

6 October 2005

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

Dear Sir

ED 139: Proposed Amendments to AASB 3 Business Combinations.

The Institute of Chartered Accountants in Australia (ICAA) welcomes the opportunity to make a submission on ED 139.

Whilst we support a number of the minor proposals in this ED, we do not agree with the fundamental position that fair value accounting should be the basis of accounting for non-purchased goodwill. We do not agree that a fair value can generally be reliably measured for a business when less than 100% is purchased. This is of particular concern in the Australian context where the majority of reporting entities are not listed.

Our view is that the proposals in the ED will result in significant additional costs for entities with less than 100% equity ownership. Given the questionable reliability of the numbers, this increase in cost would not be compensated for by a corresponding increase in the relevance of the information provided.

We are extremely concerned that the IASB is proposing a standard that disregards the criteria of reliable measurement, hence departing fundamentally from the Framework, without due consultation on changes to the Framework. We also note that the IASB itself regards the proposals as contentious, with five members of the IASB disagreeing at least in part with the proposals. Accordingly we request the Business Combinations project not proceed until there has been appropriate consultation, through a Discussion Paper, on any proposed changes to the Framework.

Our detailed comments can be found in the appendix to this letter.

Finally, we appreciated the publication of the AASB's preliminary views in ED 140, and would have found similar views very useful for ED 139. We believe this is an ideal way for the AASB to illustrate thought leadership by circulating views to local businesses and thus eliciting more local comment.

Yours sincerely

A handwritten signature in black ink that reads "Claire Locke". The signature is written in a cursive, flowing style.

Claire Locke CA
Technical Standards Consultant

Appendix

Specific Matters for Comment to AASB

(a) whether constituents support the proposed amendments;

The ICAA does not support the proposed amendments.

(b) whether there are any forms of business combination that are not covered by the revisions but which should be addressed;

We are not aware of any.

(c) any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

- (i) not-for-profit entities;
- (ii) public sector entities; and

Our concern is that the fair value approach to valuing business combinations, and thereby recognising goodwill relating to the minority interest, will be based on unreliable estimates in many cases. We question whether these estimates are sufficient to provide a true and fair view as required by the Corporations Act.

(d) whether the proposals are in the best interests of the Australian economy.

We believe the cost of implementing the proposals outweighs any possible benefits.

IASB Questions

Question 1—Objective, definition and scope

The proposed objective of the Exposure Draft is:

...that all business combinations be accounted for by applying the acquisition method. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (the acquiree). In accordance with the acquisition method, the acquirer measures and recognises the acquiree, as a whole, and the assets acquired and liabilities assumed at their fair values as of the acquisition date.

The objective provides the basic elements of the acquisition method of accounting for a business combination (formerly called the purchase method) by describing:

(a) what is to be measured and recognised. An acquiring entity would measure and recognise the acquired business at its fair value, regardless of the percentage of the equity interests of the acquiree it holds at the acquisition date. That objective also provides the foundation for determining whether specific assets acquired or liabilities assumed are part of an acquiree and would be accounted for as part of the business combination.

(b) when to measure and recognise the acquiree. Recognition and measurement of a business combination would be as of the acquisition date, which is the date the acquirer obtains control of the acquiree.

(c) the measurement attribute as fair value, rather than as cost accumulation and allocation. The acquiree and the assets acquired and liabilities assumed would be measured at fair value as of the acquisition date, with limited exceptions.

Consequently, the consideration transferred in exchange for the acquiree, including contingent consideration, would also be measured at fair value as of the acquisition date.

The objective and definition of a business combination would apply to all business combinations in the scope of the proposed IFRS, including business combinations:

- (a) involving only mutual entities
- (b) achieved by contract alone
- (c) achieved in stages (commonly called step acquisitions)
- (d) in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at the acquisition date.

(See paragraphs 52-58 and paragraphs BC42-BC46 of the Basis for Conclusions.)

Question 1—Are the objective and the definition of a business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?

We agree they are appropriate.

Question 2—Definition of a business

The Exposure Draft proposes to define a *business* as follows:

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:

- (1) a return to investors, or
- (2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants. [paragraph 3(d)]

Paragraphs A2-A7 of Appendix A provide additional guidance for applying this definition. The proposed IFRS would amend the definition of a business in IFRS 3. (See paragraphs BC34-BC41.)

Question 2—Are the definition of a business and the additional guidance appropriate and sufficient for determining whether the assets acquired and the liabilities assumed constitute a business? If not, how would you propose to modify or clarify the definition or additional guidance?

We agree they are appropriate for the for-profit sector. Additional guidance is required for the not-for-profit sector.

Questions 3-7—Measuring the fair value of the acquiree

The Exposure Draft proposes that in a business combination that is an exchange of equal values, the acquirer should measure and recognise 100 per cent of the fair value of the acquiree as of the acquisition date. This applies even in business combinations in which the acquirer holds less than 100 per cent of the equity interests in the acquiree at that date. In those business combinations, the acquirer would measure and recognise the non-controlling interest as the sum of the non-controlling interest's proportional interest in the acquisition-date values of the identifiable assets acquired and liabilities assumed plus the goodwill attributable to the non-controlling interest. (See paragraphs 19, 58 and BC52-BC54.)

Question 3—In a business combination in which the acquirer holds less than 100 per cent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognise 100 per cent of the acquisition-date fair value of the acquiree, including 100 per cent of the values of identifiable assets acquired, liabilities assumed and goodwill, which would include the goodwill attributable to the non-controlling interest? If not, what alternative do you propose and why?

We do not agree it is appropriate to recognise 100% of the equity interests of the acquiree at acquisition date. Whilst conceptually recognising 100% of the interests is consistent with the concept of the group as a single entity, the reality is that a business often does not have a fair value that can be measured reliably other than by purchase price. A business is worth what an acquirer will pay for it, and in any case no two acquirers or acquirees are identical.

We propose that only purchased goodwill be recognised, as this can be measured reliably. We are also concerned that recognising goodwill that has not been purchased (the minority interest share) is inconsistent with IAS 38 Intangible Assets, which prohibits the recognition of similar internally generated assets.

We support the proposed clarification that 100% of all assets and liabilities acquired be recognised. We do not extend this to goodwill as goodwill is not an asset that can be separately measured; rather, it is the residual.

The Exposure Draft proposes that a business combination is usually an arm's length transaction in which knowledgeable, unrelated willing parties are presumed to exchange equal values. In such transactions, the fair value of the consideration transferred by the acquirer on the acquisition date is the best evidence of the fair value of the acquirer's interest in the acquiree, in the absence of evidence to the contrary.

Accordingly, in most business combinations, the fair value of the consideration transferred by the acquirer would be used as the basis for measuring the acquisition date fair value of the acquirer's interest in the acquiree. However, in some business combinations, either no consideration is transferred on the acquisition date or the evidence indicates that the consideration transferred is not the best basis for measuring the acquisition-date fair value of the acquirer's interest in the acquiree. In those business combinations, the acquirer would measure the acquisition-date fair value of its interest in the acquiree and the acquisition-date fair value of the acquiree using other valuation techniques. (See paragraphs 19, 20 and A8-A26, Appendix E and paragraphs BC52-BC89.)

Question 4—Do paragraphs A8-A26 in conjunction with Appendix E provide sufficient guidance for measuring the fair value of an acquiree? If not, what additional guidance is needed?

As our view is that in many cases the fair value of the acquiree cannot be estimated reliably, the guidance cannot be sufficient.

In the Australian context the majority of reporting entities are not listed entities. There is little guidance for these entities. We anticipate these entities are likely to simply gross up the purchase price to estimate fair value, and question whether the resulting information will be relevant or reliable.

The Exposure Draft proposes a presumption that the best evidence of the fair value of the acquirer's interest in the acquiree would be the fair values of all items of consideration transferred by the acquirer in exchange for that interest measured as of the acquisition date, including:

- (a) contingent consideration;
- (b) equity interests issued by the acquirer; and
- (c) any non-controlling equity investment in the acquiree that the acquirer owned immediately before the acquisition date.

(See paragraphs 20-25 and BC55-BC58.)

Question 5—Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?

Given we do not believe fair value can be reliably estimated, we would support the view that purchase price is the best estimate of fair value.

In terms of the proposals, we do not believe measuring the fair value of contingent consideration at acquisition date is reliable. Often contingent consideration is negotiated because the acquirer and acquiree cannot agree on the purchase price.

The Exposure Draft proposes that after initial recognition, contingent consideration classified as:

- (a) equity would not be remeasured.
- (b) liabilities would be remeasured with changes in fair value recognised in profit or loss unless those liabilities are in the scope of IAS 39 *Financial Instruments: Recognition and Measurement* or [draft] IAS 37 *Non-financial Liabilities*. Those liabilities would be accounted for after the acquisition date in accordance with those IFRSs.

(See paragraphs 26 and BC64-BC89.)

Question 6—Is the accounting for contingent consideration after the acquisition date appropriate? If not, what alternative do you propose and why?

We believe the contingent consideration should be remeasured after acquisition date and the cost value of the acquisition adjusted. This is in the nature of revising an estimate.

The Exposure Draft proposes that the costs that the acquirer incurs in connection with a business combination (also called acquisition-related costs) should be excluded from the measurement of the consideration transferred for the acquiree because those costs are not part of the fair value of the acquiree and are not assets. Such costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; the cost of issuing debt and equity instruments; and general administrative costs, including the costs of maintaining an internal acquisitions department. The acquirer would account for those costs separately from the business combination accounting.

(See paragraphs 27 and BC84-BC89.)

Question 7—Do you agree that the costs that the acquirer incurs in connection with a business combination are not assets and should be excluded from the measurement of the consideration transferred for the acquiree? If not, why?

Under the fair value model we would agree that the costs should be excluded.

However, under the cost model we support, the costs should form part of the cost of the acquisition, as they are part of the consideration the acquirer is willing to pay to acquire the acquiree.

Questions 8 and 9—Measuring and recognising the assets acquired and the liabilities assumed

The Exposure Draft proposes that an acquirer measure and recognise as of the acquisition date the fair value of the assets acquired and liabilities assumed as part of the business combination, with limited exceptions. (See paragraphs 28-41 and BC111- BC116.) That requirement would result in the following significant changes to accounting for business combinations:

- (a) Receivables (including loans) acquired in a business combination would be measured at fair value. Therefore, the acquirer would not recognise a separate valuation allowance for uncollectible amounts as of the acquisition date.
- (b) An identifiable asset or liability (contingency) would be measured and recognised at fair value at the acquisition date even if the amount of the future economic benefits embodied in the asset or required to settle the liability are contingent (or conditional) on the occurrence or non-occurrence of one or more uncertain future events. After initial recognition, such an asset would be accounted for in accordance with IAS 38 *Intangible Assets* or IAS 39 *Financial Instruments: Recognition and Measurement*, as appropriate, and such a liability would be accounted for in accordance with [draft] IAS 37 or other IFRSs as appropriate.

Question 8—Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose?

We agree with the proposal in principle and the specific items above. However, we believe there are some items, particularly intangible assets, where it may not be possible to measure fair value reliably. We do not believe the pursuit of the fair value ideal is sufficient reason to present unreliable information.

The Exposure Draft proposes limited exceptions to the fair value measurement principle. Therefore, some assets acquired and liabilities assumed (for example, those related to deferred taxes, assets held for sale, or employee benefits) would continue to be measured and recognised in accordance with other IFRSs rather than at fair value. (See paragraphs 42-51 and BC117-BC150.)

Question 9—Do you believe that these exceptions to the fair value measurement principle are appropriate? Are there any exceptions you would eliminate or add? If so, which ones and why?

As mentioned above, exceptions are where fair value cannot be measured reliably. For consistency we also believe the treatment under IFRS 3 should be consistent with the treatment in the other standards until such time as the other standards are amended.

Questions 10-12—Additional guidance for applying the acquisition method to particular types of business combinations

The Exposure Draft proposes that, for the purposes of applying the acquisition method, the fair value of the consideration transferred by the acquirer would include the fair value of the acquirer's non-controlling equity investment in the acquiree at acquisition date that the acquirer owned immediately before the acquisition date. Accordingly, in a business combination achieved in stages (step acquisition) the acquirer would remeasure its non-controlling equity investment in the acquiree at fair value as of the acquisition date and recognise any gain or loss in profit or loss. If, before the business combination, the acquirer recognised changes in the value of its non-controlling equity investment directly in equity (for example, the investment was designated as available for sale), the amount that was recognised directly in equity would be reclassified and included in the calculation of any gain or loss as of the acquisition date. (See paragraphs 55, 56 and BC151-BC153.)

Question 10—Is it appropriate for the acquirer to recognise in profit or loss any gain or loss on previously acquired non-controlling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?

We do not agree that this is appropriate, as we do not believe the acquirer is better or worse off as a result of obtaining control. If the fair value model is applied, remeasuring the acquiree to fair value is appropriate, but we propose the adjustment should be to equity.

The Exposure Draft proposes that in a business combination in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest (referred to as a bargain purchase) any excess of the fair value of the acquirer's interest in the acquiree over the fair value of the consideration transferred for that interest would reduce goodwill until the goodwill related to that business combination is reduced to zero, and any remaining excess would be recognised in profit or loss on the acquisition date. (See paragraphs 59-61 and paragraphs BC164-BC177.) However, the proposed IFRS would not permit the acquirer to recognise a loss at the acquisition date if the acquirer is able to determine that a portion of the consideration transferred represents an overpayment for the acquiree. The boards acknowledge that an acquirer might overpay to acquire a business, but they concluded that it is not possible to measure such an overpayment reliably at the acquisition date. (See paragraph BC178.)

Question 11—Do you agree with the proposed accounting for business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest? If not, what alternative do you propose and why?

Yes, we agree.

Question 12—Do you believe that there are circumstances in which the amount of an overpayment could be measured reliably at the acquisition date? If so, in what circumstances?

We do not believe there would be any value in estimating the amount of an overpayment.

Question 13—Measurement period

The Exposure Draft proposes that an acquirer should recognise adjustments made during the measurement period to the provisional values of the assets acquired and liabilities assumed as if the accounting for the business combination had been completed at the acquisition date. Thus, comparative information for prior periods presented in financial statements would be adjusted, including any change in depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting. (See paragraphs 62-68 and BC161-BC163.)

Question 13—Do you agree that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments? If not, what alternative do you propose and why?

We believe these are in the nature of changes in accounting estimates, and should be recognised in the period the change is made for consistency with IAS 8.

In any event, we do not support prior period adjustments against comparatives that could have a profit impact except in rare circumstances. Historically such methods have been used to hide losses.

Question 14—Assessing what is part of the exchange for the acquiree

The Exposure Draft proposes that an acquirer assess whether any portion of the transaction price (payments or other arrangements) and any assets acquired or liabilities assumed or incurred are not part of the exchange for the acquiree. Only the consideration transferred by the acquirer and the assets acquired or liabilities assumed or incurred that are part of the exchange for the acquiree would be included in the business combination accounting. (See paragraphs 69, 70, A87-A109 and BC154- BC160.)

Question 14—Do you believe that the guidance provided is sufficient for making the assessment of whether any portion of the transaction price or any assets acquired and liabilities assumed or incurred are not part of the exchange for the acquiree? If not, what other guidance is needed?

We agree with the proposals.

Question 15—Disclosures

The Exposure Draft proposes broad disclosure objectives that are intended to ensure that users of financial statements are provided with adequate information to enable them to evaluate the nature and financial effects of business combinations. Those objectives are supplemented by specific minimum disclosure requirements. In most instances, the objectives would be met by the minimum disclosure requirements that follow each of the broad objectives. However, in some circumstances, an acquirer might be required to disclose additional information necessary to meet the disclosure objectives. (See paragraphs 71-81 and BC200-BC203.)

Question 15—Do you agree with the disclosure objectives and the minimum disclosure requirements? If not, how would you propose amending the objectives or what disclosure requirements would you propose adding or deleting, and why?

We agree with the proposals.

Questions 16-18—The IASB's and the FASB's convergence decisions

The Exposure Draft is the result of the boards' projects to improve the accounting for business combinations. The first phase of those projects led to the issue of IFRS 3 and FASB Statement No. 141. In 2002, the FASB and the IASB agreed to reconsider jointly their guidance for applying the purchase method of accounting, which the Exposure Draft calls the acquisition method, for business combinations. An objective of the joint effort is to develop a common and comprehensive standard for the accounting for business combinations that could be used for both domestic and cross-border financial reporting. Although the boards reached the same conclusions on the fundamental issues addressed in the Exposure Draft, they reached different conclusions on a few limited matters. Therefore, the IASB's version and the FASB's version of the Exposure Draft provide different guidance on those limited matters. A comparison, by paragraph, of the different guidance provided by each board accompanies the draft IFRS. Most of the differences arise because each board decided to provide business combinations guidance that is consistent with its other standards. Even though those differences are candidates for future convergence projects, the boards do not plan to eliminate those differences before final standards on business combinations are issued. The joint Exposure Draft proposes to resolve a difference between IFRS 3 and SFAS 141 relating to the criteria for recognising an intangible asset separately from goodwill. Both boards concluded that an intangible asset must be identifiable (arising from contractual-legal rights or separable) to be recognised separately from goodwill.

In its deliberations that led to SFAS 141, the FASB concluded that, when acquired in a business combination, all intangible assets (except for an assembled workforce) that are identifiable can be measured with sufficient reliability to warrant recognition separately from goodwill. In addition to the identifiability criterion, IFRS 3 and IAS 38 required that an intangible asset acquired in a business combination be reliably measurable to be recognised separately from goodwill. Paragraphs 35-41 of IAS 38 provide guidance for determining whether an intangible asset acquired in a business combination is reliably measurable. IAS 38 presumes that the fair value of an intangible asset with a finite useful life can be measured reliably. Therefore, a difference between IFRS 3 and SFAS 141 would arise only if the intangible asset has an indefinite life. The IASB decided to converge with the FASB in the Exposure Draft by:

- (a) eliminating the requirement that an intangible asset be reliably measurable to be recognised separately from goodwill; and
- (b) precluding the recognition of an assembled workforce acquired in a business combination as an intangible asset separately from goodwill.

(See paragraphs 40 and BC100-BC102.)

Question 16—Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:

- (a) *the intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability; and*
- (b) *cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?*

Our constituents tell us there are difficulties valuing intangible assets.

For the joint Exposure Draft, the boards considered the provisions of IAS 12 *Income Taxes* and FASB Statement No. 109 *Accounting for Income Taxes*, relating to an acquirer's deferred tax benefits that become recognisable because of a business combination. IAS 12 requires the acquirer to recognise separately from the business combination accounting any changes in its deferred tax assets that become recognisable because of the business combination. Such changes are recognised in post-combination profit or loss, or equity. On the other hand, SFAS 109 requires any recognition of an acquirer's deferred tax benefits (through the reduction of the acquirer's valuation allowance) that results from a business combination to be accounted for as part of the business combination, generally as a reduction of goodwill. The FASB decided to amend SFAS 109 to require the recognition of any changes in the acquirer's deferred tax benefits (through a change in the acquirer's previously recognised valuation allowance) as a transaction separately from the business combination. As amended, SFAS 109 would require such changes in deferred tax benefits to be recognised either in income from continuing operations in the period of the combination or directly to contributed capital, depending on the circumstances. Both boards decided to require disclosure of the amount of such acquisition-date changes in the acquirer's deferred tax benefits in the notes to the financial statements.

(See paragraphs D4 and BC119-BC129.)

Question 17—Do you agree that any changes in an acquirer's deferred tax benefits that become recognisable because of the business combination are not part of the fair value of the acquiree and should be accounted for separately from the business combination? If not, why?

We agree.

The boards reconsidered disclosure requirements in IFRS 3 and SFAS 141 for the purposes of convergence. For some of the disclosures, the boards decided to converge. However, divergence continues to exist for some disclosures as described in the accompanying note *Differences between the Exposure Drafts published by the IASB and the FASB*. The boards

concluded that some of this divergence stems from differences that are broader than the Business Combinations project.

Question 18—Do you believe it is appropriate for the IASB and the FASB to retain those disclosure differences? If not, which of the differences should be eliminated, if any, and how should this be achieved?

We fully support convergence with the FASB.

Question 19—Style of the Exposure Draft

The Exposure Draft was prepared in a style similar to the style used by the IASB in its standards in which paragraphs in bold type state the main principles. All paragraphs have equal authority.

Question 19—Do you find the bold type-plain type style of the Exposure Draft helpful? If not, why? Are there any paragraphs you believe should be in bold type, but are in plain type, or vice versa?

We do find it useful to differentiate between the principles and guidance.