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ACCOUNTING
STANDARDS
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Sir David Tweedie
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30 Cannon Street
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Dear David

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

Thank you for the opportunity to comment on ED 3 and the ED of Proposed Amendments to IAS 36 and IAS 38 (the "IASB EDs").

The AASB issued the IASB EDs in December 2002 in Australia with a wrap around as ED 109 "Request for Comment on IASB ED 3 Business Combinations; IASB ED of Proposed Amendments to IAS 36 Impairment of Assets and IAS 38 Intangible Assets; and AASB added material" and encouraged Australian constituents to respond to the IASB, with copies of those responses to the AASB. The AASB has prepared its comments after having considered Australian constituents' comments on ED 109.

The AASB is generally supportive of the proposals within the IASB EDs. However, we have a number of concerns, including:

- reverse acquisition accounting;
- identifying one of the pre-existing entities as the acquirer when a new entity is formed to issue equity instruments to effect a business combination;
- recognising an 'excess over cost' as an immediate gain;
- prohibiting the recognition of certain internally generated items as intangible assets; and
- restricting revaluations of intangible assets to fair value determinations by reference to an active market.

These and other concerns of the AASB are explained in the appendices to this letter.

The AASB would also like to take this opportunity to highlight its concerns about the expected timing of the Standards arising from Phase I (that is, second half of 2003). Specifically, the AASB is concerned about the possibility of subsequently amending these Standards by virtue of the Standard/Amendments arising from Phase II (expected during the first half of 2004). The AASB believes that it is inappropriate to issue Standards that are likely to be significantly amended in the very near future. The AASB believes that the release of one Standard on business combinations and one revision to IAS 36 is a far more desirable outcome than the current proposal to issue and subsequently amend both Standards. Therefore, given the relatively short period of time between the expected release of Standards from Phases I and II, the AASB believes that the IASB should postpone the release of any Standards arising from the business combinations project until after Phase II is completed, assuming that both phases are to be completed by 31 March 2004.

Yours sincerely

Keith Alfredson

Keith Alfredson
Chairman

1. GENERAL COMMENTS

We generally support the proposals within ED 3. In particular, we support:

- the abolition of the unitings of interests method; and
- a non-amortisation/impairment only approach for goodwill.

2. IASB SPECIFIC QUESTIONS

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?

This proposal is supported.

(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?

This proposal is supported.

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?

This proposal is supported.

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?

We do not support this proposal.

We consider that the circumstances in which reverse acquisition accounting is required inappropriately represents a proprietary view rather than an entity view. In light of this, the AASB is strongly of the view that reverse acquisition accounting is not an appropriate accounting method.

We acknowledge the IASB's proposal to amend the guidance for identifying when reverse acquisition accounting is appropriate to ensure that the identification of an acquirer in a business combination effected through an exchange of equity instruments is based on the notion of control. However we believe that reverse acquisition accounting is inconsistent with the commonly held notion that control is determined from an entity viewpoint.

We consider that the "form" of the transaction is relevant in determining its "substance". That is, as a result of the transaction, it is the legal parent that "controls" the legal subsidiary and should therefore be treated as the acquiring entity (any control that the previous shareholders of the legal subsidiary have over the combined entity is by virtue of the ownership and control that the legal parent has over the legal subsidiary).

Therefore, we believe that reverse acquisition accounting should not be permitted in the Standard arising from ED 3.

(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?

As mentioned in 3(a) above, we believe that reverse acquisition accounting should not be permitted in the Standard arising from ED 3. However, if reverse acquisition accounting is retained, we have two concerns with regard to the guidance provided, namely: (i) parent entity reporting (specifically, how the legal parent should account for its investment in the legal subsidiary); and (ii) determining the cost of the business combination when a minority interest in the legal subsidiary exists. Each of these is discussed in turn.

(i) *Parent entity reporting (separate financial statements)*

The last sentence in paragraph 5 states:

> "It [parent entity] includes its interest in the acquiree in its separate financial statements as an investment in a subsidiary…"

To help prevent the emergence of diverse accounting practices, it would be useful for the Standard to prescribe the accounting treatment of the legal parent's investment in the legal subsidiary in the parents separate financial statements. For example, how is the value of this investment determined? Is it the same as the cost of the business combination as determined by Company B (that is, $1,600 in the example), or is it based on the fair value of the shares issued by the legal parent to effect the business combination (that is, $1,800: 150 shares @ $12 per share, as per the example)? We believe that the investment should be measured based on the fair value of the shares issued by the legal parent.

Regardless of how the investment is measured in the parent entity's financial statements, upon preparation of consolidated financial statements, any accounting for the investment in the legal subsidiary by the legal parent should be eliminated (that is, eliminated against the corresponding increase in the parent entity's issued capital).

(ii) *Determining the cost of the business combination when a minority interest in the legal subsidiary exists*

The "general principle" to be applied in determining the cost of the business combination is expressed as 'determine number of shares the legal subsidiary would have to issue to provide the same percentage ownership of the combined entity to the shareholders of the legal parent as they have in the combined entity as a result of the reverse acquisition' [paragraph B5].

Using this general principle, we have worked through the examples of both 100% participation of the legal subsidiary shareholders in the equity exchange (no minority interest) and where less than 100% of the legal subsidiary's shareholders participate in the exchange (creating a minority interest in the legal subsidiary). In either case, we are satisfied that the end result (i.e. the consolidated numbers) is logical. We are also satisfied that the general principle works for the 100% participation. However, we have difficulty aligning the mathematics with the general principle in relation to the less than 100% participation. Specifically, we have difficulty determining the number of shares needed to be issued by the legal subsidiary in order to provide 'the same percentage ownership interest of the combined entity to the shareholders of the legal parent as they have in the combined entity as a result of the reverse acquisition'. This is because, as far as we can determine, the percentage ownership interest of the shareholders of the legal parent is not the same when the legal subsidiary is assumed to acquire 100% of the legal parent (because of the minority interest in the legal subsidiary).

As mentioned above, despite our inability to align the mathematics with the general principle for less than 100%, we understand the consolidated figures. This is because we have considered the transaction in the following manner:

In the illustrative example, A has acquired 56 of B's 60 shares (i.e. 93.3% interest in B). Therefore, in the consolidated financial statements, A will be consolidated with B and there will be a minority interest in B (i.e. the remaining 6.7%).

Applying reverse acquisition accounting, B (the legal subsidiary) is determined to be the acquirer and A (the legal parent) is determined to be the acquiree. Therefore, the cost of the business combination will be determined from the point of view of B and then allocated to the identifiable net assets of A on the basis of fair value. To determine the cost of the business combination, it is easy to consider this from the end result (i.e. the consolidation will consist of 100% of A at fair value and B at pre-combination carrying amounts, with a minority interest in B).

Given 100% of the fair value of A's net identifiable assets will be included in the consolidated financial statements (and attributed to the controlling interest), the cost of the business combination to B should be the equivalent of acquiring 100% of A (which has already been determined as 40 shares at $40 per share in the 100% participation example). Despite the minority interest in B, the cost of the business combination will always be for 100% of the legal parent for all reverse acquisitions.

Our concern is that the general principle may not be drafted in a manner that is consistent with how we rationalise the end result (when a minority interest in the legal subsidiary exists).

We propose that the second and third paragraphs on page 12 of "Draft Illustrative Examples on ED 3" be replaced with the following text:

> "The cost of the business combination is calculated by assuming that the combination had taken place in the form of B issuing additional ordinary shares to the shareholders of A in exchange for their ordinary shares in A. Given 100% of the fair value of A's net identifiable assets will be included in the consolidated financial statements (and attributed to the controlling interest), the cost of the business combination to B should be the equivalent of acquiring 100% of A (which has already been determined as 40 shares at $40 per share in the 100% participation example). Despite the minority interest in

B, the cost of the business combination will always be for 100% of the legal parent for all 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?

We do not support this proposal.

Treating one of the combining entities as the in-substance acquiring entity looks through the transaction to the shareholder group ultimately obtaining control over the other entity. We have concerns as to whether this approach is consistent with the notion of control, which is normally judged from the ability of an entity, and not from the viewpoint of a group of shareholders that may be a disparate group with no capacity or intention to vote as a group. We consider that the "form" of the transaction is relevant in determining its "substance". That is, as a result of the transaction, the new entity "controls" the combining entities and should therefore be treated as the acquiring entity. This is also consistent with the final sentence in paragraph 4 which states:

> "It [business combination] may involve the establishment of a new entity to *control* the combining entities..." (emphasis added)

Therefore, the new entity should determine the cost of acquiring the combining entities and allocate that cost across the combining entities' identifiable net assets accordingly.

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?

We do not support this proposal.

Post-acquisition restructuring activities are frequently undertaken in order to achieve the perceived synergies and other opportunities that gave rise to the acquisition. The cost of a proposed restructuring is often a factor in purchase price negotiations. Therefore, given the proposed definition of goodwill (that is, "future economic benefits from assets that are not capable of being individually identified and separately recognised"), and the proposal to measure goodwill as a residual, we believe that a restructuring provision should be recognised separately from goodwill when certain criteria are met.

We believe that the existing requirement in paragraph 31 of IAS 22, *Business Combinations* should be retained. Furthermore, we believe that the Standard arising from ED 3 should specify the subsequent treatment of any restructuring provision as follows:

- any increases in the provision shall be recognised in profit or loss for the period in which the increase occurred; and
- the reversal of any surplus provision shall be recognised as an adjustment to goodwill.

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?

We do not support this proposal.

We believe the recognition of contingent liabilities of the acquiree is at odds with the IASB conceptual framework (recognition criteria for liabilities) and results in different accounting treatments for similar items depending on the manner in which they arise (which ultimately compromises the qualitative characteristic of comparability).

We believe that a consistent accounting treatment should be applied to all contingent liabilities regardless of the manner in which they arise. Any reconsideration of the appropriate accounting treatment should be made as part of a broader project that considers the accounting treatment for all contingent liabilities (not just contingent liabilities assumed as part of a business combination).

Therefore, we believe that paragraph 36(c) should be eliminated and consistent with all other liabilities assumed in a business combination that fail the general recognition criteria, contingent liabilities of the acquiree that fail the general liability recognition criteria should be subsumed within goodwill.

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?

Subject to our response to question 6 above, this proposal is supported.

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?

This proposal is supported.

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?

(i) Treatment of 'excess over cost'

We do not support this proposal.

Despite the arguments raised in favour of recognising the excess as a gain (paragraphs BC109 – BC120), we believe that, given the subjectivity of fair value determination, any excess of the estimated fair values of identifiable net assets acquired over cost should be accounted for as a mismeasurement of fair value rather than a gain. We consider that in an arm's length transaction the cost of the business combination should be equal to the value of the net assets acquired.

Paragraph BC120 states "the Board [IASB] observed that the accounting for an excess proposed in the draft IFRS is consistent with the...working principle that the IASB and the US FASB have agreed should underpin their joint project on issues related to the application of the purchase method". In contrast, we consider the proposed treatment contradicts the IASB/FASB working principle. For instance, on the one hand, the working principle suggests that the accounting for a business combination is based on the assumption that the transaction is an exchange of equal values. On the other hand, the working principle requires any excess over cost to be recognised as a gain in the income statement. This treatment does not imply an exchange of equal values.

Furthermore, we consider the proposed treatment to be inappropriate in light of the proposal regarding liabilities for terminating or reducing the activities of an acquiree. For example, even after a reassessment of the identification and measurement of the identifiable net assets acquired, the excess over cost is likely to be higher in the absence of recognising an amount for terminating or reducing the activities of an acquiree as a liability, the value of which, has potentially been taken into consideration in determining a purchase price. We consider it anomalous that any gain recognised would ultimately be increased by virtue of not recognising these amounts as liabilities.

We believe that any excess over cost is most likely to arise as a result of errors in measuring the fair value of either the consideration paid or the identifiable net assets acquired or a requirement in an accounting standard to measure identifiable net assets acquired at an amount that is not fair value, rather than a true bargain purchase. Therefore, we believe that the acquirer should first reassess the identification and measurement of the identifiable net assets acquired. Any remaining excess should then be accounted for; first, by reducing the carrying amounts recognised in respect of the acquiree's identifiable net assets for which valuations may not be as reliable as for items traded in an active market; and then, by recognising any remaining excess immediately in the income statement as a gain.

(ii) Terminology to describe excess over cost

In the event that the proposed treatment is adopted in a Standard, we consider that an appropriate label for the excess would be "excess over cost" (consistent with the proposed label). However, if the suggested treatment described in (i) above were adopted, we consider "discount on acquisition" to be an appropriate label.

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?

This proposal is supported.

(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?

This proposal is supported.

3. OTHER COMMENTS

Paragraph	**Comment**
9	We acknowledge that the inclusion of the phrase 'and that control is not transitory' is for the purpose of "anti-avoidance". However, we are concerned as to how the word 'transitory' is to be interpreted. For instance, what period of time is implied by the word 'transitory'. Whilst we appreciate the aim of the IASB to produce principle-based Standards, we consider that this word may be subject to broad interpretation.
26	We query the appropriateness of the expression "more clearly evident" in fourth sentence of paragraph 26 and consider that the expression should be replaced with a more familiar expression such as "more reliably measurable".
36(c), 43, BC67 – BC79	Refer to our comments to question 2 of the ED of Proposed Amendments to IAS 38, *Intangible Assets* below.

Paragraph	Comment
57 – 59	This comment refers to the illustrative example "Business combination achieved in stages" in *Draft Illustrative Examples on ED 3 BUSINESS COMBINATIONS.* The illustrative example indicates that the parent's share of any movement in the subsidiary's accumulated profits subsequent to the parent's initial ownership interest (that is, any interest pre-control), is to be included as part of consolidated accumulated profits attributable to the parent (refer to Note (e) on page 19). We believe that where the parent entity has previously carried its investment at cost, this post-acquisition profit figure should be recognised in the consolidated profit or loss for the period. We consider this treatment to be consistent with [Draft] IAS 1, *Presentation of Financial Statements*. Specifically, paragraph 73 of [Draft] IAS 1 states "All items of income and expense recognised in a period shall be included in the determination of profit or loss unless a Standard requires or permits otherwise". We propose the following paragraph to be included after paragraph 59 of ED 3: "In the annual reporting period in which the parent entity obtains control over the subsidiary, where the parent entity has previously carried its investment at cost, the parent's share of any movement in the subsidiary's accumulated profits prior to obtaining control shall be recognised in the consolidated profit or loss for the period. In subsequent reporting periods, the adjustment shall be made to the opening balance of accumulated profits." Regardless of the treatment to be prescribed, we believe that the treatment should be explicitly articulated in the Business Combination standard (and not merely by way of an illustrative example). *We acknowledge that the proposals and guidance contained within ED 3 regarding step acquisitions is likely to be amended in light of tentative decisions made by the IASB as part of Business Combinations Phase II (application of the purchase method). Nevertheless, we include our comments here for the sake of completeness.*
64	We believe that goodwill should not be adjusted for the subsequent recognition of deferred tax assets (consistent with the subsequent treatment of other acquired assets and assumed liabilities in that goodwill is not adjusted for events that occur subsequent to acquisition date). We believe that deferred tax assets acquired as part of a business combination should be treated like any other acquired asset. That is, • if the initial accounting of the deferred tax asset can only be determined provisionally, the acquirer shall account for the deferred tax assets using those provisional values and subsequently recognise any

Paragraph	Comment
	adjustments to those provisional values as a result of completing the initial accounting of the deferred tax assets within twelve months of the acquisition date (as per paragraph 61); and • any adjustments to the initial accounting of the deferred tax assets after that initial accounting is complete shall be recognised only to correct an error (as per paragraph 62). Therefore, we believe paragraph 64 should be deleted (and paragraph 62 amended to delete the reference to paragraph 64). *We acknowledge that the proposals within ED 3 (and the requirement in IAS 12 Income Taxes) regarding the subsequent recognition of deferred income taxes acquired in a business combination is likely to be amended in light of tentative decisions made by the IASB as part of Business Combinations Phase II (application of the purchase method). Nevertheless, we include our comments here for the sake of completeness.*
66(f)	We question the usefulness of disclosing "the carrying amount of each of those classes [of the acquiree's assets, liabilities and contingent liabilities]...immediately before the combination". This disclosure runs the risk of information overload.
67	We question whether this information would be relevant in the event that aggregated information continues to be immaterial.
B15(c)	In principle we support the fair value determination of receivables (that is, present value of amounts to be received less allowances for uncollectibility and collection costs). However, such a requirement may not be appropriate in the context of business combinations involving financial institutions (for example, loan provisioning may be a key performance indicator, in which case it may be considered appropriate to recognise loan receivables acquired in a business combination at their gross amount with a corresponding provision).

1. GENERAL COMMENTS

With the exception of the proposed goodwill impairment test (question 5 below) and some of the proposed disclosure requirements (question 7 below), we support the proposed amendments to IAS 36.

In addition to commenting on the proposed amendments to IAS 36, we would like to take this opportunity to comment on a number of the requirements of the existing IAS 36 that are expected to be retained, namely:

- cash-generating units; and
- future capital expenditure.

(a) Cash-generating units

We believe the proposed amended IAS 36 fails to provide definitive guidance for the identification of an asset's cash-generating unit. In particular, we are concerned that entities will potentially be required to identify cash-generating units that are below the level at which management monitors the business.

Consistent with the development of a main principle for the purpose of allocating goodwill to cash-generating units (paragraph 74), we believe a main principle should be established for identifying an "asset's cash-generating unit".

Accordingly, we believe that paragraphs 61 and 62 should be combined to form a main principle (bold text) and placed immediately after paragraph 59. We propose the following wording:

> *An asset's cash generating unit is the smallest group of assets that includes the asset and that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets. In identifying whether cash inflows are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including how management monitors the entity's operations or how management makes decisions about continuing or disposing of the entity's assets and operations.*

This principle could then be followed by the existing paragraph 60. Paragraphs 61 and 62 could be combined as follows:

> 61. ~~As defined in paragraph 5, an asset's cash-generating unit is the smallest group of assets that includes the asset and that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.~~ Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an ~~enterprise~~ entity identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an ~~enterprise~~ entity considers various factors including how management monitors the ~~enterprise~~ entity's operations (such as by product lines, businesses, individual locations, districts or regional areas or in some other way) or how management makes

decisions about continuing or disposing of the ~~enterprise~~ entity's assets and operations.

> ***Example***
>
> *A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.*
>
> Because the ~~enterprise~~ entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. *This represents the level at which management makes decisions about continuing or disposing of the entity's operations.* The cash-generating unit for each route is the bus company as a whole.

~~68~~ 62. ~~Cash inflows from continuing use are inflows of cash and cash equivalents received from parties outside the reporting enterprise entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an enterprise entity considers various factors including how management monitors the enterprise entity's operations (such as by product lines, businesses, individual locations, districts or regional areas or in some other way) or how management makes decisions about continuing or disposing of the enterprise entity's assets and operations.~~ Appendix A, Example 1, gives examples of identification of a cash-generating unit.

This would ensure that, for impairment purposes, an asset's cash-generating unit is identified in a manner that is consistent with the way in which management manages the business. Identification of cash-generating units in this manner may alleviate concerns that cash-generated units identified on the basis of "largely independent cash flows" may not necessarily coincide with the way in which management manages the business.

(b) Future capital expenditure

Paragraph 37 proposes that for the purpose of calculating an asset's value in use, future cash flows shall be estimated for the asset in its current condition. It proposes to exclude future capital expenditure that will improve or enhance the asset's standard of performance assessed immediately before the expenditure is made.

We have concerns in relation to the calculation of an asset's value in use when an entity commences a multi-period expansion project to enhance the long-term production capacity of an asset, but in the short term, the production capacity of the asset is necessarily reduced to accommodate the work in progress.

Assuming an indicator of impairment is present, an entity will be required to determine the recoverable amount of the asset. If it is assumed that because of the nature of the asset a net selling price cannot be readily determined, the asset's recoverable amount is the asset's value in use. Paragraph 37 requires that the future cash flows used to calculate value in use of an asset be based on the asset in its current condition. Where the cash-generating capacity of an asset is temporarily scaled down, the value in use based on current condition could result in the asset being written down even though the long-term cash flows for the asset do not justify a write down. The net effect is that the entity would have to recognise a large impairment loss in the current period, which would then be reversed after the asset is returned to full capacity (that is, once the expansion project is complete).

We believe there are two views on calculating the value in use of an asset undergoing an expansion project, given that, under paragraph 37, the impact of future capital expenditure is excluded if it enhances the asset in excess of its standard of performance assessed immediately before the expenditure is made:

(1) It could be argued that, once the entity commences the expansion project, the assessed standard of performance of the asset changes to that level of performance expected after the expansion project has been completed. This would be consistent with the interpretation used for assets being built, whereby during the construction phrase, the asset's standard of performance is assessed as that level expected to be achieved once construction is completed. Under this approach, the remaining future capital expenditure and all of the expected benefits would be incorporated in calculating the value in use. The disadvantage of allowing all future benefits to be incorporated in the value in use without the necessary capital expenditure being incurred is that an entity may exploit the process to avoid recognising a loss on an asset that is actually impaired. To avoid this potential exploitation, guidance would have to be included within the ED to identify when an expansion project changes the asset's standard of performance assessed immediately before the expenditure.

(2) The entity could be allowed to incorporate the expected benefits of the expansion project proportionally based on the percentage of completion. For example, if the expansion project were 50% complete, in calculating value in use, the entity would incorporate 50% of the expected benefits. No future capital expenditure (at least to the extent that it relates to the expansion project) would be incorporated in calculating value in use. A disadvantage of this approach is that it assumes a direct linear relationship between the degree of completion of the expansion project and the resulting benefits. It could be argued that this is unrealistic. Further, this approach could lead to entities being required to recognise large impairment losses, as a result of the asset being idle.

We believe Option 1 is superior to Option 2 as it results in a higher level of internal consistency within the proposed Standard. Option 1 is also viewed as producing asset values that are likely to better reflect economic reality.

In order to operationalise Option 1, we believe an additional paragraph should be added stating that:

> *When an entity is committed to a project to enhance the asset's standard of performance assessed immediately before the expenditure, estimates of future cash flows should include both future capital expenditure and the benefits resulting from that expenditure.*

In addition, we recommend that an example based on Option 1 should be included in the Appendix A.

2. IASB SPECIFIC QUESTIONS

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?

This proposal is supported, having regard to the proposal to carry forward the most recent detailed calculation in a preceding reporting period of recoverable amount.

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?

This proposal is supported.

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?*

    This proposal is supported.

(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?*

    We do not support this proposal.

    We believe that management would necessarily take into consideration its past ability to forecast cash flows accurately. On that basis, we do not consider that this aspect warrants emphasis in an accounting Standard.

(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?*

This proposal is supported.

However, we believe that entities should be permitted to use either pre-tax or post-tax cash flows and discount rates in the determination of value in use. The only requirement being that the selection of the discount rate shall be consistent with the cash flows used (for example, pre-tax discount rate with pre-tax cash flows). We believe that this election is appropriate because for some industries tax deductions and allowances may have an impact on the calculation of value in use (for example, the extractive industry).

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?*

This proposal is supported.

(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?*

This proposal is supported.

(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?*

This proposal is supported.

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?

This proposal is supported.

(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?

This proposal is supported.

(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?

This proposal is supported, subject to the exclusion of contingent liabilities from the notional purchase price allocation that is performed to calculate the implied value of goodwill (see our response to IASB Question 6 in Appendix A above).

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?

This proposal is supported.

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?*

We do not support this proposal.

We believe the proposed disclosure requirements to be excessive and run the risk of information overload. Furthermore, given the extent of proposed disclosures associated with goodwill and intangible assets with indefinite useful lives, we are concerned about the (implicit) direction of disclosure requirements for other (more) significant balance sheet items.

We note that the FASB do not require this level of detailed disclosure and propose that the disclosure requirements in the Standard arising from this ED should align with the FASB requirements. Accordingly, we believe that paragraphs 134(d), (e) and (f) should be removed.

(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?*

Refer to our comment to 7(a) above.

1. GENERAL COMMENTS

With the exception of the proposed criteria for recognising intangible assets acquired in a business combination separately from goodwill (question 2 below), we support the proposed amendments to IAS 38.

In addition to commenting on the proposed amendments to IAS 38, we would like to take this opportunity to comment on a number of the requirements of the existing IAS 38 that are expected to be retained, namely:

- non-recognition of certain internally generated intangible assets; and
- revaluation of intangible assets.

(a) Non-recognition of certain internally generated intangible assets

Paragraph 55 states "internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets".

Paragraph 56 states that "expenditure on [these internally generated items] cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets".

In contrast, it can be argued that prohibiting recognition of such items is arbitrary and overly restrictive. It may also undermine the relevance of financial reports, if expensing such items ignores their future economic benefits.

Conceptually, all internally generated intangible assets should be subject to the same recognition criteria. Whilst we acknowledge the difficulty inherent in distinguishing between the creation of these types of intangible assets and the development of internally generated goodwill, we believe that such items should be capable of recognition if the recognition criteria and guidance applicable to internally generated intangible assets is satisfied.

(b) Revaluation of intangible assets

Paragraph 70 states "for the purpose of revaluations…fair value shall be determined by reference to an active market".

We consider that this requirement represents a restrictive bias for the measurement of intangible assets. Paragraph 37 of the Basis of Conclusions to the existing IAS 38 notes that "intangible assets are often unique and methods to estimate their fair value reliably are still under development", and that the potential for abuse of fair value measurements led the IASB to adopt a more restrictive approach.

Arguments opposing this view include:

- there are no such restrictions on the revaluation of tangible assets (limiting the revaluation of intangible assets ignores the possibility that specialist valuers could provide sufficiently reliably measures);
- there may be a large difference between the cost and the economic value of an intangible asset, and cost may not provide an appropriate balance between relevance and reliability; and

- it seems incongruous to suggest that the fair value of identifiable intangible assets can be determined when acquired as part of a business combination (and for the purpose of impairment testing), but not when considered *outside* a business combination.

Conceptually, identifiable intangible assets should be subject to the same revaluation principles as tangible assets (including the revaluation conditions contained within IAS 16 *Property, Plant and Equipment,* such as regularity of revaluations and revaluing an entire class). Therefore, we believe that revaluation to fair value should be allowed where fair value can be determined reliably.

(c) First-time adoption of IFRS

The AASB recently revised AASB 1041 "Revaluation of Non-Current Assets" to conform more closely with IAS 16 "Property, Plant and Equipment" as it relates to the revaluation of assets. We moved from a situation where entities could choose to revalue or not revalue on a year-by-year basis to the approach in IAS 16 under which an entity chooses either the cost basis or the fair value basis and, once on the fair value basis, the entity is effectively locked-in to that basis. The AASB included transitional arrangements in AASB 1041 that allowed an entity that changed from a revaluation basis to a cost basis to treat the revalued amount at the date of the change as deemed cost. A large number of entities used the transitional arrangements in 2000 and 2001 and currently have a policy of measuring assets (both tangible and intangible) at cost and carry many of their assets at deemed cost, being the revalued amount in 2000 or 2001.

We note that the ballot draft of IFRS 1, *First-Time Adoption of IFRSs,* requires the de-recognition of intangible assets that fail to meet the recognition criteria in IAS 38. It also requires the de-recognition of any revaluations of intangible assets that do not meet the criteria for revaluation in IAS 38.

We consider it punitive to require the de-recognition of items that satisfied the general asset recognition criteria under previous national GAAP (particularly where that general asset recognition criteria is consistent with the IASB's recognition criteria). We consider that de-recognition in these circumstances would compromise the relevance of financial reports.

We also note that internally generated intangible assets and revaluations are to be reconsidered as part of the IASB/AASB joint project on intangible assets. We therefore question the appropriateness of requiring de-recognition when there is a possibility that the intangible assets project may support the recognition of these items.

We suggest that the IASB consider permitting the use of a previously deemed cost determined under national GAAP as deemed cost for the purposes of first-time adoption of IAS 38.

2. IASB SPECIFIC QUESTIONS

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?

In principle, this proposal is supported, however we have concerns regarding the proposal to separately identify and recognise a number of intangible assets that we believe should form part of acquired goodwill (for example, customer lists and non-contractual customer relationships). Therefore, whilst we are generally supportive of this proposal, we recommend that the IASB have regard to the US experience in terms of identifying and recognising these types of intangible assets.

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.

We do not support the proposal regarding reliable measurement.

Specifically, we are concerned about the presumption that 'sufficient information could reasonably be expected to exist to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity' (paragraph BC75). Whilst we note that the IASB has acknowledged that "the fair value estimates for some intangible assets that meet the contractual-legal or separability criteria might lack the precision of the fair value measurements of other assets", we are concerned that the IASB is favouring the relevance of financial statements over their reliability in this regard. As a principal qualitative characteristic of financial statements, we believe it is inappropriate to presume that the reliability criterion can be met (particularly with regard to some of the intangible assets included within "Draft Illustrative Examples on ED 3 Business Combinations", such as customer lists and non-contractual customer relationships).

Therefore, we believe that paragraph 36(c) should be amended as follows:

> (c) it is an intangible asset as defined in IAS 38 *Intangible Assets* (revised 200X), including an in-process research and development project that meets that definition, and it is not an assembled workforce, <u>and its fair value can be reliably measured.</u>

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?

This proposal is supported.

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)?

This proposal is supported.

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?

This proposal is supported.