Restructuring Transactions — Basis for Conclusions

Section PS 3430

Foreword

CPA Canada Public Sector Accounting Handbook Revisions Release No. 43, issued in June 2015, contained a new standard, RESTRUCTURING TRANSACTIONS, Section PS 3430.

The primary objective of a Basis for Conclusions document is to set out how the Public Sector Accounting Board (PSAB) reached its conclusions. As well, it sets out significant matters arising from comments received in response to the proposals exposed and indicates how PSAB has dealt with the issues raised.

These documents are intended to assist financial statement users, preparers, auditors and other parties interested in public sector financial reporting in understanding the rationale followed by PSAB when developing standards.

This document has been prepared by staff of PSAB. It does not form part of the CPA Canada Public Sector Accounting (PSA) Handbook nor is it part of public sector generally accepted accounting principles (GAAP). Basis for Conclusions documents also do not include any guidance on the application of the relevant Section or Guideline.

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BACKGROUND

1 Restructuring transactions are, in some ways, similar to acquisitions as both involve transfers of assets, liabilities, and related operations or responsibilities. The CPA Canada Public Sector Accounting (PSA) Handbook addresses acquisitions of governmental units in ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510, and acquisitions of government business enterprises in INVESTMENT IN GOVERNMENT BUSINESS ENTERPRISES, Section PS 3070.

2 In the absence of specific guidance in the PSA Handbook, restructuring transactions are often accounted for by public sector entities using the continuity-of-interest method. However, according to guidance in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section PS 1150, it can be interpreted that restructuring transactions should be accounted for using the purchase method prescribed in ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510, and INVESTMENT IN GOVERNMENT BUSINESS ENTERPRISES, Section PS 3070.

3 Similar to the accounting for an asset purchase, the purchase method is appropriate for accounting for acquisitions because they are similar to purchases. Restructuring transactions usually involve no or nominal payment. Using the purchase method to account for them would not be appropriate given their non-purchase nature.

4 Other national and international public sector standard setters also recognized the need for a standard to address public sector entity combinations and transfers of operations among public sector entities. Their pronounced and proposed guidance were considered in the development of this standard.

5 Section PS 3430:

(a) defines a restructuring transaction;

(b) distinguishes restructuring transactions from other similar transactions;

(c) distinguishes restructuring-related transactions from restructuring transactions;

(d) establishes how assets and liabilities transferred in a restructuring transaction should be recognized and measured; and

(e) sets out presentation and disclosure requirements.

6 The intended outcomes are that:

(a) the economic substance of restructuring transactions will be fairly represented and consistently accounted for by public sector entities;

(b) the effects of a restructuring transaction will be transparently presented on the face of the financial statements; and

(c) sufficient information about a restructuring transaction will be provided in note disclosures.

7 The expected results are that users will:

(a) be able to compare and understand the nature and effects of a restructuring transaction on the financial position and operations of the transferor and the recipient; and

(b) have sufficient information for accountability assessment and decision-making.

8 In approving the standard, the Public Sector Accounting Board (PSAB) recognized that before undertaking a restructuring, entities may need to obtain additional legal authority. However, the transaction is reported when it occurs, notwithstanding the status of legal authority.

APPROACH

9 When PSAB approved this project, it considered taking a transaction-based approach that is commonly used by other standard setters in developing similar standards. That is, to define common types of public sector restructuring transactions and to develop transaction-specific guidance.

10 The earlier attempt to define an amalgamation based on the private sector definition and criteria of mergers indicated that very few restructurings in the public sector would meet the definition of an amalgamation. Even modifying the criteria of mergers with a change in control concept to make them relevant to public sector entities does not help. It is because restructuring transactions are rarely mergers of equals. Amalgamations of entities of different sizes would be classified as acquisitions following the private sector approach to differentiate between mergers and acquisitions. The biggest amalgamating entity would be perceived as the dominant or controlling entity and the logical "acquirer".

11 PSAB also considered the three methods of accounting for entity combinations in the accounting literature, namely, the purchase method, the carryover or the continuity-of-interesting method, and the fresh start method. The purchase method is appropriate for accounting for acquisitions but not for restructuring transactions, which are of a non-purchase nature.

12 The fresh start method is often used after a corporation emerges from bankruptcy. The remaining assets and restructured liabilities are remeasured at their fair value. This method is not appropriate for restructuring transactions because the assets transferred from the transferor will be realized, the liabilities transferred will be discharged and the service needs related to the transferred responsibilities will be met by the recipient.

13 Though the continuity-of-interest method is widely used in accounting for restructuring transactions by public sector entities, some elements of the method are not consistent with the general recognition and presentation principles in other Sections. For example, how the effect of in-year transactions and observable events is accounted for and presented.

14 PSAB concluded that it should take a different approach to this project. The objective was to define a restructuring transaction based on their common characteristics, and to develop principles-based guidance that:

(a) is consistent with the general accounting and reporting principles in other Sections; and

(b) would result in a faithful representation of the economic substance of restructuring transactions from the perspectives of the transferors and the recipients.

15 Taking this approach allows the standard to be applicable to a wide range of restructuring transactions. Amalgamation is only one type of restructuring transactions. Shared service arrangements are emerging to be a possible interim or alternative solution to amalgamations. Other restructuring transactions also include, but are not limited to, annexations or boundary alterations and realignment of programs or operations.

CHARACTERISTICS OF RESTRUCTURING TRANSACTIONS

16 Distinguishing a restructuring transaction from other similar transactions is important because Section PS 3430 requires that a recipient in a restructuring transaction recognize the individual assets and liabilities received at their carrying amount at the restructuring date. Guidance in other Sections that address similar transactions (such as acquisitions and contributions of tangible capital assets) requires that a recipient recognize the assets and/or liabilities received at their transaction date fair value.

17 Some respondents suggested that PSAB define or further divide restructuring transactions based on whether a restructuring transaction is:

(a) among entities under common control; and/or

(b) imposed by another government or a controlling government.

18 These respondents argued that restructuring transactions among entities under common control are different because there is no change in control over the assets and liabilities at the government reporting entity. PSAB noted that this does not override the fact that there is a change in control in the net / individual assets / liabilities at the transferor and the recipient level in the period a restructuring transaction occurs. Taking the perspectives of the transferor and the recipient is important because the standard applies to the preparation of general purpose financial statements of the transferor and the recipient. It does not apply to the consolidated financial statements of the government reporting entity if the government itself is not a party to a restructuring transaction.

19 A controlling government or another level of government that has authority to impose a restructuring transaction would likely have authority to impose an acquisition, a transfer of an asset, an assumption of liabilities and other similar transactions. Whether a transaction is imposed by others is not helpful in distinguishing restructuring transactions from other similar transactions. Who initiates or dictates the terms of a transaction is not the substance of the transaction. It is the terms (for example, whether payment is made, whether assets, liabilities and responsibilities are transferred) that constitute the economic substance of a transaction.

20 One respondent to the Exposure Draft suggested that "continuation of provision of services by the recipient" be included in the definition of a restructuring transaction. Given the common objectives of restructurings, services that were previously provided by the transferor may not be delivered in the same way and at the same level by the recipient. Using the suggested wording may result in transactions that would otherwise meet the definition of a restructuring transaction being accounted for differently simply because of changes in service delivery mechanism subsequent to the restructuring date. Applying the concept of service continuation in the context of restructurings means that a recipient in a restructuring transaction has an obligation or responsibility to continue to meet the need for services that were previously provided by the transferor.

SCOPE

21 Taking the principles-based approach, Section PS 3430 relies on the definition of a restructuring transaction to determine which transaction is included or excluded from its scope of application.

Government partnerships

22 A few respondents to the Statement of Principles suggested that clarification be provided on whether the standard applies to government partnerships as the PSA Handbook has a Section on government partnerships. PSAB noted that the purpose and scope of GOVERNMENT PARTNERSHIPS, Section PS 3060, is different from this Section. Section PS 3060 addresses how an entity should account for its interest in government partnerships. It does not provide guidance on how a government partnership should account for assets and liabilities it receives from its partners.

23 The formation of joint ventures is often excluded from the scope of entity combinations standards of other standard setters. Consistent with the principles-based approach taken in the standard, PSAB considered no reason to exclude government partnerships from the scope because:

(a) government partnerships are public sector entities;

(b) some government partnerships follow the PSA standards for their financial reporting; and

(c) government partnerships should account for and report transactions that have the same economic substance as restructuring transactions in the same way as the other public sector entities.

Entities adhering to the PSA standards

24 A few respondents to the Statement of Principles were uncertain whether Section PS 3430 would apply only to restructurings among public sector entities. Another respondent questioned whether the standard would apply if the transferor is a government business enterprise.

25 Consistent with the principles-based approach, Section PS 3430 applies to the accounting for transactions that meet the definition of a restructuring transaction for transferors and recipients that adhere to the PSA standards for their financial reporting. Whether all the transferors and recipients follow the PSA standards in their financial report is irrelevant and should not affect how a transferor or recipient accounts for the transaction in its own financial statements.

Guidance for transferors

26 The Statement of Principles did not include guidance for transferors. Respondents told PSAB that transferor guidance should be included because both transferors and recipients have been restructured as a result of a restructuring

transaction. Expanding the scope of the standard to include transferors would ensure consistent and transparent reporting of the effects of a restructuring transaction in the transferor's financial statements. The scope exclusion was removed in the Exposure Draft and specific guidance on transferor issues was proposed. The Exposure Draft proposals received overall support.

DEFINITIONS

Carrying amount

27 One respondent to the Exposure Draft commented that the definition of the carrying amount should be consistent with the definition in INTER-ENTITY TRANSACTIONS, Section PS 3420. PSAB acknowledged that while they should be consistent, the definition of the carrying amount in Section PS 3430 is not and need not be the same as the definition in Section PS 3420 because they refer to the carrying amount of different elements in an entity's financial statements. Section PS 3430 refers to the carrying amount of assets and liabilities while Section PS 3420 refers to the carrying amount of an item and the cost of services.

28 Another respondent to the Exposure Draft was concerned that the historical cost information of the transferred assets and liabilities would be lost as the carrying amount is defined as an amount net of valuation allowance. Based on the general presentation and disclosure principle in other Sections, an asset and a liability would be reported net of valuation allowance in the financial statements and its gross amount would be disclosed along with the valuation allowance in the notes. The definition of the carrying amount reflects these general principles.

Restructuring transaction

29 The definition of a restructuring transaction is made up of its key characteristics. Getting the definition of a restructuring transaction right is crucial because it draws the line as to which transaction would be accounted for under the guidance in this Section. Stakeholders were asked whether they found the definition in the Statement of Principles practical and workable, and whether the definition and related guidance provided effective tools to help distinguish restructuring transactions from other similar transactions in the Exposure Draft. Their responses to the questions in both documents were positive.

30 The definition of a restructuring transaction is primarily the one proposed in the Statement of Principles, with minor editorial changes. The part of the definition that explains the meaning of "consideration of a purchase nature" was removed from the definition in the Exposure Draft. The purpose was to simplify the definition and explain the concept of the non-purchase nature of a restructuring transaction in the supporting guidance. Respondents to the Exposure Draft commented that the shortened definition appears to contradict the guidance because the definition states that a restructuring transaction does not involve an exchange of consideration, while the guidance explains that consideration is possible if it is not based primarily on the fair value of the individual assets and liabilities transferred. They suggested that PSAB go back to the definition in the Statement of Principles.

31 One respondent to the Exposure Draft suggested that the term "exchange transaction" be used in the definition of a restructuring transaction, with the same meaning as defined in TAX REVENUE, Section PS 3510. Exchange transactions is defined in Section PS 3510 as "transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange." Whether the "equal value" is the carrying amount or fair value is not specified. The concept of exchange transaction would not help explain the concept of non-purchase nature, nor distinguish a restructuring transaction from an acquisition. The word "exchange" was removed from the definition of a restructuring transaction to avoid a similar association.

RECOGNITION

32 Section PS 3430 requires that the increase in net assets or net liabilities resulting from recognition and derecognition of assets and liabilities received from all transferors and transferred to all recipients in a restructuring transaction be recognized as revenue or as an expense. It is because any increase in net assets / liabilities arising from restructurings meets the definitions of revenue and expense. Revenue and expense are described in terms of increases and decreases in assets and liabilities resulting from the operations, transactions and events of the accounting period.

33 Reporting the increase in net assets or net liabilities as revenue or as an expense (rather than as an adjustment to the opening accumulated surplus or deficit):

(a) provides greater transparency regarding the effects of a restructuring transaction on the transferors and the recipients;

(b) is consistent with how the effects of in-year transactions and observable events are treated in other Sections; and

(c) faithfully represents the substance of a restructuring transaction and the fact that the transaction does not change the history of the transferors and the recipients.

34 While there is general support for this treatment for restructurings among entities not under common control, half of the respondents to the Exposure Draft either preferred or believed that any increase in net assets or net liabilities recognized in restructuring transactions among entities under common control should be treated as an adjustment to the opening accumulated surplus or deficit.

35 The respondents argued that recognizing the increase in net assets or net liabilities as revenue or as an expense would distort the annual surplus or deficit because:

(a) there is no change in control of the resources and responsibilities within the government reporting entity;

(b) no value is created or reduced within the government reporting entity;

(c) the net assets or net liabilities transferred have been previously recognized in the annual surplus or deficit by the transferor and the government reporting entity; and

(d) the decision about restructurings among entities under common control is often made by the controlling government. The performance of the transferor and recipient should not be affected by a decision not made by them.

36 While these are facts in the context of restructurings among entities under common control, they are not relevant considerations for determining how the transferor and the recipient, not the government reporting entity, should account for the restructuring transactions. From the transferor's and the recipient's perspectives, a restructuring transaction among entities under common control:

(a) is an in-year transaction; and

(b) results in an increase in net assets or net liabilities

in the accounting period in which the restructuring occurs that meets the definitions of revenue and expense. Based on the definitions of revenue and expense, an entity is not restricted to recognize only in-year increases and decreases in economic resources that result from their own decisions as revenue and as an expense.

37 Section PS 3430 applies to the transferors and the recipients, not the consolidated financial statements of the government reporting entity if the government is not a party to the restructuring transaction. How the transferor and the recipient account for a restructuring transaction with entities under common control in their financial statements should have no effect on the consolidated financial statements. No artificial gain or loss will be created at the government reporting entity level as any inter-entity gains and losses and balances will be eliminated upon consolidation.

38 The accounting for a restructuring transaction by the transferor and the recipient should reflect the economic substance of that transaction from their own perspectives, not the government reporting entity to which they belong, to meet the information needs of users of their financial statements. Whether the transferor and the recipient are under common control is not the economic substance of a restructuring transaction. Who makes the decision about a restructuring transaction is not the economic substance of the transaction either. For example, it is the decisions regarding whether payment should be made and, if so, the amount (fair value or other value) and which entity should make the payment, that form the economic substance of a restructuring transaction.

39 A few respondents argued that restructurings among entities under common control are similar to related party transactions that are outside the normal course of operations with no change in ownership in the private sector. Recognizing the gains and losses arising from such transactions directly in accumulated surplus or deficit would be consistent with the equity treatment in RELATED PARTY TRANSACTIONS, Section 3840 in Part II of the CPA Canada Handbook – Accounting.

40 Recognizing the net effect of a restructuring transaction among entities under common control as revenue or as an expense is consistent with the guidance in INTER-ENTITY TRANSACTIONS, Section PS 3420. The net effect of a restructuring transaction is the summation of compensation and the carrying amount of the individual assets and liabilities transferred. Paragraph PS 3420.09 states: "If inter-entity transactions involve the transfer of assets or liabilities, both entities would recognize the transactions. The provider would remove the assets or liabilities from its financial statements and any difference between the net proceeds received, if any, and the carrying amounts transferred would be accounted for as a revenue or expense in the statement of operations." Whether this treatment is consistent with the accounting guidance followed by private enterprises is less relevant. Also, the equity treatment in RELATED PARTY TRANSACTIONS, Section 3840, does not apply as equity is not an element in public sector financial statements.

41 One respondent commented that the definitions of revenue and expense exclude transfers with other governmental units within the same government reporting entity. FINANCIAL STATEMENT CONCEPTS, Section PS 1000, was written primarily for the consolidated financial statements of the government reporting entity. Paragraphs PS 1000.47 and PS 1000.50 state that revenues and expenses do not include transfers to and from other governmental units in the government reporting entity. This means that transfers to and from other governmental units are not revenue or expense at the government reporting entity level. This wording will be subject to review in the Concepts Underlying Financial Performance project.

MEASUREMENT

42 A few respondents to the Statement of Principles questioned whether the going concern assumption would be met by a transferor prior to the restructuring date. They noted that guidance issued by other standard setters may require changes to the accounting or measurement if the going concern assumption is not met. One of the assumptions underlying the measurement principles in the conceptual framework is that a public sector entity is a going concern. Paragraph PS 1000.63 states: "Financial statements are prepared on the assumption that the government is a going concern, meaning

it will continue in operation, and will be able to realize assets and discharge liabilities and meet its statutory obligations in the normal course of operations for the foreseeable future."

43 Based on the definition of a restructuring transaction and the underlying concepts, a recipient will take control of the assets, assume the liabilities and responsibilities for programs and operations of a transferor. Therefore, the transferor's assets will continue to be realized by the recipient, though not necessarily in the same nature and extent of usage. The transferor's financial and program obligations will continue to be satisfied by the recipient, though this may be through a different delivery mechanism. It would not be appropriate for the transferor to remeasure the individual assets and liabilities to be transferred because of an upcoming restructuring or any expected change in the usage of the assets after a restructuring.

PRESENTATION

44 Unlike the continuity-of-interest method, the presentation requirement in the standard does not allow the transferors and the recipients to restate their financials prior to the restructuring date as if the restructuring transaction took place prior to that date. This principle is consistent with the fact that a restructuring transaction is an economic event that does not change the history of the transferor or the recipient. It is also consistent with the treatment of a change in status of a governmental unit to a government business enterprise and vice versa as described in ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510, and INVESTMENT IN GOVERNMENT BUSINESS ENTERPRISES, Section PS 3070. In both standards, even in the consolidated financial statements of the government reporting entity, the financial position and prior period results would not be adjusted to reflect the changes in status as if the government organization had always been a government business enterprise or a governmental unit, where applicable.

45 Though there was general support for this presentation principle, a number of respondents to the Statement of Principles and the Exposure Draft did not agree, particularly regarding restructuring transactions among entities under common control. They cited comparability as the issue and argued that comparable information would be useful for assessing whether the objectives of a restructuring have been achieved.

46 Comparable information will continue to be available at the government reporting entity level. Whether the economic objectives of restructurings among entities under common control have been achieved would better be evaluated at the government reporting entity, not at the transferor or the recipient level, as more than one entity are involved.

47 Comparability differs from uniformity. For information to be comparable, like things must look alike and different things must look different. Financial statements should faithfully represent the economic reality of an entity. Entities that went through restructuring should look different from entities that did not. Entities that were formed as a result of restructuring should look different from entities that received assets and liabilities in a restructuring.

48 One respondent to the Statement of Principles and another respondent to the Exposure Draft were concerned that the presentation requirement in Section PS 3430 would be inconsistent with the requirement in SEGMENT DISCLOSURES, paragraph PS 2700.24, which states: "If there is a change in segments, prior period segment data presented for comparative purposes should be restated to reflect the newly reported segment(s) unless the necessary financial data are not reasonably determinable."

49 Restructurings among entities under common control should not result in changes in segment disclosures at the government reporting entity level as segment is not equivalent to entity. A segment is described in SEGMENT DISCLOSURES, Section PS 2700, as a distinguishable activity or group of activities of a government for which it is appropriate to separately report financial information to achieve the objectives of segment disclosures. Activities of an entity can be attributed to different segments. Reallocating these activities to different entities generally does not affect the segment to which they belong.

50 The guidance in SEGMENT DISCLOSURES, Section PS 2700.24, refers to regrouping of financial information that would not change the bottom line total number. Restating financial information prior to the restructuring date as if the restructuring transaction occurred at the formation of the entity will change the bottom line total number in all prior periods, as well as the current period if the restructuring date does not fall on the beginning of the current reporting period.

51 Section PS 3430 acknowledges that restated financial information prior to the restructuring date as if the restructuring transaction took place since the formation of an entity may provide useful information for readers of financial statements. A transferor or a recipient can choose to provide this information in the notes or schedules but not in the financial statements.

DISCLOSURE

52 Section PS 3430 includes mandatory and optional disclosures. There was overall support to this approach from respondents to the Statement of Principles. One respondent to the Exposure Draft believed that the optional disclosure of restated financials prior to the restructuring date should be mandatory for restructurings among entities under common control. This is an optional disclosure because significant work may be involved to restate prior period numbers with the adjustments made to the carrying amounts of assets and liabilities transferred at the restructuring date. Some of the information may not be available to the recipient to make the necessary restatement. Though the necessary information may be more readily available in restructurings among entities under common control, the work involved

in restatement can vary depending on the individual circumstances. It is unclear whether the incremental benefit of making this optional disclosure mandatory would justify a change.

53 One respondent to the Exposure Draft suggested that reference be made to subsequent events disclosure in the standard where it addresses disclosure in the reporting period prior to the restructuring. Though wording used may be similar to those used in SUBSEQUENT EVENTS, Section PS 2400, the disclosure requirements are not meant to be restricted to restructuring agreement or decision reached during the subsequent events period.

TRANSITIONAL PROVISIONS

54 Section PS 3430 applies to restructuring transactions occurring in fiscal years beginning on or after April 1, 2018. Neither retroactive nor prospective application is required for restructuring transactions occurring prior to April 1, 2018 or an earlier adoption date because the information required may not be available. Prospective application would require applying the standard to any outstanding related balances existing at the date it is adopted.

55 ACCOUNTING CHANGES, paragraph PS 2120.13, states: "when a change in an accounting policy is made to conform to new PSA standards or to adopt PSA standards for the first time, the new standards may be applied retroactively or prospectively." Paragraph PS 2120.11 also states that the standards in that Section do not override any specific provisions as to prospective or retroactive application contained in other PSA standards.

56 There is a need to state that ACCOUNTING CHANGES, Section PS 2120, does not apply to this standard in the transitional provisions. Otherwise, entities will be left with no choice but to apply Section PS 3430 either retroactively or prospectively to previous restructuring transactions in accordance with paragraph PS 2120.13.