

Letter of Comment No. 37 File Reference: 1204-001

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October 28, 2005

Director of Technical Application and Implementation Activities Financial Accounting Standards Board

Subject: File Reference No. 1204-001

Dear Director:

Eaton Corporation appreciates the opportunity to respond to the Financial Accounting Standards Board's (the Board) Exposure Draft on *Business Combinations - a revision of FASB Statement 141* (the Draft). Eaton Corporation is a global company with sales of \$9.8 billion in 2004 and with over 57,000 employees on six continents serving the industrial, commercial, construction, automotive and consumer sectors.

Our experience has provided us a good understanding of the needs and a relevant basis for sharing our views on the fundamental changes in accounting principles proposed in the Draft.

After review of the Draft, we have concluded that we disagree with a number of major conclusions in the Draft because of the potential distortion to the Income Statement, resulting in the lack of comparability from period to period. In particular we believe that:

- Acquisition-related transaction costs for all outside advisors, such as investment banking, legal, accounting, and taxation and valuation should continue to be considered part of the acquisition cost of the acquired company and, therefore, capitalized on the balance sheet in goodwill.
- Business integration and restructuring costs related to the acquired company should continue to be considered part of the acquisition cost of the acquired company and, therefore, capitalized on the balance sheet in goodwill.
- In-process research and development costs of the acquired company should continue to be expensed at the date of acquisition.

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 Contingent assets and liabilities related to the acquired company should be recognized on the balance sheet at the date of acquisition, only if they are estimable and probable, which is consistent with the accounting for contingencies under Statement of Financial Accounting Standards No. 5 (FAS 5).

It is our opinion that the implications of the proposals in the Draft are significant and once issued, the impact these principles will have when applied to similar circumstances that occur outside of a business combination is inevitable. We believe that such critical decision points require more than the usual level of evaluation and consideration. Therefore, we find it extremely important that you take into account our experience and that of others in deciding whether adoption of these principles will allow for improved accounting and financial reporting.

We are also convinced that for acquisitive global companies such as ours, the requirements set forth in this Draft are illogical and inconsistent with existing generally accepted accounting principles related to accounting for acquisition costs, research and development, and contingencies, and could potentially provide for a great deal of confusion, complexity and inconsistent financial reporting amongst companies. We find the possibility of inconsistencies to be especially relevant for contingencies in which a fair value is not estimable or probable, as the accounting for such assets and liabilities would likely become highly judgmental in nature.

We appreciate the Board's consideration of these important matters and welcome the opportunity to discuss any and all issues with the Board at its convenience. Comments requested by the Board on selected issues contained in the Exposure Draft are included below. If you have questions regarding this letter, please call me at (216) 523-4175.

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Sincerely,

Billie K. Rawot

Vice President & Controller

Eaton Corporation

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Comments on Selected Proposed Disclosure Issues

Our comments on the Board's specific proposed concepts are as follows:

Issue 1: Transaction Costs

We do not agree that costs paid to third-party advisors by the buyer solely in transacting the business acquisition should be expensed, as required by the Draft, because of the potential distortion to the Income Statement, resulting in the lack of comparability from period to period. We believe such costs should be included as part of the fair value of the acquisition. The definition of fair value provided by the Board 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 many cases, parties lack the expertise to fully consummate a transaction, therefore, may require the assistance of specialists such as lawyers, investment bankers, external accountants, and valuation experts.

Not unlike loan origination costs, which are incurred at the inception of the loan, we believe the fees paid for specialists do add to the fair value of the exchange. These costs are incurred solely to complete the transaction and do not represent expenses to the acquirer in the period(s) in which they are incurred. We believe that fair value should include direct costs paid to third parties in order to bring the collection of net assets into operation under the acquirer's control.

Issue 2: Business Integration and Restructuring Costs

Consistent with the discussion above on transaction costs, we do not believe integration and restructuring costs related to the acquired business should be expensed, as required by the Draft, because of the potential distortion to the Income Statement, resulting in the lack of comparability from period to period. We believe a buyer's assessment of the fair value of an acquired entity includes costs that will be incurred to integrate the acquired business and achieve synergies, therefore, integration and synergy costs and the related benefits are an integral component of the acquisition economics. Such costs would include those covered in EITF Issue 95-3, including employee separation and relocation, contract cancellation and other exit costs. In our experience, at the time an acquirer assesses the qualities of a prospective acquisition, if the potential value created by the merger is not sufficient to cover both transaction costs paid to third parties as well as the costs that would be incurred to integrate the business, the transaction will be terminated by the acquirer. Thus, such costs (and the resulting fair value) can be objectively determined because, similar to consideration paid to a seller, these costs are paid to a third party. Furthermore, we believe a model that capitalizes such costs is consistent with the existing model for other assets, for instance fixed assets, in which the amount capitalized is equal to the amount paid to acquire and place the asset into service.

Issue 3: In-Process Research & Development

We do not believe in-process research and development (IPR&D) of the acquired business should be capitalized on the balance sheet, as required by the Draft, because of the potential distortion to the Income Statement, resulting in the lack of comparability from period to period. In our view, the proposed change will result in significant inconsistencies in the accounting for research and development (R&D) related costs under generally accepted accounting principles. Based on the Draft, internal R&D costs on acquired R&D and 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. We believe that this will significantly reduce comparability between companies with heavy R&D spending. More acquisitive companies will report comparatively small IPR&D expense and significant amounts of speculative IPR&D costs on their balance sheets, resulting in potentially significant future impairment charges. Meanwhile, those companies that achieve most of their growth through acquisitions of specific IPR&D projects will have charges for the acquisition of IPR&D, no capitalized IPR&D costs, and therefore no future impairment charges.

We believe that the Board needs to reevaluate whether IPR&D is truly an asset. If adopted, the new principles will result in several significant implementation issues. Our observations are that research programs never actually end. Information resulting from one project, successful or not, is repeatedly used again. Because technology is constantly in a state of change, it would be nearly impossible to determine which IPR&D project portfolios will materialize. In some circumstances, findings from projects that are put aside may be revisited years later when a new idea, a new market, or a complementary R&D project makes the research relevant once again. It is this ambiguity, and the relationships among research efforts, that make it difficult to sustain an accurate valuation of IPR&D on the balance sheet.

In addition, we believe that the procedure of the impairment test would be quite a costly task to undertake. Our experience with appraisals of such assets resulting from business acquisitions would imply that any benefit from the proposed impairment test is inferior to the high costs of engaging and retaining outside valuation advisors. We are concerned that the judgmental nature of determining whether or not an R&D project is impaired will cause companies to endure a fair amount of criticism when these decisions are observed.

We would expect that the speculative nature of the IPR&D assets capitalized and the chance that many of these assets will ultimately fail, therefore, incur impairment charges, would need to be disclosed in the footnotes and discussed in MD&A. We believe this would lead to our investors' confusion, as the financial statements will capitalize IPR&D as assets, however would be accompanied by disclosures stating that it is highly probable that the assets will ultimately need to be written off. We believe that the division between the required accounting and the necessity to make such cautionary disclosures will decrease the credibility of

the reporting entity's financial statements. Especially if IPR&D expense must be written off shortly after original capitalization, critics may speculate that the company aggressively capitalized IPR&D, rather than question the accounting model that resulted in them initially being recognized as assets.

We do not feel it is appropriate to conform this area without addressing the broader issue, given the already existing fundamental differences between US and IFRS standards on intangibles. Rather than looking at R&D accounting on an individual basis, we believe it would be preferable to reconsider all R&D accounting at the time that SFAS 2 is reexamined.

For the reasons we've mentioned, we are uncertain that this is an area where the U.S. GAAP accounting model will be improved in the short term. We believe that a more appropriate path to convergence is through a complete reconsideration of SFAS 2, as we feel that many of the concerns that existed with the accounting for IPR&D have been 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.

Issue 4: Contingent Assets & Liabilities

We do not believe that all contingent assets and liabilities related to acquired businesses should be recorded on the balance sheet if they are considered less than probable of realization because of the potential distortion to the Income Statement, resulting in the lack of comparability from period to period.

Currently under paragraph 40 of FAS 141, contingent assets and liabilities should be recorded at fair value or, if fair value cannot be determined, should be evaluated based on if they are estimable and probable, consistent with accounting for contingencies under FAS 5. We believe that this current guidance is the more appropriate and practical model. Instead of what is proposed in the Draft, we would suggest the Board to consider improving the guidance in FAS 141, paragraph 40(a), which discusses determining the fair value of preacquisition contingencies.

We agree that certain contingent assets and liabilities' fair values are determinable simply by basing them on historical analysis, such as warranty and workers compensation insurance related reserves. If such contingent items are able to be valued based on observable market values, historical analysis, or if a contingency is used in determining the total consideration, then we believe that fair value would be determinable, thus a fair approach of valuation. However, we do not feel that this method can be applied to all contingent assets and liabilities. For certain other less frequently occurring contingencies, such as litigation, environmental remediation and contractual claims, a FAS 5 model combined with an appropriate allocation period enables preparers to evaluate and properly record these contingencies in the purchase price allocation. These contingencies, particularly legal claims, are often for significant amounts, are subjective in nature

and are more likely to take a number of years to resolve. Therefore, we believe that contingencies for which a fair value or probable amount cannot be determined in the allocation period, should be disclosed with any resolution (favorable or unfavorable) being recorded as a component of income.

It is our understanding that most companies are using FAS 141, paragraph 40(b), to account for their most subjective preacquisition contingencies. Due to the requirement in the Draft, suggesting fair value to be the only acceptable model for recording contingent assets and liabilities, we find it unlikely that companies will come to a unison conclusion regarding fair value of such contingencies. Furthermore, because the fair value of the more subjective contingencies will be allocated in the purchase price based on an average of expected outcomes, the final result of the contingency will still need to be recorded, thus creating timing differences in the recognition of the ultimate resolution of the contingencies. We believe that each of these issues will result in significant practical issues to companies and result in less comparability among financial statements.