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SALZGITTER AG
Stahl und Technologie

**Der Vorstand**

International Accounting Standards Board
30 Cannon Street

GB - London EC4M 6XH

Salzgitter,10. Januar 2003

**Business combinations (Phase I)**

Ladies and Gentlemen,

Referring to your letter dated 30. September 2002 and with regard to the meanwhile published Exposure Draft 3 of the Business Combinations project (phase I) of the IASB, on behalf of the Board of Salzgitter AG, Peine, Germany, we would like herewith to send our formal response relating to an upcoming revision of the accounting treatment of negative goodwill on acquisition in a business combination. On behalf of all interest groups involved and taking into consideration the economic background in the steel-producing sector, we would like to draw your attention to the present circumstances of low market capitalisation of steel producers and to further industry-specific features so that these may enter into your deliberations in designing the standard.

**Introduction**

The accounting treatment of business combinations is currently undergoing a process of modification in connection with an active project of the International Accounting Standards Board (IASB) "Business Combinations (phase I)". The end result will be a replacement of IAS 22 by an IFRS. In this process of deliberation by the Board, it emerges at the present time (December 2002) that the accounting treatment of negative goodwill will differ substantially from the treatment hitherto under IAS 22 (revised 1999).


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The working principles currently used by the IASB presuppose that an excess amount of the fair values of the assets acquired in a business combination over the costs of acquisition can only arise in certain economic constellations. In the Exposure Draft 3 “Business Combinations (phase 1)" (status of December 2002), the IASB indicates that it is planning a procedure which will be considerably different to the present arrangement for both presently existing negative goodwill and negative goodwill incurred in future.

**Comparison: Accounting of negative goodwill under US-GAAP**

On 29 June 2001, the Financial Accounting Standards Board (FASB) substantially concluded the Business Combinations Project, which had been initiated in August 1996, with the approval of the Statement of Financial Accounting Standard (SFAS)
141, Business Combinations, and SEAS 142, Goodwill and other Intangible Assets. SFAS 141/142 are mandatory for financial years beginning after 15 December 2001. Negative goodwill which has arisen or which arises in future is also treated according to these two statements of the FASB. SFAS 141 paragraph 44 does not provide for capitalisation on the liabilities side of negative differences between purchase price and assets, instead the difference is to be offset against the acquired assets. If negative goodwill still remains, SFAS 141 paragraph 45, provides that it must be recognised immediately as extraordinary income. The transitional regulations for existing goodwill, which apply prior to the entry into force of SFAS 141 on 15 December2001, provide according to SFAS 141 Appendix B paragraph 219 that the negative goodwill be taken completely to income.

**Negative goodwill according to the projected regulations of the IASB**

The Exposure Draft 3 “Business Combinations (phase 1)" (status December 2002) allows the conclusion that negative goodwill might arise from the fair values of the acquired assets under a business combination in comparison with the costs of
acquisition only on certain assumptions:

- errors in measuring the fair values of the identifiable net assets acquired or

- by the existence of contingent liabilities of the acquired enterprises, which may arise as a result of the business combination.

The logical consequence is that the excess (negative goodwill), is to be credited immediately in the year of acquisition to the income statement without a step-down in basis of identifiable acquired assets (distinct difference to US-GAAP).

**Negative goodwill existing at the time of the change in the standard (transitional provisions)**

According to the projected regulation of accounting for business combinations, the requirements on recognition of negative goodwill are to take effect retrospectively. It is therefore provided that negative goodwill existing at the time of the entry into force of the new regulation is to be retired without effect on income against the equity.

This regulation is also found in SFAS 141. Contrary to the IASB, there is a write-down of specific assets. This leads to a distinctly different presentation of the income position over time.

**Divergence between the economic situation and the accounting treatment expected for negative goodwill in the steel industry**

The planned accounting treatment of negative goodwill according to the present project status of the IASB leads, in our opinion, to a presentation of the assets and income situation which does not correspond with the actual economic situation; it also leads to an inconsistency between the recording of profits from the release of negative goodwill and the amortisation/depreciation of the assets of the enterprise acquired.

This divergence between economic situation and the expected accounting for negative goodwill is produced against a background of under-capitalisation and a cyclical market in the steel industry. The criteria proposed by the IASB for the existence of negative goodwill do not, in our opinion, fully reflect this circumstance and hence a situation such as it arises in the steel industry has not been addressed exhaustively.

**Market capitalisation of international steel-producing companies**

A comparison of market capitalisation with the book equity of major steel-producing enterprises shows that the equity reported by the companies is consistently much higher than their market capitalisation.

| Enterprise | Country | equity | | market capitalisation | | ratio |
|---|---|---|---|---|---|---|
| | | date | amount | date | amount | % |
| ARBED | Luxembourg | 31.12.01<br>31.12.00 | 6.258<br>6.320 | 26.06.02 | 1.459 | 23,3% |
| CORUS | UK | 31.12.01<br>31.12.00 | 2.747<br>2.721 | 26.06.02 | 2.546 | 92,7% |
| Salzgitter | Germany | 31.12.01<br>31.12.00 | 1.085<br>911 | 26.06.02 | 579 | 53,4% |
| ThyssenKrup | Germany | 30.09.01<br>30.09.00 | 8.786<br>8.797 | 26.06.02 | 7.589 | 86,4% |
| Usinor | France | 31.12.01<br>31.12.00 | 4.123<br>4.544 | 26.06.02 | 3.482 | 84,5% |
| US Steel | USA | 31.12.01<br>31.12.00 | 2.201<br>2.131 | 26.06.02 | 1.960 | 89,1% |

amounts in million units local currencies

**Figure 1: Comparison of market capitalisation and equity of steel-producing companies**

A comparison of the equity reported in the balance sheet and the present market capitalisation shows that the divergence of these two factors is not coincidental: the relationship is a result of the cyclical nature of the steel market, as has been characteristic of this industrial sector in the past.

**Inference from the divergence between the economic situation and the accounting treatment expected for negative goodwill for companies in the steel industry**

If market capitalisation is an indicator of the purchase price a potential buyer would pay, acquisitions in the steel sector would always give rise to negative goodwill.

According to IAS 16.53 in conjunction with IAS 36.9d, the fact that the book value of the net assets of a reporting enterprise is greater than its market capitalisation is an indicator that there is an impairment. Since a lower market capitalisation exists compared with the equity of the assets for all enterprises reviewed and nevertheless no substantial impairment has been recorded, this leads us to the conclusion that there is no impairment. This means that it has been assumed that there has not been any permanent impairment and that there has not been any over-valuation of the book assets above the fair values.

If — in the absence of any impairment as described above and on non-observance of the fact that the equity to be offset according to IAS 22 would tend to increase further by the statement of fair present values on initial consolidation — this negative goodwill were attributable solely to the existence of potential “lucky buys” in an almost perfect capital market — especially as the data mentioned above is in the public domain — steel-producing enterprises would always be subject to takeovers when the business cycle is in decline. Since this is neither the case at present nor has it been in the past, other fundamental reasons must be responsible for the value relationship between market capitalisation and equity as disclosed in the balance sheet.

Since the steel industry is a strongly cyclical sector, the valuation of these companies on the capital markets is subject to risk discounts. The negative goodwill from the notational acquisitions described above is, therefore, attributable neither to an erroneous determination of the fair values of assets nor to the existence of “lucky buys”.

**Effects of the divergence on the net worth of steel-producing enterprises**

The proposed treatment of negative goodwill is inconsistent with the regulations on impairment. According to IAS 36.5, the recoverable amount is the higher of net selling price and value in use.

Applying these impairment criteria, there is no impairment in the steel industry. This is economically in line with the regulation under US-GAAP; here there is only a deviating presentation in the balance sheet (present IAS: gross; US-GAAP: net).

In our view, the present arrangement for the treatment of negative goodwill (IAS 22.61 and IAS 22.62, each revised in 1998) is appropriate. The negative goodwill presents a correction item on the liabilities side to the fixed assets which are measured at fair values.

On application of the new provisions, in the case of an acquisition of a steel-producing company, the entire negative goodwill would be shown as income in the first year of acquisition. This would have two effects:

- Firstly, under certain circumstances in the subsequent periods — even with a moderately successful enterprise — a loss would normally be recorded consequent on the high depreciation coming from the subsidiary acquired, especially near the bottom of the steel cycle, and this loss would only be compensated for over the total life cycle of the enterprise by the negative goodwill which would have been realised immediately on acquisition.

This would lead to a distortion of the earnings position of the Group over time, since the investment of the Group in the form of acquisition (purchase price) is profitable in comparison to the annual results obtainable from the subsidiary, if the negative goodwill — as to date — is understood as a compensatory item to the depreciation on the revalued assets.

- Secondly, the assets of the subsidiary reported in the consolidated statements, less debts, produce an accounting value which is above the capitalised earning power (indicator market capitalisation).

The Ausschuss fur Internationale Zusammenarbeit (AFIZ) (a committee for international collaboration of the German Accounting Standards Committee (DRSC)) agrees with this opinion, stating: “In the opinion of the AFIZ, an immediate taking to profits of negative goodwill is at the least not justified in cases where it is to be expected that the business operation of the acquired enterprise will lead to losses in future periods. In such cases, negative goodwill should be taken to income as the losses are incurred.” (report of the Board from the meeting held on 18 June 2000, in the technical journal IDW-Eachnachrichten, 7/2000, page 313). Here inference by analogy to the accounting treatment of existing negative goodwill — since according to the plans of the IASB, here too a different accounting treatment is under consideration — would certainly seem b be appropriate. In the projected IFRS, in the year of first application, any existing negative goodwill is to be reclassified under equity.

This does not lead to an appropriate modelling of the economic import of the acquisition of an undercapitalised enterprise in the steel industry with assets which are demonstrably not overvalued. The depreciation of the assets of the enterprise acquired leads, if the correction item on the liabilities side is removed — whether in the case of existing negative goodwill with recognition without effect on income or in the case of future negative goodwill with recognition as income in the absence of this compensating item to a burdening of the annual results of future periods of the acquiring enterprise. This leads to an income shift in favour of the year of the acquisition and higher expenses in later periods.

As illustrated in Appendices I and II, on retention of the present accounting rules and on the assumption of a going concern for both enterprises — acquiring and acquired enterprises — the income shift to the year 2001 produces a presentation of the financial position which does not correspond with the economic situation in the steel sector. The absence of the compensation of the pro rata recognition of the negative goodwill balancing the depreciation of the assets over the economic term leads, in our opinion, to erroneous interpretations of the net assets, financial and earnings situation by the relevant quarters in the capital market.

Moreover, the planned procedure fails to correspond with the IASB's aim of fair value accounting. In contrast to the treatment of goodwill, the proportionate statement of the net assets of the subsidiary at the date of acquisition is closer to their fair value. Because the negative goodwill is taken to income on initial consolidation, there is a proportionate statement of the net assets of the subsidiary above the fair value (i.e. market value).

**Summary**

We ask you to take the aforementioned reasoning into consideration in the final revision of the IFRS and also to provide a possibility in future, when these preconditions pertain, to release negative goodwill to income over the remaining weighted average useful life of the identifiable acquired amortisable assets.

Yours sincerely,

Salzgitter Aktiengesellschaft

Enclosures

## Calculation according to the planned change in method

### Example - projected treatment according to IAS 22

purchase price should be equal to market capitalisation (60 units)
amortisation over the remaining weight average usefull life: 10 years
reinvestments equal to depreciation

balance sheet of subsidiary as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 200 | equity | 100 |
| receivables | 200 | liabilities | 300 |

| income statement xx01 | | income statement xx02 | | income statement xx03 | | income statement xx04 | | income statement xx05 | |
|---|---|---|---|---|---|---|---|---|---|
| sales | 600 | sales | 575 | sales | 550 | sales | 575 | sales | 600 |
| depreciation | -20 | depreciation | -20 | depreciation | -20 | depreciation | -20 | depreciation | -20 |
| other operating exper | -570 | other operating exper | -550 | other operating exper | -530 | other operating exper | -550 | other operating exper | -570 |
| | 10 | | 5 | | 0 | | 5 | | 10 |

balance sheet parent company as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 60 | equity | 60 |
| receivables | 0 | liabilities | 0 |

balance sheet of subsidiary as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 200 | equity | 100 |
| receivables | 200 | liabilities | 300 |

realization of hidden reserves of the subsidiary as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 50 | equity | 0 |
| receivables | 0 | liabilities | 10 |

consolidated balance sheet as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 250 | equity | 60 |
| | | negative goodwill | 80 |
| receivables | 200 | liabilities | 310 |

| income statement xx01 | | income statement xx02 | | income statement xx03 | | income statement xx04 | | income statement xx05 | |
|---|---|---|---|---|---|---|---|---|---|
| sales | 600 | sales | 575 | sales | 550 | sales | 575 | sales | 600 |
| amortisation of negative goodwill | 80 | amortisation of negative goodwill | | amortisation of negative goodwill | | amortisation of negative goodwill | | amortisation of negative goodwill | |
| depreciation | -25 | depreciation | -25 | depreciation | -25 | depreciation | -25 | depreciation | -25 |
| other operating exper | -570 | other operating exper | -550 | other operating exper | -530 | other operating exper | -550 | other operating exper | -570 |
| | 85 | | 0 | | -5 | | 0 | | 5 |
| net assets | 140 | net assets | 135 | net assets | 130 | net assets | 125 | net assets | 120 |
| ROCE | 60.7% | ROCE | 0.0% | ROCE | -3.8% | ROCE | 0.0% | ROCE | 4.2% |

## Calculation according to the present accounting rule

### Example - Existing treatment according to IAS 22

purchase price should be equal to market capitalisation (60 units)
amortisation over the remaining weight average usefull life: 10 years
reinvestments equal to depreciation

balance sheet of subsidiary as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 200 | equity | 100 |
| receivabl | 200 | liabilities | 300 |

| | income statement xx01 | | income statement xx02 | | income statement xx03 | | income statement xx04 | | income statement xx05 |
|---|---|---|---|---|---|---|---|---|---|
| sales | 600 | sales | 575 | sales | 550 | sales | 575 | sales | 600 |
| depreciation | -20 | depreciation | -20 | depreciation | -20 | depreciation | -20 | depreciation | -20 |
| other operating expe | -570 | other operating expe | -550 | other operating expe | -530 | other operating expe | -550 | other operating expe | -570 |
| | 10 | | 5 | | 0 | | 5 | | 10 |

balance sheet parent company as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 60 | equity | 60 |
| receivabl | 0 | liabilities | 0 |

balance sheet of subsidiary as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 200 | equity | 100 |
| receivabl | 200 | liabilities | 300 |

realization of hidden reserves of the subsidiary as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 50 | equity | 0 |
| receivabl | 0 | liabilities | 10 |

consolidated balance sheet as of 1.1.xx01

| | | | |
|---|---|---|---|
| PPE | 250 | equity | 60 |
| | | negative | |
| receivabl | 200 | goodwill | 80 |
| | | liabilities | 310 |

| | income statement xx01 | | income statement xx02 | | income statement xx03 | | income statement xx04 | | income statement xx05 |
|---|---|---|---|---|---|---|---|---|---|
| sales | 600 | sales | 575 | sales | 550 | sales | 575 | sales | 600 |
| amortisation of | | amortisation of | | amortisation of | | amortisation of | | amortisation of | |
| negative goodwill | 8 | negative goodwill | 8 | negative goodwill | 8 | negative goodwill | 8 | negative goodwill | 8 |
| depreciation | -25 | depreciation | -25 | depreciation | -25 | depreciation | -25 | depreciation | -25 |
| other operating expe | -570 | other operating expe | -550 | other operating expe | -530 | other operating expe | -550 | other operating expe | -570 |
| | 13 | | 8 | | 3 | | 8 | | 13 |
| net assets | 140 | net assets | 135 | net assets | 130 | net assets | 125 | net assets | 120 |
| ROCE | 9,3% | ROCE | 5,9% | ROCE | 2,3% | ROCE | 6,4% | ROCE | 10,8% |