Friday, 4 April 2003

CL 41

The Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM
By email & Original in mail

Dear Sir

IASB ED 3 “Business Combinations”; - IASB ED of Proposed Amendments to IAS 36 “Impairment of Assets” and IAS 38 “Intangible Assets”

CPA Australia is pleased to provide comments on Exposure Draft 3 “Business Combinations”; - IASB ED of Proposed Amendments to IAS 36 “Impairment of Assets” and IAS 38 “Intangible Assets” (‘ED 3’). Our submission has been prepared by the Victorian Cell of the External Reporting Centre of Excellence and reviewed by the Centre of Excellence. This submission represents the views of CPA Australia.
Before addressing specific issues relating to ED 3, CPA Australia expresses its considerable concern at the structure, format and presentation of materials coming from the IASB. The IASB material is not user friendly, being more difficult to read, unnecessarily lengthy and not well structured and presented. For example, the main message is sometimes contained in the supporting material, whereas it is expected that general principles would be presented and highlighted in bold type.

The hardcopy of published material is so tightly bound, that the publication needs to be disassembled so that it can be read and even then, the type face is so small and compact that it militates against readability. CPA Australia believes that all aspects of the process in the development of new standards should facilitate and encourage stakeholders to contribute to the process. Unfortunately, CPA Australia has received feedback suggesting that stakeholders feel they are not being encouraged to participate because of the issues addressed above. CPA Australia therefore would like to express concern at the structure, format and presentation of IASB publications and supporting materials.

In general, CPA Australia supports the proposals contained in ED 3, however we do have some differing views on the proposed standards.

Concern has been expressed about the complexities being put forward within the impairments exposure draft and would prefer that the further development of the fair value framework should encompass the measurement of impairment. However, it is recognised that while a modified historical cost framework exists, then measurement of any impairment remains a requirement.

A general concern is expressed as to the value to users of financial statements that results from the proposed allocation of goodwill to cash generating units. We believe the proposed level of disclosures needs to be reviewed so that users of financial statements do not loose focus on the essential messages.

Our comments to the specific issues identified in ED 3 are contained in the attached appendix.

Should you wish to discuss any matters in relation to this submission, please contact Jim Dixon - Director Accounting and Audit on Tel: (61-3) 9606-9608 or Naomi Carroll - Accounting and Audit Technical Adviser on Tel: (61-3) 9606-9872.

Yours sincerely

Greg Larsen, FCPA
Chief Executive
CPA Australia
GPO Box 2820AA, Melbourne Victoria 3001, Australia
Tel: (61-3) 9606 9689
Email: Greg.Larsen@cpaaustralia.com.au

IASB Request for Comment

ED3 Business Combinations

Question 1 – Scope

The Exposure Draft proposes:

(a) to exclude from the scope of the IFRS business combinations in which separate entities or operations of entities are brought together to form a joint venture, and business combinations involving entities under common control (see proposed paragraphs 2 and 3 and paragraphs BC9-BC11 of the Basis for Conclusions).

Are these scope exclusions appropriate? If not, why not?

CPA Australia believes that the scope exclusions are appropriate, however the position of dual listed entities is not addressed. A minority opinion supports the removal of the exemption for internal reconstructions.

(b) to include in the IFRS a definition of business combinations involving entities under common control, and additional guidance on identifying such transactions (see proposed paragraphs 9-12 and Appendix A, and paragraphs BC12-BC15 of the Basis for Conclusions).

Are the definition and additional guidance helpful in identifying transactions within the scope exclusion? If not, what additional guidance would you suggest, and why?

CPA Australia believes that the definition and additional guidance are helpful in identifying transactions within the scope exclusion.

Question 2 – Method of accounting for business combinations

The Exposure Draft proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method (see proposed paragraphs 13-15 and paragraphs BC18-BC35 of the Basis for Conclusions).

Is this appropriate? If not, why not? If you believe the pooling of interests method should be applied to a particular class of transactions, what criteria should be used to distinguish those transactions from other business combinations, and why?

CPA Australia supports the use of the purchase method and the abolition of the pooling of interests approach. However, we are reserving judgment as to alternatives or variations until the completion of the Business Combinations Project Part 2 which is developing an approach to "fresh start" accounting.

Question 3 – Reverse acquisitions

Under IAS 22 *Business Combinations*, a business combination is accounted for as a reverse acquisition when an entity (the legal parent) obtains ownership of the equity of another entity (the legal subsidiary) but, as part of the exchange transaction, issues enough voting equity as consideration for control of the combined entity to pass to the owners of the legal subsidiary. In such circumstances, the legal subsidiary is deemed to be the acquirer. The Exposure Draft:

(a) proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity that has the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. As a result, a reverse acquisition occurs when the legal subsidiary has the power to

govern the financial and operating policies of the legal parent so as to obtain benefits from its activities (see proposed paragraph 21 and paragraphs BC37-BC41 of the Basis for Conclusions).

Is this an appropriate description of the circumstances in which a business combination should be accounted for as a reverse acquisition? If not, under what circumstances, if any, should a business combination be accounted for as a reverse acquisition?

CPA Australia believes that this an appropriate description of the circumstances in which a business combination should be accounted for as a reverse acquisition.

(b) proposes additional guidance on the accounting for reverse acquisitions (see proposed paragraphs B1-B14 of Appendix B).

Is this additional guidance appropriate? If not, why not? Should any additional guidance be included? If so, what specific guidance should be added?

CPA Australia commends the IASB on the quality of additional guidance provided on accounting for reverse acquisitions.

Question 4 – Identifying the acquirer when a new entity is formed to effect a business combination

The Exposure Draft proposes that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available (see proposed paragraph 22 and paragraphs BC42-BC46 of the Basis for Conclusions).

Is this appropriate? If not, why not?

CPA Australia does not support this approach as it is inconsistent with the decision not to continue to support the pooling method of accounting. Under the proposal, one entity adopts fair value accounting while the other retains historical cost. In respect of retaining historical cost, this is tantamount to retaining the pooling of interests method. Hence, CPA Australia believe the proposal is fundamentally flawed and is an artificial contrivance that does not reflect the underlying economic reality. CPA Australia believes that the fundamental approach adopted in the Australian Standard AASB 1024 “Consolidated Accounts” provides the correct basis for accounting in the circumstances described above.

Question 5 – Provisions for terminating or reducing the activities of the acquiree

Under IAS 22, an acquirer must recognise as part of allocating the cost of a business combination a provision for terminating or reducing the activities of the acquiree (a ‘restructuring provision’) that was not a liability of the acquiree at the acquisition date, provided the acquirer has satisfied specified criteria. The Exposure Draft proposes that an acquirer should recognise a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see proposed paragraph 40 and paragraphs BC55-BC66 of the Basis for Conclusions).

Is this appropriate? If not, what criteria should an acquirer be required to satisfy to recognise a restructuring provision that was not a liability of the acquiree as part of allocating the cost of a combination, and why?

CPA Australia does not support this proposal and believes it to be unrealistically limiting. For example, prior to a business combination there may be no justifiable reason for restructuring. However, the agreement to combine may provide the justification for restructuring and itself should not prevent the creation of a valid restructuring provision.

Question 6 – Contingent liabilities

The Exposure Draft proposes that an acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably (see proposed paragraphs 36 and 45 and paragraphs BC80-BC85 of the Basis for Conclusions).

Is this appropriate? If not, why not?

CPA Australia believes this proposal should not only relate to contingent liabilities but also to contingent assets. Furthermore why only set down conditions for recognition at acquisition date, we believe reference to possible subsequent re-measurement of such items also needs to be addressed.

Question 7 – Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

IAS 22 includes a benchmark and an allowed alternative treatment for the initial measurement of the identifiable net assets acquired in a business combination, and therefore for the initial measurement of any minority interests. The Exposure Draft proposes requiring the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. This proposal is consistent with the allowed alternative treatment in IAS 22 (see proposed paragraphs 35 and 39 and paragraphs BC88-BC95 of the Basis for Conclusions).

Is this appropriate? If not, how should the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of a business combination be measured when there is a minority interest in the acquiree, and why?

CPA Australia agrees with the recognition of contingencies in the determination of the value of the minority interest. Our comments made in respect of question 6 above are also relevant.

Question 8 – Goodwill

The Exposure Draft proposes that goodwill acquired in a business combination should be recognised as an asset and should not be amortised. Instead, it should be accounted for after initial recognition at cost less any accumulated impairment losses (see proposed paragraphs 50-54 and paragraphs BC96-BC108 of the Basis for Conclusions).

Do you agree that goodwill acquired in a business combination should be recognised as an asset? If not, how should it be accounted for initially, and why? Should goodwill be accounted for after initial recognition at cost less any accumulated impairment losses? If not, how should it be accounted for after initial recognition, and why?

While the approach is conceptually flawed, CPA Australia agrees with the pragmatic proposals for accounting for goodwill in a business combination.

Question 9 – Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities recognised as part of allocating the cost of the combination exceeds that cost. The Exposure Draft proposes that when such an excess exists, the acquirer should:

(a) reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination; and

(b) recognise immediately in profit or loss any excess remaining after that reassessment.

(See proposed paragraphs 55 and 56 and paragraphs BC109-BC120 of the Basis for Conclusions.)

Is this treatment appropriate? If not, how should any such excess be accounted for, and why?

CPA Australia believes the proposed treatment to be appropriate.

Question 10 – Completing the initial accounting for a business combination and subsequent adjustments to that accounting

The Exposure Draft proposes that:

(a) if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to be recognised within twelve months of the acquisition date (see proposed paragraphs 60 and 61 and paragraphs BC123-BC126 of the Basis for Conclusions).

Is twelve months from the acquisition date sufficient time for completing the accounting for a business combination? If not, what period would be sufficient, and why?

CPA Australia supports this proposal. While the 12 months is an arbitrary period, the treatment of subsequent adjustments against current profit is not an unacceptable consequence, when attempting to obtain a comprehensive measure of profit from events or transactions occurring in the period in which the profit has been measured.

(b) with some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error (see proposed paragraphs 62 and 63 and paragraphs BC127-BC132 of the Basis for Conclusions).

Is this appropriate? If not, under what other circumstances should the initial accounting be amended after it is complete, and why?

CPA Australia supports that adjustments to the initial accounting for a business combination after that accounting is complete should be recognised only to correct an error.

Invitation to Comment (IAS 36)

Question 1 – Frequency of impairment tests

Are the proposals relating to the frequency of impairment testing intangible assets with indefinite useful lives and acquired goodwill appropriate (see proposed paragraphs 8 and 8A and paragraphs C6, C7 and C41 of the Basis for Conclusions)? If not, how often should such assets be tested for impairment, and why?

CPA Australia does not support the proposals relating to the frequency of impairment testing of intangible assets with indefinite useful lives and acquired goodwill. If at reporting date there are no indications of impairment, then no impairment testing should be required. CPA Australia supports an annual screening test as distinct from an impairment test to determine if the more rigorous impairment testing is required.

Question 2 – Intangible assets with indefinite useful lives

The Exposure Draft proposes that the recoverable amount of an intangible asset with an indefinite useful life should be measured, and impairment losses (and reversals of impairment losses) for such assets accounted for, in accordance with the requirements in IAS 36 for assets other than goodwill (see paragraphs C10-C11 of the Basis for Conclusions).

Is this appropriate? If not, how should the recoverable amount be measured, and impairment losses (and reversals of impairment losses) be accounted for?

While CPA Australia supports this proposal as appropriate we remain concerned with how to achieve consistent measurement outcomes in practice in all adopting countries.

Question 3 – Measuring value in use

The Exposure Draft proposes additional guidance on measuring the value in use of an asset. Is this additional guidance appropriate? In particular:

(a) should an asset's value in use reflect the elements listed in proposed paragraph 25A? If not, which elements should be excluded or should any additional elements be included? Also, should an entity be permitted to reflect those elements either as adjustments to the future cash flows or adjustments to the discount rate (see proposed paragraph 26A and paragraphs C66 and C67 of the Basis for Conclusions)? If not, which approach should be required?

No comment

(b) should the assumptions on which cash flow projections are based take into account both past actual cash flows and management's past ability to forecast cash flows accurately (see proposed paragraph 27(a)(ii) and paragraphs C66 and C67 of the Basis for Conclusions)? If not, why not?

CPA Australia believes that the assumptions on which cash flow projections are based should take into account both past actual cash flows and management's past ability to forecast cash flows accurately.

(**c) is the additional guidance in proposed Appendix B to [draft] IAS 36 on using present value techniques in measuring an asset's value in use appropriate? If not, why not? Is it sufficient? If not, what should be added?**

CPA Australia believes that the guidance on using present value techniques is appropriate and sufficient.

Question 4 – Allocating goodwill to cash-generating units

The Exposure Draft proposes that for the purpose of impairment testing, acquired goodwill should be allocated to one or more cash-generating units.

(a) **Should the allocation of goodwill to one or more cash-generating units result in the goodwill being tested for impairment at a level that is consistent with the lowest level at which management monitors the return on the investment in that goodwill, provided such monitoring is conducted at or below the segment level based on an entity's primary reporting format (see proposed paragraphs 73-77 and paragraphs C18-C20 of the Basis for Conclusions)? If not, at what level should the goodwill be tested for impairment, and why?**

CPA Australia believes that the proposal drills down too far and should not go beyond the segment level of reporting. Hence, our general reservation applies in our responses to (b) and (c) below.

(b) **If an entity disposes of an operation within a cash-generating unit to which goodwill has been allocated, should the goodwill associated with that operation be included in the carrying amount of the operation when determining the gain or loss on disposal (see proposed paragraph 81 and paragraphs C21-C23 of the Basis for Conclusions)? If not, why not? If so, should the amount of the goodwill be measured on the basis of the relative values of the operation disposed of and the portion of the unit retained or on some other basis?**

No comment

(c) **If an entity reorganises its reporting structure in a manner that changes the composition of one or more cash-generating units to which goodwill has been allocated, should the goodwill be reallocated to the units affected using a relative value approach (see proposed paragraph 82 and paragraphs C24 and C25 of the Basis for Conclusions)? If not, what approach should be used?**

No comment

Question 5 – Determining whether goodwill is impaired

The Exposure Draft proposes:

(a) **that the recoverable amount of a cash-generating unit to which goodwill has been allocated should be measured as the higher of the unit's value in use and net selling price (see proposed paragraphs 5 (definition of recoverable amount) and 85 and paragraph C17 of the Basis for Conclusions).**

Is this appropriate? If not, how should the recoverable amount of the unit be measured?

CPA Australia supports the proposed measurement method of the recoverable amount.

(b) **the use of a screening mechanism for identifying potential goodwill impairments, whereby goodwill allocated to a cash-generating unit would be identified as potentially impaired only when the carrying amount of the unit exceeds its recoverable amount (see proposed paragraph 85 and paragraphs C42-C51 of the Basis for Conclusions).**

Is this an appropriate method for identifying potential goodwill impairments? If not, what other method should be used?

CPA Australia supports the use of a screening mechanism for identifying potential goodwill impairments.

(c) **that if an entity identifies goodwill allocated to a cash-generating unit as potentially impaired, the amount of any impairment loss for that goodwill should be measured as the excess of the goodwill's carrying amount over its implied value measured in accordance with proposed**

paragraph 86 (see proposed paragraphs 85 and 86 and paragraphs C28-C40 of the Basis for Conclusions).

Is this an appropriate method for measuring impairment losses for goodwill? If not, what method should be used, and why?

CPA Australia believes this to be an appropriate method for measuring impairment losses.

Question 6 – Reversals of impairment losses for goodwill

The Exposure Draft proposes that reversals of impairment losses recognised for goodwill should be prohibited (see proposed paragraph 123 and paragraphs C62-C65 of the Basis for Conclusions).

Is this appropriate? If not, what are the circumstances in which reversals of impairment losses for goodwill should be recognised?

CPA Australia supports the proposed rule, even though it is arbitrary in its chosen application.

Question 7 – Estimates used to measure recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives

The Exposure Draft proposes requiring a variety of information to be disclosed for each segment, based on an entity's primary reporting format, that includes within its carrying amount goodwill or intangible assets with indefinite useful lives (see proposed paragraph 134 and paragraphs C69-C82 of the Basis for Conclusions).

(a) Should an entity be required to disclose each of the items in proposed paragraph 134? If not, which items should be removed from the disclosure requirements, and why?

(b) Should the information to be disclosed under proposed paragraph 134 be disclosed separately for a cash-generating unit within a segment when one or more of the criteria in proposed paragraph 137 are satisfied? If not, why not?

CPA Australia believes that the proposed disclosures are onerous and that the requirements should be revisited

Invitation to Comment (IAS 38)

Question 1 – Identifiability

The Exposure Draft proposes that an asset should be treated as meeting the identifiability criterion in the definition of an intangible asset when it is separable or arises from contractual or other legal rights (see proposed paragraphs 10 and 11 and paragraphs B6-B10 of the Basis for Conclusions).

Are the separability and contractual/other legal rights criteria appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset? If not, what criteria are appropriate, and why?

CPA Australia believes that the separability and contractual/other legal rights criteria appropriate for determining whether an asset meets the identifiability criterion in the definition of an intangible asset.

Question 2 – Criteria for recognising intangible assets acquired in a business combination separately from goodwill

This Exposure Draft proposes clarifying that for an intangible asset acquired in a business combination, the probability recognition criterion will always be satisfied and, with the exception of an assembled workforce, sufficient information should always exist to measure its fair value reliably (see proposed paragraphs 29-32 and paragraphs B11-B15 of the Basis for Conclusions). Therefore, as proposed in ED 3, an Exposure Draft of a proposed International Financial Reporting Standard *Business Combinations*, an acquirer should recognise, at the acquisition date and separately from goodwill, all of the acquiree's intangible assets, excluding an assembled workforce, that meet the definition of an intangible asset (see proposed paragraphs 36, 43 and 44 of ED 3).

Do you agree that, with the exception of an assembled workforce, sufficient information can reasonably be expected to exist to measure reliably the fair value of an intangible asset acquired in a business combination? If not, why not? The Board would appreciate respondents outlining the specific circumstances in which the fair value of an intangible asset acquired in a business combination could not be measured reliably.

CPA Australia agrees with this proposal in that for most intangible assets acquired the recognition criteria will be satisfied. However, the situation is somewhat problematic with items such as customers lists and non contractual customer relationships.

Question 3 – Indefinite useful life

The Exposure Draft proposes to remove from IAS 38 the rebuttable presumption that an intangible asset's useful life cannot exceed twenty years, and to require its useful life to be regarded as indefinite when, based on an analysis of all of the relevant factors, there is no foreseeable limit on the period of time over which the asset is expected to generate net cash inflows for the entity (see proposed paragraphs 85-88 and paragraphs B29-B32 of the Basis for Conclusions).

Is this appropriate? If not, under what circumstances, if any, should an intangible asset be regarded as having an indefinite useful life?

CPA Australia supports the proposal to remove the rebuttable presumption as it is made redundant by the other criteria proposed.

Question 4 – Useful life of intangible asset arising from contractual or other legal rights

The Exposure Draft proposes that if an intangible asset arises from contractual or other legal rights that are conveyed for a limited term that can be renewed, the useful life shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost (see proposed paragraphs 91 and 92 and paragraphs B33-B35 of the Basis for Conclusions).

Is this an appropriate basis for determining the useful life of an intangible asset arising from contractual or other legal rights that are conveyed for a limited term that can be renewed? If not, under what circumstances should the useful life include the renewal period(s)?

CPA Australia supports this an appropriate basis for determining the useful life.

Question 5 – Non-amortisation of intangible assets with indefinite useful lives

The Exposure Draft proposes that an intangible asset with an indefinite useful life should not be amortised (see proposed paragraphs 103 and 104 and paragraphs B36-B38 of the Basis for Conclusions).

Is this appropriate? If not, how should such assets be accounted for after their initial recognition?

CPA Australia supports the proposal that an intangible asset with an indefinite useful life should not be amortised.