Australia's Most Famous Wine

ROSEMOUNT ESTATE
The prestige wine of Australia

LINDEMANS
making life more enjoyable

CL 08

17 March 2003

Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom
(CommentLetters@iasb.org.uk)

Dear Sir,

COMMENTS ON IASB ED3

1. Introduction

Southcorp Limited is one of Australia's top 100 listed companies by market capitalisation and is one of the largest wine companies in the world. We are highly vertically integrated, with our activities ranging from vineyard ownership / grape production and wine production through to international distribution and marketing of our wine products. Our internationally recognised brands include Penfolds, Rosemount, Lindemans and Wynns. More than 50% of our wine is sold outside of Australia, with particularly strong markets in UK / Europe and North America. We have entered into many business combination transactions over the last 20 years.

Southcorp supports the international convergence and harmonisation of accounting standards and is pleased to comment on ED3. We were also pleased to be part of the field-testing of these proposals and met with Mr Warren McGregor (IASB member) and Ms Annette Kimmitt (IASB Senior Project Manager) in January 2003 to discuss ED3 in Southcorp's context. We are generally in agreement with these proposals and have not commented specifically on all of the matters on which comments have been invited, however we do have serious concerns in relation to a number of the proposals and have concentrated this submission on those issues.

2. Impairment - Linkage Between Cash Generating Unit and Primary Segment

While we are supportive of many of the impairment testing proposals, we do not support the establishment of a formal linkage between "cash-generating unit" and primary segment as proposed in the revised IAS36, paragraph 74. We believe that mandating the allocation of such assets as goodwill between primary segments will often result in artificial allocations which are not supported by the economic and business factors which give rise to those assets. This is particularly the case where a single industry company has geographic segments as its primary segments.

Taking Southcorp as an example, we are a pure wine company selling to international markets. Under the principles of IAS14 "Segment Reporting", geographic segments (being the major geographic regions in which we sell our wine) are our primary segments. In 2001 we acquired another major Australian wine producer with international distribution. A requirement that we allocate the goodwill arising from this acquisition between our primary segments and then test it for impairment on the same basis is inconsistent with the economic and business factors giving rise to that goodwill.

One possible scenario would be that this goodwill is allocated on the basis of regional sales or regional profitability. If one region's sales / profitability subsequently declined, the goodwill allocated to that region would be viewed as impaired and need to be written down. We do not support this as the acquired business may still be as profitable or more profitable than at acquisition. An example would be a strategic decision to reduce product volumes in a lower margin / higher risk region in order to increase product volumes in another higher margin / lower risk region. As a wine company our sales volumes are limited by the availability of suitable grapes / wine, particularly for our premium, higher margin products which can vary significantly. We believe the relevant impairment issue is whether we can recover our investment in the acquired business from the earnings that business can generate under our management. In a company like Southcorp this requires the earnings of the acquired business across all segments to be considered in aggregate, not based on an artificial allocation between segments based on the operations of the business at one point in time.

We believe that shareholders, directors, analysts and other interested persons would rightfully fail to understand why changes in the regional mix of sales that increase the profitability and value of the acquired business should result in writedowns of allegedly impaired goodwill. This problem can easily be avoided by requiring companies to identify the appropriate cash generating unit against which to test impairment without a formal and mandatory linkage to primary segments, and disclose the basis of this assessment.

3. Implied Value of Goodwill

The proposed amendments to IAS36, paragraphs 85 to 87 require that once impairment of a cash-generating unit has been established, the "implied value of goodwill" be determined in order to determine the extent that goodwill should be written down rather that other assets within the relevant cash generating unit. This essentially amounts to undertaking a full "fair value exercise" to determine what value would be given to goodwill at the date of the testing if the business were acquired for its assessed recoverable amount. We do not support this proposal on the basis that;

- it is inconsistent with the economic and business factors giving rise to the goodwill
- it is inconsistent with the historic cost basis of measuring goodwill, as it is impacted by post-acquisition movements in the value of non-goodwill assets
- compliance could arguably be impossible in the common situation where the acquired business has been merged with an existing business and it is no longer possible to separate the assets, liabilities, revenues and expenses of the acquired business from the previously owned business

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- compliance would be excessively onerous – “fair value exercises” are expensive and very time consuming with much of the effort to comply with this aspect being required to obtain and assess information that is not otherwise needed to manage the business or satisfy financial reporting requirements

We suggest that where impairment is established, the resultant loss should be written down first against goodwill, with other assets only considered for impairment writedowns if goodwill has been fully written off and the carrying value of the remaining assets still exceeds their recoverable amount. The following point further addresses this latter aspect.

4. Impairment Writedowns – Allocation to Non-Goodwill Assets

The proposed amendments to IAS36, paragraph 103(b) requires that where impairment writedowns are to be booked against assets other than goodwill, that writedown is to be made pro-rata to all of the assets in the cash generating unit based on their carrying amounts. This requirement is then adjusted by paragraphs 104 to 107.

We believe it will often be excessively onerous to determine the net selling price of each asset in the cash generating unit and frequently it will not be feasible to determine the value in use of individual assets given that they generate value as part of a cash generating unit. In such circumstances, proposed paragraph 105 permits an “arbitrary allocation” of the impairment loss between non-goodwill assets.

We suggest that it should be clarified that the requirements of paragraph 104 do not apply to paragraph 105 and that paragraph 105 should include further guidance which could, for example, indicate that the sequence of writedowns should be identifiable intangible assets then non-current non-monetary tangible assets then current non-monetary tangible assets then non-cash monetary assets, with individual allocation (i.e. as opposed to pro-rata write-downs of all items) within those groupings permitted.

5. Reversal of Goodwill Impairment

The proposed amendments to IAS36, paragraph 123 provides that goodwill impairment write-downs will not be permitted to be reversed. We disagree with this proposal and believe that such impairment reversals should be permitted where the impairment was caused by external factors beyond the control of the entity and those external factors are later reversed. Examples would include impairment caused by government policies (e.g. taxes, duties, prohibition, nationalisation, war etc) where the relevant government later “changes its mind” and reverts to the previous policy settings.

6. Restructuring Provisions – Business Acquisitions

ED3 proposes that restructuring provisions only be permitted when accounting for a business acquisition where that provision would have qualified as a liability of the acquired entity at the moment it is acquired, that is the previous management had entered into transactions that would have required the booking of a liability absent the fact that ownership of the business would change. We do not support this highly restrictive approach. Post-acquisition restructuring is frequently a feature of business

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acquisitions in order to achieve the synergies and other opportunities which give rise to the acquisition, and we therefore believe that where the planned restructuring is appropriately documented either at the time of acquisition or shortly thereafter, and will occur within a reasonable time, provisions for the required costs should be permitted in the acquisition balance sheet. This better reflects the economic and business factors underlying the acquisition and results in a better matching of the costs with the benefits. Naturally appropriate controls should be implemented such as requiring any surplus provisions to be written back against goodwill rather than taken to profit.

7. Recognition of Contingent Liabilities

ED3 proposes that contingent liabilities be recognised when accounting for business combinations. We do not support this proposal. If contingent liabilities are not generally recognised, we do not accept that business combinations give rise to different circumstances which should require recognition. We also note that contingent assets would not be recognised and do not support this inconsistency.

8. Inclusion of Committed Capital Expenditure in "Value in Use" Assessment

The proposed amendments to IAS36, paragraph 37 prohibits including the impact of future capital expenditure that will improve or enhance an asset when determining "value in use". We disagree with this proposal and submit that committed capital expenditure should be included when determining "value in use" as this properly reflects management's intentions regarding utilisation of the asset/s and is consistent with provisions for restructuring costs which must be booked when there has been formal commitment to those costs.

9. Disclosure Requirements

ED3 proposes a range of highly detailed disclosures which we believe are excessively onerous and lack appropriate protection for commercially sensitive information. We submit that the IASB should reconsider these requirements with a view to requiring disclosure of only materially relevant information with commercially sensitive information being excluded.

We would welcome any opportunity to further clarify our views or assist the IASB in any way in relation to this submission. Please contact me or Wayne Materne, our Manager – International Accounting, if we can assist or further clarification is needed.

Yours sincerely

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