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Andreas Bergmann
Chair
International Public Sector
Accounting Standards Board
529 Fifth Avenue, 6th Floor
New York, NY 10017
USA

October 31, 2012 541/584

Dear Mr. Bergmann,

Re.: Consultation Paper: Public Sector Combinations

The IDW would like to thank you for the opportunity to provide the International Public Sector Accounting Standards Board (IPSASB) with its comments on the Consultation Paper: Public Sector Combinations (hereinafter referred to as the "CP"). We have included our responses to each of the Specific Matters for Comment (SMCs) in an appendix to this letter. We also submit some general comments as follows:

Support for the Project

As IPSAS 6 explicitly does not deal with the methods for accounting for public sector combinations, we support the IPSASB developing a consultation paper to initiate discussion in this area and elicit the views of its constituents. Whilst we continue to support the principles behind the IPSASB conversion project, we agree that this is a particular area in which the rationale, motives and methods of combining operations or entities may often differ significantly from those prevalent in the private sector.

Terminology – Modified Pooling of Interests Method

In our view, in respect of accounting for amalgamations it is appropriate that the differences between the private and public sectors be given due consideration. Given this, we support the IPSASB's Preliminary View 8, whereby a resulting entity in an amalgamation should apply a modified pooling of interests method of accounting. We do not support the fresh start approach for public sector amalgamations.

As mentioned in our responses to the SMCs, we appreciate that, mainly due to the propensity for misuse within the profit-oriented private sector, the pooling of interests method of accounting is no longer permitted under IFRS nor in favour throughout much of the private sector, but agree that in the public sector context an approach based on this method may be appropriate. In this context, we wonder whether the proposed term “modified pooling of interests method of accounting” might be replaced with a more appropriate term e.g., “predecessor accounting”, or similar. Such a term might be preferable in order to deflect negative associations with the term pooling of interests. Furthermore, it is not clear what, if any, the difference is between the so-called “modified pooling of interests method of accounting” and the proposed treatment for acquisitions under common control (UCC) and those not UCC where there is no or only nominal consideration in practical terms, since both entail carrying values being adjusted to align to policies of the resultant combined entity. Thus a different term to reflect this aspect might be preferable.

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

Yours truly,

Klaus-Peter Naumann
Chief Executive Officer

Gillian G. Waldbauer
Technical Manager

APPENDIX

Specific Matter for Comment 1:

In your view, is the scope of this CP appropriate?

The scope is appropriate at this stage of the project, although in reaching certain decisions consideration of subsequent application in practice may be relevant. For example, as we explain in our response to SMC 5, in deciding whether it would be appropriate for goodwill to be recognized separately in a recipient entity's statement of financial position, consideration as to the immediate and future impact on the entity's statement of financial performance is highly relevant.

We agree that the scope exclusions as explained in paragraph 2.43 et seq. are appropriate at this stage of the project. We also note that various issues including disclosures, the treatment of non-controlling interests and of costs related to public sector related combinations will have to be given further consideration once feedback on the CP has been reviewed. In our view, this is an appropriate course of action.

Specific Matter for Comment 2:

In your view, is the approach used in this CP of distinguishing between acquisitions and amalgamations, with a further distinction for PSCs, NUCC and UCC, appropriate? If you do not support this approach, what alternatives should be considered? Please explain your reasoning.

Distinguishing between acquisitions and amalgamations

In our view, the arguments put forward in the private sector for treating all combinations as acquisitions (i.e., "true" amalgamations are rare events in the private sector) will not necessarily hold true in the public sector, since amalgamations may be commonly more in the nature of reorganization initiatives or may be undertaken to relocate selected operations. Thus we agree that a differentiation between acquisitions and amalgamations as defined in the CP is appropriate because of the difference in substance between these two types of combinations in the public sector context and the relevance thereof to financial statement users.

According to our understanding, the main reason for discontinuing the IAS 22 approach to accounting for amalgamations was the potential for "misuse" in the private sector, as entities claiming to have effected an amalgamation as opposed to an acquisition sought not to "uncover" goodwill that would subsequently have to be amortized thus impacting financial performance for several years into the future. Such issues are likely to be of far less relevance in the public sector context, but may be relevant to some degree in certain cases.

Further distinction between not under common control (NUCC) and UCC

We agree that differentiating between combinations under common control and those not under common control is also appropriate in the public sector. In particular, users are likely to benefit from information about an acquired operation that prior to the combination was outside an area under common control, since this is, by nature, an introduction of a new operation(s) to an economic entity.

In contrast, acquisitions that occur within an area under common control may, by their nature, effectively be reorganization initiatives rather than "true" acquisition initiatives.

Thus, we agree that the accounting for this type of combination would not be expected to give rise to the recognition of any hidden reserves that would not be accounted for otherwise in line with the entity's accounting policies. In contrast, financial information on combinations involving operations or entities that were prior to the combination not under common control needs to be considered separately as it may be appropriate for users to be informed of the difference between the consideration transferred and the fair value of the net assets acquired.

Specific Matter for Comment 3:

In your view, are there other public sector characteristics that should be considered in determining whether one party has gained control of one or more operations?

IPSAS 6 deals with control for financial reporting purposes. Characteristics may vary from jurisdiction to jurisdiction, as well as by type of entity. The way in which combinations are undertaken may well be subject to very different provisions under prevailing laws and regulations. We therefore believe that sufficient flexibility needs to be given such that individual circumstances may be taken into consideration in any determination of whether control has or has not been gained.

Paragraph 3.12 seems to us to constitute a questionable argument for identifying whether the combination constitutes an amalgamation as opposed to an acquisition. It is equally conceivable that imposition by another level of government could also relate to an acquisition and may also be achieved without consideration being paid. There is a marked difference between control over an operation as defined and explained in IPSAS 6 and the situation described in paragraph 3.12 of the CP, whereby a higher level of government has the authority to order a public sector combination; however both demonstrate control relationships. In our view, further explanation as to these indicative circumstances is needed as is a discussion as to what control is and is not deemed to be for the purposes of differentiating between acquisitions and amalgamations. For example, there may be some confusion as to whether there is a difference between the “ultimate controlling entity” (Para. 6.1(c)) and the “another level of government“ (Para. 3.12) in terms of ability to specify the terms of a combination, including level of consideration to be transferred.

Specific Matter for Comment 4:

In your view, should the recipient in an acquisition NUCC recognize in its financial statements, the acquired operation’s assets and liabilities by:

a) *Applying fair value measurement to the identifiable assets acquired and liabilities assumed in the operation at the date of acquisition for all acquisitions (Approach A);*
b) *Distinguishing between different types of acquisitions (Approach B) so that:*
    i. *For acquisitions where no or nominal consideration is transferred, the carrying amounts of the assets and liabilities in the acquired operation’s financial statements are recognized, with amounts adjusted to align the operation’s accounting policies to those of the recipient, at the date of acquisition; and*
    ii. *For acquisitions where consideration is transferred, fair value measurement is applied to the identifiable assets acquired and liabilities assumed in the operation, at the date of acquisition; or*
c) *Another approach?*

Please explain why you support Approach A, Approach B or another approach.

As explained in more detail below, conceptually we have some sympathy with Approach B, however, we tend to support Approach A, from a practicability perspective.

In our view, the substance of those public sector acquisitions NUCC where no or nominal consideration is transferred will usually differ considerably from the (for-profit) acquisition scenario common to the private sector. As public sector entities are aimed at service provision rather than profit generation, we suggest that political factors need to be considered in determining how to account for such acquisitions. In our view, any negotiation process that results in the transfer of no or nominal consideration, as referred to in paragraph 5.16, would generally not be comparable to a market-driven negotiation common in the private sector, particularly when directed by another level of government. Furthermore, as noted above, clarification as to the capacity of that instance to exercise control is an issue that we believe needs further explanation.

If the transaction is in substance a reorganizational initiative without “true” commercial purpose, measuring the net assets acquired at fair value and computing the difference with the consideration transferred together with the resultant impact on the recipient entity’s financial performance – irrespective of whether accounted for on acquisition or over time – will not lead to a fair presentation of the underlying transaction. The “difference” between the fair value of net assets acquired and the consideration transferred would not represent a so-called “lucky buy” (private sector term) or “clever” use of resources on the part of management, but would likely be perceived as an accounting complexity not reflecting reality. From a conceptual viewpoint, where no or only nominal consideration is transferred we do not believe that the measurement at fair value of net assets acquired is likely to be entirely appropriate.

We also note the reasons given in the CP in support of this approach.

In contrast, where commensurate consideration is transferred in a public sector acquisition NUCC the situation may well generally be more similar to an acquisition in the private sector. This type of acquisition is covered by Approach B (ii).

However, we are concerned that it may neither make sense nor be practicable to categorize public sector acquisitions according to Approach B (i) and (ii). Such categorization will be even more problematical when consideration transferred is intended to be neither nominal nor commensurate, but is more of in the nature of a token sum, perhaps resulting from adherence to budget, rather being market-driven.

Therefore, from a purely conceptual viewpoint, whether it would be appropriate for fair value measurement to be applied to the identifiable assets acquired and liabilities assumed in the operation, at the date of acquisition ought to depend on the individual circumstances, including the motives underlying the individual.

In view of the above discussions, we would, however, tend to support Approach A, but suggest the IPSASB consider whether the accounting treatment could be determined based on a rebuttable presumption that may be challenged in the individual circumstances as appropriate.

One further issue we would like to mention in this context relates to the understanding of the term “fair value”. Whilst we appreciate that the IPSASB is currently discussing the definition as well as methods of measuring fair value as part of its ongoing Conceptual Framework Project, we would like to note that the measurement method to be applied is also a factor that will need to be given consideration in this context, since for example, rather than aiming to use observable exit prices, replacement cost may be more relevant in the context of public sector combinations.

Specific Matter for Comment 5:

In your view, where the consideration transferred is in excess of the net assets acquired, should the difference arising in an acquisition NUCC (for both Approach A and Approach B, acquisitions where consideration is transferred) be recognized in the recipient’s financial statements, on the date of acquisition, as:

- *a) Goodwill for acquisitions where the acquired operation is cash-generating and a loss for all other acquisitions;*
- *b) Goodwill for all acquisitions (which would require development of a definition of goodwill that encompasses the notion of service potential); or*
- *c) A loss for all acquisitions?*

Please explain why you support (a), (b), or (c).

In our opinion, the subsequent accounting treatment of goodwill, and in particular the impact on the recipient’s statement of financial performance has to be taken into account in forming a view as to initial accounting treatment at acquisition in response to this SMC. From a conceptual viewpoint the IDW strongly favors amortization of goodwill over time rather than the impairment only approach of IAS 36, because there are significant conceptual flaws in the latter approach, which we would like to explain in the next paragraphs.

From a conceptual point of view, acquired goodwill is an asset with a limited useful life and therefore should be amortized on a systematic basis over its expected useful life like any other non-current wasting asset. If an entity is able to maintain over time the original overall value of goodwill acquired in a combination, the acquired goodwill will be consumed but continuously replaced with internally generated goodwill. There should, however, be no exception to the general principle that internally generated goodwill cannot be recognized. Amortization of acquired goodwill over its limited useful life with regular impairment testing ensures that the carrying amount of acquired goodwill is reduced to zero at the end of its estimated useful life. In our view, this leads to a more faithful representation of the acquired goodwill than the impairment-only approach.

The IDW is on record as disagreeing with the IASB's conclusion reached in paragraph BC131G of IAS 36 that "if a rigorous and operational impairment test could be devised, more useful information would be provided to users of an entity's financial statements under an approach in which goodwill is not amortized, but instead tested for impairment (at least) annually." In addition to the fact that we do not support the recognition of internally generated goodwill at all, we question the informative value of an asset reflecting internally generated goodwill that is not necessarily recognized comprehensively, but restricted to the amount previously recognized as acquired goodwill, even when the internally generated goodwill can, in fact, exceed this amount.

Moreover, we do not agree with the IASB's argument in paragraph BC131E of IAS 36 that "the useful life of acquired goodwill (…) is not possible to predict" and therefore, "the amount amortized (…) can be described as at best an arbitrary estimate of the consumption of acquired goodwill during a period". The problem of determining the useful life not only applies to acquired goodwill, but also to other tangible and intangible assets. Generally, estimations are necessary for many accounting issues; thus this does not constitute a compelling argument against the amortization of goodwill. In any case, all sources of estimation uncertainty have to be disclosed.

From an auditor's point of view, whilst estimations and judgment are unavoidable, the impairment test is overall highly subjective and open to abuse. For example, determining whether an indication for impairment exists or not is almost completely at the discretion of an entity's management. Auditors can often only evaluate whether the underlying assumptions are plausible as opposed to being completely unrealistic. The auditability of impairment testing is therefore problematical. Therefore, from our point of view, amortization of acquired goodwill would be the best solution, since the significance of the impairment test and thus difficulties in achieving a reliable measurement as well as the corresponding audit risk would decline over time.

Furthermore, we are not convinced that a differentiation as to whether an acquired operation is cash-generating or not is appropriate, and therefore do not support Approach A.

Equally we do not believe Approach C would be appropriate in the majority of circumstances, since this would imply that funds had not been well managed in allocating compensation, which in turn would likely have a reputational impact. There may however be cases where such accounting treatment is wholly justified, i.e., any goodwill that would otherwise be recognized is seen to be impaired on acquisition.

On balance, we therefore favor Approach B for those acquisitions that have been made with the aim of equating compensation transferred with the net assets received, and on the basis that the difference between these two amounts has a value to the future service potential of the recipient entity in terms of efficiencies, synergies etc.

Specific Matter for Comment 6:

In your view, should the recipient in an acquisition UCC recognize in its financial statements, on the date of acquisition, the difference arising as:

a) *A gain or loss recognized in surplus or deficit (in the statement of financial performance);*
b) *A contribution from owners or distribution to owners recognized directly in net assets/equity (in the statement of financial position); or*
c) *A gain or loss recognized directly in net assets/equity (in the statement of financial position), except where the transferor is the ultimate controlling entity and then the gain or loss meets the definition of a contribution from owners or distribution to owners?*

Please explain why you support (a), (b), or (c).

In general, we do not support Approach A, as – for the reasons discussed above – we do not believe that motives underlying public sector acquisitions UCC normally reflect the intention of affecting financial performance.

Whether B or C might be appropriate would depend on the individual circumstances, although we suspect this is likely more often to be C.

Specific Matter for Comment 7:

In your view, should the accounting treatment for the recipient and transferor of an acquisition UCC be symmetrical?

We are not aware of any public-sector specific reasons to the contrary.