



March 21, 2005

Mr. Robert H. Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856

Dear Bob:

The Committee on Corporate Reporting of Financial Executives International and the Financial Reporting Committee of the Institute of Management Accountants (“the Committees”) are writing to provide their views on the Financial Accounting Standards Board’s Staff Drafts (the “Drafts”) on *Consolidated Financial Statements* and *Business Combinations (a revision of FASB Statement 141)* posted to the FASB website. While we understand that the wording of the Drafts may change in an effort to conform the styles of International Financial Reporting Standards and FASB standards, we expect that the principles will remain unchanged when issued as formal EDs. The Committees strongly disagree with the conclusions in both of the Drafts. Moreover, we believe that the issues we have with the conclusions in the Drafts are indicative of broader concerns we have with the overall direction of accounting standards.

We therefore wish to focus our cover letter on the Board’s overall direction and have provided detailed comments on the Drafts in Attachments A (Consolidated Statements) and B (Business Combinations) to this letter. We are responding to the Drafts in the hope that you will take the additional time to consider the concerns identified in this letter and to engage with us in a dialogue on these difficult issues before you publish these documents for public comment. If the Board decides to proceed with exposure, we believe that the appropriate form would be Preliminary Views documents rather than Exposure Drafts, which would be more consistent with how the Board has traditionally approached changes of this magnitude.

Overview

A majority of FEI and IMA members are financial statement preparers and our membership represents the interests of both large and small businesses. In our roles as preparers, we have regular, direct contact with the broad array of financial professionals who buy and sell our securities based, in part, on information that is provided in our financial statements.

Users of our financial statements include buy- and sell-side analysts, large and small investment funds, credit rating agencies, lenders, and individual investors. The attention that these users pay to information we provide and the questions that they ask provide an indication of what they find useful. This experience coupled with the continuous dialogue that we maintain with these financial statement users provides us with a good understanding of their needs and a relevant basis for sharing our views on the fundamental changes in accounting principles proposed in the Drafts, which include:

- Recognizing assets and liabilities for contingencies that are not probable of being realized or incurred and incorporating the uncertainty over whether cash will be realized or paid into the measurement.
- Marking to fair value certain types of contingencies and contingent consideration through earnings post-acquisition.
- Replacing the parent company view of the reporting entity with the economic unit view, with all of its attendant consequences for step transactions and financial statement display.
- Requiring transaction costs to be expensed and prohibiting recognition of liabilities for exit costs in purchase accounting.

The implications of these proposals for the future shape of the financial reporting model are both profound and far-reaching. Once issued as final standards, extension of these principles to similar circumstances that occur outside of a business combination is inevitable. Therefore the utility of these changes to this diverse group of financial statement users cannot be assumed or taken for granted. Recently, the Chairman of the FASB stated that "...we are at a critical juncture and how we collectively and collaboratively address and resolve these issues will... be fundamental in determining the kind of reporting system we will have for many years to come."¹ We strongly agree with that assessment and believe that such critical decision points require more than the usual level of analysis and consideration. It is therefore essential that we take into account everything we know from experience in deciding whether adoption of these principles will move accounting and financial reporting in the right direction.

The principles advanced in these Drafts are consistent with a pattern we have observed in the latest standards developed by the Board. Over the past ten years, the Board has issued a significant number of standards that are among the most complex we have ever encountered. These standards have caused significant difficulties in practice due to one or more of the following: scopes that are broad and hard to comprehend; complex accounting principles that require extensive supplemental interpretive guidance; and measurement principles that presume a level of valuation capabilities that do not exist uniformly across the preparer community. We are concerned that the cumulative consequences of these recent standards are that most accountants are struggling to understand what they are required to do and often need assistance from external subject matter experts in order to

¹ Robert H. Herz, AICPA Remarks before the 2004 AICPA National Conference on Current SEC and PCAOB Developments, December 7, 2004.

apply the requirements. Similar observations may be made about challenges these standards pose to auditors in practice offices who must review the accounting judgments made and render opinions relative to the fairness of the resulting financial statement effects.

This is happening at a time when there is a heightened sensitivity and attention to accounting and financial reporting with the widely-held expectation that the enactment of the Sarbanes-Oxley Act of 2002 will ensure that accountants and their auditors get the right answers 100% of the time. The Committees believe that further movement of the accounting literature in the direction of complex, hard-to-apply principles is not sustainable in the long term. To change this dynamic, we must embrace a broader concept of quality that explicitly contemplates how constituents will apply the proposed requirements in practice.

We believe that high quality means that the standards are understandable and capable of implementation and audit by practitioners without requiring the extensive use of specialized expert assistance. Those standards should have a focused scope that is clearly defined. The standards should require measurements that are capable of being made with reasonably high precision using models that are widely available, or are capable of being developed internally, and are generally understood by practitioners in industry and public accounting. The principles underlying standards should endeavor to reflect the underlying economics of transactions and events in accounting results. Most importantly, those standards should drive an accounting result and disclosure that is not only good in concept but also provides the most relevant information for the effective decision-making of financial statements users.

Influence of the Conceptual Framework

We see in these Drafts many of the same issues that have arisen in the application of recent standards. The principles of the Drafts appear to be driven largely by the Board's view of what the Conceptual Framework meant to say but perhaps doesn't articulate very clearly. Our members read the Conceptual Framework definitions differently and are concerned by the effect that the Board's present interpretations have had on the development of new standards. This has been particularly the case in standards developed since the issuance of Concepts Statement No. 7 (CON 7). We question whether the heavy reliance on CON 7, in particular, and the current interpretation of the rest of the Conceptual Framework, in general, has resulted in high quality accounting standards as defined above. We support the Board's recent decision to revisit its Conceptual Framework and to examine such fundamental issues as the appropriate trigger for recognition of assets and liabilities and implications of relying on evolving measurement techniques for capturing uncertainty in areas such as contingencies and contingent consideration. In addition, we believe that recognition of subsequent changes in the fair value of such assets and liabilities in earnings raises fundamental questions about the elements of enterprise performance and how they are most appropriately presented in financial statements. The joint FASB/IASB project on Performance Reporting is intended to address those questions and we believe that the work in that area should be allowed to progress to completion before these changes are put into effect.

As this work progresses, we ask the Board to take into consideration the inherent limitations of the Conceptual Framework. Its development was the focus of a series of projects that occupied Board members and a limited number of FASB staff, on a part time basis, from the time the Board was created through the mid-1980's. Even during that time, Board members held different views about the implications of the Conceptual Framework for new standards. Although the concepts statements were subject to due process, certain aspects were controversial at the time they were being developed and remain so today. Another key concept in the business combinations project, the Economic Unit model, is not presently addressed in the concepts statements, which suggests to us that the sequencing of this project vis a vis the broader project on the Conceptual Framework needs to be reconsidered.

It is important to recognize that the principles in the concepts statements, and emerging interpretations thereof, do not represent natural laws – they cannot be observed and tested like the laws of physics. It is therefore imperative that the introduction of fundamental changes to the accounting model based on those concepts be preceded by a validation process that ensures that the needs of financial statement users are being met and that companies are able to comply with the requirements.

We observe that the Board's newest standards, inclusive of subsequent amendments thereto, have all sought to modify fundamental principles underlying existing practice, in line with its view of the Conceptual Framework. Whether it be the criteria for derecognition of assets and liabilities, the definition of a controlling financial interest or the definition of liabilities versus equity – all of these changes have had widespread consequences for financial statements. As preparers and auditors we have struggled to cope with these changes, and only time will tell whether we fully understood what the Board intended. In assessing the quality of those standards in retrospect, it is impossible to separate process from content because the former strongly influences the latter. The following observations are relevant in that regard:

- FAS 140 – The financial components approach, which the Board worked on long and intensively, was closely associated with the rapid growth of securitization and the emergence of the trillion-dollar asset backed securities market. This model embraced the notion that upon securitization, the Conceptual Framework definitions could be applied to the resulting rights and obligations and that derecognition of the asset was appropriate, provided control was surrendered. Despite the subsequent issuance of interpretive documents and amendments, this remains an unsettled area, as evidenced by the Board's current project, which propose additional fundamental changes to the current standard.
- FAS 143 – Since the issuance of this standard, constituents have had significant difficulty applying CON 7 measurements for asset retirement obligations. In part, the measurement challenge results from the fact that market participants rarely stand ready to assume these unique obligations for a fee. We also have struggled with an approach in which existing recognition principles are

subservient to the measurement attribute selected. While we respect the theory that probabilistic distributions of outcomes can approximate fair value for certain types of transactions, it does not necessarily follow that preparers are able to appropriately factor uncertainty into the measurement of these types of liabilities. The difficulties preparers face in applying FAS 143 to conditional obligations were not solved by the proposed Interpretation issued in June 2004. Real measurement issues related to these obligations persist and they have significantly hindered application of the standard.

- FAS 150 – Many companies have struggled with the implementation of this standard, in part as a result of its broad scope and also as a result of the manner in which it was made effective. The standard was issued in May of 2003 and made effective for interim periods beginning after June 15, 2003. This transition period was uncharacteristically short given the nature of the changes required by the standard. In addition, certain key principles in the standard were changed from the exposure draft (which was issued in 2000), and those decisions were not re-exposed for public comment. The confluence of these factors resulted in many companies realizing that they were significantly affected by certain provisions of the standard after the end of the fiscal period in which they were to have implemented the requirements. Only the subsequent issuance of FSPs, which provided for indefinite deferral of the provisions in question, averted misapplication of the standard by affected companies.
- FIN 46R – This standard adopts the principles in CON 7 for determining when an entity is a Variable Interest Entity (VIE) and for identifying who is the Primary Beneficiary (PB). Identification of VIEs and PB's has proven to be very difficult in practice and most companies do not fully understand and have had difficulty applying major parts of the Interpretation's requirements. These include but are not limited to: evaluating disproportionate voting and ownership interests, identifying related parties and de-facto agents, determining what it means for activities to be conducted on behalf of an investor and numerous other definitional issues. Application of the expected loss methodology is likewise very difficult and is potentially subject to major revisions as the definition of what is a variable interest, a linchpin of the standard, is being deliberated by the EITF. Although we understand the environment at the time, the decision to require FIN 46 to be adopted in such an abbreviated time frame and the reconsideration of a central principle of the standard so quickly thereafter puts preparers and auditors in a difficult position with respect to judgments that had to be made under less than ideal conditions. As the EITF last week decided to ask the Board to add the issue to its agenda, we note that it will be important for the FASB, if it acts on that request, to be sensitive to this issue as deliberations progress.

We believe that our experience with these standards is fairly indicative of the difficulties we face as preparers and auditors of financial statements as well as the unintended consequences of the core concepts that have been introduced in response to calls for

fundamental changes in financial reporting. We are struggling to operationalize the requirements of new standards while we simultaneously try to cope with the continuing demands of Sarbanes-Oxley, changes in governance and regulatory regimes and other factors that limit the amount of time that can be devoted exclusively to applying accounting standards. We do not raise these points to be critical of the Board's actions – we raise them because we need to communicate candidly about the difficult conditions that exist throughout the preparer community. As discussed further below and in the attachments, we see the same complexity and potential for application issues in the Drafts, but with a far more pervasive impact on the reporting model. These concerns lead us to believe that a Preliminary Views that focuses on the underlying concepts is a more appropriate next step than formal EDs.

Economic Unit Model – Like the financial components approach to accounting of a decade ago, the Economic Unit model is primarily a creation of the FASB. The model seems to have no natural constituency that readily identifies with it, nor is there an obvious intended use for the information it provides. We continue to question whether the economic unit perspective provides a relevant portrayal of minority interest, as their rights and interests tend to differ substantially from those of both creditors and controlling share owners. Furthermore, we believe the model provides a view of the entity that is inconsistent with what we believe are the information needs of the primary users of consolidated financial statements: the equity investors and creditors of the parent company. We believe that implementation of this model will diminish the relevance of financial statements to this group. We also expect that preparers will have tremendous difficulty preparing the myriad of schedules required for minority interest and reconciling between measures for the parent company and the economic unit. Finally, we note that the most important performance measures, earnings and earnings per share, continue to be provided on a parent company basis, which suggests to us that this is the more relevant view of the enterprise.

Contingencies, Including Contingent Consideration – In the same way that we struggle with the valuation of conditional asset retirement obligations under FAS 143, we expect that valuing and accounting for contingencies and contingent consideration will be extremely difficult. As the Board is aware, contingent consideration is frequently the compromise solution that results from differences of opinion between buyer and seller regarding the value of a business. Accordingly, it is not intuitive that these arrangements should be presumed to be reliably measurable. Our view is that it is not feasible in many cases to determine a reliable fair value and that the Board should take that fact into consideration in determining the appropriate course of action. Retaining the present approach in FAS 141 would be responsive to this concern.

With respect to other contingencies, while we acknowledge that the CON 7 approach is a valid method to determine a value under certain circumstances (e.g., fair values related to large populations of items that are normally distributed and for which adequate history exists for assessing the risks or opportunities being measured), we do not see how this will aid financial statement users in assessing projected cash flows related to the most common types of contingencies which do not share those characteristics. We suspect that most users would be troubled by moving from a standard that results in recognition of the most likely

scenario of future cash outflows to a standard that requires the “expected value” to be recorded, which will rarely be the amount at which the liability will actually be settled, particularly in those situations in which the probability of any cash outflows is remote.

We also are concerned that a CON 7 approach to fair valuing contingencies of all types through earnings could be prone to abuse. We also question the auditability of probabilities determined on what may be significant potential values examined in an acquisition. Academic research appears to support the view that application of this new approach to recognition and measurement will be very problematic in practice.² What sort of rigor can be put around the use of a probability when one percent or even one tenth of one percent could have a material effect on the financial statements? In the present environment, these types of measurement issues are difficult to deal with and the auditing literature has yet to catch up with where these proposals are heading.

We believe that financial statement users would be better served by a model that requires recognition of the most likely outcome, with additional disclosure about the nature of significant contingencies and other potential outcomes.

Restructuring and Exit Costs – The contrast between the treatment of contingencies in the Drafts with the decisions on how to account for restructuring and exit costs is unsettling. It is difficult to reconcile prohibitions on recognizing integration costs in purchase accounting, when they are virtually certain of being expended, while requiring recognition of all contingencies, even when the likelihood of occurrence is remote. While we may be able to provide an explanation in accounting terms for this difference, we struggle to provide an economic rationale that makes sense to investors and to our own Boards. Like us, those constituents find it difficult to equate the economics with the accounting.

The Committees strongly believe that we have reached a critical juncture in the development of standards. We note that there are important linkages between this project and other Board projects related to the Conceptual Framework and Performance Reporting that should bear on the sequence in which these projects are deliberated and finalized. We understand that the Board is committed to fully exploring this new direction to financial reporting. Given that it will be both difficult and expensive for preparers to implement this new model and our concern that the resulting changes are not responsive to user needs and may not be capable of high quality application in practice, our strong recommendation is that the Board proceed cautiously in this effort. We ask that the Board specifically examine whether these are principles that can be implemented and audited in practice. We also ask that the Board validate these proposed changes with a broad population of financial statement users before issuing final standards. If the result of these steps provides sufficient

² "Psychology research repeatedly shows that people are very poor intuitive statisticians (e.g. people consistently make axiomatic violations when estimating probabilistic outcomes). In light of this, statements such as 'the estimated fair values should be the same' provide preparers, auditors, and users with an unfounded (deceptively false) belief that the process suggested in the ED will lead to consistent fair value estimates." AAA Comment Letter Response to FASB ED on Fair Value Measurements

support for the new model, we will offer to work with Board to identify ways in which the practicability and auditing issues might be addressed. If, on the other hand, the results indicate only tepid support, we believe that the Board should narrow the scope of the proposed changes to specific, identified issues with the present model for business combinations.

We have provided our detailed comments to the Drafts in Attachments A and B of this letter. Members of the FEI/IMA Business Combinations Working Group will be pleased to meet with the Board and Staff at its earliest convenience to discuss these issues in more depth and to clarify any comments contained herein.

Sincerely,



Frank H. Brod
Chair, Committee on Corporate Reporting
Financial Executives International



Teri List
Chair, Financial Reporting Committee
Institute of Management Accountants

cc: Sir David Tweedie, Chairman IASB

Attachment A
Consolidated Financial Statements Draft

The Board's tentative conclusions in the Draft reflect a significant underlying change from the Parent Company model to the Economic Unit model. Although we acknowledge that there are certain inherent weaknesses in the application of the Parent Company model to business combinations, we do not believe that the Economic Unit Model results in financial reporting that is meaningful to users. Rather, as discussed in more detail in the following paragraphs, we believe the approach will produce counterintuitive and confusing accounting results that will reduce the usefulness and clarity of consolidated financial statements. We believe that application of the Parent Company model to accounting for business combinations, which has formed the bedrock of accounting practice, has served both users and preparers satisfactorily and has not resulted in significant practice issues.

The Economic Unit model failed to gain widespread support from constituents in either of its previous incarnations: as the procedural cornerstone of the 1995 Consolidations Exposure Draft and as the basis for combining minority interests with parent company equity in the 2000 Exposure Draft on accounting for financial instruments with characteristics of liabilities and equity. Among other reasons, constituents rejected the model because it does not recognize the inherent fundamental differences between the interests and rights of non-controlling investors in a subsidiary of the reporting entity and the interests and rights held by share owners of the parent. The unique rights provided to non-controlling share owners of a consolidated subsidiary under state law and in bankruptcy, including the ability to sue the controlling interest, are different from those of the controlling shareholder and from those of debt-holders. Moreover, in certain circumstances the objectives of the minority share owners may actually conflict with those of the controlling share owners. We are not persuaded by the argument that it must be equity because this financial statement element doesn't meet the Conceptual Framework definition of a liability. Since the Board is revisiting many aspects of the Conceptual Framework in a separate project, we believe that this issue should be added to the scope of that project. We believe that a definition could be developed for minority interest that supports having a separate mezzanine caption between equity and liabilities. At a minimum, the Board should do the requisite research before it concludes that inclusion in equity is the only acceptable answer.

Although the model may be conceptually appealing to some, the ultimate test for determining whether it should become the basis for an accounting standard is whether the model provides decision-useful information for investors. It is unclear how the Economic Unit model is either supportive of this objective or is demonstrably superior to what is currently in place. We believe that a number of the Board's preliminary conclusions driven by this model will result in financial information that is not decision useful, requiring users to re-create (at some cost) the current Parent Company model financial statement presentation. As discussed in more detail below, a number of our concerns relate to application of the Board's proposed model to transactions in which a business is acquired or divested in steps. In those circumstances, application of the model will not accurately

reflect the cost of a business acquired and will require recognition of holding gains or losses before they are realized. In addition, application of the model in instances where control is gained through means other than an acquisition event is unclear.

Acquisition of a Business in Steps

The Economic Unit model requires the full recognition of fair value for acquired assets and liabilities, including goodwill, upon the acquisition of a controlling interest. While we understand that the full fair value method is necessary to maintain the internal consistency of the model, it is an inoperable concept to apply in practice. Assume Company A purchases a controlling interest of 80% in Company B for \$1,000. The proposed model would require Company A to determine the theoretical value of goodwill as if 100% of Company B were purchased. Although an imputed full fair value of \$1,250 would be simple to compute, this value would only be directionally accurate because the purchase of 80% controlling interest would include a control premium in many instances. As a result, goodwill and minority interest would be very imprecise. As one might expect, this approach will create significant comparability problems in practice: two acquisitions that are otherwise similar in nature will differ substantially in terms of the accounting applied simply because one was accomplished in steps while the other was consummated in a single purchase transaction.

We find the proposed approach troubling as it relates to holding gain or loss that would be recorded for previously owned shares when acquisitions of partial interests result in gaining control over a subsidiary. We do not agree with allowing a company to record a gain based on a purchase transaction as this is fundamentally inconsistent with the concept of realization that governs existing revenue and gain recognition rules. For perspective, we would be equally troubled if the realization concept was not part of the criteria used to recognize revenues and gains in the Board's current project on revenue recognition.

The application of the full fair value method would also present practical limitations as it relates to the allocation of any subsequent impairment of goodwill of the acquired business between majority and minority interests. Consider a partial acquisition in which the derived full goodwill becomes part of a larger pool of goodwill of one of the controlling shareholder's reporting units, and hence loses its separate identity. It would likely be impractical to determine an appropriate allocation of the subsequent impairment to the minority share owners, who would only have a partial interest in a component of the larger reporting unit, which may or may not have contributed to the impairment. This issue would be further complicated when the subsidiary's operations are allocated to multiple reporting units. In this circumstance, the Draft proposes a pro-rata allocation of impairment charges between goodwill and imputed goodwill attributable to the minority – a technique that has the real potential to misstate earnings for both controlling and non-controlling interests.

The Board's proposed approach would require the purchase of additional shares of a controlled entity to be accounted for as though they are treasury stock transactions. Accordingly, to the extent the price paid for the additional shares differs from the price paid

to obtain control, goodwill (positive or negative) on those subsequent purchases would be charged or credited to equity instead of goodwill. Such a treatment is not reflective of the true economics of the acquisition, because the assets and liabilities of the business being acquired do not accurately reflect the price that an entity has paid to acquire the business if the acquisition is done in steps.

Dispositions of Subsidiaries in Steps

Similarly to the previous point, we disagree with the Board's conclusion that any reduction in a majority owner's proportionate interest in a subsidiary that does not result in the loss of control should be accounted for as treasury stock transactions. There are two basic methods to achieve a reduction in the level of ownership of a subsidiary - an action of the subsidiary through the issuance of new shares and a sale of subsidiary shares by the parent. We believe that neither of them are treasury stock transactions. This is consistent with the view that since non-controlling share owners of a subsidiary do not have an ownership interest in the parent, transactions involving the non-controlling share owners' ownership interest in a subsidiary should not be reflected in equity in the financial statements of the controlling shareholder.

This approach is prone to misapplication in a step disposition of a subsidiary, as it would permit opportunities to record losses on partial dispositions in equity and take gains through earnings. For example, assume Company A owns 90% of Company B and intends to sell at a loss. Under the Economic Unit Model, Company A can sell up to 39.9% of its interest in Company B and hold any losses on the sale in equity, thereby minimizing the recorded loss in earnings upon the subsequent incremental sale of the 0.1% interest that results in a loss of control. On the other hand, if economics indicate that Company A can sell Company B for a gain, it would execute the sale in one transaction in order to recognize the resulting gain.

Cumulative Impact of Purchase and Sale of a Business in Steps

The full impact of the Board's proposed Economic Unit Model does not become apparent until one follows the complete cycle of a hypothetical business transaction that is accomplished in three steps: the purchase of a controlling interest in period 1, followed by the purchase of the remaining interest period 2, and disposition of the entire subsidiary in period 3. In illustrating the accounting required by the Board's tentative conclusions, we have made the following assumptions:

- At the acquisition date, the target company had assets of \$100 million, liabilities of \$60 million and equity of \$40 million.
- The book value of identifiable assets purchased and identifiable liabilities assumed are equal to their fair value.
- In the first step, the acquirer purchases a 60% controlling interest for \$30 million, reflecting a premium for the target's assembled work force.
- In the second step, the acquirer purchases the remaining 40% for \$45 million.
- Intangible asset amortization is ignored.

- The acquirer subsequently sells 100% of the target for \$55 million.

Based on our understanding of the Board's tentative conclusions, the acquiring entity would record \$10 million of goodwill on the first step of the transaction, along with a minority interest of \$20 million (based on the extrapolated fair value of \$50 million). In the second step, the acquiring entity would eliminate the minority interest and record the excess purchase price (\$25 million) as a debit to equity. When the subsidiary is sold, the company recognizes a gain of \$5 million (\$55 million - \$50 million initial valuation) even though the company has realized an economic loss of \$20 million (\$55 million - \$75 million).

With regard to the issue of whether this fact pattern is realistic and likely to occur in practice, we offer the following observations: many companies do in fact make acquisitions in steps as their preferred practice and the Board's tentative conclusions will only encourage more companies to do the same. As a result, whenever the step transaction that follows control involves goodwill, the accounting gain or loss on the disposition of the subsidiary will not reflect the economics of the sale. Under any scenario we can envision, the debits or credits to equity (resulting from the treasury stock treatment of transactions involving a subsidiary's shares) will stay in equity for the life of enterprise - despite the fact that 100 percent of the subsidiary may have been sold.

Display of Non-controlling Interests in the Financial Statements

The Economic Unit Model requires minority interests to be displayed within share owners' equity and shifts the focus of reporting operations to the reporting of total entity earnings, with a secondary allocation of such earnings to controlling (majority) and non-controlling interests. As it relates to the primary users of financial statements, we believe this is the wrong focus, since we believe majority share owners of the parent company are more interested in their rights to the underlying entity's net assets and earnings.

We are also unaware of any expressed user desire for non-controlling interests to be commingled with the ownership interests of the controlling entity. We believe the Conceptual Framework definition of equity needs to be viewed from the perspective of the primary user of the financial statements, which in the case of a for-profit entity is an investor. When viewed from the perspective of the primary owners, non-controlling interests in a subsidiary cannot be considered equivalent to the equity of the controlling party, since they have no residual ownership interest in the parent company. Thus, we believe that the equity of the controlling party should only represent the controlling share owners' equity interest in the residual interest of the subsidiary and that activity recorded in the equity accounts should only represent items or transactions that directly impact the controlling party's residual interests. Non-controlling share owners normally have other financial information available to them relative to their investments (e.g., separate financial statements of the subsidiary are usually provided) such that they have more limited interest in the consolidated financial statements.

The income statement presentation resulting from application of the Economic Unit model will also be confusing to the primary users of the controlling party's financial statements, who are typically more interested in the portion of net income that is available to them as

share owners in the parent. Our concerns related to the model's impact on the income statement are compounded in situations where the non-controlling interest turns negative due to losses incurred by a subsidiary in excess of the underlying minority interest investment. The loss allocation required under the Economic Unit Model may violate the governance documents by apportioning losses to the minority shareholder that will not be borne by them. This may not be reflective of the controlling interests' true exposure to underlying losses.

Conclusion

We believe that the changes caused by the application of the Economic Unit Model would require significant education of financial statement users to ensure that they adequately understand what is being changed and why. In addition, we struggle to identify the specific practice issues the proposed change in display is fixing, since on the surface it doesn't appear to be advancing the ball in the area of presentation and disclosure. Indeed, the disclosures proposed in paragraph 35 of the Draft (and further illustrated in Appendix A) underscore the tentative support for the model. The objective of these disclosures appears to be preserving a path back to the existing parent-company model financial statements through footnote disclosure. These voluminous disclosures will add substantial cost and complexity to the preparation of financial statements and they are likely to confuse rather than enlighten users of financial statements.

We believe that if the Board continues down the current path with the Economic Unit model, there will be a substantial number of implementation issues that will need to be addressed, as well as education of the user community as to the fundamental differences between the Board's proposed model and the current model. In light of this reality, as well as our belief that what is being proposed by the Board is not superior to the current model, we ask the Board to reconsider whether such a sweeping change is necessary.

Attachment B
Business Combinations Draft

As discussed in the cover letter, we question whether the Board's tentative conclusions in this Draft will actually improve financial reporting for business combinations. Our detailed comments on specific issues follow.

Fair Value Objective – Transaction Costs

The Board's proposed concept of fair value for a business acquired specifically excludes acquisition-related costs or other amounts paid in connection with the transaction that are not payments in exchange for the acquired entity's net assets or equity interests. We struggle to understand how costs paid to a third-party or incurred by the buyer or seller solely in transacting the exchange are not part of the fair value of the exchange. The definition of fair value provided in the Board's project summary is: "the amount at which an asset or liability could be exchanged (or settled) in a current transaction between knowledgeable, unrelated willing parties when neither is acting under compulsion." In practice, parties may be required to engage specialists such as lawyers, investment bankers, and external accountants. These costs are not unlike origination costs incurred at the inception of loan or transportation and installation costs related to equipment. One can view the acquisition as a basket of productive assets and these transaction costs as being those necessary to bring them to a state in which they can begin producing revenues. In most cases, parties to the business combination lack the expertise to fully consummate a transaction without specialists. We believe that the fact that such costs were paid to a third party and not directly to the seller does not justify the conclusion that such costs are not part of the fair value of the exchange. These costs were incurred solely to consummate the transaction and do not represent losses to the acquirer in the period(s) they are incurred.

We note that the June 2004 ED, Fair Value Measurements (the Fair Value ED), the Board defines a going-concern or in-use valuation premise as including installation costs (paragraph B6). Since the appropriate valuation premise for an acquisition is its Value in Use, we continue to believe that fair value should include direct costs paid to third parties to bring the collection of net asset into operation under the acquirer's control. We also do not believe there is any confusion or disparity among companies, analysts, and the investing community with respect to the practice of capitalizing transaction costs that would warrant such a major change in the accounting model.

Fair Value Objective – Exit Costs

Consistent with the discussion above on transaction costs, we believe a buyer's assessment of the fair value of an acquired entity also includes costs that will be incurred to integrate the acquired business and achieve synergies. Such costs would include those covered in EITF Issue 95-3, including employee separation and relocation, contract cancellation and other exit costs. For acquiring companies, integration and synergy costs and the related benefits are an integral component of the acquisition economics. In fact, when an acquirer assesses the merits of a potential acquisition, value created by the merger must be sufficient to cover both transaction costs paid to third parties, and the costs that will be incurred to

integrate the target. If the buyer believes the target's fair value is insufficient to cover these costs, the transaction will not be consummated. Importantly, such costs (and the resulting fair value) can be objectively determined since, like consideration paid to a seller, these costs are paid to a third party (for example, either a separated employee or in the case of a terminated contract, the other party to the contract). We believe a model that capitalizes such costs also is consistent with the existing model for other assets (i.e., fixed assets), wherein the amount capitalized is equal to the amount paid to acquire and place the asset in service. For example, in an acquisition of land containing a building that must be demolished prior to construction of a new facility, costs of demolition are normally capitalized as part of the value of the land. Only in rare cases would the costs of demolition meet the Conceptual Framework definition of a liability. In the case of business integration, the costs to eliminate redundant facilities, much like the costs to raze the old building, are a necessary part of bringing the portfolio of acquired assets into operation under the acquirer's control.

Fair Value – Marketplace Participants

Another area of concern in the Draft involves the definition and application of rules pertaining to marketplace participants. We are concerned with the reliability of fair value measurements for non-financial assets and liabilities where no objective market information exists and there is significant uncertainty regarding the timing and method of disposal or settlement. There is a presumption in both this project and the Board's Fair Value ED that all assets and liabilities can be measured at fair value based on a hypothetical transaction with a market participant. The Board has defined a marketplace participant as an entity that has utility for the item (or group of items) being valued, has the legal and financial ability to complete a transaction in the form contemplated, and is willing to complete the transaction. The marketplace participant is hypothetical and does not represent the perspectives of a particular participant, but rather reflects the notional consensus of the market. To us, it appears as though the application of these rules may, at times, result in counterintuitive results that are not representative of the economic substance. In a competitive bidding situation, the party that prevails in an acquisition is usually the party that has the highest bid. The rationale for bidding higher than the other interested parties generally stems from a particular strategic rationale to consummate a particular transaction, or the existence of greater synergy opportunities. A hypothetical third party would not consider these specific factors, resulting in a valuation that is inconsistent with the actual economics.

As a result of the above issues, a lack of clarity quickly surfaces when trying to interpret the Board's guidance in this area. Applying the guidance in the Draft and auditing the resulting valuations will present financial statement preparers and auditors with significant issues to consider. Due to the high level of importance being placed on the concept of a marketplace participant, we are troubled that many questions continue to surface regarding its proper application and more importantly, whether or not a broad-based, standard notion of a hypothetical marketplace participant is feasible or appropriate as the basis for measuring fair value. We note the following specific areas of concern:

The relevant market and how it is defined

The most significant challenge with applying the concept of a marketplace participant is the fact that such a participant is hypothetical. As such, difficulty arises when trying to determine what a company should look for when determining a market comparable. Should a market comparable be based on a financial measure (i.e., assets or revenues), market measurements (i.e., market capitalization) or industry, region or country of operation? If consideration should be given to a number of variables, then which should be considered foremost in determining the relative order of importance in making a final determination? As the Board can appreciate, a diversified, multinational company faces competition from many entities. Should a competitor be presumed to be an appropriate market comparable? If so, should other potential participants be excluded? Any attempt to proceed with a marketplace participant approach in measuring fair value should better define a marketplace participant and the relevant market to be referenced.

Hypothetical nature of the transaction

Under the Board's fair value hierarchy set forth in the Fair Value ED, we believe the majority of non-financial assets acquired in a business combination will fall into Level 3 of the hierarchy for guidance in valuation. Level 3 of the fair value measurement hierarchy indicates that valuation techniques are to be applied in a manner consistent with the objective of estimating fair value, that is, their application should incorporate assumptions that marketplace participants would use based on facts or information known or knowable as of the measurement date whenever such information is available without undue cost and effort. While the Board has acknowledged that information pertaining to unique advantages or efficiencies a purchaser may possess should be incorporated into a valuation model by substituting the purchaser's own estimates and assumptions, the proposed rules require that market inputs be "emphasized" and Example 3 in Appendix B of the Fair Value ED underscores that point by suggesting that the fair value would be based on a quoted prices for similar used machines. We are troubled by this concept since, in any acquisition, actual facts and circumstances exist surrounding the business rationale for consummating a transaction – circumstances which we believe hold more relevance to the determination of value of an asset or liability to a particular entity. While utilizing marketplace participant data may result in the determination of a hypothetical fair value, it may not, however, yield the best value for an asset that could have a number of alternatives depending on the intent of the acquiring entity.

The following example was prepared by a valuation specialist with extensive experience in valuing tangible assets for major companies.

Consider three items of equipment; each has a replacement cost new ("RCN") of \$100,000; each is 5 years old; and each had an expected useful life of 15 years when it was purchased. Each piece of equipment supplies utility and service to the owner but on the used market, one item would be considered a high demand item, the second a low demand item and the third a no demand item (say a highly specialized equipment item). With all other variables being considered equal, Value in Use for each item would be as follows:

	<u>High Demand</u>	<u>Low Demand</u>	<u>No Demand</u>
<u>Value In-Use</u>			
RCN (Installed)	\$100,000	\$100,000	\$100,000
Physical depreciation	36%	36%	36%
Functional obsolescence	10%	10%	10%
Total depreciation	<u>46,000</u>	<u>46,000</u>	<u>46,000</u>
Value In-Use	<u>\$54,000</u>	<u>\$54,000</u>	<u>\$54,000</u>

Value In-Exchange would be gathered through market research, which would indicate value based on current transactions of similar equipment in the marketplace, where market data is available. Application of Value in Exchange for the same items of equipment would be as follows:

Value In Exchange	\$45,000	\$15,000	\$0
Add in:			
Installation, freight	<u>4,500</u>	<u>4,500</u>	<u>0</u>
Adjusted Value In-Exchange	<u>\$49,500</u>	<u>\$16,500</u>	<u>\$0</u>

Since Value in-Use calculations are based on depreciation measured to account for loss of useful life (*Quantity* of life remaining) and loss of utility (*Quality* of life remaining) along with any functional obsolescence and certain types of economic obsolescence, given a strong marketplace and high demand for an item, the value in-exchange can be higher. However, this valuation specialist believes that the Value in-Use is the value of the asset to the current owner and if the value of that asset to the owner is greater if sold in the marketplace, then at this point the Value in-Use becomes synonymous with its Value in-Exchange and the final Value in-Use conclusion will be its Value in-Exchange.

The primary difference in value between the in-use and in-exchange concepts would be economic obsolescence as it relates to the marketplace (supply and demand relationships). It is reasonable to assume that there was a reason for the owner putting \$100,000 into a machine that has no marketability. In that instance, the buyer is not in the business of selling equipment in the marketplace; it was built for internal use in producing a product (it fills a need just as much as the marketable equipment).

A simple example would be the purchase of an automobile for personal use, which depreciates in value on an exchange basis by 15% the day it is driven off the lot. The resulting difference would be as follows:

Purchase Price	\$20,000
Value In-Use	\$20,000
Value In-Exchange	\$17,000

What would account for the difference? The automobile has no physical wear and tear, so there is no physical depreciation; it continues to be state of the art, so there is no functional obsolescence. The only difference appears to be the marketplace relationship – what it would sell for.

In conclusion, if a true Value in-Exchange were the basis for determining fair value in a business combination (or even a current purchase on its own), then companies should, upon acquisition, depreciate the acquired assets anywhere from 10% to 100% immediately, depending on the type of asset. It appears that using a market participants approach would be similar to a Value In-Exchange basis. If so, the aggregate consideration allocated to assets could be anywhere from 10% to 40% less than in a Value In-Use valuation, and goodwill would be correspondingly higher. As a result, companies would report lower depreciation expense on an ongoing basis and higher goodwill upon acquisition.

Concept of undue cost and effort

Level 3 of the fair value measurement hierarchy indicates that valuation techniques are to be applied in a manner consistent with the objective of estimating fair value, that is, their application should incorporate assumptions that marketplace participants would use based on facts or information known or knowable as of the measurement date whenever such information is available without undue cost and effort. We foresee the potential for significant costs associated with researching and seeking to develop valuations based on market participant assumptions as it will be difficult for a company to support whether or not its due diligence efforts can be considered sufficient to identify all information “knowable” as of the measurement date. We recommend that the Board delete the references to undue cost and effort and simply refer to matters that are known by the acquirer.

Overall, we believe that the Board needs to give additional consideration to the application of the guidance in the Fair Value ED to business combinations. This should include guidance that recognizes the reality that market prices of similar used equipment may be a very poor proxy for the actual fair value of the acquired equipment. We also believe that the concept of the market participant is in need of significant refinement to eliminate wasted effort and blind alleys that are inevitable as preparers and their valuation experts struggle to identify the appropriate valuation perspective. Even with improvements, we suspect that the marketplace participants approach will almost certainly increase, potentially significantly, the cost of valuing acquired assets and liabilities and in certain cases, without intervention by the Board, the resulting values may be less accurate.

Preacquisition Contingencies

The Board has concluded that all preacquisition contingencies that meet the definition of an asset or liability should be recorded at fair value. Currently under FAS 141 paragraph 40, such contingent assets and liabilities should also be recorded at fair value or, if fair value cannot be determined, the alternative is a FAS 5 probable and reasonably estimable model. We believe that the current guidance is the more appropriate and practical model. We believe the Board should simply consider improving the guidance in FAS 141, paragraph 40(a), which discusses determining the fair value of preacquisition contingencies. We do not believe that the example in footnote 14 (in which consideration is adjusted in the purchase agreement because of the contingency) is a practical example. As a result, most companies are following the FAS 5 probable and reasonable estimable model included in paragraph 40 (b).

By definition, contingent assets and liabilities often do not lend themselves to observable market values because they are not frequently exchanged or sold. In fact, in paragraph B182 of the Basis for Conclusions in FAS 141 (which is a carryforward from paragraph 31 of FAS 38), the Board acknowledged that: "...the fair value of a preacquisition contingency usually would not be determinable." We agree that certain contingent assets and liabilities' fair values are determinable because they typically are supported by historical analysis, such as warranty and workers compensation insurance related reserves. However, we believe there are significant practice issues in the application of such a model to all contingent assets and liabilities. If such contingent items are based on observable market values, historical analysis or if, as described in footnote 14 of FAS 141, a contingency is used in determining the total consideration, then we believe that fair value would be determinable. However, for certain other less frequently occurring contingencies, such as litigation, environmental remediation and contractual claims, a FAS 5 model coupled with an appropriate allocation period enables preparers to evaluate and properly record these contingencies in the purchase price allocation. These contingencies, particularly legal claims, can be for significant amounts, are subjective in nature and often take years to resolve. For those contingencies where a fair value or probable amount cannot be determined in the allocation period, we believe that the contingency should be disclosed with any resolution, favorable or unfavorable, being recorded as a component of income.

We believe that most companies are using paragraph 40(b) of FAS 141 to account for their most subjective preacquisition contingencies. Because the Board is requiring fair value to be the only acceptable model for recording contingent assets and liabilities, it is likely that different companies will come to different conclusions regarding fair value of such contingencies. Companies will likely use the CON 7 expected cash flow approach, which is judgmental in nature and the inputs used (e.g., probabilities) are often incapable of being independently verified. In addition, since the fair value of the more subjective contingencies will be subsumed in the purchase price allocation based on an average of expected outcomes, the final outcome of the contingency will still need to be recorded and will create timing differences in the recognition of the ultimate resolution of these contingencies. Each of these issues, further discussed below, will result in significant practical issues to

companies.

We believe that a CON 7 approach (expected present value) to fair valuing preacquisition contingencies is destined for future financial reporting headlines, whether the result of accounting misapplication or appropriate application of these principles, an important factual determination that may be difficult to reach in many circumstances. Importantly, we know that by definition, amounts assigned to contingencies will be wrong, since the amount recognized is extremely unlikely to equal the amount ultimately settled/realized. We do not see how this will aid financial statement users and suspect they would be troubled by this change. We also question the auditability of probabilities on what will often be some of the most subjective values analyzed in the acquisition. It is unclear how one could ever achieve the level of rigor required in the preparation of financial statements around the use of a probability applied to a potential scenario that is unlikely to occur. It is also unclear how an auditor would assess the reasonableness of such probabilities.

Valuation Variability

Contingent assets, as defined, would include contractual disputes and claims, patent applications and, arguably, in-process research and development. We have included an example (Example 1 below) of a situation related to a pool of outstanding contract claims whereby a reasonable fair value may be determinable because there is a past history of recovery. In other situations, such as a claim under a contract or a new patent, there may be no history upon which to rely. In these situations, a CON 7 expected cash flow approach would likely be used. Under the current model, such assets would not be recognized until realized.

In addition, the proposed guidance related to subsequent recognition of the assets categorizes them into intangible assets and financial instruments. We believe the Board should look further to see if all such assets would be deemed an intangible or a financial instrument. For example, a claim for reimbursement under a contract dispute may not be considered a financial instrument, nor would it be considered an intangible.

Contingent liabilities, as defined, would include normal and recurring operating accruals and accruals for the more judgmental areas, such as litigation, environmental remediation, and liabilities for removal of improvements at lease expiration. Operating accruals are typically recorded based on a past history of recurring outcomes and, therefore, are susceptible to a high degree of precision. For the more judgmental accruals, the ultimate outcome is often unclear. As a result, under a FAS 5 model, a liability is not recognized until the amount is deemed probable and estimable. As illustrated in Example 2 below, under a fair value approach, even if it is remote that a company would have to pay a \$5 billion litigation claim, the fair value of the contingent liability would be recorded. Using a CON 7 expected cash flow approach, the company would record \$500 million in purchase accounting and when the contingency is ultimately resolved the amount would be reversed into income. Alternatively, if it was highly probable that a \$5 billion claim will be paid, the amount recorded in purchase accounting would be less than the probable liability because there is a slight chance such amount would not be paid. We believe that the current

guidance, utilizing a FAS 5 model and disclosure provides a better and more operational model.

Ongoing Income Statement Variability

If it was the intent of the Board to record preacquisition contingencies sooner than they would have otherwise been recorded, this proposal does not necessarily achieve that goal. For example, in a CON 7 expected cash flow approach, the asset or liability that is recorded is an average of expected outcomes, not the amount that is expected to be received or paid. As presented in Example 2 below, the expected outcome is zero, but under this proposed guidance \$428.7 million would be recorded and subsequently reversed into income when the contingency is ultimately resolved. Under the FAS 5 model, if the probable amount was determined in the allocation period, that amount would be recorded in purchase accounting. If it was not determinable, the amount would be disclosed.

If the Board ultimately concludes that fair value is the only acceptable model, we do not believe that such preacquisition contingencies should be adjusted to fair value each period but rather should be subject to adjustment based on changes or triggering events, not simply passage of time.

Contingent Consideration

With the proposed accounting for contingent consideration, we see many of the same issues regarding valuation and future income statement variability as have already been discussed above. Contingent consideration typically is in the form of earn-outs and milestone payments that are used when the purchase price cannot be agreed upon between the parties. The likely range of possible outcomes vary given that the two parties could not initially agree upon a set purchase price. We believe that FAS 141 paragraph 28 (APB 16, paragraph 79), has the appropriate conclusion, which is that contingent consideration should be recorded when the contingency is resolved.

For example, Company A acquires Target for \$1 billion with an additional \$100 million to be provided to the sellers of Target if EBIDTA reaches a certain level after year two. Assume that the EBIDTA level was achieved and the amount was paid out. Under this example, also assume that there was a 50/50 probability that the contingency would be paid at the time of the acquisition. Under the application of this proposed guidance, the fair value would likely be approximately \$50 million, which would be recorded in purchase accounting. In year two, the additional \$50 million would be recognized in earnings. Economically, the company was acquired for \$1.1 billion, yet the purchase price allocation would only reflect \$1.05 billion.

We agree that when a former owner is involved in the continuing business that such contingent consideration needs to be carefully evaluated to determine if the additional amounts represent additional purchase price or compensation for services provided. The FASB and the EITF have already addressed this in existing guidance and there do not appear to be significant practice issues in this area.

We believe that the financial statement presentation for contingent consideration prior to the resolution of the contingency could best be accomplished through additional disclosure.

The following examples further illustrate the concerns expressed above regarding the tentative conclusions.

Example 1 – Contingent Assets

Company A purchases Company B, and both are in the real estate industry. Company B has a number of old leases that are in default. Company B has ceased recognizing rental income and all receivables have been reserved. However, Company B has continued pursuing claims against these former tenants for default penalties. Based on experience, a percentage of these claims will be recovered.

At the acquisition date, Company B has 1,000 claims outstanding against former tenants, each with a claim value of \$100. Thus, the estimated “portfolio value” of these claims is \$100,000. From past experience, Company B has determined that it historically recovers 10% of the claim’s value. The following are two accounting alternatives to measuring this contingent asset and the accounting for any subsequent recoveries:

- (1) Company A would value 10% of the entire portfolio of claims as a contingent asset. Since the portfolio value is estimated to be \$100,000, Company A would establish a contingent asset of \$10,000 at acquisition date. If a \$100 claim is recovered, that same amount would be credited against the contingent asset recorded in purchase accounting.
- (2) Company A would value each claim at \$10. This represents the full value of each claim discounted for the estimated 10% recovery rate. If a \$100 claim is recovered, \$10 would be credited against the contingent asset and \$90 would be recognized as income.

We believe that the Board should consider providing guidance on valuation of, and subsequent accounting for, groups of homogeneous contingent assets and liabilities.

Example 2 – Contingent Liabilities

A company has a contractual legal dispute that, if the ultimate outcome is unfavorable, could result in a loss of \$5 billion. The Company’s attorneys are very confident (90% confidence level) the Company will be successful in the defense of the litigation. There is a remote chance the Company will lose and be liable for the full \$5 billion. For purposes of this example, assume that there is no possibility of a settlement and the ultimate outcome will be determined in year two. Under the expected cash flow approach in CON 7, the company would record a liability of \$428.7 million (see below). When the litigation is resolved the amount initially recorded would be recognized in income.

(\$ in thousands)

<u>Year</u>	<u>Estimated Payment</u>	<u>Probability Assessment</u> <u>t</u>	<u>Expected Cash Flow</u>
1	0	0%	0
	0	0%	<u>0</u>
			0
2	0	90%	0
	5,000,000	10%	<u>500,000</u>
			500,000
Discount Rate -	8%		
Net Present Value =	\$428,669		

If after its initial assessment the case was moved to an unfavorable jurisdiction such that the attorneys were not as confident of success (70%), the proposed model would require that this liability would be increased. The change in value would be recorded as an expense in the period in which the evaluation was changed, even though a loss is still not probable.

In-Process Research & Development

While we recognize that a major goal of the Board's project is convergence with international standards, the proposed change will result in significant inconsistencies in the accounting for research and development (R&D) related costs under US GAAP. Internal R&D costs on acquired R&D and in-process research and development (IPR&D) projects without alternative future use purchased outside of a business combination will continue to be expensed, while IPR&D purchased as part of a business combination would be capitalized. This will significantly reduce comparability between companies in R&D intensive industries: companies that are acquisitive will have comparatively small IPR&D charges and significant amounts of speculative IPR&D costs on their balance sheets, and potentially significant impairment charges as certain of these projects inevitably fail, while those companies that achieve most of their growth organically or through acquisitions of specific IPR&D projects will have charges for the acquisition of IPR&D, no capitalized IPR&D costs, and no impairment charges.

We believe that the Board needs to reconsider whether IPR&D is in fact an asset. CON 6, paragraph 25, states that: "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Paragraph 168 of CON 6 further clarifies this definition whereby an item does not qualify as an asset if "...the item involves future economic benefit that the entity may in the future obtain, but the events or circumstances that give the entity access to and control of the benefit have not yet occurred." IPR&D comprises various programs that one day may lead to future benefit;

however, having control over IPR&D programs does not give an entity the ability to control whether that future benefit ever occurs. Paragraph 175 of CON 6 adds: “Uncertainty about business and economic outcomes often clouds whether or not particular items that might be assets have the capacity to provide future economic benefits to the entity . . . , sometimes precluding their recognition as assets.” Markets are fickle, technologies change, competitors innovate – who is to say which IPR&D project portfolios will win the end game or will be the first to be patented or whether the market for the technology will ever materialize? Further, the proposal would require some companies to capitalize assets with a likelihood of success of less than 20% (e.g., pharmaceutical companies). While it is not clear exactly what percentage should be applied to “probable” in the CON 6 definition of an asset, it does seem clear that 20% would not meet this threshold. In short, we believe that money spent directly on IPR&D programs is a cost and not an asset under the Conceptual Framework.

If adopted, the new principles will yield a number of significant, and perhaps insurmountable, implementation issues. We observe that the nature of research programs is that they never truly end. Information derived in one project (even failed projects) is used over and over again. Even findings from projects that are put aside may be reexamined years later when a new idea, a new market or a complementary R&D project makes the research relevant once again. It is this uncertainty, and the relationships among all research efforts, that make it difficult if not impossible to maintain an accurate valuation of IPR&D as an asset. In addition, we believe that the mechanics of the impairment test will be very costly to undertake. Our experience with appraisals of such assets in the context of business acquisitions would suggest that any benefit from the proposed impairment test is far outweighed by the high costs of retaining and regularly engaging outside valuation experts. Further, we are very concerned that the judgmental nature of determining whether or not an R&D project is impaired (e.g., has the project really failed?) will cause companies to endure a fair amount of criticism when these decisions are viewed with the clarity of hindsight.

We would anticipate that the speculative nature of the IPR&D assets capitalized (some of which may have only a 20% or less chance of success) and the likelihood that many of these assets will ultimately fail, resulting in a future impairment charge, will need to be disclosed prominently in the footnotes and discussed in MD&A. We would imagine that investors will be confused by financial statements that capitalize IPR&D as legitimate assets but are accompanied by disclosures that essentially state that it is highly probable that these assets will ultimately need to be written off. We believe that the dichotomy between the required accounting and the necessity to make such cautionary disclosures serve to undermine the credibility of the reporting entity’s financial statements, especially in today’s reporting environment. As some of these assets fail and must be written off shortly after they are initially capitalized, critics may assert that the company aggressively capitalized IPR&D. In reality, they should be questioning the accounting model that caused them to be recognized as assets in the first place.

Given the underlying fundamental differences between US and IFRS standards on intangibles that already exist (e.g., development costs are capitalized under the latter

model), it does not make sense to conform this area without addressing the broader issue. Rather than looking at R&D accounting on a piecemeal basis, we believe it would be preferable to reconsider all R&D accounting at the time that SFAS 2 is revisited.

For all of the above reasons, we question whether this is an area where the US GAAP accounting model will be improved by convergence in the short term. We believe that a more appropriate path to convergence is through a complete reconsideration of SFAS 2. We observe that many of the concerns that existed with the accounting for IPR&D were addressed with the issuance of the AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*.