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AN INDEPENDENT VICTORIAN PARTNERSHIP

2 April 2003

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir/Madam,

IASB ED 3 "Business Combinations"
IASB ED of Proposed Amendments to IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets"

Our comments on the IASB exposure draft and amendments to IAS 36 and IAS 38 are provided in the attachments to this letter. Our overriding concerns are detailed below.

Pitcher Partners is a large accounting firm of 34 partners and 440 staff, which provides accounting, audit and advisory services to medium and large *Australian* based (ie. local) businesses. Our comments reflect the issues arising in implementing the recommendations of ED 3 and amendments to IAS 36 and IAS 38 to reporting entities in this segment of the market place, in contrast to those primarily concerned with capital markets.

We have concerns regarding the proposed accounting for business combinations of entities under common control, which we understand will be considered in Phase II of the Business Combinations project. If restructures of entities under common control are recorded at fair value rather than carrying values, effectively this will mean the recognition of internally generated goodwill. In Australia, where groups may be restructured to achieve certain tax advantages rather than for the purpose of financial reporting, there is the potential for both conflicts and inconsistencies to develop in using this framework. We strongly recommend that for group restructures of entities that remain under common control both before and after the restructure, an option should be available to permit transfers of assets and liabilities at carrying amounts rather than fair value.

Secondly, as indicated in our previous submissions we have serious doubts regarding the reliability of estimation techniques regarding probable outcomes and fair values applied by privately owned local businesses that do not operate in capital markets. These entities typically do not have the in-house technical expertise or resources to develop sound estimation models for fair value, compounded further by a lack of suitable input data. Also, the cost-benefit in preparing financial reports on this basis is questionable in these circumstances. We believe that privately owned businesses (referred to as proprietary companies in Australia) should be excluded from the scope of standards that *require* the employment of fair value measurement.

Our final area of major concern regards the "audit-ability" of proposed accounting treatments. It is becoming increasingly difficult for an auditor to report whether accounts are "true and fair" given the increasing dependence on the fulfilment of management business strategies in the determination of fair value models. We have made separate representations to the International Auditing & Assurance Standards Board regarding this issue. However, recognising that high quality financial reporting is dependent on the successful interaction of a number of variables, the IASB should be mindful of the impact that a fair value basis of accounting has on the effective operation of the audit process. We believe there is an urgent need for communication between the IASB and IAASB to prevent the expansion of an expectation gap between standard setters.

Please contact Dianne Azoor Hughes to discuss further any matters arising from this submission (telephone: +61 3 9289 9772 or e-mail: dhughes@pitcher.com.au).

Yours sincerely

Terry Benfold
PARTNER

S. Dianne Azoor Hughes
TECHNICAL DIRECTOR

ED 3 - Responses to IASB specific questions 1 to 10

ED 3 Question 1

We agree that separate entities or operations of entities that are brought together to form a joint venture, and ventures involving entities under common control should be excluded from the scope of the proposed IFRS.

We agree that it is appropriate that the IFRS should include a definition of business combinations – including the requirement that control should not be transitory as given in paragraph 9.

We also believe that where groups are restructured to achieve taxation or other advantages rather than to improve operating efficiencies, the option to transfer net assets at carrying amounts should be available (applicable for phase II).

ED 3 Question 2

We agree that the pooling of interests method should be eliminated as an option for business combinations, to improve comparability between financial reports.

Where entities have in substance come together to "pool their interests" these transactions would be better represented under a different operating structure such as a joint venture entity rather than as a business combination, where one entity gains control, as required under this IFRS.

ED 3 Question 3

Although we recognise the substance of a "reverse acquisition" transaction, they are not common in our experience with our client base. In simple terms the transfer of control to the subsidiary effectively changes the group structure so that the subsidiary becomes the head entity. The discussion and explanation in the draft IFRS is confusing. We believe the focus should be on where the control of the combined entity rests to determine the effective acquirer and head entity, explained in terms of a restructure rather than a reverse acquisition.

We have serious concerns regarding financial reporting requirements that are divorced from the legal form and legal responsibilities of entities. For example, if an entity issues equity to members, whether the members are individuals or other entities does not change the legal responsibility for the entity to be accountable to its members. We believe that the financial reporting framework should mirror the accountability relationships laid down in legislation.

ED 3 Question 4

This discussion is also confusing and is akin to the reverse acquisitions in determining where control rests. We reiterate the need for the financial reporting framework to address the accountability relationships laid down in legislation, as determined by power (ie control) in each entity. The need to "adjudge an acquirer" seems to ignore any legal structure – thereby rendering the legal structure as irrelevant for financial reporting. We do not concur with this divergence.

ED 3 Question 5

When an entity acquires the operations of another entity it is **un**likely that the acquiree will have recognised provisions for restructuring that arise through the intentions of the acquiring entity. The restructuring provision is unlikely to be dependent solely on the intention of the acquiree but is more likely to reflect the needs of the combined entity after the acquisition in response to the operating plans of the acquirer.

Therefore the proposal that an acquirer should recognise a restructuring provision only when the acquiree has an existing liability will not always be a feasible or realistic.

The acquirer ordinarily purchases net assets and goodwill, which it then "absorbs" into the operating strategy of the new combined entity. If a provision for restructuring by the parent is offset against the acquisition price, this will have the effect of increasing the amount attributed to the goodwill acquired. However, if the parent entity *knows* that certain restructuring expense must be incurred, then it is likely that the acquisition cost would have been depressed accordingly. This means that the amount of goodwill acquired already reflects the amount of restructuring expense anticipated.

We believe that a provision for restructuring should only be recognised as part of the allocation of cost of a business combination when the *parent* entity has a formal plan in place for restructuring which is in existence at the acquisition date, determined as part of the proposal for purchase. Where the decision to restructure is made some time after the acquisition, (rather than together with the acquisition), the costs of the restructure represent current expenditure of the combined entity. Therefore in that scenario the restructuring costs are not related to the acquisition and should not be included in the net assets acquired.

ED 3 Question 6

We strongly disagree with the proposal that the acquirer should recognise separately the acquiree's contingent liabilities at the acquisition date. By definition, a contingent liability is only possible, but not probable, and often the amount of the liability cannot be estimated reliably.

To *recognise* contingent liabilities is inconsistent with basic accounting principles. Recognition of contingent liabilities at "best estimate" values also provides opportunity for manipulation of the amount of goodwill acquired. In reality, the acquisition price will already include a "discount" factor in respect of the contingency.

ED 3 Question 7

As stated above, we strongly disagree with the recognition of contingent liabilities in the allocation of the cost of acquisition. Subject to that exception, we concur with the proposal that the acquiree's identifiable assets and liabilities should be measured at their fair values at the acquisition date. We also concur that any minority interest in the acquiree will be stated at the minority's proportion of the net fair value of those items.

ED 3 Question 8

Goodwill is increasingly the primary asset acquired in a business combination and therefore it is appropriate that it should be recognised. We concur with the proposal that goodwill should be measured as the excess of the acquisition cost over the fair value of identifiable net assets acquired.

We have concerns that the systematic amortisation of goodwill acquired in business combinations is an arbitrary measure of the consumption of that asset over time. We also consider that while the acquired goodwill is being consumed, it is effectively replaced at the same time by internally generated goodwill – for which recognition is not permitted. Therefore to expense acquired goodwill and not recognise the internally generated goodwill is inconsistent. On this basis we concur with the proposal that acquired goodwill should not be amortised.

However, we have concerns as to how impairment losses can be identified and measured. On acquisition the acquired goodwill is effectively absorbed into the business operations and it is likely that over time, the goodwill relating to one acquisition will not be separately identifiable from other portions of goodwill within the combined entity. While one segment of the business may see a decline, another may see growth and it is difficult to determine whether goodwill in one segment should be written down, while an increase in value in another segment cannot be recognised. Guidance is required to determine whether goodwill should be considered for impairment as one asset across reporting segments, or whether the initial value of goodwill recorded at acquisition should be considered separately for each acquisition. This latter option does not reflect the reality of the way goodwill is utilised in diversified operations.

In our view the impairment of goodwill can only be determined when the ongoing profitability of operations is questionable. We would like to see clarification in the IFRS of circumstances that provide indicators of impairment.

ED 3 Question 9

As stated above, we strongly disagree with the recognition of contingent liabilities in the allocation of the cost of acquisition. Subject to that exception, we believe that if the fair value of the net assets acquired exceed the cost (ie. if the acquisition reflects a bargain purchase), then it is appropriate to recognise the excess in the profit or loss.

The ability to reassess the identification and measurement of the acquiree's identifiable assets and liabilities and the measurement of the cost of the combination, implies that either there is scope for manipulation, or that there was something wrong in the initial allocation of fair values. If the determination of fair values is carried out appropriately it is difficult to understand how reassessment is feasible.

We recommend that determination of fair values should be closely aligned with the purpose of the acquisition so that any excess of cost over fair value is deemed to be goodwill, while any excess of fair value over cost is recognised in profit or loss.

ED 3 Question 10

Ordinarily twelve months should be sufficient for completing the accounting for a business combination, to determine fair values. An exception arises where the acquisition cost is dependent on future events (such as achieving certain performance hurdles).

For those acquisitions where the price is based on future events (maybe over two or three years), it is necessary to incorporate best estimates of cost over the corresponding period until actual outcomes are known. Except for these types of acquisitions, the acquisition cost and fair value of net assets should be determined within the twelve month period, with any further adjustments disclosed as errors.

Amendment to IAS 36 - Responses to IASB Invitation to Comment Questions

We have serious concerns regarding the reliability of business model estimates used to determine fair value. Factors to be considered, assumptions and fair values are not constants, but vary over time. Also both the availability and reliability of detailed budgets and cash flows are questionable in an environment where unforeseen global events, beyond the control of the entity's management may have an enormous impact on business opportunities. For example, the most recent of these events being the SARS outbreak in SE Asia is already having unforeseen economic impact on businesses with trading interests in that region.

Except for transactions when business models are used to support a transaction price, we believe that business models incorporating management assumptions introduce a new dimension of uncertainty into financial reporting. These models should be used only for indicative information to support carrying values in preparation of financial information, and not as the primary basis for measurement or disclosure.

Question 1- Frequency of impairment tests

We consider that the recommendations of paragraphs 8A and 8B are theoretically idealistic and are **not** workable in practice. We do **not** support the proposals to carry out an annual estimate of the recoverable amount of an intangible asset and we do **not** support the requirement to test goodwill acquired in a business combination annually. We consider that fulfilment of these obligations will be onerous and costly, and to minimise costs the results achieved are likely to be unreliable.

We do not believe that the value or recoverable amount of an intangible asset can be carried out in isolation but would effectively require consideration of the whole business unit of which it is a part. This means that annual valuations and projections will be required. It is possible that for larger listed entities these valuations *may* be part of an on-going management monitoring system. However, in 'smaller large' entities – for example those that are family businesses or even smaller listed entities in the Australian market, it is highly unlikely that such valuations would be available ordinarily.

Business valuations are costly and time consuming for entities that do not have the available resources to carry out such tasks in-house. An alternative outcome is that a "business model" will be "updated" each year to reduce costs. However, the business environment is dynamic and we have concerns that quick-fix-models will only pay lip service to the required tasks and the results will only provide superficial support of carrying values.

Further, in our experience, goodwill acquired in a business combination is rapidly "absorbed" into the group's operations. An acquisition is often made to achieve synergies or strategic advantage and therefore the goodwill acquired is absorbed into the overall goodwill of the group, and cannot be separately identified for impairment testing.

We strongly recommend that the IASB should

- Provide guidance to identify factors that indicate the possible impairment of an intangible asset and goodwill; and

- Require that tests for recoverable amount and impairment must be carried out when such factors are in existence.

Examples of factors indicating the impairment of an intangible asset or goodwill include:

- Declining sales
- Declining profits
- Loss of expertise that has not or cannot be replaced (intellectual capital)
- Changing market conditions (technology, health, safety etc)
- Loss of key customers to competitors.

Question 2 – Intangible assets with indefinite useful lives

We consider that the guidance provided in paragraph 20A will only provide superficial support of recoverable amount in periods that depend on calculations carried out in preceding periods, despite the requirement for certain criteria to be met. In contrast we believe that a comprehensive list of key factors indicating impairment and the requirement to rigorously calculate recoverable amount and impairment losses would not only improve the quality of reporting, but would be achievable. The existence of these factors would provide clear evidence that carrying values needed adjustment and would prevent opportunities for management to justify taking a preferred position.

Question 3 – Measuring value in use

(a) Paragraph 25A simply states the basis for preparing cash flow projections. It would be preferable to explain the meaning of the term "value in use" rather than steps for preparing calculations. For example, "value in use" means the value of that asset (or group of assets) to the entity when used in its current location for the purpose for which it is currently designated.

(b) We agree that cash flow projections should take into account both past actual cash flows and management's past ability to forecast cash flows accurately. However, guidance is needed to explain "take into account". For example does this mean that sensitivity analysis should be used to take a middle position between best and worst outcomes when management does not have a good track record in forecasting cash flows accurately?

(c) We have mixed views as to whether this type of guidance should be provided with an IFRS. Appendix B basically explains the accounting theory for using present value techniques, more akin to accounting textbook information rather than information that explains the application of an accounting principle. Although the information is useful, it makes the document lengthy and difficult to handle, and therefore detracts from its main purpose in establishing accounting principles. Conversely, inclusion of this material promotes the IFRS as a more comprehensive, although not exhaustive, reference point. Overall we believe that an IFRS should contain and explain accounting principles and *not* accounting techniques and therefore the guidance in Appendix B should be omitted from the final document.

Question 4 – Allocating goodwill to cash-generating units

(a) We concede that in some situations it may be possible to allocate goodwill to a cash-generating unit. However, in other situations this allocation may be a purely arbitrary exercise. For example, our client base comprises large national entities that are generally not widely diversified. Acquisitions are more likely to complement their existing activities, and are unlikely to create separate "cash-generating units". This means that any goodwill acquired in an acquisition will become "absorbed" into the existing goodwill and not be separately identifiable. Paragraph 73 states that "each of those cash-generating units shall represent the smallest cash-generating unit to which a portion of the goodwill can be allocated on a reasonable and consistent basis". For many of our clients, the smallest cash-generating unit may be the whole business.

(b) *If* goodwill can be allocated to a cash-generating unit, we agree that it should be included in the carrying amount of the operation to determine the gain or loss on disposal. This is consistent with the statement in paragraph 75 "Goodwill does not generate cash flows independently of other assets or groups of assets." When such assets are sold, any intrinsic goodwill must, by definition, be disposed with those assets.

(c) We do not believe that paragraph 82 is achievable in practice, beyond providing an arbitrary re-allocation of the goodwill value. This may be the only feasible option, but it also raises questions as to how the recoverable amount and impairment tests will be evaluated. We anticipate that in practice a higher proportion of goodwill will be allocated to those units where higher levels of future profits are foreseen. It is unlikely that goodwill would be allocated to loss making units, with the immediate prospect of recoverable amount or impairment loss write-downs. This argument supports our recommendation above (see question 1) that recoverable mount or impairment loss tests should be required only when key factors exist to provide evidence of possible impairment. The key factors provide actual evidence of an existing situation, whereas all other allocations are theoretical or arbitrary and are open to manipulation if desired.

Question 5 – Determining whether goodwill is impaired

(a) We do not concur with annual appraisals and we do not concur with the inclusion of contingent liabilities in the measurement of the net fair value of net assets. Except for these items, we agree that recoverable mount should be measured as the higher of the unit's value in use and net selling price.

(b) We concur with this treatment except that contingent liabilities should *not* be included in the measurement of fair values. [See discussion under the response to IASB 3 question 6].

(c) We concur with this treatment, except for the inclusion of contingent liabilities in the measurement of the net fair value of net assets.

Question 6 – reversals of impairment losses for goodwill

We concur with paragraph 123 and with the reasons given in paragraph 124.

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

(a) When there are no prevailing indicators of potential impairment, the disclosures required by paragraph 134 are onerous and disclosure in paragraph 134(d) is potentially misleading. The disclosure of the amount by which recoverable amount (either value in use or net selling price) exceeds the aggregate carrying amount provides only indicative and not conclusive information. We do not believe that the majority of users will understand the subtly of this difference, nor that these values may be sensitive to changes in the assumptions used in their calculation. Therefore we question the cost-benefit in providing this information *unless* there is evidence of impairment. When there is evidence of potential impairment additional disclosures of this kind will provide information that supports the amount of the write-down recognised, or forewarns users of possible future write-downs.

(b) We consider that information for cash-generating units within a segment provides users with a high level of detail that is not consistent with the level of detail in the rest of the financial report. This level of detail is too high and unnecessary. Paragraph 137 should be deleted.

Amendment to IAS 38 - Responses to IASB Invitation to Comment Questions

Question 1- Identifiability

We concur with the identifiability criterion given.

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

We believe that the fair value of intangible assets acquired in a business combination can be measured reliably.

Regarding an assembled work force – in our experience some acquisitions involve the transfer of minimal tangible net assets and a large amount of intellectual capital. Acquisitions of entities involved in the development of information technology frequently have a low tangible asset base and a high value of intellectual capital. This type of 'goodwill' is clearly different to the 'goodwill' attaching to a group of income-producing assets, which is not dependent on a specialised work force. Therefore it is important to recognise that in certain industries the 'capture' of intellectual capital, and the future sharing of that capability, is essentially the whole purpose of the acquisition. In these situations paragraph 31 cannot be upheld and intellectual capital should be recognised as the primary asset in the acquisition, rather than 'goodwill'.

Therefore we do not agree with paragraph 31. In certain situations intellectual capital can be measured separately at the acquisition date, subject to employee contractual obligations being in place at that date. In these situations the intangible asset for the assembled workforce can be separately identified, and is likely to have a finite useful life over the term of the employment contracts.

Question 3 – Indefinite useful life

We agree with the removal of the presumption that an intangible asset's useful life cannot exceed twenty years. However, the use of the term "indefinite" to mean "there is no foreseeable limit on the period of time over which the asset is expected to generate net cash inflows" is somewhat spurious and perhaps misleading. Similarly paragraph 88 is not helpful.

In the life cycle of a business, although an asset currently has no foreseeable limit on the period of time over which it is expected to generate net cash inflows, it is probable that at some time in the future that time limit will become foreseeable. In reality the entity may, for example, before that time limit arrives, vary its product range and commence a new period of activity on the basis of (now internally generated) goodwill, to create a new "unforeseeable limit" for use of that asset.

Although we concur with the outcome, we do not believe the explanation has been properly established or justified.

Paragraph 105 is important but we also believe that when an intangible asset is impaired, it is likely that the indefinite life presumption is no longer appropriate. To briefly summarise a chain of events in the life cycle of a business:

i. Purchase of goodwill at acquisition – recognised as an intangible asset with an indefinite life

ii. *X* number of years of good sales and profits and indefinite life, with no amortisation

iii. Occurrence of an event provides first indication of impairment (could be declining sales, change in technology etc)

iv. Management revamps operations/product if possible to relaunch business in the changing environment

v. Close monitoring of recoverable amount and impairment over an undefined period – could be 2-5 yrs, or 12ms depending on industry and market.

vi. If relaunch is successful restart process from step ii. above.

vii. If relaunch is not anticipated to be successful recognise impairment loss/recoverable amount write-down

viii. Estimate remaining useful life – depending on whether it is a permanent or temporary event(s) causing decline.

ix. Commence write-down over remaining useful life if the relaunch is not anticipated to generate a new "unforeseen limit" for useful life.

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

We concur with the proposal.

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

We concur with the outcome but consider that the discussion is not complete. Please refer to our response to question 3 above.