21.11.2005
Joint comments of Deutsche Bundesbank and BaFin on the ED’s “Proposed amendments to IFRS 3 Business Combinations/IAS 27 Consolidated and separate financial statements/IAS 37 Provisions, contingent liabilities and contingent assets”

Dear Sir David,

BaFin and Deutsche Bundesbank appreciate the opportunity to comment on the ED’s of Proposed Amendments to IFRS 3 Business Combinations, IAS 27 Consolidated and Separate Financial Statements and IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

We hope that even in the case that we are providing our comment letter after the end of the comment deadline that it will be taken into consideration by IASB.

Comments regarding ED-IFRS 3

Through the introduction of the “full goodwill method” and the related requirement of a "fair valuation" of the acquiree the proposed amendments to IFRS 3 seem to further enlarge the use of the concept of “fair value measurement”. Under this new approach the reliability of goodwill measurement could further decrease, since the calculation of goodwill would only in rare cases be based on a “verified” amount, i.e. the consideration transferred. Especially in the context of a business combination, situations may occur where no liquid or active markets exist. Thus, the new approach would presumably involve greater discretionay scope, and, as a consequence, would lead to goodwill amounts which are less verifiable than under the existing approach in IFRS 3. It is our impression that such a
broader use of the “fair value” concept needs an intensive discussion with all interested parties. From a supervisory point of view, this issue is of key importance as indicated in various comments on IAS/IFRS in the past. From our viewpoint it seems doubtful whether the short comment period for the proposal on hand is sufficient for such a broader discussion.

We have doubts whether the proposed “economic entity approach” in IFRS 3 would really provide information which is more relevant compared to the existing “parent entity approach” of IFRS 3.

In addition, the introduction of the “economic entity approach” would presumably “swap” relevance for reliability.

In any case we are worried that the potential need for further amendments to IFRS 3 in the near future could impede planning reliability of affected companies. This is mainly due to the fact that, at least in our view, some areas still need to be revised (the new definition of a “business combination”, for example).

In more detail:

The full goodwill method in ED-IFRS 3, which is in line with the “economic entity approach”, would contribute to a further promotion of the “fair value concept” within IFRS 3, as the recognisable goodwill would no longer be determined as the difference between the fair value of the consideration transferred and the fair value of the acquired identifiable net assets (on a pro rata basis), but rather as the difference between the fair value of the acquiree, as a whole, and the fair value of the (total) acquired net assets. The measurement of goodwill will therefore no longer be based in all cases on the fair value of the consideration which is a reliable measure of value as it has been paid by the acquirer. In cases where there are indications that the fair value of the consideration does not equal the fair value of the acquirer’s interest in the acquiree (i.e. in many cases when less than 100% are acquired), other information (valuation methods, i.e. income approach, DCF) has to be considered in order to estimate the fair value of the acquiree. In such cases the risk that the estimation could be based on intransparent internal assumptions is relatively high. As a consequence, this information does not necessarily need to be reliable, as the generation of this information typically involves greater subjectivity and discretionary scope.

In addition it is questionable whether the use of a general “fair value model” as proposed in the draft on hand will provide useful information for the investors. In the context of a business acquisition a separate calculation of market driven “fair values” is a theoretical exercise, only, because such an exercise requires the simulation of presumed price reactions of third parties which are not directly involved in the acquisition. Therefore the consideration paid by the acquirer is the most relevant information for the market and not only a best evidence of current values.

We also fear that the new approach could create inconsistencies to existing IAS/IFRS, as, for example, IAS 38. The “full goodwill approach” now seems to view the “goodwill” as a separate identifiable intangible asset. Such an interpretation seems to be possible because the calculation of “goodwill” – in particular in the cases where less than 100 % are acquired – could be independent from the consideration which was paid for the transaction. As a consequence, it could be argued that the “goodwill” is no longer a pure residual amount but
an asset that could be measured individually. In this context, no further distinction would be made between an internally generated and a purchased goodwill. In our opinion, this perception of “goodwill” would contradict IAS 38.48 ff. where the recognition of an internally generated goodwill is explicitly prohibited, as an internally generated goodwill is not considered as an intangible asset that meets the recognition criteria of IAS 38. Thus, the “full goodwill approach” could also undermine the existing distinction between a purchased goodwill (to be recognised as an asset) and an internally generated goodwill (not to be recognised, according to IAS 38). In fact, parts of the recognised goodwill according to the new approach have not been acquired actually in the course of the business combination.

As a consequence, we tend to prefer the current “purchase method” (and, implicitly, the “parent entity approach”), i.e. the allocation of the acquisition costs to the acquired identifiable assets and liabilities (on a pro-rata basis, if the acquirer holds less than 100%), where the residual amount would be the “goodwill” (without non-controlling interest!). In fact, we are not convinced that the proposed new approach would really provide information which is more relevant and reliable than under the current IFRS 3. We also noticed that even 5 out of 14 IASB members voted against the introduction of the “full goodwill method” at that time.

An additional aspect regarding intangible assets has to be taken into account. The implicit assumption of the new approach in ED IFRS 3.28 ff. seems to be that all identifiable assets and liabilities acquired in a business combination are reliably measurable and should therefore be recognised separately from goodwill. However, we have concerns with regard to this approach. There are several identifiable assets which are not reliably measurable, as for example, product licences. Often, active markets are also lacking. Moreover, the new proposal again is likely to create an inconsistency to the general recognition criteria of the IASB framework and IAS 38, as the requirement that an intangible asset has to be reliably measurable to be recognised separately from goodwill has obviously been eliminated in ED IFRS 3 (BC 100-102). As a regulator, we deem the “reliability of measurement” criterion as extremely important. Moreover, in the course of the discussions on the “fair value option” (IAS 39), this particular matter had been one of the most controversially disputed issues. It is our view that in case the “purchase method” is applied to identify a goodwill using an objective upper limit (the purchase price) it could be justified to accept the recognition of intangible assets including those which can hardly be identified and measured in accordance with strict reliability criteria, since the purchase price is an objective element and any further breakdown for recognition of tangible and intangible assets may contribute to more transparency and the identification of a real remaining good will. But without the purchase price as an objective starting point to derive a goodwill, any recognised intangible asset should be subject to a strict reliability criterion in line with the IASB framework and IAS 38. As a result in the “fair value context” as proposed the deletion of the “reliability criterion” is not acceptable.

In view of a “principle based” accounting system, we would also prefer common definitions which are broadly applicable in any IAS/IFRS. For example, we do not understand why the definition of “fair value” in ED IFRS 3 differs (although only marginally) from the definition of “fair value” in IAS 32. Unlike ED IFRS 3, IAS 32.11 refers to the amount, not the price for which an asset could be exchanged. Furthermore, the definition in ED IFRS 3 targets “knowledgeable, unrelated willing parties”; IAS 32.11, on the other hand, aims at “knowledgeable, willing parties in an arm’s length transaction”. Particularly with regard to the overall significance of “fair value measurement”, adequate care should be dedicated to a common definition of “fair value”.

The new definition of a “business combination” emphasises the “control by the acquirer”. In our view, it is questionable whether the new definition is better than the old
one at reflecting "true mergers", since, in the case of the latter, no control is acquired and an acquirer is not identifiable. We have the impression that a "true merger" would meet the conditions of the current definition of a business combination in IFRS 3 (→ "bringing together" of businesses), but not the definition of the proposed new ED IFRS 3 due to the fact that the interpretation of "control" will as a matter of principle not allow business combinations in the sense of a "merger of equals". On the other hand, ED IFRS 3.26 clarifies that true mergers would also fall under the new definition of business combinations. Due to the mentioned inconsistency, we believe there is still a need for the new definition to be revised.

ED IFRS 3.27 suggests not considering acquisition-related costs (i.e. advisory or legal fees) as part of the consideration transferred in exchange for the acquiree. In our opinion, this approach runs counter to the treatment of acquisition-related costs in other standards. In IAS 38, for example, professional fees arising directly from bringing an intangible asset to its working conditions are to be included in the initial measurement of the intangible asset. Moreover, we believe that this proposal would be contradictory to the otherwise valid "principle of the neutral valuation of acquisitions". Nevertheless there seem to be good reasons not to consider acquisition costs in such unique cases of business combinations. But this should not impede the different treatment of those costs in other circumstances and standards, where they become part of an asset value and are recoverable in case of sale of those assets.

Finally, we believe it is premature to propose a further move in the direction of a "full fair value concept" before undertaking a comprehensive analysis of the concept, especially in view of the "convergence project".1

Comments regarding ED-IAS 37

In some cases, some of the proposed amendments to IAS 37 seem to be in conflict to the regulations of the framework (i.e. the proposed movement of the probability criterion from recognition to measurement in ED IAS 37). In our opinion, changes to existing IAS/IFRS should be aligned in any case to the regulations of an updated framework. In this context, the outcome of the current "framework project" (where a discussion paper is scheduled to be issued in the 2nd quarter of 2006) should also be taken into account. Otherwise, we see a risk that IFRS could lose its status of a "principle based" accounting system. Moreover, it seems to us that the convergence project (FASB - IASB) is generally given a higher priority, possibly at the expense of consistency and reliability aspects.

Regarding definition of "non-financial liabilities" the IASB proposes no longer using the term "provisions" in the new version of IAS 37. Instead, any liabilities not within the scope of other IAS/IFRS are to be termed "non-financial liabilities". The revision of IAS 37 is likewise an element of the IASB/FASB convergence project. However, we find this approach to be of dubious merit. In our view, it does make sense to draw a distinction between "liabilities" and "provisions" in order to recognise the differences between each concept in the degree of uncertainty associated with them.

We are rather concerned of the practical implications of the proposed distinction between unconditional and conditional obligations, even if the theoretical conception seems to make sense. In particular, it does not seem clear to us when exactly an unconditional obligation arises. In addition, the exact question of what constitutes an

1 The FASB plans to issue a final Statement on fair value measurement in the end of 2005. The definition of "fair value" may still change in the final document.
"obligating event" is a central theme of the "conceptual framework project", i.e. the revision of the framework.

In this context, it also seems to be inconsistent with the IASB framework to shift the probability criterion to the area of measurement. Although the probability criterion has been removed from IAS 37.14 (b), it is still required by the definition of a liability within the IASB framework. We are of the opinion that changes to individual IAS/IFRS should be consistent with the revision of the framework at any rate. Furthermore, we are worried that, as a consequence of the proposed amendments, more and more unreliable information that was once covered in the notes could find its way onto the balance sheet.

Finally, as a more general note, we do not see any necessity to amend the recognition criteria for liabilities, as the existing approach seems to have demonstrated its "practicability" in the past. We are not convinced that the proposed new approach would in fact provide more relevant and reliable information.

Yours sincerely

Karl-Heinz Hillen

Ludger Hanenberg