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12 May 2014

The Chairman
The International Accounting Standards Board
30 Cannon Street
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UK

CC Australian Accounting Standards Board

By email

Dear Sir

Re: Post-implementation Review: IFRS 3 Business Combinations

Westworth Kemp Consultants (www.westworthkemp.com.au) value the opportunity to provide feedback into the post-implementation review of IFRS 3.

General introductory comments

The questions raised on the post implementation review of IFRS 3 would be easier to answer if there was already a generally accepted conceptual foundation for accounting, answering such questions as: what is a balance sheet for? Is it a repository of unamortised cost (historical cost); is it to be used for bank security or to give owners a sense of the values that might be achieved if the entity had to be sold as bits; is it a dynamic statement of anticipated cash flows (fair value) and can or should it give alternative use values if higher than value in use to illustrate lost opportunities? The answers to these questions tend to dictate one's response to other accounting issues. For business combinations the commercially useful answer in a dynamic business is either fair value or value in use, but there is also a place for security values and alternative use values. Should these be items for disclosure?

Question 1 – who we are and our interest in the project

We are a boutique consultancy, based in Sydney, Australia, specialising in financial reporting, assurance and compliance issues, particularly in the context of litigation and dispute resolution and we also provide advice to clients on the application of financial reporting standards. We do not prepare financial statements, but we have analysed financial statements prepared under the 2004 version of IFRS 3 and advised clients on the application of the 2008 version.

Question 2 – Definition of a business

(a) Are there benefits of having separate accounting treatments for business combinations and asset acquisitions? If so, what are these benefits?

Separate accounting treatments for business combinations and asset acquisitions in their simplest form are unavoidable. If goodwill is "An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised" (AASB Glossary) there is no place for it in an asset acquisition, and so the consideration paid for the asset must be the agreed value of that asset. If that amount is greater than fair value, it needs to be written off as impairment, as the asset would be held at greater than its recoverable amount. A business combination, however, involves a bundle of assets and liabilities and opens the possibility of the existence of goodwill.

(b) What are the main practical implementation, auditing or enforcement challenges you face when assessing a transaction to determine whether it is a business? For the practical implementation challenges that you have indicated, what are the main considerations that you take into account in your assessment?

In some cases, it is hard to decide whether one is dealing with a single asset or a business. The prime example is a complex building held as an investment property - as the building comprises the structure, machinery with in it, maintenance staff and something akin to goodwill if that building is being managed by a well-known manager like Westfield. Applying the guidance, there is no clear line differentiating an asset from a business, giving rise to opportunities for structuring and obtaining a preferred accounting treatment. In our view the definition is quite clear, but paragraph B7 of the Guidance reduces that clarity and should be removed.

Question 3 – Fair value

(a) To what extent is the information derived from the fair value measurements relevant and the information disclosed about fair value measurements sufficient? If there are deficiencies, what are they?

Information derived from fair value measurements is relevant within the terms of the conceptual framework, particularly when the acquisition relates to a business that has not changed hands in many years and has been using historical cost information. Deficiencies in fair value measurement include "Day 2" issues, different experts having a range of opinions of fair value methodology and the objectivity and quality of data inputs to the model. These deficiencies do not however ultimately outweigh the benefits of some sort of contemporaneous value, whether market value or value in use. Fair value does establish for users a means of measuring the transaction and its implications for the entity in which they are investing.

(b) What have been the most significant valuation challenges in measuring fair value within the context of business combination accounting? What have been the most significant challenges when auditing or enforcing those fair value measurements?

Ascertaining the fair value of unusual assets always presents practical problems, and while specialised valuers exist, smaller entities may resist paying for valuations. Practical problems include: isolating reliable revenue streams on which to base the valuation model; attributing costs; assessing value in the context of the new owner's strategies; and assessing contingent outcomes. Another challenge we have seen, however, is a reluctance on the part of management to accept that the fair value of assets acquired in a business combination may in certain circumstances fall dramatically not long after acquisition. This is however a human problem that cannot be solved by accounting standards.

(c) Has fair value measurement been more challenging for particular elements; for example, specific assets, liabilities, consideration, etc?

In our experience, establishing the fair value of liabilities and contingent liabilities can be particularly challenging. The concept of the fair value of a liability or contingent liability being the amount it would be reasonable to pay a third party to assume that liability presents challenges where there are differing views as to how remote the contingency actually is. A further challenge is the inconsistency between the recognition of probability-based liabilities for contingencies in an acquisition situation, but not in stand alone accounts. We suspect the answer to this conundrum may lie in the liability recognition criteria in the conceptual framework. Once the recognition criteria are settled, a liability should qualify for recognition or not, regardless of the context in which it is recognised.

The measurement of contingent consideration without the ability to alter the goodwill later has also been challenging, but has probably been beneficial overall as it forces management to think carefully about what they really think the consideration, including contingent elements, is worth in today's terms.

Question 4 – goodwill and indefinite life intangibles

(a) Do you find the separate recognition of intangible assets useful? If so, why? How does it contribute to your understanding and analysis of the acquired business? Do you think changes are needed and, if so, what are they and why?

The encouragement to separately recognise intangibles has been generally helpful as in our experience it has encouraged acquirers and subsequent decision makers to analyse more deeply exactly what they are buying in a business combination. For example, the reasoning of "We paid x for a brand – is it performing, can it be optimised, could/should we sell it, are we good at making but not selling etc are all questions that can flow from more detailed information about intangible assets acquired.

(b) What are the main implementation, auditing or enforcement challenges in the separate recognition of intangible assets from goodwill? What do you think are the main causes of those challenges?

We have seen two main challenges. The first is that having teased out the identifiable intangibles, they then need to be assigned their fair value. In the case of some assets of a type that is not often sold, such as customer lists, this can be difficult. Furthermore, the value of a good customer list in the hands of a prior owner can quickly dissipate under new management. The second is that there is inconsistency between how such identifiable intangible assets are treated on acquisition and how they are treated in standalone financial statements. Allowing an asset to be recognised on acquisition but not within the standalone financial statements of the creator of the asset is inconsistent. As with liabilities, application of the recognition criteria for assets should be consistent across entities.

(c) How useful do you find the recognition of negative goodwill in profit or loss and the disclosures about the underlying reasons why the transaction resulted in a gain?

We have encountered no difficulties with this aspect of the standard. We have difficulty understanding the concept of negative goodwill in the context of fair market valuations.

Question 5 – non-amortisation of goodwill and indefinite intangibles

(a) How useful have you found the information obtained from annually assessing goodwill and intangible assets with indefinite useful lives for impairment, and why?

Impairment of goodwill and intangibles is good in theory, but in practice there seems to be a lag between events giving rise to impairment and the recognition of that impairment in the financial statements. We are aware of many instances where this has occurred and the market reflected a reduction in company value before impairment was recognised, including instances where impairment was only recognised shortly before the entity ceased to trade.

(b) Do you think that improvements are needed regarding the information provided by the impairment test? If so, what are they?

We are starting to question whether replacing amortisation with impairment has been effective and has improved the quality of financial reporting.

(c) What are the main implementation, auditing or enforcement challenges in testing goodwill or intangible assets with indefinite useful lives for impairment, and why?

The main challenge appears to be the complexity of the impairment calculation. Amortization of goodwill may not have produced such reliable and relevant information, but it was simple to apply. It was a practical answer reflecting the fact that without amortisation acquired goodwill is gradually replaced by internally generated goodwill. Traditionally internally generated goodwill has not been recognised because it is incapable of objective measurement. We are seeing the impairment of acquired goodwill as being subject to the same sorts of frailties, such as management optimism and the lack of an objective market value for the business acquired, once it has been absorbed by the acquirer.

Question 6 – non-controlling interests

(a) How useful is the information resulting from the presentation and measurement requirements for NCIs? Does the information resulting from those requirements reflect the claims on consolidated equity that are not attributable to the parent? If not, what improvements do you think are needed?
(b) What are the main challenges in the accounting for NCIs, or auditing or enforcing such accounting? Please specify the measurement option under which those challenges arise.

To help us assess your answer better, we would be grateful if you could please specify the measurement option under which you account for NCIs that are present ownership interests and whether this measurement choice is made on an acquisition-by-acquisition basis.

Paragraph 19(b) is consistent with Australian practice and reflects the claims on consolidated equity that are not attributable to the parent. It also provides a relatively simple and auditable method of arriving at NCI.

(a) How useful do you find the information resulting from the step acquisition guidance in IFRS 3? If

any of the information is unhelpful, please explain why.

(b) How useful do you find the information resulting from the accounting for a parent's retained investment upon the loss of control in a former subsidiary? If any of the information is unhelpful, please explain why.

We welcome the introduction of clear requirements in this area hinging on the passing of control.

Question 8 – disclosures

(a) Is other information needed to properly understand the effect of the acquisition on a group? If so, what information is needed and why would it be useful?
(b) Is there information required to be disclosed that is not useful and that should not be required? Please explain why.
(c) What are the main challenges to preparing, auditing or enforcing the disclosures required by IFRS 3 or by the related amendments, and why?

In our view the prescribed disclosures relating to acquisitions are helpful. We have encountered financial statements in the course of our work where disclosures relating to acquisitions are missing and have felt the lack of that information.

Question 9 – other matters

Are there other matters that you think the IASB should be aware of as it considers the PiR of IFRS 3?
The IASB is interested in:
(a) understanding how useful the information that is provided by the Standard and the related amendments is, and whether improvements are needed, and why;
(b) learning about practical implementation matters, whether from the perspective of applying, auditing or enforcing the Standard and the related amendments; and
(c) any learning points for its standard-setting process.

We have seen instances where consolidated information generated as a result of a business combination may not be the most useful information for all the users. Summarised financial information about material subsidiaries in which there is a material NCI would give all stakeholders useful information about both that entity and the group. Such disclosure would give more information about the rights in the assets and liabilities underpinning the consolidation. If external parties own 49% of one of your assets, you may control it, but you are subject to constraints as to how you can use that asset and share the benefits derived from it.

There has also been an interesting interaction with the new IFRS 10. Under the new IFRS 10, parent/subsidiary relationships need to be reassessed and from time to time an entity is assessed to be a subsidiary that used to be classified as an associate. The question arises as to whether this re-evaluation of the application of the accounting policy under the new IFRS 10 has to be treated as an acquisition under AASB 3 and how the transitional provisions should be applied when there has been no change in ownership.

Question 10 – effects

From your point of view, which areas of IFRS 3 and related amendments:
(a) represent benefits to users of financial statements, preparers, auditors and/or enforcers of

financial information, and why;

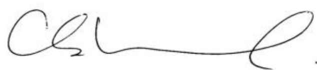
(b) have resulted in considerable unexpected costs to users of financial statements, preparers, auditors and/or enforcers of financial information, and why; or

(c) have had an effect on how acquisitions are carried out (for example, an effect on contractual terms)?

Hitherto, we have noticed fewer changes than we anticipated. Increased costs to preparers are as much due to increased expectations of governance (leading to the use of external valuers, for example) as to changes in the wording of the standard..

If you wish to discuss any of these matters further, please contact me at chris@westworthkemp.com.au.

Yours faithfully



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