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INSTITUT DER WIRTSCHAFTSPRÜFER

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Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

GB London EC4M 6XH
United Kingdom

Düsseldorf, 5 December 2003
540/520

Dear Sir David

Re: Exposure Draft ED 3: Business Combinations
Exposure Draft of Proposed Amendments to IAS 36: impairment of Assets
Exposure Draft of Proposed Amendments to IAS 38: Intangible Assets

In our letter, dated 31 March 2003, regarding Exposure Draft ED 3: Business Combinations, Exposure Draft of Proposed Amendments to IAS 36: Impairment of Assets and Exposure Draft of Proposed Amendments to IAS 38: Intangible Assets, we have previously submitted various comments concerning the proposed guidance. Recently, additional problems with regard to particular aspects of the accounting treatment of business combinations and impairment testing have been identified. In our opinion, these concerns need to be addressed before the final Standards are published, notwithstanding the fact that the comment period expired on 4 April 2003. At least, these issues should be considered as part of the Board's conceptual project on measurement.

Certain concerns relating to the concept of value in use were considered by the Board at its November meeting. We would like to comment on the Board's decisions as set out in the IASB Update November 2003.

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Several problems result from the differing valuation concepts applied in accounting for business combinations on the one hand and in subsequent impairment testing on the other hand. Firstly, we would like to outline our understanding of the current definitions and related concepts in this regard.

Definitions and concepts:

ED 3.23 states that the **'cost of a business combination'** is the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred, and equity instruments issued by the acquirer, in exchange for control of the acquiree, plus any costs directly attributable to the business combination. The aggregate consideration given in the exchange transaction(s) normally takes into account, inter alia, all income tax effects of the business combination and the capital structure of the acquiree. The income tax effects comprise all income taxes that relate to future net cash flows being generated as a result of the business combination, i.e.

- future tax cash flows based on 'temporary differences' (reported as deferred tax assets/liabilities) and
- other future tax cash flows that result if the tax base is equal to the carrying amount.

Expected synergies and other benefits from the combination will also be incorporated in the initial recognition of goodwill (ED 3.BC97).

In allocating the cost of a business combination to the assets acquired and (contingent) liabilities assumed at the acquisition date, the notion of 'fair value' is relevant (ED 3.35). As fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction, fair value (representing the present value of future net cash flows to be paid or received by these parties) includes, in our view, the effects of business taxation because knowledgeable parties will not ignore these issues.

Subsequent impairment testing is based on the concept of the **'recoverable amount'** being the higher of the 'net selling price' and the 'value in use' (ED IAS 36.5).

'Value in use' is the present value of the future cash flows expected to be derived from an asset or cash-generating unit (ED IAS 36.5). In measuring value in use both estimated future cash flows and discount rate must exclude aspects of financing and taxation of income (ED IAS 36.43/44 and 36.48). Furthermore, future cash flows shall be estimated for the asset in its current condition. I.e. estimates of future cash flows shall not include cash flows from a future restructuring to which the entity is not yet committed or future capital expenditure that will improve or enhance the asset in excess of its standard of performance assessed immediately before the expenditure is made (ED IAS 36.37).

'Net selling price' is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal (ED IAS 36.5). As the definition of net selling price is very similar to the definition of fair value, we are of the opinion that net selling price is measured on a post-tax basis.

If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an entity could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal (ED IAS 36.23). In our view, it is not clear, whether only transaction-related amounts can be used in the absence of a binding sale agreement/active market or whether net selling price may also be determined using discounted cash flows. In this context it should be borne in mind that Exposure Draft 4 "Disposal of Non-Current Assets and Presentation of Discontinued Operations" proposes that all references in IAS 36 to 'net selling price' are replaced by 'fair value less costs to sell' (C7). If the term 'fair value' is introduced in this case, the use of estimation techniques such as discounted cash flow analysis would appear to be relevant in the determination of fair value (see IAS 32.82).

We would very much appreciate that clarification of the definitions and related concepts be given in the final standards in order to preclude differences in application of interpretations in practice.

Above all, we are concerned about the risk of unsatisfactory accounting treatments being adopted, particularly in the following areas:

Inclusion/exclusion of tax and financing aspects

In a business combination the acquirer considers tax and financing issues when determining (the upper limit of) the total cost of the acquisition and the fair values of individual assets acquired, liabilities assumed and goodwill.

In future periods when impairment tests have to be performed, the entity will not be allowed to include tax considerations in the measurement of value in use, thus perhaps leading to an impairment loss without economic substance (assuming that all other circumstances have not changed and net selling price is not relevant), because discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate will usually not yield the same result.

In contrast to paragraph B72 of the current IAS 36 we are of the opinion that a pretax discount rate according to ED IAS 36.48 does not take into account any tax effects. The 'real' pre-tax discount rate as mentioned in paragraph B72 of the current IAS 36 is, in fact, a discount rate that considers taxation aspects.

Apart from the problem of recognition of impairment losses without economic substance, difficulties also arise with regard to the required measurement technique. In practice, post-tax cash flows and post-tax discount rates are applied in arriving at present value measurements. As IAS 36 requires a pre-tax calculation in measuring value in use, tax effects have to be excluded from estimates of future cash flows and discount rate. Whilst the compliance with that requirement is straightforward regarding cash flows, the adjustments concerning the discount rate may be quite complex. If an entity, as a starting point in making an estimate of the pre-tax discount rate, takes into account the Weighted Average Cost of Capital (WACC) determined using the Capital Asset Pricing Model (CAPM), it is generally necessary to adjust such rates, because WACC and CAPM are post-tax estimates that must be modified to reflect a pre-tax rate (ED IAS 36.B1 7 and B20). Clarification of these issues is a matter of considerable urgency.

We acknowledge that, in November, the Board considered the possibility of amending the requirements in IAS 36 for pre-tax cash flows to be discounted at a pre-tax discount rate. Nevertheless, in our opinion it would be unadvisable to postpone the necessary decisions for too long.

Additionally, we question why value in use must be calculated ignoring financing activities in all cases. In our view, with regard to goodwill, an unfounded impairment loss may result from the different treatment of financing in accounting for a business combination and in impairment testing: In an acquisition of a business comprising assets and liabilities, i.e. by the valuation of the acquired entity as a whole, the capital structure of the acquiree is taken into account. Subsequently, liabilities have to be excluded in an impairment test for goodwill. As a result, the discount rate applied in determining the purchase price of a unit including liabilities will differ from the discount rate applied in determining the value in use of the respective unit without liabilities.

Therefore, ED IAS 36.43 should be interpreted as follows: Estimates of future cash flows shall not include cash flows from financing activities as far as the method the entity financed the purchase of the asset or the cash-generating unit is concerned (analogous BI 9 referring to discount rate). However, if a cash-generating unit that comprises assets and liabilities is acquired, the capital structure of the acquiree has to be taken into account when the impairment test for goodwill is performed.

Future restructuring and capital expenditure

Future cash outflows or related cost savings (e.g. reductions in staff costs) and other benefits that are expected to arise from a future restructuring to which an entity is not yet committed may well be part of the expected synergies and other benefits from the combination and therefore be incorporated in initial recognition of goodwill. If there is still no commitment at the time of impairment testing, an impairment loss based on value in use has to be recognised in respect of goodwill provided that net selling price is not relevant (assuming that all economic circumstances have remained the same since initial recognition of goodwill). In order to avoid allowing management too much leeway we consider such an impairment loss as justified where there is a protracted time period between the date of acquisition and the date of impairment testing, but an entity should not be required to recognise an impairment loss where there is only a short period between these dates.

At its November meeting the Board stated that in such a case the comparison of carrying amount and value in use will not result in the recognition of an impairment loss because the recoverable amount would be net selling price, rather than value in use (see IASB Update November 2003): The best evidence of a recently acquired unit's net selling price would be the arm's length price the entity paid to acquire the unit, adjusted for disposal costs and for any changes in economic circumstances between the transaction date and the date at which the estimate is made. If the unit's net selling price were to be estimated otherwise, it would have to reflect the market's assessment of any net benefits to be derived from restructuring the unit. Therefore, the benefits of restructuring would be reflected in the unit's recoverable amount.

On the grounds of the rationale of impairment testing we doubt that an impairment test could be based on the price the acquirer paid for the acquiree. Instead, only the outcome of recent transactions involving a third party should be considered relevant. Moreover, regarding the reflection of benefits to be derived from restructuring in the determination of net selling price we believe that only those restructuring plans should be taken into account as could be considered as highly likely to be implemented by almost all potential acquirers. In contrast, acquirer-specific effects should not be considered within the net selling price. They can only be part of value in use and we contend that the concept of value in use should therefore be amended.

Similar problems arise from the current concept of value in use with regard to future capital expenditure that will improve or enhance the asset in excess of its standard of performance assessed immediately before the expenditure is made and the related future benefits from this future expenditure.

Moreover, we believe that the following stipulations concerning value in use should be redeliberated: Pursuant to ED IAS 36.27(c) cash flow projections beyond the period covered by the most recent budgets/forecasts shall be estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. The respective growth rate may be connected with an extension of production that can only be achieved by future capital expenditure that improves or enhances the respective assets. However, such capital expenditure is precluded from consideration.

In this context we suggest the Board provide additional guidance on the qualifying date of valuation: According to ED IAS 36.37 future cash flows shall be estimated for the asset in its current condition. It is not clear whether measures (except for future restructuring and future capital expenditure) that have been initiated and that are substantiated by board decisions or by appropriately documented forecasts are to be taken into account or not.

As previously mentioned these significant issues have arisen only recently and we therefore apologise for any inconvenience the late submission of this letter may cause. As stated above, we strongly feel that these matters represent issues which merit further deliberation before final standards can be issued and would urge the Board to consider our comments.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter as necessary.

Yours sincerely

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Executive Officer

Norbert Breker
Technical Director
Accounting and Auditing