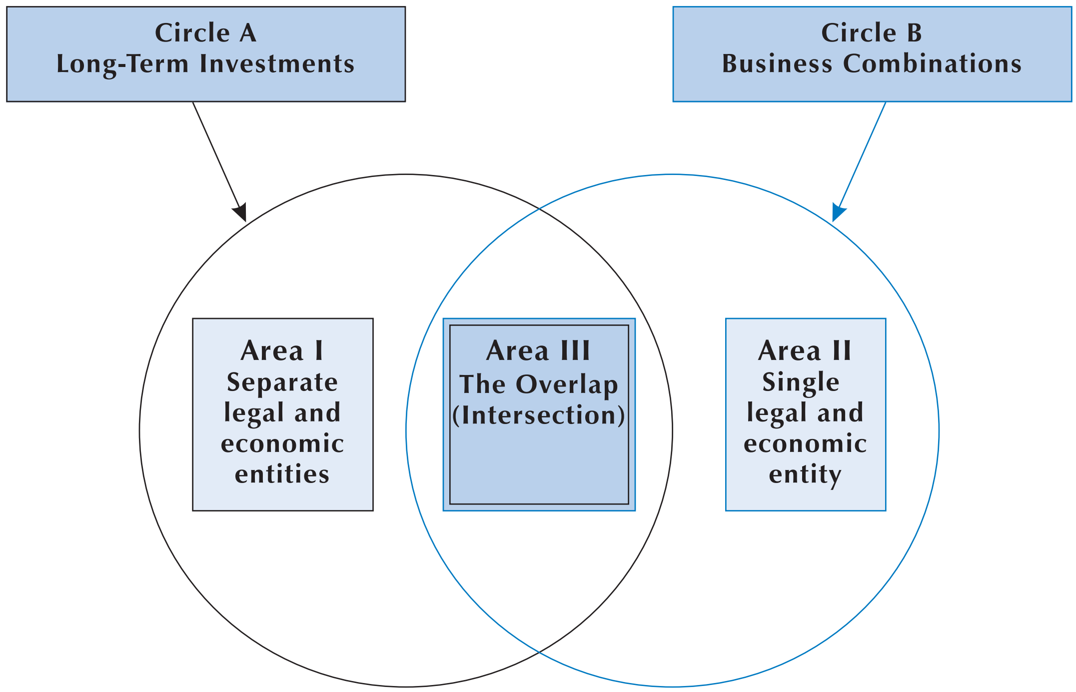
1-73. As can be seen in Figure 1-3, if Circle A represents the subject matter of investments in equity securities and Circle B represents the subject matter of business combinations, there is an overlap or intersection between the two circles. Including this intersection, three separate areas can be identified. These areas can be described as follows:

Area I This area represents investments in equity securities that have not resulted in an economic unification of the investor and investee companies. Stated alternatively, these are the investment situations where the investor and investee companies have retained both their separate legal identities as well as their separate economic status. In practical terms this includes all non-strategic investments, as well as investments where the investor has significant influence over the investee or shares joint control of that entity. However, situations where the investor company has acquired control (subsidiaries) would be excluded.

Area II This area represents business combinations in which there is no continuing investment relationship between the combining companies. Stated alternatively, these are the business combination transactions where the assets and liabilities of the two companies have been combined into a single legal entity. In general, this would involve situations where one company has acquired the assets of the other company or, alternatively, situations in which the assets of both companies have been transferred to a new company. In either case, all of the assets of the combining companies will be on the books of one legal entity, resulting in a situation in which the legal and economic entities coincide.

Area III (Overlap) In Areas I and II, there is no conflict between the legal and economic entities involved. In Area III, this situation changes. Area III involves situations where the two companies have achieved economic unification by one company acquiring a controlling interest in the shares of the other company. This means that we

Figure 1-3
Long-Term Investments and Business Combinations



are dealing with two separate legal entities (i.e., a parent and its subsidiary) that are being operated as a single economic unit. When accountants are confronted with a conflict between the economic entity and the legal entity, we have noted previously that the entity assumption requires that attention be directed to the economic entity. The two separate legal entities will have to be accounted for as a single unified business entity, a goal that is achieved through the preparation of consolidated financial statements.

AcSB And IASB Standards

Differences

1-74. This section will provide you with a listing of the various *CICA Handbook* Sections and IFRSs that relate to the subjects of business combinations, investments in equity securities, and the preparation of consolidated financial statements.

1-75. In many cases, there are important differences between the Canadian standard and the corresponding international pronouncement. We do not, however, believe that it would be meaningful to catalogue these differences at this point in the text. Our approach will be to include, at the end of each Chapter of the text, an analysis of how international convergence is likely to change the concepts and procedures discussed in that Chapter. At that point, a discussion of the relevant differences will be far more understandable.

Business Combinations

1-76. The relevant AcSB and IASB pronouncements in this area are as follows:

CICA Handbook Section 1581: "Business Combinations" This Section requires that all business combination transactions be accounted for by the purchase method. In addition, it provides guidance with respect to the application of this method of accounting for business combinations. It is also relevant to the preparation of consolidated financial statements in that it specifies the basis for measuring the assets and liabilities acquired in the combination transaction.

CICA Handbook Section 3062: "Goodwill and Other Intangible Assets" This Section provides guidance on accounting for any goodwill and other intangible assets that may be recognized in a business combination transaction.

IFRS No. 3: *Business Combinations* The content of this IFRS corresponds to *CICA Handbook* Section 1581. In addition, it contains material on goodwill that corresponds to the material in *CICA Handbook* Section 3062.

IAS No. 38: *Intangible Assets* The content of this IFRS corresponds to the material in *CICA Handbook* Section 3062 on intangible assets other than goodwill.

Investments In Equity Securities

Subsidiaries

1-77. The relevant AcSB and IASB pronouncements in this area are as follows:

CICA Handbook Section 1590: "Subsidiaries" This brief Section defines a subsidiary as an enterprise controlled by another enterprise and defines control as the continuing power of an enterprise to determine operating, investing and financing policies of the controlled enterprise. The Section also specifies that all subsidiaries must be consolidated.

CICA Handbook Section 1600: "Consolidated Financial Statements" This Section contains detailed rules for the preparation of consolidated financial statements.

IAS No. 27: *Consolidated And Separate Financial Statements* This IFRS has coverage that corresponds to the combined content of *CICA Handbook* Sections 1590 and 1600.

Significantly Influenced Companies

1-78. The relevant AcSB and IASB pronouncements in this area are as follows:

Section 3051: Investments This Section defines investments in significantly influence companies and requires the use of the equity method to account for these investments.

IAS No. 28: *Investments In Associates* The content of this IFRS corresponds to the content of *CICA Handbook* Section 3051. Note, however, the IASB uses the term "associate" to refer to the companies that Section 3051 refers to as "significantly influenced companies".

Joint Ventures

1-79. The relevant AcSB and IASB pronouncements in this area are as follows:

Section 3055: "Interests In Joint Ventures" This Section defines joint ventures, requires the use of proportionate consolidation to account for joint venture arrangements, and provides specific procedural rules which reflect the unique nature of joint venture arrangements.

IAS No. 31: *Interests In Joint Ventures* The content of this IFRS corresponds to the content of *CICA Handbook* Section 3055. Note, however, it requires the use of the equity method, rather than proportionate consolidation, to account for these investments.

Held-For-Trading And Available-For-Sale Investments

1-80. The relevant AcSB and IASB pronouncements in this area are as follows:

CICA Handbook Section 3855: "Financial Instruments - Recognition And Measurement" This Section defines held-for-trading and available-for-sale investments and, in general, requires that they be recognized and carried at their fair values.

IAS No. 39: *Financial Instruments: Recognition And Measurement* With respect to held-for-trading and available-for-sale investments, the content of this IFRS corresponds to the content of *CICA Handbook* Section 3855.

Summary

1-81. Figure 1-4 summarizes the relevant AcSB and IASB standards for dealing with business combinations and investments in equity securities.

Figure 1-4
AcSB and IASB Standards For Business Combinations And Investments In Equity Securities

Subject	CICA Handbook	IFRS
Business Combinations	Section 1581	IFRS No. 3
	Section 3062	IAS No. 38
Strategic Investments:		
Subsidiaries	Section 1590	
	Section 1600	IAS No. 27
Significantly Influenced Companies	Section 3051	IAS No. 28
Joint Ventures	Section 3055	IAS No. 31
Non-Strategic Investments:		
Held-For-Trading	Section 3855	IAS No. 39
Available-For Sale	Section 3855	IAS No. 39

EIC Abstracts

1-82. In addition to the *CICA Handbook* Sections cited in the preceding material, there are a large number of EIC Abstracts that deal with the subjects of business combinations and investments in equity securities.

1-83. We will be referring to a number of these Abstracts as we move through this material. However, as they often involve issues that are of interest only to those who specialize in this field, we will generally not provide detailed coverage of their content.

CD-ROM Note For anyone with a more detailed interest in this subject, we would refer you to our *Guide to Canadian Financial Reporting* which is included on the CD-ROM which accompanies this text. There is a Chapter in that source for each *CICA Handbook* Section and, at the end of each of these Chapters, there is a comprehensive list of additional readings, including relevant EIC Abstracts. In most cases, the Chapter also includes summaries of the relevant Abstracts.

Investments In Equity Securities and Business Combinations in Canadian Practice

1-84. Both business combinations and investments in equity securities are important areas in Canadian practice. The 2006 edition of *Financial Reporting In Canada* states that, in their 2005 annual reports, all of the companies included in the survey indicated that the statements presented were on a consolidated basis. This, of course, indicates the presence of one or more subsidiaries. Also for 2005, 122 of the 200 companies reported the presence of non-strategic investments, while 80 of the companies reported the presence of joint ventures.

1-85. With respect to business combinations, 69 of the 200 survey companies disclosed that they had implemented one or more business combination transactions during 2005. All of these combination transactions were accounted for using the purchase method.

Approaching The Subject

Canadian Material

1-86. With the completion of this overview of the subject matter of business combinations and investments in equity securities, Chapters 2 through 8 will provide a systematic and detailed presentation of the concepts and procedures associated with these subjects.

1-87. Chapters 2 and 3 will be largely conceptual in their content, dealing with the pronouncements contained in Sections 1581, 1590, and 3051 of the *CICA Handbook*. With these concepts in hand, we will then be in a position to turn our attention to the procedures that are required in the preparation of consolidated financial statements.

1-88. Chapter 4 will introduce this subject by dealing with the preparation of the consolidated Balance Sheet at the date of acquisition of a subsidiary. This will include material on the conceptual alternatives in consolidation, as well as on the allocation of the investment cost to fair value changes and goodwill.

1-89. Chapter 5 extends the analysis to cover consolidation in periods subsequent to the acquisition and covers the preparation of the consolidated Income Statement, the consolidated Statement Of Retained Earnings, and the consolidated Statement of Cash Flows. Procedures dealt with here include write-offs of fair value changes, recognition of goodwill impairment, elimination of intercompany assets and liabilities, elimination of intercompany expenses and revenues and the elimination of intercompany dividends.

1-90. Chapter 6 further expands the coverage of basic consolidation procedures by providing a comprehensive analysis of unrealized intercompany profits. The analysis includes consideration of unrealized profits in opening and closing inventories, unrealized profits on the sale of non-depreciable capital assets, and unrealized profits on the sale of depreciable capital assets. Additional coverage of the equity method of accounting for investments is also included in this Chapter.

1-91. Chapters 4 through 6 provide in depth coverage of basic consolidation procedures, including some material on conceptual alternatives in the preparation of consolidated financial statements. In our view, this coverage is sufficient to meet the needs of most accounting students. However, there are also a number of more advanced topics that related to the preparation of consolidated financial statements that some instructors may wish to cover.

1-92. While it is unlikely that an instructor would choose to cover all of these advanced topics, there does not appear to be a consensus as to which subjects are the most important. In order to deal with this situation, we have relegated coverage of all of these topics to a separate Chapter 7.

1-93. The final Chapter on these subjects is Chapter 8 which deals with the unique features associated with joint venture arrangements. This includes proportionate consolidation procedures, as well as the special treatment of intercompany transactions that is required by Section 3055 of the *CICA Handbook*.

International Convergence

1-94. We have given considerable thought as to the most appropriate manner in which to provide coverage of the IFRSs that relate to the material covered in the text. We considered integrating this material throughout each Chapter and providing coverage of how the international standard differs with respect to each issue covered. However, we concluded that this could lead to confusion with respect to current Canadian requirements.

1-95. Our conclusion was that the best alternative was to provide coverage at the end of each Chapter of how the treatment of the issues covered in that Chapter would be different under the related IFRSs. In the case of the Chapters involving consolidated financial statements, this will include comparative examples of the application of the Canadian and international standards.

Problem Material

1-96. The material in this Chapter has been very general in nature. As a consequence, there is no problem material included for this Chapter.