

January 13, 2015

Financial Reporting and Assurance Standards Canada
277 Wellington Street West
Fourth Floor
Toronto, ON M5V 3H2

RE: Exposure Draft on Redeemable Preferred Shares Issued in a Tax Planning Arrangement

Dear Sir/Madam:

I am writing to provide comments regarding the above-noted exposure draft proposed by the Accounting Standards Board (“AcSB”). This proposal intends to change Accounting Standards for Private Enterprises (“ASPE”) such that there will no longer be an exception allowing redeemable preferred shares issued in a tax planning arrangement (“freeze shares”) to be presented as equity in the issuing company’s financial statements. Currently, such freeze shares are reported as a separate line of capital stock at the tax cost of the shares, usually a nominal amount. If this proposal is approved, generally accepted accounting principles (“GAAP”) will require that such shares be reported as a current liability at their redemption amount with a corresponding reduction of retained earnings.

I would like to provide some background on me and my firm. I was a Senior Audit Manager at KPMG. In 1994, I left to start my own firm. I continue to be a sole practitioner, however the firm now totals nine professional staff. We have two managers, both of which obtained their CA designations at large firms, and six staff accountants, including our latest co-op student. We are a non-traditional training office.

I have also been very active with the Richmond Hill Chamber of Commerce, joining as a member in 1999. I served on the Board for seven years including a year as the Chair. I continue to be a member of the Chamber’s Government Affairs Committee, having served since 2002.

My practice focuses on owner-managed businesses. We provide accounting, tax, financial and estate planning advice to these small to medium sized business owners. This represents 85% to 90% of our billings and our time. We likely focus more of our time and effort on tax planning, asset protection planning and estate planning for our clients than many other smaller accounting firms. We believe this because the majority of our new clients over the past three to four years have come to us because of the corporate restructuring work that we do for them. We constantly have restructuring projects in process. At the moment, we have eight such projects in various stages, as an example.

I have copied the CEO of the Richmond Hill Chamber of Commerce on this letter because the majority of the members of the Chamber are also small to medium sized owner-managed businesses, very similar to my clients. This proposed change to GAAP will likely impact the Chamber members in a similar manner as my clients.

Because of all of the corporate restructuring work that we do, we have many clients that hold freeze shares. There are many reasons for issuing freeze shares. In our client base, an estate freeze is the least common reason for doing so. We have probably only carried out a freeze with



estate planning as the primary purpose on two or three occasions. Our clients are primarily active, growing businesses. They are not at the stage where they are looking to retire and pass their business to the next generation. The most common reasons for our clients to carry out a freeze transaction are as follows:

- Restructuring the corporation to protect operating assets and retained earnings from unsecured creditors
- A spouse or a family member has joined the business and the owner wants them to share in the future growth of the business without them having to invest additional money
- Family income splitting to reduce the overall family tax bill
- Protecting the owners small business capital gain exemption (“SBCGE”)

For those clients that require review engagements, this proposed change will have a significant impact on their financial statements. These businesses typically are not capital intensive. Their value comes from goodwill and/or intangible assets and intellectual property. Since we focus on ensuring that our clients protect their assets and equity from unsecured creditors, we are setting up holding company structures to allow them to move the majority of the operating company’s retained earnings to the holding company. The majority of the value of the freeze shares represents the goodwill and intangible assets of the business. This proposed change will decimate their balance sheets by creating very large deficits and horrible current ratios.

As owner-managed businesses, our clients do not have experienced financial accountants on staff. They rely on us for their financial reporting. They will not understand why they need to revise their financial statements to report a large current liability for the freeze shares that they hold. They will also not understand why they have to record a significant reduction to their retained earnings. They will not understand why they have to record interest expense when they declare a dividend on these freeze shares. They will disagree that the freeze shares represent a liability of their company. They will not be able to explain to their lenders why their balance sheet makes it look like their company is insolvent.

The exposure draft states that lenders now understand this accounting treatment and that they agree that the freeze shares represent a liability. I do not agree with this assertion. The account managers that our clients deal with do not have significant expertise in financial reporting. They will not understand why the company is so far off of its current ratio, debt-service ratio and tangible net worth ratio covenants. It is highly unlikely that our clients will be able to convince their lenders to adjust the covenants in their loan agreements to bring them inside. There is no bank in the world that would agree to a 1:8 current ratio or a negative tangible net worth ratio as acceptable covenants. The only hope that our clients would have is to negotiate with their lender to ignore the liability created by the freeze shares and reverse the reduction to retained earnings. If this is the case, it defeats the purpose of this proposed change to ASPE.

While freeze shares technically meet the definition of a liability, in many cases they are not a liability. Our clients will not be redeeming these freeze shares because they are growing their businesses. Any excess cash is being re-invested in the business and there are no excess retained earnings. Our clients that have performed a freeze to protect their SBCGE are a perfect example. These are clients that have performed a freeze to setup a holding company for asset protection purposes without setting up a family trust at the same time. In these cases, there was no benefit to setting up the family trust because the owners and their children are too young to benefit from it. This means that they probably lose the benefit of their SBCGE unless they continue to hold

shares personally. We accomplish this by issuing approximately \$800,000 of freeze shares to them personally. These freeze shares will not be redeemed by the owner. The strategy is to hold these shares in case the shares of the company are sold. The sale of the freeze shares will trigger the appropriate amount of capital gain for the owner to use their SBCGE limit. The shares of the company held by the holding company will not qualify for the SBCGE. I argue that these freeze shares do not represent a liability, even though they are redeemable. They will not be redeemed. They continue to be equity.

I believe that the proposed changes to ASPE will make the financial statements misleading for the majority of our clients that have issued freeze shares.

Owner-managed businesses such as our clients and Chamber members make up the majority of businesses in Canada. They employ a significant number of people. They are a very important part of the Canadian economy. These are the businesses that are creating innovative and challenging jobs. I believe that this proposed change to ASPE will make it much more difficult for such businesses to obtain or extend the financing that they need to continue to grow their businesses. These are the businesses that can least afford a decrease in the availability of financing and/or an increase to the cost of their financing.

I believe that the proposed changes to ASPE could cause confusion with lenders because of the significant differences that will result between financial statements that are prepared for assurance engagements and those that are prepared for compilation engagements. Accounting firms such as ours will not adopt the proposed changes for compilation engagements. We will continue to account for freeze shares as equity because it presents a more realistic picture of the company's financial position. This means that lenders will be reviewing financial statements with very different financial statement presentation for the exact same transactions depending on the report that is issued by the accountant.

The proposed changes will increase the risk of errors in tax reporting because adjustments will be required to the tax return to re-characterize interest expense to its legal form as a dividend. The cost information for the issued shares will not be readily available, making it difficult to calculate deemed dividends when there are share redemptions. It will be easy to miss reporting dividends because they will not be presented as such on the financial statements. These are additional reasons why accountants will continue to follow the existing method of accounting for freeze shares, rather than switching to the proposed method, if they are preparing the financial statements under a compilation engagement.

My preference for accounting for freeze shares is to leave the accounting standard as it is, but consider adding some additional disclosure requirements. My suggestion is that paragraph 3856.47(c) be revised to include a requirement to disclose who the holders of each class of freeze shares are, similar to related party disclosures. I think that this will provide the users of the financial statements important information to help them understand the nature of the transactions. Knowing who holds the freeze shares will also allow the users to request specific additional information from the business, if they require it.

I am not convinced that it is necessary to present the total redemption amount for all classes of freeze shares on the face of the balance sheet. I believe that disclosure of this information in the notes to the financial statements is adequate.

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Yours truly,

LOTT & COMPANY

Glenn Lott

Glenn D. Lott, CPA, CA

c.c.: Leslie Whidden, Richmond Hill Chamber of Commerce