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RWEAG Opernplatz 1 45128 Essen, Germany

Sir David Tweedie
Chairman of the
International Accounting
Standards Board (IASB)
1st Floor, 30 Cannon Street
EC4M 6XH
United Kingdom

Group Accounting
Our ref. HR/Ri/Dr.Bee
Name Fred Riedel
Dr. Thomas Beerman
Telephone + 49 (0) 201 12 15269
Fax +49(0) 201 12 15196
E-mail fried.riedel@rwe.com
thomas.beermann@rwe.com

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ED 3 "Business Combinations", ED lAS 38 "impairment of Assets",
ED IAS 38 "Intangible Assets"

Dear Sir David

We appreciate the opportunity to comment on the Exposure Draft ED 3 "Business Combinations", the Exposure Draft of proposed amendments to IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets".

Business combinations have become an important factor in global business. The number and importance of business combinations have increased during the last few years. The old accounting rules for business combinations do not seem to lead to a fair presentation of business combinations in the financial statements in any respect.

Therefore the IASB started a project on business combinations which led to the aforementioned Exposure Drafts. In these Exposure Drafts the IASB proposes an impairment-only approach to goodwill. We support this approach because we think that it leads to a fairer presentation of business combinations in financial statements.

Nevertheless, in reviewing the Exposure Drafts, we identified a number of significant issues that we believe should be addressed by the IASB before the standards are finalised:

Consideration of Income Taxes
In measuring the value in use, estimates of future cash flows should not include income tax receipts or payments (ED IAS 36.43) and, under ED IAS 36.48, the discount rate should be a pre-tax rate. However, investment decisions are generally considered on an after-tax basis, i.e., cash flows after taxes and income after taxes. In business reality, taxes are an important driver of investment decisions.

if tax effects are taken into account when the acquisition price of an entity is determined, whereas the value in use is calculated before taxes, this may create a fundamental discrepancy in the goodwill impairment approach proposed by the IASB.

We recommend that the IASB propose to consider all tax effects in determining value in use. The Board's proposals should at least offer an option of determining the future cash flows under ED IAS 36.48 either on a pre-tax- or post-tax basis.

Furthermore, under the US GAAP rules in FAS 142, the goodwill of a reporting unit is not considered impaired if the fair value exceeds its carrying amount The fair value of a reporting unit is the amount at which the reporting unit could be bought or sold in a current transaction between willing parties and includes all tax effects. This is also reflected in current financial statements of FAS 142 adopters. Therefore the proposed regulation in ED 3 would give rise to a discrepancy between the proposed treatment of income taxes under ED IAS 36 and under FAS 142.

Tax effects are an important part of investing decisions, and premise by the USGAAP goodwill impairment approach. We advocate that income taxes be considered in determining the value in use of a cash generating unit.

In measuring the value in use under ED IAS 36.32 and 36.37, future cash flows should be estimated for the cash generating unit in its current condition. Estimates of future cash flows should not include estimated future cash flows that are expected to arise from a future restructuring to which the entity is not yet committed or future capital expenditure that will improve or enhance the cash generating unit over its standard of performance assessed immediately before the expenditure is made.

But, when a company determines the acquisition price, it takes into account all cash flows from a planned restructuring even if the company is not yet committed to it, or all cash flows from planned future capital expenditures which improve or enhance the cash generating unit.

If, when the acquisition price of an entity is determined, cash flows from future restructuring or future capital expenditures to improve or enhance the cash generating unit are taken into account, and such cash flows are not taken into account when the value in use is calculated, there will be a fundamental discrepancy to the goodwill impairment approach proposed by the IASB.

Because cash flows from future restructurings and capital expenditures form part of the acquisition price, we recommend that all planned cash flows linked to future restructurings and capital expenditures at the date of acquisition be taken into account in determining value in use.

Under ED IAS 36.27 (b) cash flow projections should be based on the financial budgets/forecasts that have been approved by the management. In practice, financial budgets/forecasts always include expected capital expenditures independent of capital expenditures which are intended to replace or enhance an asset. Therefore the requirement in ED IAS 36.37 necessitates two different budgets/forecasts: one including all capital expenditures to enhance an asset and one which does not include this kind of capital expenditure.

This contradicts the management approach generally implemented in ED IAS 36 (cf. for example ED IAS 36.74 and 77). We believe, there should be no differences between the information used for the impairment test and the information used in management reporting to evaluate the performance of the business and the allocation of resources.

Moreover, in our opinion the costs of differentiating between capital expenditures which will replace or enhance an asset materially exceed the benefits derived from this information. Consideration should be taken of the fact that distinguishing between capital expenditures for the replacement and enhancement of an asset, as required in ED IAS 36, cf. Example 6, involves a high degree of judgment in practice. Should the capital expenditures for a new power plant which replaces an old plant with lower capacity and higher fuel consumption be categorised as capital expenditures to replace or to enhance the asset?

We recommend that all future cash outflows and inflows approved by management be taken into account when determining the value in use of a cash generating unit. Instead of excluding capital expenditures for asset enhancement attention should be turned to the accuracy and reliability of the cash flow estimates.

Currency of Entity Valuation

Under ED IAS 36.47, future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. We understand the value in use of all foreign entities under IAS 21.7 should be measured in their functional currencies.

However, we would be grateful for additional guidance on the treatment of foreign exchange translation differences in determining value in use. Should translation gains or losses be included in the carrying amount of a cash generating unit?

Consideration of Capital Structures

Appendix B.19 to ED IAS 36 states that the discount rate is independent of the entity's capital structure and the way the entity financed the purchase of the cash generating unit. Obviously, the Board assumes that there is a perfect capital market with rational individuals (Modigliani/Miller's Proposition I), so that the capital structure has no influence on the discount rate. In reality, we observe that capital markets are not perfect (e.g. there are imperfections and opportunities created by government regulations, cf. Brealey/Myers, Principles of Corporate Finance, p. 489 et seq.). Therefore we believe that there are indeed some merits to the traditional position, which stipulates that leverage affects the discount rate.

In our opinion, the standard should offer more guidance on how to determine an appropriate discount rate taking into account different capital structures.

Disclosures

ED IAS 36 calls for excessive disclosures that clearly exceed the requirements of FAS 142. In our opinion, the proposed disclosures, especially in ED 36.134 d—f, contravene the balance between cost and benefit. The disclosure of all assumptions underlying the goodwill impairment test goes beyond the purpose of financial statements and places an undue burden on the readers of financial statements.

Even more important, such excessive disclosures would lead to an unjustifiable publication of business secrets, since only companies which entered into business combinations in the past are affected. Whereas companies which grow internally would not have to publish the assumptions underlying their financial budgets, companies with acquisitions would have to provide excessive disclosures (including underlying growth rates, for example). In addition, the board should consider that there may be conflicts in particular cases between such disclosure requirements and current laws which prohibit the publication of business or state secrets, if such secrets are addressed.

Moreover disclosure requirements under FAS 142 are less detailed than ED IAS 36 (cf. the latest US GAAP financial statements, e.g. of General Electric or AOL Time Warner). In our opinion, the disclosure requirements requested by ED IAS 36 materially exceed the insignificant benefits derived from this complex information.

Transitional Provisions

ED IAS 38.124 (b) states that the revised Standard should apply to the accounting of intangible assets prospectively. Therefore all intangible assets acquired in a business combination and which meet the separability and contractual or legal right criterion in accordance with ED IAS 38.11, but do not meet the recognition criteria in accordance with the current IAS 38, would not be disclosed separately from goodwill. This requirement diminishes the comparability of financial statements because intangible assets which are acquired in a business combination after ED 3 becomes effective ("new" intangibles) might be disclosed and measured separately from goodwill, whereas the same intangible assets might be disclosed and measured as part of goodwill in business combinations entered into before ED 3 becomes effective (“old” intangibles).

Furthermore, in contrast, FAS 141 Par. 61 requires the carrying amount of all recognised intangible assets that meet the recognition criteria in FAS 141 Par. 39 (...) included in the amount reported as goodwill to be reclassified and accounted for as an asset separately from goodwill.

In order to avoid significant comparability difficulties between “old” and “new” intangibles, we recommend that the board consider adequate transition regulations for the adoption of ED 3 that allow intangible assets to be recognised separately from goodwill that did not meet the recognition criteria under current IAS.

ED IAS 36 calls for the prospective application of the goodwill impairment test Because the proposed impairment rules differ from the actual requirements in IAS 36 (e.g. comparison of the implied value of goodwill with its carrying amount versus comparison of the recoverable amount of a cash generating unit with its carrying amount) the outcome of the impairment test in accordance with ED IAS 36 may differ from the current accounting rules in respect of the goodwill which already exists when the Standard becomes effective.

Moreover FAS 142 Par. 55 et seq. contains a transitional impairment test. An impairment loss as a result of the transitional impairment test should be recognised as the effect of a change in accounting principles and presented In the income statement between the “extraordinary items” and “net income” line items.

In our opinion, the presentation of possible impairment losses as a result of the transitional impairment test should be accounted for as change in accounting policy retrospectively (that is also the standard procedure in ED IAS 8). Therefore we advocate the implementation of transitional provisions which allow the recognition of the results of the initial impairment test in the opening balance of retained earnings for the period in which the Standard is adopted.

In closing, we would like to make the following remarks on two proposals of the Exposure Drafts:

IAS 36

Question 1: Frequency of impairment tests

We approve the proposal allowing the annual impairment test for a cash generating unit to which goodwill has been allocated to be performed at any time during an annual reporting period, provided the test is performed at the same time every year. In our view, this proposal is suitable for reducing the cost of applying the test and appropriately considers the accounting processes of the companies.

Question 5: Determining whether goodwill is impaired

We support the proposal to implement the screening mechanism for identifying potential goodwill impairments similar to that in SFAS 142. In our view, it is an appropriate compromise between the cost of an impairment test and its integrity.

Due to the significant impacts of the revised rules on accounting for business combinations and a number of practical implications, we kindly suggest that the IASB consider holding public roundtable discussions on the various aspects of ED 3 “Business Combinations”, ED IAS 36 "Impairment of Assets”, and ED IAS 38 “Intangible Assets”. We appreciated the opportunity to take part in the public roundtable discussions on the amendments of IAS 32 and IAS 39 and are convinced that roundtable discussions are an effective way to exchange views on principles and practical problems regarding IASB's proposals.

Sincerely yours,

RWE Aktiengesellschaft

Sturany
(CFO)

Riedel
(Head of Group Accounting)