



Stephen J. Cosgrove
Vice President
Corporate Controller

One Johnson & Johnson Plaza
New Brunswick, NJ 08933
(732) 524-3737

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Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

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Business Combinations, a replacement of SFAS 141

Johnson & Johnson is pleased to comment on the Exposure Draft related to the abovementioned topic. We believe the Business Combinations project is an important project and we commend the Board on its efforts to work through this complex area of accounting in various phases.

The following are some summary comments on select aspects of the Exposure Draft.

Definition of a Business Combination

We agree with the Board's proposal to modify the definition of a business combination to include transactions or events in which entities obtain control of a business. We understand this will lead to a change in accounting practice in certain cases of change in control. We agree that an event that leads to change in control should be accounted for as a business combination.

Definition of a Business

The Board's proposal would change the definition of a business now described in EITF 98-3. The current definition essentially defines a business as an integrated set of activities and assets [meaning: inputs – processes – outputs] that are self-sustaining and provide a return to investors. Under the proposed definition, such integrated set of activities and assets needs to be capable of providing a return to investors. In other words, outputs are not required.

We agree with the new definition proposed by the Board. We believe certain entities, now considered development stage entities, are truly businesses in the economic sense and the accounting for the acquisition of such entities should follow the business combinations rules. We also believe the definition of a business applies to variable interest entities accounted for under FIN 46R.

In-Process Research and Development [IPR&D]

The Board proposes that IPR&D acquired in a business combination be capitalized as an indefinite-lived intangible asset, subject to impairment. Amortization would commence upon the project's completion, over the asset's useful life. R&D costs incurred after or outside of a business combination will be expensed. We believe this proposal will lead to conflicting accounting in the R&D area and introduce undesired complexities.

We do not believe there is any conceptual difference between R&D acquired in a business combination [IPR&D] and R&D costs incurred outside of a business combination, such as internally incurred R&D costs. Therefore, we do not see how the accounting for these items would be different. We believe the guidance per SFAS 2 [and its related pronouncements] is sound and clear to preparers and investors. We believe all R&D costs should be expensed as incurred. The proposal will lead to situations where a portion of the R&D costs of a project [the acquired portion] will be capitalized and any subsequent spending on the same project will be expensed. We believe this is a conflicting outcome.

The review for impairment of IPR&D would represent a highly complex and very subjective activity. In our industry, the nature of research projects changes constantly, meaning that projects are often altered or combined with other internal projects or new emerging technologies. The direction of projects may change as new indications are being pursued and even if a project fails, the information obtained often leads to other projects that may have value. The requirement to perform an impairment analysis on a specific project overlooks the reality that projects are entered into and managed on a portfolio basis, meaning that “wins” on certain projects pay for the “losses” of other projects. Therefore, if an impairment analysis would be required, it should be performed on a portfolio basis, rather than on a specific project basis, not dissimilar to the goodwill impairment requirements.

Finally, we believe this proposal will lead to an ongoing need to rely on valuation reports that will be very complex, resulting in higher costs for the Company for engaging outside valuation experts.

Valuation date for Consideration exchanged

We agree with the Board’s proposal that the valuation date for consideration exchanged, including the acquirer’s stock, should be the date at which control is acquired [generally the closing date of the transaction]. We believe this proposal is closer to the economic reality of the transaction.

Pre-Acquisition Contingencies

The Board is proposing that all pre-acquisition contingencies of the acquired entity would be recognized at fair value at the acquisition date. Subsequent changes in fair value of these contingent assets and liabilities would be recognized in the income statement. Current practice for such contingencies follows the guidance per SFAS 5 leading to accounting when the criteria of probability and estimatability are met. We believe this proposal will lead to conflicting accounting in the area of contingencies. Accounting for contingencies of the acquiring entity will continue to follow the guidance per SFAS 5, whereas contingencies acquired in a business combination will follow a different approach, although their nature might be the same [example: litigation]. We believe this will be confusing to investors.

The requirement to continuously measure such contingencies at fair value will be highly judgmental and subjective and will lead to volatility in reported earnings based on those judgments. As in the case with IPR&D, we believe this proposal will lead to an ongoing need to rely on valuation reports that will be very complex, resulting in higher costs for the Company for engaging outside valuation experts.

We believe the guidance on accounting for contingencies should be uniform, following the principles per SFAS 5, coupled with robust disclosure requirements.

Contingent Consideration

The Board is proposing that the fair value of contingent consideration would be included in the purchase price that is recorded at acquisition date. A liability will be recognized, and subsequent changes in fair value will be recorded in the income statement. Our comments in this area are similar to the ones in the area of pre-acquisition contingencies. The guidance will lead to different accounting under similar circumstances [example: contingent consideration in a licensing situation] and the practical aspects will be complex and costly. Moreover, in our industry, contingent consideration is often a case of success versus failure [1 or 0], such as in the case of a contingent payment triggered by product approval. The fair value, while the result of a precise calculation, will in all cases be inaccurate and if the product development fails, a gain would be recorded based on that failure. In other words, bad news results in the accounting of a gain. For these reasons, we believe no change to the current accounting guidance is needed.

Restructuring Costs

The Board is proposing to nullify EITF 95-3, essentially harmonizing the accounting of restructuring activities regardless of whether they are incurred in connection with a business combination. While restructuring of an acquired entity is typically a component of the valuation and decision to enter into a business combination, we agree with this proposal as it harmonizes the accounting for similar activities.

We thank the Board for taking our comments into consideration.

Sincerely,

Stephen Cosgrove

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