Karl Hoffmann

61462 Königstein, 20. Oct. 2005 Hardtgrundweg 28 Germany

International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

Letter of Comment No: 251 File Reference: 1204-001

Comments on exposure draft IFRS 3/IAS 27 and IAS 37

Dear Ladies and Gentlemen,

I appreciate the opportunity to comment on the aforementioned Exposure Drafts.

Basis of the following comments on ED IFRS 3/IAS 27 is the view, already expressed by the alternative view of some of the board members, that the financial statements of a group should primarily focus on the informational needs of the owner of the equity interest of the parent company of the group.

Although I agree that the minority interests in subsidiaries are equity of the group and should be presented as equity, the holder of these equity instruments can not get (much) useful information from the financial statements of the total group. The relevant source of information about the investment in the subsidiary is the financial statements of the respective subsidiary including the disclosures about related party transactions with the total group to which the subsidiary belongs. Therefore the group accounts should primarily serve the informational needs of the equity holder of the parent company.

1.) full goodwill

The ED proposes to estimate the fair value of 100% of the new subsidiary, to derive on this basis the total goodwill and allocate this goodwill in the next step to the controlling interest and the minority interest, based on the cost of the controlling interest.

To recognise goodwill also for the minority interest seems to be consequent, since all other assets and liabilities "belonging" to these investors are also recognised in the financial statements of the group.

To estimate the fair value of 100% of the new subsidiary in the case that less than 100 % are actually purchased by the group, might be difficult for various reasons.

Therefore I would suggest measuring the amount of goodwill relating to the minority interest on an easier way. In the **first step** the goodwill relating to the controlling interest in the subsidiary should be calculated on basis of the purchase price of the controlling interest (I agree to exclude from cost of the controlling interest the cost of activities surrounding the acquisition transaction, since the material amounts of these costs are often costs to evaluate the investment to get the informational basis for the investment decision. Such costs to

evaluate alternatives should be expensed when occurred.) and the proportional fair value of the identifiable assets and liabilities of the respective new subsidiary recognised as of the acquisition date. In a **second step** this goodwill relating to the controlling interest should be allocated to the cash generating units, which are affected by the acquisition, treating the new subsidiary as a cash generating unit or group of cash generating units (even if the parent does not intend to monitor goodwill on the subsidiary level, but only on a higher aggregated level). In a **third step** the amount of goodwill which is allocated to the cash generating unit "new subsidiary" should be simply "grossed up" to measure the amount of goodwill allocated to the minority interest in the subsidiary. The amount of goodwill (due to expected synergy effects) allocated to cash generating units of the group outside the new subsidiary is not grossed up, since the minority interest in the new subsidiary does not participate in these parts of the goodwill.

The proposed procedure would overestimate the goodwill relating to the minority interest in case of a "control premium" that is not reflected in allocating parts of the goodwill relating to the controlling interest to cash generating units of the group outside the new subsidiary. The only effect on the group income relating to the parent could be, that due to the overestimated goodwill allocated to the minority interest the impairment test indicates an impairment of the goodwill (and the goodwill relating to the controlling interest), that would be lower, if the goodwill relating to the minority interest were not overestimated. But I assume that such control premiums are rarely of such an amount, that a possible overestimation of the goodwill relating to the minority interest would deteriorate the usefulness of the financial statements for the holder of the equity investments of the parent company of the group. Therefore I would prefer this simplified method to estimate the amount of goodwill relating to the minority interest, accepting a certain degree of "error", but avoiding a speculation of a fair value of 100% not actually observed. Under the present impairment rules for goodwill we use also a "grossing up method" in case a cash generating unit comprises goodwill of subsidiaries not wholly owned, which causes the same "errors", as described above. But so far I am not aware that this was seen as a serious problem. According to the ED this grossing up method for the impairment test will be used also in the future in cases, where cash generating units comprises goodwill recognised only partially (resulting from acquisitions before the new IFRS 3 becomes effective).

2.) Step acquisition

The ED proposes to re-measure the investments in the new subsidiary, which was purchased before the acquisition date, to fair value as of the acquisition date with the effects recognised in income.

Since the earnings process is not complete with regard to these investments, I would prefer not to show income under such circumstances, with the exception that the investment qualified as trading under IAS 39 or an impairment loss has occurred.

In case of a joint venture investment, accounted according to the proportionate consolidation method, this valuation should be continued for the "old" share in the subsidiaries assets and liabilities. The new share in the subsidiaries assets and liabilities should be valued according to its purchase price and the new minority interest, if any, at the same basis.

In case of an investment accounted for under the equity method, the valuation for the assets and liabilities of the respective share in the subsidiary implicit in this "one line consolidation"

should be continued. The new share in the subsidiaries assets and liabilities should be valued according to its purchase price and the new minority interest, if any, at the same basis.

In both cases a revaluation of the assets and liabilities including goodwill to fair values as of the acquisition date might be allowed, but this revaluation should be treated similar to a revaluation under IAS 16.

In case the investment was classified as available for sale investment, the valuation of the assets and liabilities should be based on the fair value of the investment as of the acquisition date of the new subsidiary. The difference between cost of the investment and fair value as of the acquisition date is recognised directly as an "available for sale reserve" in equity and should only be recycled to income, when the investment in the subsidiary is (partly) derecognised.

3.) Purchase of shares of a subsidiary after control was established

The ED proposes to show the purchase price for the additional shares of the subsidiary, which exceeds the respective minority interest, as reduction from the (parent) equity of the group. The obvious advantage of this accounting is that it is easy. But from the perspective of the equity holder of the parent company of the group, the purchase of (parts of) the minority interest in a subsidiary is an investment as any other investment. Therefore I believe that it is more useful information for the equity holder of the parent company to show the exceeding purchase price as additional cost of the respective proportionate share of the assets/liabilities of the subsidiary.

4.) Sale of shares of a subsidiary without loose of control

The ED proposes to show the sales price, that exceeds the additional respective minority interest, as a direct addition to the (parent) equity of the group. From the perspective of the equity holder of the parent company of the group, the sale of parts of the investment is similar to any other sale of an investment. Therefore I believe it would be better to show this excess sales price as gain in the income statement.

5.) Sale of a subsidiary with a remaining investment

The ED proposes to recognise the remaining investment in the former subsidiary at its fair value at the time the status of the investment changes from subsidiary to joint venture, associate or available for sale investment, with recognition of the resulting gain or loss in the income statement.

Since the earnings process with regard to the remaining investment in the subsidiary is not complete, the change of the status of the remaining investment should not affect income, with the exception, that the remaining investment is classified as trading investment under IAS 39 or is impaired.

If the remaining investment qualifies as joint venture and the group uses proportionate consolidation, than the measurement of the respective part of the assets/liabilities of the former subsidiary in the group accounts should be continued.

If the remaining investment has to be accounted under the equity method, the former consolidation of the subsidiary should be continued proportionally as "one line consolidation".

If the remaining investment qualifies as available for sale investment under IAS 39, the deemed cost of the investment, should be the sum of the respective share of the group values of the assets/liabilities of the former subsidiary. The re-measurement to fair value should be recognised in a reserve in equity and only recycled to income, when the investment is derecognised or impaired.

So I would prefer the current method, used in accounting for such circumstances.

6.) Discrepancies between IFRS 3 and IAS 38 with regard to "control"

In IAS 38.16 it is explicitly explained, that an entity usually has no sufficient "control" over customer relationships that are not protected by legal rights.

The examples in ED IFRS 3 Appendix A49 seem to indicate, that "control" is not (or in some way less) necessary for recognition of an intangible asset within a purchase price allocation. The renewal of supply contracts or insurance contract by the customer is alone in the sphere of the customer. Therefore I would believe that "control" in the sense of IAS 38.13-16 is not present.

It would be helpful for users of the standards to clarify, whether the "control" criterion for intangibles within a purchase price allocation is "reduced" (because there will be an asset in any case: the separate asset or goodwill) or to clarify the meaning of "control" in IAS 38, if no distinction in "control" is intended between a purchase price allocation and a separate acquisition.

7.) Comment on ED 37: onerous contract

If a cash generating unit (term used as in IAS 36) owns its property, plant and equipment, there is an impairment loss on this property, plant and equipment, if the present value of the expected net cash flows from the planned activities of the cash generating unit is less than the book value of the property, plant and equipment.

Assume a cash generating unit, with the same activities as the cash generating unit above, but with the difference that all or a mayor part of the property, plant and equipment is leased under operating leases. If the present value of the expected net cash flows from the planned activities of the cash generating unit (including the cash outflows for the rentals for the leased property, plant and equipment) is negative, this should be reflected in a liability for onerous lease contracts.

I would suggest introducing the "cash generating unit concept" explicitly in IAS 37.55-59.

In case a leased asset is not used any more by the lessee for its own operations, the lease ceases to be part of a cash generating unit and becomes its own "cash generating unit". In case the lease contract does not allow a sublease, theoretical sublease rentals should not reduce the amount of a liability for an onerous contract.

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

Kind regards

K. Hoffmann