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Technical Director
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File Reference 1204-001 – Business Combinations

Dear Director:

This letter includes my comments on the Proposed Statement of Financial Accounting Standards, “Business Combinations – a replacement of FASB Statement No. 141.” The Exposure Draft retains the requirement that all acquisitions be accounting for as purchases, and I continue to support that approach. However, I am concerned that many of the purchase accounting procedures introduced in the ED will not improve financial reporting and will lead to even more complicated application of purchase accounting rather than the simplification that the Board states is one of its principal goals.

In my December 3, 1999 comment letter on the first ED on Business Combinations and Intangible Assets, I expressed concern about the lack of guidance on how to do purchase accounting. I quoted the old television commercial that said, “you can pay me now or you can pay me later.” Based on the Board’s experience with Statement 133 on derivatives and otherwise, I anticipated that the Board would be inundated with requests for EITF rulings or other implementation guidance. However, I have been pleasantly surprised to see that this largely has not happened. Thus, the current ED is not a response to constituent demand but rather a collection of ways in

which the Board wants to see the accounting for business combinations change to a more theoretically appealing (to the FASB) approach.

In some cases the ED would reduce or eliminate inconsistencies in practice, and such proposals may be appealing to users, auditors, and some preparers. But in other cases the ED would require all companies to change what have been accepted practices for many years. I question whether these changes are necessary, particularly given the fact that many of them relate to more fundamental matters that the Board will be reconsidering in the conceptual framework project.

Due to the length and complexity of the ED, I have limited my specific comments to three aspects of the proposal that trouble me greatly. They are covered in questions 7, 8 and 10 of the Notice for Recipients so I will organize my comments in response to those questions. My silence on the remaining questions should not be construed as agreement with the ED's conclusions on those matters.

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?

No, I do not agree. Instead, my views are the same as expressed in the first two sentences of paragraph B97. That is, I believe that acquisition-related costs are an unavoidable part of the investment in a business and should be capitalized. I do not think it is relevant to observe, as the Board does in that same paragraph, that a seller would not accept less than fair value for his business because the buyer incurs acquisition-related costs. Instead, I think it is more relevant to argue that the cost of an asset includes both the fair value of what is acquired and the direct costs of its acquisition.

In my view, determining the amount to assign to the purchase of a business should be no different than determining the amount to assign to the purchase of an individual asset. The Board agrees with that approach in paragraph B96. However, rather than describing the assigned amount as “cost,” as has been the case in practice for as long as I can remember, the Board concludes that the assigned amount should be “acquisition-date fair value.”

As you know, footnote 19 (in the section describing the characteristics of an asset) to FASB Concepts Statement No. 6, “Elements of Financial Statements,” states that “Cost is the sacrifice incurred in economic activities—that which is given up or forgone to consume, to save, to exchange, to produce, and so forth. For example, the value of cash or other resources given up (or the present value of an obligation incurred) in exchange for a resource measures the cost of the resource acquired. Similarly, the expiration of future benefits caused by using a resource in production is the cost of using it.”

Further, paragraph 40 of FASB Statement No. 34, “Capitalization of Interest Cost,” notes in part that, “On the premise that the historical cost of acquiring an asset should include all costs necessarily incurred to bring it to the condition and location necessary for its intended use, the Board concluded that, in principle, the cost incurred in financing expenditures for an asset during a required construction or development period is itself a part of the asset's historical acquisition cost.”

These selective quotes from the accounting literature show that the Board itself has defined the measure of an asset in other pronouncements in a dramatically different way than is proposed in this ED. Rather than adopting a departure from such a well-accepted practice in this project, I think the Board should more fully consider the definition of an asset and how it should be measured in its current, broad reconsideration of the conceptual framework.

In that regard, I refer you to a series of memos that were written in 1994 in connection with the Derivatives and Hedging project. Board members and staff exchanged several memos in which quite different views of how “the cost of an asset” should be determined under the concepts statements or otherwise. There was no formal resolution of the question at that time. However, those memos demonstrate that more work needs to be done to consider this critically important matter before such a major change in practice as the ED would require. Board and staff members couldn't agree among themselves on how to determine “the cost of an asset” and that matter has never been subject to constituent debate, as far as I know. (I saved only a very few documents from my ten and a half years at the Board, but somehow I knew that this issue would come up again!)

The FASB is dealing with this same issue in proposed FASB Staff Position No. FAS 13-b on “Accounting for Rental Costs Incurred during a Construction Period,” and has reached a similar, tentative conclusion to the one in the Business Combinations ED. Further, I understand that at least some individual Board members would extend this same approach to transactions such as acquisitions of property, plant, and equipment. For example, rather than including in the carrying amount of the asset costs to transport a piece of machinery to where it will be used, those Board members apparently would expense the transportation costs and capitalize only the “fair value” of the machinery. Presumably, they would also expense the installation costs of the machinery.

The change proposed in this ED is counterintuitive to most business managers who would consider the “all in cost” of asset acquisitions in determining whether an investment is justified. Further, those business managers would observe that directly related costs such as investment banking, accounting, and legal fees are integral to acquiring another company – you simply can’t do the transaction without incurring these fees.

The “cost of an asset” is a fundamental issue in accounting. Rather than changing practice in a piecemeal manner as in this ED and the Proposed FSP, the Board should take a step back and reconsider this matter conceptually.

Question 8 – Do you believe that these proposed changes (measuring and recognizing assets and liabilities acquired) to the accounting for business combinations are appropriate? If not, which changes do you believe are inappropriate, why, and what alternatives do you propose?

As I have written to the Board on other occasions, recording non-financial liabilities at fair value makes little sense to me. But the Board has ignored my good advice and required this treatment in several recent projects such as guarantees, asset retirement obligations, contingent asset retirement obligations, and exit liabilities. While I’ve been troubled by those decisions, for the most part they relate to topics that are not pervasive and relatively few companies have been materially affected to date. However, the ED would extend this accounting to all contingencies acquired or assumed in a business combination. Thus, this accounting would apply to most if not all business combinations in the future, often with quite material consequences.

I agree with the Board member who expressed an Alternative View on this matter in the ED. In particular, I support the statement in paragraph B207: “Moreover, because they do not represent either what the reporting entity will do or even what it may be able to do, the Board member views such measures as artificial constructs that lack representational faithfulness with actual economic phenomena. As such, they would seem to be of questionable relevance to users of financial statements in assisting them in predicting the future cash flows of the reporting entity.”

It is ironic that the ED would prohibit recording as liabilities amounts that an acquirer believes it will and must spend to rationalize an acquired business’ operations in the near future but require recording as liabilities amounts that an acquirer knows that it will never spend. It is hard to understand how this result will help users in their assessments of future cash flows.

Recognizing the fair value of a contingent liability will, in my view, produce financial statement results that are neither relevant nor reliable. To illustrate, consider Merck’s recent experience with Vioxx litigation. There is no doubt that the company has a material contingent liability. However, if another company acquired Merck, how would the acquirer determine the fair value of that contingency? Is it the approximate \$26 million jury decision in the one case so far multiplied by the 5,000 or so cases now pending? Merck has stated publicly that it intends to fight every case and the first case’s facts certainly are different from others. What about all of the possible cases that haven’t yet been filed? No matter what kind of guesstimate is made, it is highly unlikely to represent probable future cash flows, thus appearing to lack both relevance and reliability.

I know that another company acquiring Merck would certainly take the Vioxx exposure into consideration when determining the amount it is willing to pay. However, it’s not clear that this justifies recording a liability when there is great uncertainty about whether a company is actually liable and, if so, the dollar amount. For many years, the FASB has differentiated between financial reporting and financial analysis. The proposed position on recording a fair value amount for contingent liabilities in business combinations seems to confuse those functions.

As I suggested above for the “cost of an asset,” I urge the FASB to not further change practice for the accounting for contingencies, but instead to consider the matter as part of the broad reconsideration of the conceptual

framework. The Board has acknowledged already that certain of its recent decisions do not conform to the definition of a liability in existing concepts statements. And there is no, real guidance on measuring liabilities in the concepts statements. It's time that the Board took a step back and made the effort to broadly consider these fundamental questions in accounting.

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?

I have felt uncomfortable about this proposed approach ever since I read about it in a draft of a possible Discussion Memorandum on consolidation matters in December 1986. The Board could not agree on the wording of that particular document and it was never issued. However, the “economic unit” way of thinking about consolidation (the theory that supports this accounting) rather than the “parent company” view has been kicked around by the Board from the early 1980's through the present. The “economic unit” view was the conceptual support for the first exposure draft on consolidation policy and procedures in the mid-1990's, to which I dissented. The reaction to that ED was quite negative from most parties and the Board chose to issue a modified ED a few years later that focused mainly on consolidation policy (based on control) and didn't deal with consolidation procedures such as the one in this question. I commented on that ED and did not support its issuance for some of the same reasons as my earlier dissent.

After having this and other consolidation accounting procedures largely rejected by its constituents on earlier occasions, the Board returns in this ED and the companion ED on “Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of ARB No. 51“ to propose the same notions for the second, third, or fourth time. By the sheer length and complexity of the two exposure drafts, the Board may be wearing many of its constituents down. But I don't think you have succeeded in convincing most constituents that the proposed accounting for step acquisitions and dispositions will result in more useful information to readers of financial statements.

I'm probably sounding like the proverbial broken record by now in this letter, but I think you ought to go back to the underlying concepts on this

matter as well. It's time that the Board gave a full airing to the "economic unit" and "parent company" notions for consolidation accounting. Important practical matters like these shouldn't be decided without a more formal public debate on the underlying theory to support them.

Thank you for considering my comments, and please let me know if you have any questions about this letter.

Sincerely,

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting