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Our Ref:
Your Ref:

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CL 91

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

Dear Sir

Re: Request for Comment on IASB ED3 "Business Combinations"; IASB ED of Proposed Amendments to IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets"

We are pleased to provide our comments on IASB ED3 "Business Combinations"; IASB ED of Proposed Amendments to IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets".

Epic Energy is one of Australia's largest gas transmission companies with more than A$3.5billion invested in energy infrastructure.

Overview of Submission

Epic Energy has provided comments on all questions where we believe it is appropriate to do so.

Our general comments in relation to IAS 36 reflect our disagreement to the definition of "impairment" and the methodologies used in IAS 36 to calculate an impairment loss. We strongly believe that there are major flaws with the value in use methodology that will disadvantage Australian companies when compared to their US counterparts.

We have made a submission to the Australian Accounting Standards Board (AASB) to highlight the need for further "added material" to IAS 36 such that organisations that are subject to price regulation in Australia are not disadvantaged. Epic believes that this will be in the best interests of the Australian economy.

Submission Content

We include the following appendices:

IASB ED3 Business Combinations
Appendix 1:– 10 IASB Questions

IASB ED of Proposed Amendments to IAS 36 Impairment of Assets
Appendix 2a: General Comments
Appendix 2b: 7 IASB Questions

IASB ED of Proposed Amendments to IAS 38 Intangible Assets
Appendix 3a: 5 IASB Questions

Other Matters
The definition of “impairment loss” in IAS 36 and IAS 38 is not consistent.

We thank you for the opportunity to comment on this exposure draft and trust our comments will assist with the development of appropriate standards within the international community.

Yours faithfully,

David Trapnell
Group Financial Controller

IASB ED3 Business Combinations

Appendix 1:

In terms of the ten specific questions posed by the IASB we respond as follows:

Questions 1 – 8 and Question 10
We agree with the proposals made or have no further comment.

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 and loss any excess remaining after that reassessment.*

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

The proposed treatment is effectively to take a "discount on acquisition" directly to profit and loss. The "basis for conclusion" in the exposure draft discusses circumstances in which this situation may arise and concludes that such circumstances would be rare. It further concluded that of these rare circumstances one factor might be errors that remain in the assessment or a genuine bargain purchase has been made. It could also be concluded that the "genuine bargain purchase" might, after the passage of time, not be such a bargain and in fact the purchaser had not done enough due diligence. Given the more likely scenario that the calculation contains errors a pro-rata apportionment of the "discount" against the fair value of the assets would be more appropriate.

IASB ED of Proposed Amendments to IAS 36 "Impairment of Assets"

Appendix 2a

General Comments

The standard defines an impairment loss as "the amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount". Definitions are subsequently provided on carrying amount and recoverable amount. However "impairment" rather than "impairment loss" is defined by accounting standards in the United States as the "inability to recover the carrying amount of assets over their estimated useful lives". Whilst we appreciate that US standards have no application outside of that jurisdiction the concept is fundamental to what the proposed standard is attempting to achieve.

If impairments were to be measured using "value in use" as outlined by IAS36, the definition of impairment would have to be modified to read the "inability to recover fully the carrying amount of assets, **plus a return on investment in those assets**, over their estimated useful lives". By definition, impairment should not be an evaluation of the ability to earn a profit or return on investment on those assets. Rather, it should be a measure of the ability to recover an asset's carrying value, dollar for dollar, over the asset's useful life. If every dollar invested is expected to be recovered in the future, there should not be any loss to recognise. As such the sum of undiscounted future cash flows is the proper measurement attribute. It is also the most reliable and least costly to implement.

Using the present value of future cash flow method to measure asset impairments would result in shifting profit reductions from future years and recognising them as a loss in the current year. This result is illogical because with assets recorded at cost there is no loss when full recovery occurs. For example, if in an economy where interest rates are high, a high discount rate is used to determine the present value of future cash flows, assets would be written down on this basis, resulting in a reduced profit. In future years when interest rates have fallen, the discount rate used for impairment is low and asset values have increased, an artificially high profit is recorded. In actual fact, the asset and future economic benefits derived from the asset have remained unchanged over this period.

Furthermore, present value discounting for impairment measures would result in a carrying value that has been determined based on the extent of the asset's future profitability. Such current value accounting concepts conflict with the historical cost model and would introduce some subjectivity through the use of assumptions as to the proper interest rate and the timing of the expected future cash flows. Furthermore, the users of the financial statements will be confused by the inclusion and substance of a loss that was recorded because the return on the investment in the future was not at a level deemed adequate today based on a subjective discount rate. The recording of a large loss today (understatement of profit) would be offset by an overstatement of profit in future years arising from a lower depreciation charge in subsequent years.

Epic Energy strongly agree with the approach adopted by FAS 144 to test for impairment on a sum of future cash flows basis for the fundamental reason that this test will determine whether the entity can recover the carrying value of the asset.

However, on a wider scale, Epic Energy believes that by adopting IAS36 in its current form companies will be placed at a significant disadvantage to US counterparts, resulting in weaker balance sheets. In turn this will expose these companies to the risk of takeover from US resident companies and not allow them to compete on a level playing field.

Appendix 2b

In terms of the seven specific questions posed by the IASB we respond as follows:

Question 1
Are the proposals relating to the frequency of impairment testing intangible assets with indefinite useful lives and acquired goodwill appropriate? If not, how should such assets be tested for impairment?

Due to the concept of "cash generating units" (CGU's) and allocating some intangible assets and goodwill to these CGU's means the reality for many organisations is that all assets will be tested each year as a matter of course. By suggesting that these 2 groups of assets need an annual test, despite the requirement to still test when there is any indication of impairment, suggests that entities will not in fact properly apply IAS 36 and test when there is an indication of impairment.

The preferred option would be to have a consistent test for all assets.

Question 2
We agree with the proposals made or have no further comment.

Question 3
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, what 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? If not, which approach should be required?

Epic Energy reiterates its belief that impairment be defined as in "general comments" above. This is easier for users of financial statements to understand and the proposed measurement less onerous for companies to measure. On this basis, future capital expenditure should not be included.

However, by effectively introducing or implying a different definition of impairment i.e. "inability to recover fully the carrying amount of assets, plus a return on investment in those assets, over their estimated useful lives" the reason for including future capital expenditure fundamentally changes. Including such expenditure will add further complexity to an already complex and subjective measure. However, for present value techniques it should be included as the company is measuring future returns today. To ignore them would be inconsistent. Some organisations have very long life assets; lead times for capital expenditure can be enormous. If management can justify future expenditure based on discussions with customers, that are not committed, that "adds value" to the business then they must be included.

Looked at another way, a business might acquire an asset and record goodwill. The goodwill, according to paragraph 10 of IAS 38, "represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised". Part of what a purchaser might pay for is the ability to leverage of the existing assets to make incrementally higher returns using the "goodwill" of the business. One way to measure that in future years is to include future capital enhancements, especially where they were used in originally determining an acquisition price. It would be totally inconsistent not to include future capital in an assessment of its value in use.

Future capital expenditure will be reflected by adjusting cashflow estimates.

b) *should the assumptions on which cash flow projections are based take into account both past actual cash flows and managements past ability to forecast cash flows accurately. If not, why not?*

Yes

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

Yes, but it further highlights the enormous problems associated with estimated a value in use using these techniques.

Question 4
We agree with the proposals made or have no further comment.

Question 5
We refer to Question 1 above for our comments regarding the testing of goodwill for impairment.

Question 6
The Exposure Draft proposes that reversals of impairment losses recognised for goodwill should be prohibited. Is this appropriate? If not what are the circumstances in which reversals of impairment losses for goodwill should be recognised?

Epic Energy **strongly** disagrees with this proposal.

Epic Energy is a regulated business in that a substantial part of its income is determined by regulatory authorities.

Regulation in Australia is at a delicate stage of development. IAS 36, as it is currently drafted, would lead to significant reporting concerns for such organisations. A nominated rate of return on assets is determined by the regulator and set for a period of five years. Application of IAS 36 could lead to a "cyclical" effect on net assets that are written down today and written up in future periods. The organisation must then wait for the next regulatory reset to obtain a new nominated return that takes into account its costs, including interest rates. This may lead to a write back of the previous write down. This cycle may continue over the life of the asset and yet such assets are viewed by the market as "yield" assets. The market would not understand such "adjustments" and financing of such assets would prove difficult especially for those entities that source capital in the US markets or when the refinancing occurs in the middle of a regulatory cycle (as a write back will not occur for several years).

The purchase of a long life regulated asset is often determined by making assessments of future economic benefits that can be obtained from that asset i.e. goodwill. On acquisition, this will be recorded as such. However, the goodwill will be allocated back to the CGU for annual testing. Using the "value in use" methodology it is feasible that an impairment loss will incur due to the inability of the "regulated" CGU to include those very same "future economic benefits" in its determination of that value or to increase income to recover expenditure already made until a "regulatory reset" occurs. E.g. future capital expenditures leveraging from the original asset. Thus, goodwill is written down as a result of differences in accepted valuation techniques and the methodology allowed under "value in use" for impairment testing.

Question 7
No comment.

IASB ED of Proposed Amendments to IAS 38"Intangible Assets"

Appendix 3a

In terms of the five specific questions posed by the IASB we respond as follows:

Questions 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 Conclusion).

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?

Paragraph 11 of the exposure draft refers to the definition of an intangible asset. The definition in paragraph 7 is as follows:

"An intangible asset is an identifiable non-monetary asset without physical substance"

Paragraph 51 refers to examples of development expenditure that could be classified as intangible assets. Whilst the examples focus on design work, it includes construction activities which are physical assets, albeit not in full production. For clarity the definition of intangible assets should be amended as follows:

"An intangible asset is an identifiable non-monetary asset without physical substance or an identifiable non monetary asset with or without physical substance that constitutes development expenditure as defined in this standard."

The definition of development expenditure should also be expanded to not only include a "plan" or "design" but the construction of test facilities. This will then align to the examples in paragraph 51.

Questions 2 – 5
We agree with the proposals made or have no further comment.