Auckland Council
Te Kaunihera o Tāmaki Makaurau

31 January 2019

Mr Warren Allen
Chief Executive
External Reporting Board
PO Box 11250
Manners St Central
Wellington 6142

Dear Warren

Auckland Council submission to NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations*

Thank you for the opportunity to comment on the exposure draft PBE IPSAS 40 *PBE Combinations.*

Auckland Council is Australasia's largest local government entity and is made up of the Council and six substantive council-controlled organisations. We invest heavily in infrastructure and many of our decisions will have a fiscal impact on Auckland's future generations. As Auckland Council is a "mixed group" (including profit-oriented and "not for profit entities") that provides a diverse range of services through entities which change in structure and ownership as the needs of the city change, this exposure draft is of specific interest to Auckland Council group.

Our responses to the specific questions for the respondents are included in Appendix 1 to this letter along with our additional comments for the XRB's consideration. In summary we are supportive of the changes made in developing the proposed PBE IPSAS 40.

We hope our responses and comments are helpful in aiding your decision-making process. Should you have any queries relating to the responses, please do not hesitate to contact Alvin Ang at the details provided below.

Yours sincerely

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Appendix 1 – Response to questions

1. Do you agree with the changes (as listed below) made by the NZASB in developing the proposed PBE IPSAS 40? If not, please explain why not and identify what you think would be more appropriate. (para 19 – 49)

   (a) Indicators relating to consideration (para 19 – 23)

   We agree with the amendments proposed by the NZASB to the indicators relating to consideration in PBE IPSAS 40 as they provide clearer guidance for preparers to correctly distinguish between an acquisition or amalgamation.

   (b) Definitions of equity interest and owners (para 24 – 25)

   We agree with the modification of definition of equity interests and owners. The phrase "equity interests" carries a broader scope to capture the different types of PBEs and residual interests in PBEs in New Zealand.

   (c) Use of the term "new entity" (para 26 – 33)

   We agree that the use of the term "new entity" in IPSAS 40 is unclear. The NZASB's revised paragraph 18 in the Standard provides a clear explanation of how to differentiate a "new reporting entity" and a "continuing reporting entity". We believe this will help to enhance the user's understanding.

   (d) Applying the modified pooling of interest method (para 34 – 36)

   We agree with the application of modified pooling of interest method. The existing PBE IFRS 3 does not contain sufficient guidance for combinations by way of a merger.

   The introduction of merger accounting via the modified pooling of interest method will provide public benefit entities an option that is fit for purpose when entering into combination arrangements in future.

   (e) Presentation of financial statements and disclosures (para 37 – 40)

   We agree with the NZASB to require the continuing entity to present comparative information in their first set of financial statements rather than allowing preparers the option to not present comparative information. This will ensure that consistency is maintained and readers of financial statements have a better understanding of the impact of the combination.

1. Do you agree with the changes (as listed below) made by the NZASB in developing the proposed PBE IPSAS 40? If not, please explain why not and identify what you think would be more appropriate. (para 19 – 49) (Continued)

   (f) Acquiring a non-cash generating operation (para 41 – 43)

   We concur with the inclusion of additional restrictions on the recognition of goodwill. Although Auckland Council's mandate is to provide services to the public on a non-profit basis, it also hold stakes in for-profit entities such as the Ports of Auckland and Auckland International Airports Limited. The ED addresses the issues we experience as a large mixed group as discussed below.

Conflict in producing a strong discounted cash flow that exceeds the carrying amount of goodwill

As defined by the Treasury, PBEs are reporting entities whose primary objective is to provide goods or services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than a financial return to equity holders.

In a situation where a public entity acquires a cash-generating entity, any goodwill arising from the acquisition is required to be recognised to the statement of financial position by the Standard. Subsequently, the goodwill recognised will have to be tested for impairment annually as per the requirements of PBE IPSAS 26.

The operations of PBEs are expected to be configured in a way that delivers the highest level of service to the public which often comes at the expense of profits. Therefore, by default, management's focus will be on quality of service delivery rather than maximising profits to support the discounted cash flow model that will generate higher future cash flows to support the value in use ("VIU"). This creates a conflict for management to arrive at a higher VIU to support the carrying value of goodwill.

Relevance to non-cash generating operations

Goodwill is an asset representing the future economic benefits that are expected to arise from other assets acquired in an acquisition that are not individually identified and separately recognised. In other words, goodwill is a premium that an acquirer pays on top of the fair value of the acquiree. The willingness of buyer to pay above the fair value is largely driven by the reputation, management team or customer base of the acquiree.

In the for-profit context, having goodwill on the Statement of Financial Position usually signifies that the business has gained rights to acquiree's reputation, brand names, customer lists, a unique market position, knowledge of new technology, a good location, specialist skills or operating methods via acquisitions. The goodwill helps to attract funding from potential investors or higher profits from synergies achieved.

In the PBE context, it is unlikely that having goodwill on the Statement of Financial Position will provide benefits such as an increase in revenue or the attraction of additional external funding. In an unlikely event that the PBE pays a significant premium to acquire an operation, this is likely to lead to increased public scrutiny, concerns around probity and integrity of the spend.

1. Do you agree with the changes (as listed below) made by the NZASB in developing the proposed PBE IPSAS 40? If not, please explain why not and identify what you think would be more appropriate. (para 19 – 49) (Continued)

   (f) Acquiring a non-cash generating operation (para 41 – 43) (Continued)

   Cost of compliance & timing required for subsequent annual impairment test of goodwill

   From a financial statements preparer's perspective, it is time consuming to collate the assumptions and required inputs to develop a robust discounted cash flow ("DCF") model. A preparer lacking the necessary skills may also need to seek professional advice at their own cost to complete the annual impairment test. Because of the reasons discussed above we concur with the Board to expense the resulting goodwill arising from the acquisition of a non-cash-generating operation.

   We would like to suggest the Board include the definitions of "cash-generating" and "non-cash generating" operations and provides clear guidance to identify them in the Standard as the current Glossary of Defined Terms only contains definitions for cash-generating assets and cash-generating units.

   (g) Identifying an acquirer (para 44)

   We agree that it is helpful to the users to add guidance on identifying an acquirer in a reverse acquisition.

   (h) Transition (para 45 – 47)

   We agree with the transition provisions that are set out in paragraphs 134.1 – 134.3 of the proposed Standards.

   (i) Voluntary combination not under common control (para 48)

   We agree with the added guidance and illustrative example for such combination although this is not expected to have a significant impact on Auckland Council Group.

   (j) Selection of accounting policies by the resulting entity (para 49)

   We agree with the clarification of selection of accounting policies in AG54.1 – AG54.2.

   (k) Income taxes (para 50 – 51)

   We agree with NZASB's decision.

2. Do you agree with the changes (as listed in Table 2) made by NZASB in developing the proposed PBE IPSAS 40? If not, please explain why not and identify what you think would be more appropriate. (para 52 | Table 2)

   Yes, we agree with the changes made in Table 2.

3. Do you agree with retaining paragraphs 13(b) and AG36 in the proposed PBE IPSAS 40? If you disagree, please provide reasons (para 53)

   We agree with retaining paragraph 13(b) and AG36 in the proposed PBE IPSAS 40. Whilst it may be remote for a referendum to happen in the New Zealand context, the Council consults with the public and residents of Auckland may be part of the decision-making process.

4. Do you agree with the concessions and associated RDR paragraphs in the proposed PBE IPSAS 40? If you disagree, please provide reasons and indicate any additional concessions or RDR paragraphs that you consider would be appropriate. (para 54 – 56)

   We support the proposed RDR concessions although this is not expected to impact Auckland Council Group

5. Do you agree with the proposed effective date of 1 January 2021, with early adoption permitted? If you disagree, please provide reasons. (para 58 – 59)

   We agree with the proposed effective date of 1 January 2021 as this will allow time for PBEs to plan their combination activities prior to the effect date. Considering that the proposed standard deviates from IPSAS 40 in many areas, we suggest that NZASB to consider providing a list of difference between PBE IPSAS 40 and IPSAS 40 upon issuance.

6. Do you have any other comments on the Exposure Draft?

   We have no further comments.