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21 September 2005
Our Ref: FB:DR

Dear David

ED 139 'Proposed Amendments to AASB 3 *Business Combinations*'

Deloitte Australia welcomes the opportunity to comment on the proposals contained in Exposure Draft ED 139 'Proposed Amendments to AASB 3 *Business Combinations*' (ED 139 or the 'exposure draft').

The purpose of our submission is to provide our views on the various matters discussed in ED 139 to assist the Australian Accounting Standards Board (AASB) in making its own submission to the IASB on the proposals, with the ultimate objective of developing a converged AASB Accounting Standard that is consistent with the proposed revised IFRS 3 *Business Combinations*.

Whilst we appreciate the conceptual basis for the proposals in ED 139, we do have some significant reservations as to their practical implementation. In particular:

- the requirement to determine the fair value of the acquiree as a whole where less than a 100% ownership interest is obtained, is subjective
- the determination of the fair value of acquired intangible assets is complex under the current requirements and the proposed removal of the 'reliable measurement' criterion for intangible assets will further exacerbate these difficulties
- the new fair value requirements combined with the proposed tightening of the 'measurement period' for business combinations does not reflect the commercial realities of the pricing and execution of many business combinations

Ultimately, any Australian Accounting Standard issued by the AASB as a result of ED 139 must continue to fully maintain Australia's convergence with International Financial Reporting Standards. Whilst this is self-evident, it is incumbent upon the AASB to be a

vocal supporter at the international level of pragmatic and rational solutions to the issues that have the greatest impact on Australian entities.

We also note that the comment period for ED 139 is poorly timed. With the transition to Australian equivalents to International Financial Reporting Standards (A-IFRS) in full swing, the majority of Australian entities are currently focussed on either full A-IFRS reporting in half-year financial reports, or alternatively finalising transition projects and full-year financial report disclosures under AASB 1047 *Disclosure of the Impacts of First-Time Adoption of Australian Equivalents to International Financial Reporting Standards*.

As a result, many entities may not have had a suitable opportunity to fully consider the proposals in relation to accounting for business combinations, and the consequential proposed amendments to accounting for consolidations and provisions. It has also diverted the resources of the major accounting firms over this same period and reduced the opportunity for us to engage our clients in debate over the proposals in order to identify more of the practical issues surrounding the exposure drafts. We therefore suggest that the AASB request the IASB and FASB to extend the comment period on these proposals in order to elicit more complete feedback from constituents.

Due to the later submission deadline for the equivalent IASB exposure drafts, the global firm of Deloitte Touche Tohmatsu has not finalised its views in relation to the matters raised. Furthermore, in this letter we have highlighted issues and concerns in the Australian context that may not have the same degree of relevance internationally or which may not be considered of sufficient significance to warrant separate comment by the global firm of Deloitte in its submission. Therefore, the views presented in this document should be read in this context and may not necessarily represent the view of the global firm of Deloitte.

If you have any questions concerning our comments, please contact Darryn Rundell on (03) 9208 7916.

Yours sincerely

Darryn Rundell
Partner

MATTERS FOR SPECIFIC COMMENT – IASB

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?

Whilst we understand the conceptual basis for the objective and definition of business combinations, we do have some concerns as to their practical application. These are outlined throughout this letter in response to the various questions asked.

Set out below are some general comments on the objectives, definition and scope of the proposed IFRS 3.

Fair value measurement attribute

We have some concerns as to the practical application of the measurement attribute being fair value rather than a cost accumulation and allocation (in particular, refer to our response to Questions 3 and 4 below).

However, we acknowledge that this measurement basis is necessary in order for the same principles to apply to all business combinations proposed to be within the scope of the revised IFRS 3/AASB 3, most notably business combinations involving mutual entities or by contract alone.

Scope exemption for business combinations involving entities under common control

We fully support the proposed continuation of the scope exemption from IFRS 3 for business combinations involving entities under common control. Our experience with the practical issues surrounding the original version of AASB 3 (issued in July 2004) illustrated that the application of the general requirements of IFRS 3 to these types of combinations was problematic and difficult.

These difficulties were particularly evident in relation to determining whether a particular transaction satisfied the definition of a 'business combination' and the identification of an 'acquirer' due to the focus under AASB 3 on *control*, which is (by definition) already in existence in these types of transactions.

Whilst we understand that the IASB and FASB have effectively deferred consideration of the appropriate accounting treatment for common control transactions to a latter phase of the overall business combinations project, we consider that there is a need to address these issues due to a diversity of opinion and practice in accounting for these transactions.

Guidance on the accounting for common control transactions is particularly acute in the Australian context because of the requirements of the *Corporations Act 2001* and other legislation and regulation for the widespread preparation of separate financial statements. The issue is further amplified in relation to entities governed by the *Corporations Act 2001* as the method of accounting adopted for common control transactions often has a direct impact on distributable reserves and dividends are only permitted to be paid out of 'profits' under s.254T of the Act.

Therefore, we would strongly recommend that the AASB encourage the IASB and FASB to bring forward consideration of this matter.

However, in the absence of IASB/FASB consideration of this matter, we would *not* support the AASB developing its own guidance as it may potentially:

- lead to claims of non-compliance with IFRS by Australian entities
- result in the adoption of a method of accounting for common control transactions in the Australian context that is not ultimately adopted at a global level
- place Australian entities at a commercial disadvantage when compared to their international counterparts.

Definition of a business combination

We strongly support the revised definition of a 'business combination' in the proposals. In particular, the removal of the reference to 'entity' and the focus on gaining control of a 'business' will assist in removing some of the interpretational difficulties in practically applying the current definition.

However, we believe that for this change in definition to be appropriately applied within the overall context of the proposed revised IFRS 3, further consideration needs to be given to the definition and application of the concept of an 'acquirer'. Because the term 'acquirer' is defined by reference to an 'entity', it is commonly interpreted to refer to a legal entity, particularly when considered in light of the existing apparent distinction between a 'business' and 'entity'.

As a result, it is commonly understood that any legal entity can be identified as an acquirer for the purposes of the existing IFRS 3, e.g. in the Australian context, this may encompass a company, partnership, trust, registered scheme, co-operative and so on. However, we note that there is some uncertainty in identifying the acquirer where a 'business' is legally acquired by a legal entity but that business combination is considered a 'reverse acquisition' under IFRS 3.

Example – 'backdoor listing'

The Jones family operates a successful family business that is rapidly growing. In order to provide funds for further expansion, the Jones family arranges for the business to be legally acquired by Dormant Limited, a listed company that itself has a small residual business. The acquisition legally occurs through Dormant Limited issuing shares to the family members in exchange for the net assets of the business. The family members hold a majority of the shares on issue after the combination and form a majority of the board. Furthermore, the family business largely continues on in the same manner as before the transaction using the existing management structure.

This transaction would be readily considered a 'reverse acquisition' if the transaction occurred as a 'share for share swap' whereby Dormant Limited acquired an existing trust, partnership or other legally recognised entity controlled by the Jones family. However, in order to achieve the same conceptual outcome in this instance, it is necessary to consider the existing Jones family 'business' as the *acquirer* for the purposes of applying the 'reverse acquisition' requirements of IFRS 3.

We would also welcome the inclusion in the revised IFRS 3 of examples of transactions that are *not* considered business combinations under IFRS 3 because they do not meet the definition because of their substance. This could include references to such transactions and events as:

- the redomiciling of an entity in a different jurisdiction by incorporating a new holding company and doing a 'share for share swap'
- the transfer of an existing business from one legal entity to another in preparation for a trade sale, e.g. from a trust to a company
- internal restructuring of part of an entity in preparation for an initial public offering or in-specie distribution to shareholders (i.e. a spin-off).

In our experience, these types of transactions are often initially considered 'business combinations', perhaps due to a bias towards the legal form of these transactions under existing Australian accounting pronouncements required to be applied prior to the transition to A-IFRS. Regardless of their substance, the IASB and FASB may even intend that some or all of these transactions be considered 'business combinations'. Therefore, clarification on whether transactions such as those listed above would be considered 'business combinations' would be welcome[1].

Interaction between IFRS 3 and IAS 27

We are concerned that the exposure draft does not appropriately deal with the interaction between IFRS 3 and IAS 27 *Consolidated and Separate Financial Statements* in relation to the concept of 'control', particularly where a business combination has been accounted for as a reverse acquisition.

The IASB has previously indicated that the concept of control should be consistently applied between IFRS 3 and IAS 27, such that the entity that is the acquirer should be considered the parent for the purposes of applying IAS 27. The exposure draft proposes to make this clear by defining 'control' and other relevant terms by reference to IAS 27.

Where a business combination has been accounted for as a reverse acquisition, the legal subsidiary is considered the acquirer when applying IFRS 3. Consequently, the subsidiary is considered to be the parent entity for the purposes of applying IAS 27. If this is then the case, then is it unclear as to who is to be identified as the acquirer if a subsequent business

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[1] It is also noted that some of these transactions may in some circumstances be considered to be 'business combinations involving entities under common control' and therefore outside the scope of IFRS 3. However, in many other cases, control is transitory due to a pending sale, in-specie distribution or other event and therefore these transactions would not meet the definition of a 'business combination involving entities under common control' and so fall *within* the scope of IFRS 3. In our view, the recording of these transactions should reflect whether they are initiated and controlled by the vendor or purchaser with only those transactions initiated or controlled by the *purchaser* considered a 'business combination' and so subject to the requirements of IFRS 3. It is also noted that some of these transactions may be structured in such a way that there is no 'acquirer', e.g. merging two unrelated businesses of an entity under a new holding company which is then floated. We recommend that the AASB suggest that the IASB/FASB's consideration of 'fresh start' accounting be brought forward as in these cases the substance of the transaction is the creation of a new entity in which no pre-existing entity can be considered the acquirer.

combination is legally effected using the legal parent and which entities are included in any consolidated financial statements prepared.

The obligation to prepare consolidated financial statements under the *Corporations Act 2001* is imposed on the parent. The legal parent is not considered a parent under accounting standards. Consequently an entity may come to the conclusion that consolidated financial reports are not required to be prepared by the legal parent because the entity is not a parent under accounting standards. We have encountered this issue on numerous occasions in the Australian context.

We also note that the revised guidance and examples in the exposure draft (paragraphs A116 – A136) does not explicitly address this issue or clearly elucidate the concepts noted above. Furthermore, the Australian paragraphs of AASB 127 (specifically Aus9.1) should be reconsidered and if necessary amended to address this issue.

Similar issues also arise in business combinations involving mutual entities and those by contract alone. We note that the appropriate accounting for stapled security and dual listed arrangements is particularly relevant in the Australian context and we would welcome more guidance on the application of the concepts of 'control', 'parent', 'subsidiary' and 'consolidated financial statements' in these situations, again in light of the concepts noted above.

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 support the amended definition of a 'business' under the proposals and welcome the additional guidance provided on the identification of a business in particular circumstances.

We suggest that further guidance would be helpful in relation to whether a 'business' exists or not in marginal cases. In particular, it would be useful to make it clear that the assessment of whether an integrated set of activities is a business is made by reference to the normal inputs, processes and outputs related to the industry in which the set operates. For example, the inputs, processes and output in relation to an infrastructure asset (e.g. road, power line, pipeline, etc) are vastly different from those related to a complex operation (e.g. geographically diversified manufacturing or service operation).

We also have encountered practical difficulties in determining whether an acquired integrated set of activities is a business where only *part* (often a small part) of an overall business is acquired in a transaction. For instance, is the acquisition of a single hotel, shop, pipeline or other asset to be considered a 'business' when the acquired item is perhaps one of many that the vendor has sold to the purchaser?

The distinction between a 'business' and 'integrated set of activities' will become much more important under any revised IFRS 3 due to the other changes proposed when accounting for business combinations, particularly in relation to the requirement that transaction costs be generally expensed.

We also note that the concept of a 'business' can be difficult to apply in situations such as the following:

- a consolidated group has a number of legal entities that are engaged in a particular business. Are the entities *together* to be considered 'one business'? If those entities are disposed of in a transaction, can that disposal give rise to reverse acquisition accounting such that the entities together are considered to be the acquirer if the conditions for such accounting exist?
- a number of different and perhaps separately managed 'businesses' are merged with other businesses through a new holding company – can the 'group of businesses' be identified *together* as the acquirer?

Therefore, guidance on these issues in the revised IFRS 3 would be welcome and would avoid 'gaming issues' whereby entities structure transactions to achieve as series of 'non-business combinations' in order to capitalise transaction costs.

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 support this proposal at a conceptual level. However, we are concerned that the requirement to determine the fair value of the acquiree as a whole is subjective and may be difficult to implement in practical terms. The relative certainty provided by using a 'cost allocation' approach will effectively be replaced by a conceptual 'fair value' approach.

The determination of the fair value of the acquired entity not only impacts the amount of goodwill recognised, but also has a direct bearing on the accounting for subsequent movements in ownership interests between the controlling and non-controlling interests. It is therefore imperative that appropriate principles and guidance be outlined in the revised IFRS 3 so that consistency in application between entities can be achieved wherever possible.

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?

We find the examples included in paragraphs A8-A26 to be overly simplistic and not representative of the practical aspects and commercial realities of business combinations. Because the examples are an important tool in understanding of the 'principle' proposed, we would prefer the examples to be more commercially realistic and to clearly indicate the factors that should be taken into account or ignored in determining the fair value of the acquiree as a whole.

For instance, the reference in Example 1 to movement in share prices pre and post combination will not necessarily happen in practice in the manner indicated. It is also overly simplistic to compare pre-combination and post-combination share prices without considering the impacts of the overall movement in market prices, economic developments that may have an impact on the entity, or inflated prices due to an expectation of a bid in the period leading up to the formal notification of a takeover offer.

The examples also do not contemplate the fact that often non-controlling shareholders may demand a premium to sell their shares to a majority shareholder after a business combination. In effect, the non-controlling shareholders will seek not only to be compensated for the fair value of their shares, but also to share some proportion of the synergistic benefits that 100% ownership may bring.

It is unclear whether factors such as those mentioned above can or should be considered in determining the fair value of the non-controlling interest ownership interest, particularly when they might be ordinarily expected to be considered in the pricing of any additional acquisition of ownership interests by the controlling interest.

It would also be useful to include an example that specifically deals with a on-market takeover where the entity seeks to achieve 100% ownership of the target and achieves control (triggering business combination accounting) before 100% ownership is achieved. This is particularly important where a takeover offer may be 'in play' over a reporting period such that control has been obtained but a full ownership interest has not be achieved. We believe that in this case, the fair value of a non-controlling interest could be readily determined by reference to the offer price, particularly if there is an expectation that 100% ownership interest is likely.

In the Australian context, there are additional factors that need to be considered and addressed if considered necessary. For instance, the specific regulatory environment in relation to the takeovers under the *Corporations Act 2001* imposes certain restrictions on the prices offered for securities, permits compulsory acquisition in some cases, and restricts post-combination 'creep' transactions to predefined limits. It might be ordinarily expected that these factors would affect the pricing (and so fair value) and execution of both any initial business combination and any subsequent acquisition of non-controlling interests, thereby directly or indirectly affecting the assessment of the fair value of the acquired entity as a whole. However, it is unclear whether these items should be taken into account in determining the fair value of the acquired entity as a whole.

Furthermore, many of the examples assume a business combination occurring between two listed entities where market-based evidence of the fair value of securities acquired (and possibly exchanged) is readily obtainable. Many business combinations commonly involve entities that are not listed and where market based evidence is not available. It would be useful to include an illustrative example of such a business combination so that constituents can appreciate how the requirements are applied in these circumstances. We would also welcome commentary reconciling any apparent differences between the requirements of IFRS 3 and IAS 39 *Financial Instruments: Recognition and Measurement* in relation to equity instruments that do not have a quoted market price.

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?

We support this approach on the basis that it is a pragmatic solution to some of the problems identified in our responses to questions 3 and 4.

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

We disagree with this proposal.

Theoretically, the vendor and acquirer should assess the fair value of any contingent consideration at the date of acquisition. In other words, in theory there should be a 'meeting of the minds' on what the fair value of the contingent consideration is at the time of the transaction and this should then be reflected in the initial accounting for the business combination and not subsequently adjusted on this basis. This would be true of contingent consideration arrangements such as 'earn out' clauses where both parties agree on the fair value of the business as a whole such that the 'earn out' clause is effectively a financing mechanism for the purchaser.

However, contingent consideration is often used as means of resolving disagreements between vendors and acquirers where the fair value of the business as whole cannot be agreed. Contingent consideration is also used where the future profitability, performance or other aspect of the business is genuinely uncertain such as in 'start-up', cyclical or variable businesses. In these cases, there may be no 'meeting of the minds' as the contingent consideration itself is a pragmatic approach to permit the business combination to occur. These types of contingent consideration are clearly different from the 'earn out' clause example mentioned above as they affect the fair value of the business acquired as a whole. As a result, they are also inherently difficult to measure at the date of acquisition.

We also anticipate that this proposed change in the treatment of contingent consideration may introduce a higher level of subjectivity in the initial accounting for business combinations, perhaps leading to some 'gaming' opportunities whereby entities attempt to recognise the highest liability possible so that some might be released to the income statement after the completion of the measurement period.

Therefore, we are concerned about the appropriateness of the proposed treatment in relation to contingent consideration arrangements and the subjectivity around measurement. We would therefore prefer that the approach under the existing IFRS 3 be retained as we believe that it more correctly reflects the substance of contingent consideration arrangements.

If the proposal is to remain, we strongly recommend that revised IFRS 3 provide clear guidance and examples on these matters so that they can be applied objectively.

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?

We agree that conceptually acquisition-related costs that are incurred by an entity should be excluded from the measurement of consideration transferred for the acquiree and that this approach is required to be consistent with the measurement attribute for a business combination being based on fair value rather than cost accumulation.

We find the arguments in favour of the proposed treatment in the draft basis for conclusions quite persuasive however we are also concerned that acquisition-related costs in relation to other assets will be capitalised into the cost of the asset (as acknowledged by the IASB in paragraph BC88).

In addition, we believe that this is a very significant change to the current method of accounting for business combinations and may not be well accepted commercially. The

general effect of this requirement will be that entities will report an expense in a period when a business combination occurs, even though the costs are incurred in order to expand the entity and presumably result in future economic benefits through that growth or diversification. Acquisition-related costs are also taken into account by a rational purchaser in the acquisition metrics and so might arguably lead to future economic benefits.

Therefore, whilst we support the proposals conceptually, we have serious concerns as to their likely acceptance by the marketplace.

Australian specific issues

In the Australian context, the question of the treatment of stamp duty arising in business combinations under these proposals appears somewhat uncertain.

Stamp duty is an unavoidable cost that must be paid by any buyer, so is conceptually different from the examples of 'acquisition-related costs' included in the exposure draft – such as finder's fees, advisory, legal, accounting, valuation and other professional or consulting fees. These examples vary in quantum from buyer to buyer and are paid in exchange for services received, these reasons for the suggested treatment being presented in the basis for conclusions, notably paragraphs BC85 and BC87.

Stamp duty is also necessarily incurred as part of the 'consideration transferred' in exchange for the acquiree and economic theory may indicate that the fair value of businesses might in some cases increase in the absence of stamp duties. In other circumstances, the consideration transferred to effect the consideration may be specifically negotiated with the explicit or implicit consideration of stamp duties. Furthermore, stamp duties cannot be avoided and there is no 'service received' (in a normal sense) from the payment of stamp duty.

Therefore, there may be differing views as to whether stamp duties should be considered 'acquisition-related costs' (and so generally expensed) or as part of the 'consideration transferred' (and so taken into account in determining the fair value of the acquiree).

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 support the fair value measurement principle that is proposed in relation to the recognition and measurement of assets acquired and liabilities assumed in a business combination. This principle is consistent with the overall objectives of the exposure draft and the principles exposed in the basis for conclusions for the existing IFRS 3.

Proposed fair value guidance

We have some concerns regarding the manner in which Appendix E to the proposed revised IFRS 3 has been exposed.

We acknowledge that timing factors prevented the IASB from proceeding with its original intention of issuing a *separate* exposure draft on 'fair value measurements' to fully harmonise with US GAAP in this area. However, the fair value guidance included in Appendix E is a major amendment to the fair value principles and we believe that it will be applied by analogy to many situations outside of business combination accounting where fair value measurement is required. We are therefore concerned that the new fair value guidance may be introduced without appropriate consideration by constituents.

We are also concerned about certain aspects of the fair value guidance in Appendix E, including:

- the requirement that the fair value of a liability consider the effect of the liability's credit standing so that the estimate reflects the amount that would be observed in an exchange between willing parties of the same credit quality – this is a major change to the measurement of liabilities in the Australian context. We are also concerned that the guidance does not clarify whether it is the credit risk of the *acquiree* or acquirer and acquiree *together* that should be taken into account. We would also welcome clarification as to whether or not credit risk should be taken into account in the measurement of non-financial liabilities under the proposed revisions to IAS 37 – to ensure no 'day one' gains/losses we assume that this would be the case.
- the lack of guidance on the impacts of tax in determining fair value. We acknowledge the IASB has tentatively decided on amendments to the definition and application of 'fair value' as part of the current joint IASB/FASB short-term convergence project on income taxes. We believe that this tentative decision should be incorporated into the fair value measurements guidance in the revised IFRS 3, in particular that the fair value of an asset should be determined on the basis that the assigned fair value is assumed to be fully deductible for tax purposes. We have encountered this issue numerous times in the Australian context in relation to intangible assets.
- insufficient guidance is included on how 'level 3' estimates are to be derived where there is significant uncertainty surrounding the entity inputs in the absence of market-based evidence. We would strongly recommend that, at a minimum, guidance similar to that found in paragraphs AG74-AG79 of IAS 39 *Financial Instruments: Recognition and Measurement* be included in the fair value hierarchy.

We suggest that the above matters be reconsidered and addressed as part of the finalisation of the revised IFRS 3.

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?

We strongly support the proposed exceptions to the fair value measurement principle suggested in the exposure draft.

Hedging relationships

We also believe that it would be appropriate to include an additional exception in the revised IFRS 3 in relation the hedge accounting relationships. Under the current IFRS 3, the acquirer is usually considered to become a party to any hedging instruments that the acquiree may have in existence at the date of acquisition. Under this view, the hedge relationship is required to be reassessed from the perspective of the combined entity and may fail the hedge accounting requirements under IAS 39 *Financial Instruments: Recognition and Measurement* due (among other factors) to the initial value (from the combined entity's perspective) of the hedging instrument being affected by market movements since the acquiree itself became a party to the hedging instrument contract. This can make the satisfaction of the effectiveness requirements of IAS 39 difficult to meet from the perspective of the combined entity.

The easiest way to address this issue would be for the revised IFRS 3 to explicitly state that hedging relationships of the acquiree are not reassessed from the perspective of the combined entity so long as they continue to meet the hedging requirements within the acquiree. However, this approach, whilst easily implemented and pragmatic, would have the effect of including the gains or losses on the hedging instrument in post-combination profits and so would be inconsistent with the IASB's stated objective in relation to the measurement of assets and liabilities acquired in a business combination.

Therefore, we instead recommend that IFRS 3 permit the fair value of the acquiree's hedging instruments that are in existence at the date of acquisition to be split into two components: one component representing a 'financing element' (fair value of the instrument at the acquisition date) and a second component being a 'hedging instrument element' (a nil or minimal amount that would arise if the hedging instrument were entered into at the acquisition date based on market rates).

On-going hedge effectiveness testing would then be conducted by reference to the hedging instrument element only, with the 'financing element' 'unwinding' over the expected life of the hedging instrument in line with the nature of the hedging instrument. This treatment would have the effect of treating the hedging relationship from the perspective of the consolidated group as one that came into existence at the acquisition date based on market rates at that date. Whilst the ultimate profit or loss outcome would be different between the acquiree and consolidated entity, the accounting adopted would be consistent with the substance of the arrangement as an effective hedge and would also treat gains and loss on the hedging instrument arising prior to the acquisition date as 'pre-acquisition'.

This approach is supportable on the basis that the business combination is the acquirer obtaining control of the business *as a whole*, rather than being seen to becoming a party to every contract that that acquired business may have in place. In our view, it also more correctly reflects the economic substance of transactions and events of the subsidiary and leads to a more realistic and rational accounting outcome.

Reassessment of embedded derivatives

We note that this exposure draft has not specifically addressed the appropriate accounting treatment for an embedded derivative acquired as a part of the business combination. IFRIC Draft Interpretation D15 '*Reassessment of Embedded Derivatives*' implies that where the entity acquires a contract with an embedded derivative it is required to reassess the embedded derivative to determine if it is still closely related to the host contract: "The IFRIC also concluded that an entity is required under IAS 39 to assess whether an embedded derivative needs to be separated from the host contract and accounted for as a derivative when it first becomes a party to a contract."

It would be reasonable to assume that the acquirer in a business combination would therefore be required to reassess the contracts acquired in the business combination to determine whether or not they contain an embedded derivative that is no longer closely related to the host contract. We note that paragraph 38 provides an exemption from reassessing classification of leases acquired in a business combination, however no exemption is provided in respect of embedded derivatives.

We question the merit of a full reassessment of embedded derivates at the date of acquisition given the potential onerous requirements it forces upon acquirers in business combinations. At the date of the business combination the acquirer will be required to reassess each and

every contract for embedded derivatives that may previously have been considered closely related to the host contract, and, therefore not accounted for separately from the host contract.

Whilst we do not expect there to be many situations where there will be a change to the economic characteristics and risks such that the embedded derivative is no longer considered to be closely related to the host contract at the date of acquisition, we question the merits of requiring entities to perform this detailed analysis. Furthermore, should the acquirer consider the embedded derivative no longer to be closely related to the host contract the group will be required to separate the embedded derivative and account for it at fair value at each reporting date. Given the fact that the acquired entity would have assessed the contract at its inception to determine whether the embedded derivative is closely related, and given that the acquired entity is still the primary party to the contract, we do not believe that this requirement is appropriate.

This approach would also be consistent with our suggested approach in relation to hedging relationships of the acquiree in existence at the acquisition date (as discussed above).

Interaction with accounting treatment for 'bargain purchases'

The exceptions to the fair value measurement principle combined with uncertainties in measurement of many assets and liabilities acquired in part of a business combination may in some cases lead to a potential 'bargain purchase' arising when initially accounting for a business combination.

For example, deferred tax assets meeting the 'probable' recognition requirements under AASB 112 *Income Taxes* may not be expected to be recovered for many years. The 'fair value' of these deferred tax assets would be significantly less than the undiscounted values assigned to them under AASB 112 when initially accounting for the business combination because AASB 112 prohibits discounting of deferred tax balances. If the difference between the recognised (undiscounted) and fair values was material, this could lead to the total recognised values of the net assets of the acquiree exceeding the fair value of the business as a whole (normally the consideration transferred to effect the business combination).

Where a 'bargain purchase' gain arises in these situations it might be better treated as a 'deferred credit' rather than being immediately recognised as a gain in the income statement. However, it may be practically difficult to delineate between a true 'bargain purchase' and one that is derived from the exceptions to the fair value measurement principle and/or measurement uncertainties.

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 understand the need for this proposal on the basis that it is necessary within the context of the fair value measurement working principle established by the IASB and FASB. We agree that the occurrence of a business combination (obtaining control over a business) is an event that should trigger an accounting remeasurement. However, we are uncertain as to whether the gain or loss should be recognised in the profit and loss, rather than directly in equity.

We are concerned that this proposal will not be well accepted from a commercial perspective as it is a common occurrence that 'strategic' investments in entities are accumulated prior to

control being obtained. These pre-combination investments often lead to a significant influence (or joint control) relationship that results in equity accounted being adopted when accounting for the investment. This equity accounted carrying amount of investment is effectively a 'one line consolidation' with notional fair value adjustments and goodwill being determined in a manner consistent with IFRS 3. The movement to a control relationship would then give rise to a gain under the proposals, and it might be argued that this gain is at least partially 'internally generated' through the pre-combination relationship and so might be better treated as an equity adjustment rather an income statement item. This would also be consistent with the treatment adopted for post-combination movements in ownership interests where control is maintained.

Where significant influence (or joint control) is not obtained and the pre-combination investment is treated as an available for sale financial asset, we would also prefer that the gain continue to be recognised in equity in accordance with AASB 139 *Financial Instruments: Recognition and Measurement*, rather than being recycled to the income statement at the time control is obtained. This gain should only be recycled to the profit and loss when control over the entity is lost and no existing ownership is retained (as either an associate, jointly controlled entity or available for sale financial asset).

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?

We support this proposal and believe that it assists to address the significant measurement difficulties that can arise where a true 'bargain purchase' arises.

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 understand the conceptual basis of the proposal that an overpayment should not exist often in practice, or if one does exist, that it would be unlikely that it could be reliably measured.

However, we believe the commercial reality of business combinations is such that they often occur in light of incomplete information about the acquiree and that such information only becomes known after the business combination has been completed. Alternatively, the metrics of an acquisition may be complex and not necessarily be linked to the fair values of the underlying assets or liabilities of the entity.

The exposure draft itself acknowledges that the fair value of the acquiree as a whole and the fair values of the individual assets and liabilities of the acquiree might not be known at the acquisition date and permits a measurement period of up to 12 months to permit these fair values to be determined. The proposal to prohibit the recognition of a loss for an overpayment in a business combination on the basis that it cannot be reliably measured therefore appears inconsistent with this view.

In addition, the suggestion that any overpayment cannot be reliably measured appears inconsistent with:

- the requirement that goodwill and intangibles with indefinite useful lives be assessed for impairment on at least an annual basis under IAS 36 *Impairment of Assets* perhaps on the basis of 'fair value less costs to sell' – if the fair value of the entity as

a whole cannot be determined at the date of acquisition, then it may imply that fair value less costs to sell is not a valid basis for measuring impairment

- the requirement to recognise a gain or loss in relation to previously acquired non-controlling equity investments in an acquiree at balance date – this again assumes that the fair value of the entity as a whole can be determined in all cases.

The requirement to recognise an expense where an 'overpayment' occurs has been present in existing Australian Accounting Standards for some time. Consistent with the IASB's observations, the circumstances leading to the recognition of an expense for an 'overpayment' under these requirements are in our experience rare. Examples we have encountered in practice have related to such items as unknown liabilities and, under existing Australian GAAP, step acquisitions. In our view, the rarity of these events is not of itself sufficient justification to develop a conceptually superior accounting treatment for them.

Treating an 'overpayment' as an expense at the acquisition date is conceptually superior to recognising an impairment loss for goodwill in the same reporting period or the immediately subsequent reporting period after the business combination. Any overpayment does not represent 'future economic benefits' and therefore cannot satisfy the definition of 'goodwill'. Treating it as goodwill may defer the recognition of loss as IAS 36 permits a 'deferred' impairment test for goodwill where the initial allocation of goodwill acquired cannot be completed before the end of the annual reporting period in which a business combination is effected.

Therefore, we believe that the revised IFRS 3 should permit the recognition of a loss for an 'overpayment', perhaps on a similar basis to the requirements for 'bargain purchases' and in conjunction with substantive disclosure requirements to discourage abuse of the requirements.

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 agree with the proposal in the context of the additional disclosures required.

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 do not believe that the proposed guidance is sufficient. As noted in our response to question 7 above, there is some uncertainty as to whether stamp duties payable on any business combination should be considered as 'acquisition-related costs' or as part of 'consideration transferred' in respect of the business combination.

Therefore, we believe that the revised IFRS 3 should explicitly address how taxes and other transaction specific amounts such as stamp duties are to be treated in a business combination. Our preference would be that these amounts be considered part of 'consideration transferred' where it can be illustrated that the fair value of the acquired business is effectively equal to the aggregate of the consideration transferred to the vendor and the stamp duty paid. As noted in our response to question 7, this would be the case where it can be shown that the purchase price for the business acquired has been negotiated in light of the mandatory

payment of stamp duty, i.e. the vendor has effectively had to accept a lower price for the business than would be achieved if no stamp duty was payable.

The guidance should also include examples of payments that might be made in connection with the business combination but which arise from pre-combination arrangements with other shareholders in the acquiree. For example, this could include agreements with former shareholders of the acquiree entered into at the time of a previous acquisition of ownership interests whereby additional payments are made to those shareholders in the event that the amount paid to achieve control is greater than received in the original transaction.

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?

In general terms, we support the disclosure requirements in the exposure draft.

However, we continue to strongly oppose the requirements in paragraph 74(b) of the exposure draft (carried over from paragraph 70 of the existing IFRS 3) to disclose the revenue and profit and loss of the combined entity 'as though' the acquisition date for all business combinations occurring during the year had occurred at the beginning of the reporting period. In our view, these disclosures:

- do not provide relevant information because the disclosures are subjective and vague pro-forma numbers with very little guidance as to their calculation basis – for instance, there is no guidance on how matters such as the following should be treated in the calculation of the pro-forma numbers:
    - changes in the fair value of acquired assets and liabilities that might have occurred between the beginning of the reporting period and the acquisition date
    - whether 'one off' pre-combination revenues and expenses should be included or excluded in the pro-forma information provided
    - whether the assessment of such items as financial instruments and non-financial liabilities should take into account information only available at the beginning of the reporting period without the benefit of information that has come to light and events that have occurred since that date, or whether the impacts of that information and events should be reflected in the pro-forma information
    - whether, and if so, how, liabilities and assets only recognised on consolidation (e.g. favourable or unfavourable contracts, intangible assets, contingencies) should be reassessed
- effectively require the governing body and auditor of the combined entity to include information about the acquiree for a period before control was obtained – therefore requiring certification and audit of amounts that are outside the stewardship of the combined entity's governing body and perhaps unverifiable or unable to be audited due to limitations of scope or other factors.

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?

We strongly disagree with the proposition that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognised separately from goodwill.

In our experience, the measurement of the fair value of intangible assets is one of the most difficult areas of the current IFRS 3 and IAS 38 to apply in practical terms. There a number of views on when an intangible asset can be reliably measured, and many intangible assets are instead pragmatically subsumed within goodwill. We do not believe that there is a generally accepted approach amongst valuation experts as to the measurement of intangible assets, which can lead to diversity in practice.

Whilst we acknowledge the conceptual superiority of the approach suggested in the exposure draft, we believe that it would be impossible in some cases to apply it in practice. The problem appears to be particularly acute in regulated industries such as electricity, water, transport infrastructure (where a licence or right is the essential element of the business as a whole) and the extractive industries (where it is difficult to differentiate between goodwill and future potential in the form of prospecting, mineral or mining rights). The recognition and measurement of customer-related intangibles is also consistently difficult across all industries, with the possible exception of certain telecommunication sectors where there may be external market transactions determined on a 'per subscriber' basis on which reliable measurement might be based.

We would prefer that the existing requirements in relation to the recognition of intangible assets remained in place under the revised IFRS 3 until such time as widely accepted valuation principles are developed permitting a consistent application and interpretation of the proposed revised requirements.

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 do not agree that any changes in an acquirer's deferred tax benefits that become recognisable because of a business combination should always be accounted for separately from the combination.

We can contemplate situations which may arise where the increased recognition of deferred tax benefits may be an intended consequence of the business combination occurring. In these situations, the consideration transferred for the business combination may partially encompass a payment for these tax benefits – in other words, a particular acquirer may be willing to pay more to secure control of an acquiree because of the existence of the improved benefit of the acquirer's own existing deferred tax assets. In conceptual terms, this is no

different to any unique synergistic benefit that a particular acquirer may have available which permits a higher purchase consideration to be paid to effect the business combination.

In other cases, the recognition of deferred tax assets of the parent may clearly not be part of any synergistic amounts included in the consideration transferred to effect the combination and so should be accounted for separately from the combination.

Therefore, we believe that from a conceptual viewpoint, deferred tax assets of the parent that become recognisable because of the business combination would be treated differently depending upon whether or not an amount has been included in consideration transferred to effect the business combination.

However, we recognise the difficulties in making this assessment from a practical perspective and therefore accept that all such benefits should be treated in the same manner, with separate accounting an acceptable treatment.

In the event that separate accounting is considered the most appropriate treatment, we note that if a material amount of the acquirer's recognised deferred tax benefits have effectively been taken into account in the consideration transferred but are not taken into account in the measurement of the fair value of the acquiree as a whole, it may lead to an 'overpayment' for the acquiree (refer to our response to question 12 for our concerns about the proposed treatment of 'overpayments').

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

The difference in the disclosure requirements between the two proposed Standards are in our view largely immaterial. Ideally, there should be no material differences between equivalent pronouncements of the IASB and FASB, particularly where the proposals have been jointly developed.

We would only be concerned about minor differences in disclosure requirements between the IASB and FASB if in the future those differences were considered so significant so as to prevent the removal of the US GAAP reconciliation requirement for IFRS reporters with issued securities traded in US markets.

Having noted this, we would not support the inclusion of the pro-forma information proposed by FASB in paragraph 74(b) of (the US equivalent) exposure draft for the same reasons as noted in our response to question 15 above. We also believe that the disclosures proposed by paragraph 76(d) are useful and should be retained.

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 support the bold type-plain type style drafting of the exposure draft.

In our view, the following paragraphs should be considered for bold type:

- the definitions in paragraph 3
- the second sentence of paragraph 20 regarding the exchange price (consideration transferred) paid by the acquirer being presumed to be the best evidence of the acquisition-date fair value of the acquirer's interest in the acquiree. We consider this to be one of the main principles under the proposals because it (for cost benefit reasons) eliminates a 'full fair value' assessment of the acquiree in all business combinations.

MATTERS FOR SPECIFIC COMMENT - AASB

(a) whether constituents support the proposed amendments

Subject to our comments made elsewhere in this letter, we generally support the proposed amendments to IFRS 3.

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

We support the wider scope of the exposure draft. As noted in our response to question 1 above, we believe that accounting for business combinations involving entities under common control (and common control transactions in general) is an area that requires urgent attention by the IASB. However, as noted elsewhere in this letter, we would not support the AASB developing Australian guidance on this matter.

(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

We note that the FASB in its equivalent exposure draft excludes from its scope business combinations between not-for-profit organisations or acquisitions of for-profit businesses by not-for-profit organisations (as identified in paragraph BC43 of the IASB exposure draft).

The AASB should consider whether it would be appropriate to adopt scope exemptions in the proposed revised AASB 3 that follow the FASB scope exemptions. Because of the commentary in the exposure drafts and the scope exemptions under the FASB exposure draft, it is clear that the proposals are primarily directed towards business combinations involving for-profit entities and may therefore not be the best conceptual approach in relation to business combinations involving not-for-profit entities and the public sector.

The motivation behind business combinations between not-for-profit or public sector entities is different from those in the for-profit sector. Obviously, profit is not a key driver and these combinations may sometimes be required by ministerial directive, legislation or other factors outside the control of the governing bodies of the combining entities. The identification and measurement at fair value of 'acquired' assets and liabilities may be difficult or impracticable. There may be no or little consideration transferred to effect the combination. In the case of the public sector, the business combination may be in substance equivalent to a 'business combination involving entities under common control', although applying the 'control' concept in the government sector can be problematic.

We would prefer that business combinations involving not-for-profit and public sector entities be outside the scope of the revised AASB 3. These entities may well apply the requirements of AASB 3 in relevant situations under the 'hierarchy' in AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*. In our view, this approach would eliminate any unintended consequences arising from a mandatory application of AASB 3 to these transactions and permit entities in these sectors to select accounting policies that are relevant and reliable such that they reflect their economic

substance, even if they depart from the principles and requirements of AASB 3 in some respects.

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

We believe that the proposals are in the best interests of the Australian economy. In order to ensure that the maximum benefits are obtained, there must be no change made by the AASB to IFRS 3 when reissuing AASB 3, other than any amendments applicable to not-for-profit and public-sector entities that are considered absolutely necessary (in the event that business combinations involving these entities remain within scope of the revised AASB 3).