Australian Government

Australian Accounting Standards Board

Level 4, 530 Collins Street
MELBOURNE VIC 3000
Postal Address
PO Box 204
Collins Street West VIC 8007
Telephone: (03) 9617 7600
Facsimile: (03) 9617 7608

28 November 2005

Mr Alan Teixeira
Senior Project Manager
The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Alan

Amendments to IFRS 3 *Business Combinations*

The Australian Accounting Standards Board (AASB) is pleased to submit its comments regarding the ED of Proposed Amendments to IFRS 3 *Business Combinations* (ED IFRS 3).

The AASB sought the views of Australian constituents and has considered the constituent responses received in formulating its comments.

The AASB strongly agrees with the proposed amendments in ED IFRS 3 on the basis that the mixed measurement model currently underpinning IFRS 3 is not satisfactory and that the approach being proposed in ED IFRS 3 will enable a number of issues to be addressed that have so far remained unresolved.

Paragraphs A8-A26 and Appendix E do not however provide sufficient guidance for measuring the fair value of an acquiree, particularly in circumstances where the acquirer holds less than 100 per cent of the equity interests of the acquiree. The full goodwill method represents a significant change from current practice. Consequently, additional guidance is necessary to ensure the consistent application of the fair value approach. This is particularly the case where the acquiree has special characteristics, which have been paid for by the acquirer. Additional guidance on the treatment of acquisition-related costs such as stamp duties (transfer taxes), and the disclosure of loan provisions is also required.

The IASB should also seek to address a number of related issues as a matter of priority, in particular the treatment of business combinations involving entities under common control and fresh start accounting.

In addition, the AASB has concerns regarding the proposed definition of non-controlling interest as it has the potential to give rise to anomalous accounting treatments in circumstances where all of the equity holders in the combining entities become equity holders in the combined entity, such as in the case of stapled security arrangements. The AASB believes that the IASB should seek to address this particular issue before issuing the Standard.

The AASB's detailed responses to the specific questions accompanying ED IFRS 3 are attached. Also find attached a detailed discussion regarding the additional issues the AASB believes the IASB should seek to address as a matter of priority.

If you have any queries regarding any matters in this submission, please contact Dean Ardern (dardern@aasb.com.au) or myself.

Yours sincerely

David Boymal

David Boymal
Chairman – Australian Accounting Standards Board

Amendments to IFRS 3 *Business Combinations*

***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?*

The AASB believes that the objective and definition of a business combination are appropriate for accounting for all business combinations, subject to consideration of issues raised regarding business combinations involving entities under common control and stapled security arrangements and similar transactions set out in the attached Appendix – Other Issues. However, ED IFRS 3 fails to clarify what 'transitory' means in the context of business combinations involving entities under common control. For instance, should restructuring arrangements involving entities under common control undertaken prior to an initial public offering/float be regarded as transitory and, consequently, be considered to be inside the scope of ED IFRS 3?

The Standard should also clarify whether the exemption for business combinations involving entities under common control should apply to individual separate financial statements in addition to consolidated financial statements.

***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?*

While the proposed definition of a business is appropriate for the purposes of business combinations involving for-profit entities, the definition could be made sector-neutral by including an additional sub-paragraph as follows:

> "(3) for the primary objective of providing goods or services for community or social benefit rather than financial return."

Inclusion of such an amendment would serve to assist those jurisdictions, including Australia and New Zealand, that use IASB Standards for for-profit as well as not-for-profit and public sector entities.

With respect to the actual wording of the proposed definition of a business, it is unclear what purpose the term 'proportionately' serves, especially as it is used in reference to 'owners, members, or participants' in connection with receiving economic benefits. If the definition envisages that different interests might attach to the same business, or that different interests attach to different types of businesses, it may be incorrect to assume that all of these interests have proportionate shares in any distributions they might be entitled to receive as a consequence of their involvement with the business. For instance, economic benefits arising out of synergistic benefits are unlikely to be distributed proportionately, particularly in business combinations involving only mutual entities and business combinations by contract alone. We recommend removing the words 'and proportionately', which does not appear to alter the meaning of the sub-paragraph.

The guidance provided in ED IFRS 3 is appropriate, however further guidance to assist in applying the proposed definition and, in particular, whether individual assets (such as investment properties) should be regarded as a business is required and would assist in promoting the consistent application of the Standard.

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?*

Yes, however the AASB has some concerns regarding the way in which the discussion in paragraphs BC149 and BC150 might be interpreted in relation to Example 4 (para. A63).

The AASB agrees with the IASB that any premium paid by the acquirer for control rights that is included in the full amount of goodwill should be allocated to the acquirer's interests, and not to the non-controlling interest. However, the Board does not believe that alternative (a) described in paragraph BC149 is the appropriate method of allocating the goodwill.

The AASB recommends that the Basis for Conclusions accompanying the Standard incorporate the relevant discussion in relation to "core goodwill" contained in the Basis for Conclusions on ED 3 *Business Combinations* (para. BC97 - BC102). In particular, it is important to distinguish between "going concern goodwill" and "combination goodwill". Applying this to Example 4, the Board would argue that going concern goodwill is $45, being the difference between the fair value of the subsidiary, $195, and the net fair value of the identifiable net assets of the subsidiary, $150. As the earnings from this goodwill will flow to the subsidiary, it will be shared between the parent interest and the non-controlling interest, being $36 to the parent [80% x 45] and $9 to the non-controlling interest [20% x $45]. As the parent paid $160 for its shares in the subsidiary, and the parent's share of the fair value of the subsidiary is $156, then the $4 difference is combination goodwill, and in the absence of evidence that these earnings will flow to both entities, would be allocated to the parent. Goodwill allocated to the parent then totals $40, while goodwill allocated to the non-controlling interest is $9. Hence, if the difference between total goodwill and the going concern element principally comprises the expected synergies and other benefits arising from the business combination, it could be more readily identified and allocated to cash generating units for the purposes of impairment testing by applying this approach.

While it is evident from the discussion in paragraphs BC149 and BC150 that the IASB have adopted a principles-based approach with regards to the allocation of goodwill, this is not clear from the requirements in paragraph 58. Consequently, the AASB is concerned that, without sufficient explanation, guidance in the form of Example 4 might be interpreted and adopted in a rule-like manner.

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?*

Paragraphs A8-A26 and Appendix E do not provide sufficient guidance for measuring the fair value of an acquiree, particularly in circumstances where the acquirer holds less than 100 per cent of the equity interests of the acquiree. The full goodwill method represents a significant change from current practice. Consequently, additional guidance is necessary to ensure the consistent application of the fair value approach. This is particularly the case where the acquiree has special characteristics that have been paid for by the acquirer.

The provision of more comprehensive examples, including examples involving reporting entities that are not listed entities, and accompanying detailed explanations would assist in ensuring the consistent application of the Standard. In addition, clarification as to whether fair value is to be determined on a pre- or post-tax basis would assist in the application of the Standard.

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?*

Yes. To ensure that the Standard clearly conveys this principle, paragraph 18 should emphasise that the acquisition date is a question of fact and, accordingly, the acquisition date may precede or follow the contractual date.

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

Yes.

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?*

The AASB previously expressed its support for a total cost of acquisition approach, wherein the total amount to be recognised is measured based on the total cost to the acquirer, including acquisition-related costs rather than the proposed fair value approach. However, the AASB now believes that, for the sake of conceptual consistency, acquisition costs should be expensed in the context of the fair value approach being proposed. The proposed treatment of acquisition-related costs is however inconsistent with the accounting treatments currently required in other Standards that adopt the fair value approach. For instance,
IAS 40 *Investment Property* requires transaction costs to be included in the initial measurement of investment properties.

To ensure that all Accounting Standards based on the fair value approach treat acquisition-related costs in a consistent manner, the proposed treatment in ED IFRS 3 should be consistent with other relevant Standards.

The treatment of certain items as acquisition costs is an issue that needs further clarification. For instance, in the Australian context, stamp duties (transfer taxes) potentially fall outside of the scope of acquisition-related costs as described in ED IFRS 3. Paragraph BC85 states that the IASB regards acquisition-related costs as separate transactions in which the buyer makes payments in exchange for services rendered. However, no identifiable services are rendered to the acquirer in exchange for the payment of stamp duties (transfer taxes).

***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?*

The AASB agrees in principle with the requirement that acquired receivables, including loans, be measured at their fair values as at the date of acquisition. However, the acquirer should be permitted to disclose loan provisioning in addition to the fair values of any loans acquired if it regards the information as useful.

While contingent assets should be recognised, after initial recognition, items that were previously described as contingent assets that now satisfy the definition of an asset should be accounted for in accordance with the relevant Accounting Standard. Furthermore, not all items described previously as contingent assets would necessarily be intangible assets. For instance, some of these items may be 'monetary' in nature and, therefore, within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

***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?*

The exceptions to the fair value measurement are an important feature of the proposed amendments and that the treatment of exceptions in the Standard should be consistent with their treatments in other Accounting Standards, until such time as the relevant Accounting Standards are amended.

***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?*

Yes, however, any consequential revaluation increments or decrements should be treated in a manner consistent with the way in which any changes in the fair value of the investment were accounted for prior to the acquirer obtaining control. For instance, if the investment had been classified by the acquirer as an available-for-sale financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* prior to gaining control, any gain or loss arising when control is obtained should be recognised in equity. In addition, if the investment had been accounted for in accordance with IAS 28 *Investments in Associates* prior to the acquirer obtaining control, the AASB believes that it is appropriate to recognise in equity any changes in the value of the investment arising when control is obtained. This approach is consistent with the view that any appreciation in the value of the investment subsequent to the acquirer gaining control is likely to be attributable to an appreciation in the value of the acquiree's assets (either recognised or unrecognised) or internally generated goodwill.

The AASB does not therefore agree with the requirement in paragraph 56 to recycle any changes in the value of any non-controlling equity investments previously recognised in equity through the profit or loss.

***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?*

The AASB is of the view that consistent application of the fair value approach would give rise to the recognition of the full amount of goodwill (that is, no reduction) and the total excess of the fair value of the acquirer's interest in the net assets acquired over consideration paid being recognised as a gain. The AASB believes a consistent application of the fair value working principle is preferable.

***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?*

In the majority of cases, an overpayment cannot be reliably measured at acquisition-date. However, the AASB acknowledges that there are some situations in which an overpayment can be reliably measured. For instance, in circumstances where the acquirer conducts insufficient due diligence and subsequently discovers that it has acquired a lesser value of net assets than anticipated.

In addition, paragraph A62 states, in part, that: "The goodwill allocated to the acquirer shall not exceed the total goodwill calculated in accordance with paragraph 49." However, ED IFRS 3 does not address the appropriate treatment where the fair value of the consideration transferred exceeds the acquirer's share of the fair value of the identifiable net assets of the acquiree by an amount greater than the goodwill attributable to the acquirer's interest. For instance, in Example 4 (para. A63), if the fair value of AC's 80% interest in TC is assumed to be 170 (rather than 160), and the maximum goodwill allocatable to AC remains at 45, it is unclear how the additional 5 would be treated. Presumably, the non-controlling interests in TC would not be reduced by 5, but it is unclear whether the 5 should be recognised as some form of 'equity' or considered an overpayment and treated in accordance with paragraph BC178.

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?

This proposal is inconsistent with the requirements in paragraph 32 to 38 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* regarding changes in accounting estimates. To ensure that all changes in accounting estimates are treated in a consistent manner, the Standard should be consistent with the equivalent requirements in IAS 8.

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?

Yes.

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?

Yes.

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?

No. For instance, licences or other rights (such as broadcasting rights) that are acquired from a government may meet the identifiability criterion in paragraph 12 of IAS 38 *Intangible Assets* on the basis that they arise from contractual or other legal rights. However, the cash flows that such licences or rights generate may be indistinguishable from the cash flows that the business generates as a whole on the basis that, without the licence or other right, the business could not continue to operate. Furthermore, by permitting intangible assets acquired in business combinations to be initially recognised even when they are not reliably measurable, the IASB is introducing an inconsistency between the treatment of intangible assets acquired in business combinations and the treatment of intangible assets acquired by alternative means.

***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?*

Yes.

***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?*

For true global comparability of accounting standards, any differences between countries should be kept to an absolute minimum. To this end, AASB fully supports convergence between the IASB and FASB and would be concerned if any differences contributed to the retention of the US GAAP reconciliation for IFRS compliant SEC registrants.

***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?*

Yes. No.

Appendix - Other Issues

Common control and fresh start accounting

The IASB should seek to address the treatment of business combinations involving entities under common control and fresh start accounting as a matter of priority.

Presently, users, auditors and preparers of financial statements are regularly being confronted with various practical accounting issues arising out of business combinations involving entities under common control and situations to which the application of fresh start accounting would be more appropriate. In the absence of authoritative guidance, diverse and/or unacceptable accounting practices are likely to develop, which could serve to undermine the relevance and reliability of general purpose financial reports.

Combinations involving only mutual entities and by contract alone

The proposed definition of non-controlling interest is premised on the parent owning an equity interest in the subsidiary. However, paragraph 6 of ED IFRS 3 envisages business combinations being achieved in several different ways, some of which do not involve the acquirer obtaining equity interests in the acquiree. This discrepancy has the potential to give rise to anomalous accounting treatments in circumstances where there is no ownership interest being acquired by one of the combining entities in another combining entity. For instance, application of the acquisition method to business combinations by contract alone, such as stapled security arrangements, can result in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree being classified in the consolidated financial statements as minority interests. However, the economic substance of stapled security arrangements is that there is no 'minority' interest. Normally, the equity holders in the combining entities become equity holders in the combined entity and, therefore, have an interest in the results and net assets of all of the combined entities.

The AASB recommends that the IASB reconsider the proposed definition of non-controlling interest as follows:

> that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, of the *ownership group of the parent.*

We note that this definition is consistent with the guidance in paragraphs A119-A120 for reverse acquisitions. We also note that this definition is similar to the definition of 'outside equity interest' as described in AASB 1024 *Consolidated Accounts* (Issued September 1991), which was superseded by AASB 3 *Business Combinations*. AASB 1024 defined outside equity interest as:

> "...the equity in the economic entity other than that which can be attributed to the ownership group of the parent entity."

In line with the scope of ED IFRS 3, the definition of non-controlling interest should focus on the equity holders that do not have an interest in the results and net assets of the parent and/or combined entity rather than the non-controlling ownership interest in the subsidiary. This is likely to make consolidated financial statements more useful, particularly to equity holders in business combinations by contract alone such as stapled security arrangements.

In addition, the IASB should include more guidance regarding business combinations by contract alone in the Standard. For instance, while ED IFRS 3 provides some guidance with respect to the treatment of the fair value of the acquiree in the context of business combinations involving mutual entities (i.e. para. 53 and BC180 – BC197), no equivalent guidance is provided for business combinations by contract alone (i.e. para. 54 and BC198 – BC199). Furthermore, some of the guidance provided in respect of business combinations involving only mutual entities could be expressed more clearly. For instance, paragraph 53 requires that:

> "…the amount equal to the fair value of the acquiree shall be recognised as a direct addition to capital or equity, not retained earnings."

However, in accordance with IAS 1 *Presentation of Financial Statements*, retained earnings are a component of equity.

The AASB is of the view that business combinations by contract alone and business combinations involving mutual entities are, in substance, the same type of business combination and, therefore, should be accounted for in a similar manner. However, ED IFRS 3 distinguishes between the two forms of business combinations for the purposes of discussion and guidance and requires the two forms of business combinations to be treated differently. For instance, paragraph 53 requires that the amount equal to the fair value of the acquiree be recognised as a direct addition to equity in business combinations involving only mutual entities. In contrast, paragraph 54 requires the fair value of the acquiree to be recognised as non-controlling interests for combinations by contract alone. In addition, as noted above, the AASB believes that the economic substance of business combinations by contract alone such as stapled security arrangements is that there is no 'minority' interest.

If the Standard requires business combinations by contract alone and business combinations involving only mutual entities to be treated differently, the AASB believes that the accompanying Basis for Conclusions should provide an explanation of the IASB's reasoning.