Letter of Comment No: 16
File Reference: 1204-001

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Technical Director – File Reference 1204-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Exposure Draft: Business Combinations, a replacement of FASB Statement No. 141 (File Reference 1204-001)

Dear Technical Director:

We appreciate the opportunity to comment on the FASB's Proposed Statement of Financial Accounting Standards, *Business Combinations, a replacement of FASB Statement No. 141.* (hereinafter referred to as the "Exposure Draft" or "Proposed Replacement". We support the Board's objectives for consistency in accounting standards and promoting international convergence of accounting standards between the International Accounting Standards Board and the Financial Accounting Standards Board. However, we are concerned about several of the provisions of the Exposure Draft and would like to share our comments with the Board.

Overview

Fitch Ratings (Fitch) is a leading global rating agency committed to providing the world's credit markets with independent, timely and prospective credit opinions. Fitch's corporate ratings make use of both qualitative and quantitative analyses to assess the business and financial risks of fixed-income issuers. Therefore, Fitch directly relies on the financial statements and that reliance places us in an informed position to comment on information we believe is useful and crucial in the credit evaluation process which is a critical component of efficient capital markets. We believe it is important for accounting standards to consider the heavy reliance on cash flow related disclosures by the credit analysts and fixed-income investors in determining a company's ability to service its debt and continue as a going concern.

While we are supportive of the Board's objectives for consistency in accounting standards and promoting international convergence of accounting standards between the two boards, execution of these new rules may create additional accounting/restatement risk given the movement to fair value and heavy reliance upon management's judgment and estimates in determining fair value. We believe comprehensive and clear disclosure will make it more difficult for companies to advantageously exploit the fair value measurement provisions of the standard.

Fitch's commentary on selected questions

Question 1—Are the objective and the definition of a business combination appropriate for accounting for all business combinations? If not, for which business combinations are they not appropriate, why would you make an exception, and what alternative do you suggest?

We agree with the Board's decision to continue to exclude from the scope of this Statement and its definition of a business combination (a) the formation of a joint venture and (b) combinations involving entities or businesses that are under common control. However, it is our view that combinations by contract alone should not be included at this time. We are concerned that without exchange of consideration, there would be significant measurement issues related to the determination of fair value of the acquired entity.

Question 3—In a business combination in which the acquirer holds less than 100 percent of the equity interests of the acquiree at the acquisition date, is it appropriate to recognize 100 percent of the acquisition-date fair value of the acquiree, including 100 percent of the values of identifiable assets acquired, liabilities assumed, and goodwill, which would include the goodwill attributable to the noncontrolling interest? If not, what alternative do you propose and why?

We believe that goodwill in a business combination should reflect the total goodwill and not just the amount that is attributable to the portion acquired. Viewing the transaction and the entity acquired as a whole and not just from the acquirer's perspective produces more meaningful and useful information for both the majority and noncontrolling interest holders' perspective. Therefore, we agree with the proposed approach of recognizing 100 percent of the acquisition-date fair value of the acquiree. The current practice for acquisitions less than 100% generally results in recognizing the identifiable assets and liabilities of the acquiree at a hybrid of some current market prices and some carry-forward of the book values versus using fair value of all assets and liabilities. This approach lacks consistency and is difficult to understand for the users of the financial statements. As noted in our response to question 15, the Board should strongly consider enhancing the required minimum disclosures to reflect the fair value of assets and liabilities and goodwill allocated to noncontrolling interest holders.

Question 6—Is the accounting for contingent consideration after the acquisition date appropriate? If not, what alternative do you propose and why?

We believe that the valuation and accounting for contingencies and contingent consideration will be difficult for the preparers of financial statements, analysts and investors alike. From an analyst perspective we have difficulty in understanding how an approach based on Concept Statement No. 7 will aid in assessing projected future cash flows in the absence of additional clear and concise disclosures for expected cash flows. This is critical as the "expected value" recorded will usually not be the amount at which the liability will actually be settled. We urge the Board to consider whether or not additional disclosures under the proposed model should be considered.

On a related note, the proposed standard would result in two different methods to account for contingent assets and liabilities whereby contingencies acquired in business combination would be accounted for at fair value with subsequent changes in value included in earnings while those incurred by companies during the normal course of business would presumably be accounted for in accordance with Statement 5. We are concerned that the development of different models for acquirers' versus acquiree's contingencies results in a mixed model which further complicates financial statement analysis. We would consider it appropriate for all contingencies to be are treated consistently, but at the very minimum be disclosed clearly in the financial statements.

Question 7—Do you agree that the costs that the acquirer incurs in connection with a business combination are not assets and should be excluded from the measurement of the consideration transferred for the acquiree? If not, why?

We are supportive of the notion that acquisition related costs are not a part of the "consideration transferred" in exchange for the acquired business. While we understand the notion that these costs were incurred solely to consummate the transaction, we do not believe they are relevant for assessing the future financial performance of the acquired business and therefore, should be excluded from the costs of the acquired business.

Question 8—Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose?

The Boards' proposal not to recognize valuation allowances separately will pose difficulties to the users of the financial statements in evaluating the overall propriety of the credit assumptions built into the valuation of assets such as receivables. The existing disclosures under the Exposure Draft should be enhanced to provide clearly the credit related discount and other assumptions that were utilized to determine fair value at date of acquisition for all material asset classes.

Question 10—Is it appropriate for the acquirer to recognize in income any gain or loss on previously acquired noncontrolling equity investments on the date it obtains control of the acquiree? If not, what alternative do you propose and why?

We do not believe that the effect of subsequently obtaining control can be analogized to an exchange. Rather, it gives the acquirer ability to direct the underlying net assets of the acquiree, and is therefore inappropriate to reclassify previous gains and losses on that investment in earnings. Reclassification would open the door to gaming of the accounting rules to manufacture income by making acquisitions in multiple steps. While we disagree with the proposed approach as it relates to holding gains and losses that would be recorded for previously owned shares when acquisitions of partial interests result in gaining control over a subsidiary, we believe clear and adequate disclosure as currently required under the Exposure Draft will assist the analysts and investors in their evaluation process and therefore, could mitigate the issues we identified under the proposed approach.

Question 13—Do you agree that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments? If not, what alternative do you propose and why?

We believe that financial statements by their general nature consist of estimates. Unless an error exists changes in estimates should be handled prospectively and this should include changes in purchase price allocation. A more useful approach would be to provide clear disclosures to the users of the financial statement with adequate information on changes in assumptions and proforma cash flow information where possible. This will allow the analysts to evaluate not only management's ability to make reliable forecasts but also cash flow information to perform a thorough analysis. Ability to predict actual cash flows is vital to the users of the financial statement especially the credit analysts.

Question 15—Do you agree with the disclosure objectives and the minimum disclosure requirements? If not, how would you propose amending the objectives or what disclosure requirements would you propose adding or deleting, and why?

We are encouraged by the extensive disclosures required under the Exposure Draft, however, we believe that in addition to presenting the fair value of debt acquired, as a result of the business combination which in most cases will not be equal to the face value, disclosures related to actual cash repayment and maturity should be included in order for the credit analysts and others to perform a thorough cash flow analysis.

We also believe the period end disclosure requirements related to noncontrolling interest holders should be enhanced. We believe it is critical for the users of the financial statements to have a clear understanding of the equity attributable to the noncontrolling interest holders as well as their share of assets and liabilities in the consolidated entity. We would like to see noncontrolling interests above a certain quantitative threshold being disclosed along with fair values of assets, liabilities and goodwill allocated to them.

We look forward to discussing these comments with the board at the roundtable conference. Members of our Credit Policy group will be happy to answer any questions on our comments above prior to that as well.

Sincerely,

Raja Akram
Senior Director
Credit Policy
Fitch Ratings
New York

Bridget Gandy
Managing Director
Credit Policy
Fitch Ratings
London