



October 6, 2008

Mr. Russell Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856

Dear Russ:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") and the Financial Reporting Committee (the "FRC") of the Institute of Management Accountants ("IMA") would like to make the Board aware of certain implementation issues we are encountering related to the adoption of FASB Statement No. 141(R), Business Combinations ("SFAS 141(R)"), and FASB Statement No. 160, Non-Controlling Interests in Consolidated Financial Statements—an amendment of ARB No. 51 ("SFAS 160"). We observe that issuance of these standards has introduced conflicts in the accounting literature that could result in diversity in practice if clarity is not provided as to how those conflicts should be resolved. In the spirit of adapting to a principles-based approach to accounting and financial reporting, our members are prepared to address these interpretive matters through discussions with our auditors provided other key stakeholders are willing to accept differences in conclusions that may be reached on each issue. In contrast, we also are concerned that issues that have arisen with the new accounting model for contingencies introduced in FAS 141(R) have raised operationality issues that warrant amendments being made. We believe that the Financial Accounting Standards Board should consider deferring the effective dates of those provisions of the standard until the underlying issues can be fully vetted with practitioners and an amendment can be developed to address these concerns.

FEI is a leading international organization of financial executives, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a financial reporting technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

IMA is a leading international organization, including accounting and valuation Partners, Controllers, Professors and other senior financial executives. The FRC is the financial reporting technical committee of IMA. The FRC is comprised of representatives from preparers of financial statements from some of the largest companies in the world, the largest accounting firms in the world, valuation experts, accounting consultants as well as academics. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

Below we have highlighted a list of some of the more significant interpretive issues we are encountering as we work through implementation of SFAS 141(R) and SFAS 160. If the Board and the SEC do not believe that diversity in practice should be permitted to develop and would be unacceptable, we would support developing guidance that clarifies the accounting in each of these areas.

1. Contingencies

This is an area of significant discussion and complexity for practitioners and auditors alike, and has resulted in considerable confusion about how to apply the new requirements. We believe that the best course of action is either defer to the effective date of these provisions or to amend the accounting model in favor of the current accounting model under SFAS 141 and FASB Statement No. 5, Accounting for Contingencies ("SFAS 5"), until the accounting for pre-acquisition contingencies can be fully vetted with practitioners and resolved. If the FASB rejects these alternatives, then we believe that implementation guidance should be provided with respect to the issues identified below. These matters reflect implementation concerns related to the accounting for contingencies acquired or assumed in a business combination.

• Day-1 Accrual for Expected Settlements. For acquired non-contractual contingent liabilities, which are *less* than *more likely than not* of resulting in a liability as defined in

Concepts Statement No. 6, Elements of Financial Statements ("CON 6"), no liability is recognized on the acquisition date under SFAS 141(R). However, a question arises when the acquiree/acquirer believes that it will make an out of court payment to settle the action after acquisition date — even though the enterprise does **not** believe that it has violated a law or a contract provision (hence SFAS 141(R) recognition criteria are not met). If these obligations are not recognized in acquisition accounting, then an inconsistency results between SFAS 5's recognition criteria and SFAS 141(R)'s recognition criteria. Specifically, if the guidance in SFAS 141(R) is applied in these circumstances, companies would likely take an immediate charge on day-2 (following the SFAS 5 criteria), even though the acquiree may have **already** recognized such a charge in their pre-acquisition financial statements pursuant to the recognition criteria of SFAS 5. We believe that liabilities for these noncontractual expected settlement amounts should be recognized in acquisition accounting.

- Noncontractual vs. Contractual Contingencies. There are a number of questions concerning how to distinguish between noncontractual and contractual acquired contingencies. Different recognition and measurement treatment is afforded under SFAS 141(R) depending on classification, thus raising the importance of this matter. However, SFAS 141(R) does not define these terms. It is understood that merely having a contract with another party in dispute does not necessarily support the existence of a contractual obligation. If the counterparty asserts breach of contract, the potential liability would be contractual (if it is clear in the contract that a breach occurred) and a liability would be recorded; if it is not clear whether a breach occurred, the potential liability may be noncontractual. Such distinctions can be very difficult to make in practice. We believe classification of contingencies in these and other circumstances will vary based on specific fact patterns involved, and accordingly may give rise to diversity in practice. If the Board and the SEC are unwilling to allow for diversity in practice, guidance will be necessary to help practitioners more precisely distinguish between contractual and noncontractual contingencies. The Committees are in the process of identifying examples of circumstances in which identification difficulties lie in practice. If it would be helpful to the Board, we could provide this information at a later date.
- Resolution of Noncontractual Contingencies. There is much uncertainty regarding the point at which an acquired noncontractual contingency that is recognized in acquisition accounting be derecognized. Paragraph 63 of SFAS 141(R) states that "The acquirer shall derecognize an asset or a liability arising from a contingency only when the

contingency is resolved, for example, when the acquirer collects the asset, sells it, or otherwise loses the right to it or when the acquirer settles the liability, or its obligation to settle it is cancelled or expires." Historically, many liabilities have been derecognized when the likelihood of loss becomes remote. However, certain acquired contingencies may not meet the literal requirements of paragraph 63 of FAS 141(R) for an extended period of time after any loss is deemed remote. We are uncertain if the FASB intended to change the historical practice of derecognizing such contingencies when the probability of loss is considered remote. If so, then we believe diversity in practice could develop regarding the point at which the underlying liabilities are derecognized.

We understand that the FASB staff is aware of these matters and is considering what action, if any, to recommend to the Board. We believe the issues discussed above, as well as others (e.g., attorney-client privilege and other legal issues), raise significant concerns about the operationality of the contingency model in SFAS 141(R). As indicated above, we believe that the Board should consider deferring the effective date of these provisions while an amendment is developed or revert to the current accounting model for contingencies.

2. Transfer of Interests to Equity Method Investees and Joint Ventures

Transfers of Interests to Equity Method Investees (other than Joint Ventures)

We are unsure about the interaction of the guidance in paragraph 36 of SFAS 160 and paragraph 19(a) of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock ("APB 18"). Consider the following two scenarios:

- 1. Company A holds a pre-existing 30% equity method investment in an investee and sells a different 100% controlled, consolidated subsidiary to that investee for cash. In this example, Company A will still retain a 30% interest (albeit indirectly) in the previously consolidated entity.
- 2. Company A sells a controlling 70% interest of a subsidiary to a third party for cash and retains the remaining non-controlling 30% interest (accounted for under the equity method of accounting).

Assume Company A realizes a gain in both scenarios. The substance of these situations argues for similar gain recognition treatment. However, the comparison highlights an inconsistency in

guidance concerning gain recognition with respect to these scenarios. Paragraph 19(a) of APB 18 and AICPA Interpretation 1 of APB 18 appear to require Company A to eliminate the 30 percent of the gain associated with its retained indirect interest in the transferred subsidiary in scenario 1. On the other hand, paragraph 36 of SFAS 160 requires 100 percent gain recognition when Company A retains a direct 30 percent interest in the transferred subsidiary (scenario 2). Does the Board agree with our interpretation of the accounting literature with respect to scenario 1? If so, does it wish to allow differences in the amount of gain recognized under these scenarios?

Transfer of Interests at Formation of a Joint Venture

There is no single comprehensive model that addresses accounting for joint ventures (as defined in APB 18). Instead, the accounting for joint ventures has developed in practice with reference to such guidance as the Accounting Standards Executive Committee (AcSEC) Issues Paper on Joint Venture Accounting dated July 17, 1979, AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures, EITF Issue No. 98-4, Accounting by a Joint Venture for Businesses Received at Its Formation, APB 18, and certain SEC speeches¹. The application of SFAS 160 raises the following questions regarding transactions with joint ventures:

- Is gain recognition now permissible upon the transfer of a subsidiary at formation of a joint venture, irrespective of whether: (1) cash is received, and/or (2) a commitment to financially support ongoing operations exists? Practice has developed to-date around historical cost accounting for such transactions, as provided for in paragraph 8 of EITF 01-2. In other words, with limited exceptions, an investor typically records its investment in a newly formed joint venture at the lower of historical cost or fair value. A pro-rata gain may be recognized if cash is received and the investor has no commitment to reinvest the cash in the venture.
- If gain recognition is required, how does this new treatment reconcile with prior SEC speeches and observations of the SEC staff included in authoritative accounting pronouncements (see footnote 1)?

¹ Example SEC speeches include: Joint Ventures (Consolidation or Equity, Gain Recognition), 1993 Twentieth Annual AICPA National Conference on Current SEC Developments; Business Combinations (What is a Business Combination?), 1993 Twentieth Annual AICPA National Conference on Current SEC Developments; Nonmonetary Exchange Transactions, 1998 Twenty-sixth Annual AICPA National Conference on Current SEC Developments; SEC Observer comments on EITF 01-2 (e.g., SEC Observer comments incorporated into paragraphs 6, 8, and 10).

3. Partial Sales of a "Real Estate" Subsidiary

FASB Statement No. 66, Accounting for Sales of Real Estate ("SFAS 66"), includes several criteria that must be met in order to recognize an immediate gain upon sale. Under that standard, the timing and amount of the gain on partial sale of real estate depends, in part, on the completion of the sale including: collectibility of the sales price, whether the seller has an obligation to support the operations of the property greater than its proportionate interest and the proportionate interest sold. SFAS 160, on the other hand, focuses only on the loss of control for gain recognition. Depending on which guidance is followed for partial sales of real estate subsidiaries, different timing of recognition of profit and different amounts of profit could result.

The question is whether SFAS 66 (and FASB Interpretation No. 43, *Real Estate Sales*) or SFAS 160 should apply to partial sales of 'real estate' subsidiaries. Paragraphs 33-34 of SFAS 66 specifically address the sale of a controlling interest in a subsidiary and do not allow full profit recognition when the seller retains either an equity interest in the property or the buyer. SFAS 160 made no changes to the language in SFAS 66. In addition, if SFAS 160 is applied, then there would be inconsistent treatment for partial real estate sales when the sale is completed via sale of a controlling interest in a subsidiary compared with sales completed through direct ownership of the real estate.

We understand that this matter was submitted as a possible topic for the Emerging Issues Task Force agenda but was not accepted by the Chairman of the FASB. If the diversity in practice that will inevitably result from this conflict in the literature is not acceptable to the FASB and the SEC, additional guidance should be provided by the EITF or the FASB.

4. Control Premium and Gain Measurement on Original Investment

SFAS 141(R) states that when control is obtained, a remeasurement event occurs with respect to any preexisting interest held. For instance, if an investor originally held 20 percent and later acquired the remaining 80 percent, a gain or loss would be recognized related to the pre-existing 20 percent ownership stake.

Assuming a control premium is included in the consideration paid for the controlling interest, where should the control premium be reflected when measuring the gain/loss on the preexisting investment? Specifically, should the gain or loss on the preexisting interest be measured *including* any control premium paid related to the controlling interest obtained – or, should it *exclude* the control premium? If the control premium is included in the fair value of the preexisting noncontrolling interest held, the related gain recognized on that interest would be larger, if the control premium is excluded, the gain recognized would be smaller.

We believe that reasonable professionals could reach different conclusions on this issue based on the specific underlying facts and circumstances of the transactions. For example, an investor may have a reasonable basis for including the control premium with the fair value of the *pre-existing* noncontrolling interest held – e.g., if a 49 percent noncontrolling interest was originally held and a 2 percent interest subsequently purchased. Arguably, the control premium may be placed with the original 49 percent interest; after all, the reporting enterprise may not have paid as much as they did for the additional interest if they did not already hold the other interest. Further, the same benefits of ownership accrue to the original interest held as those that accrue to the new ownership interest purchased. However, if the 2 percent were acquired from a 51 percent controlling shareholder, then the control premium would arguably be attributable to the 2 percent acquired. Alternatively, if an original interest was 5 percent and a controlling interest of 80 percent was later acquired, there may be a strong argument for placing the control premium with the 80 percent interest – as an investor would not generally be providing much input in the significant operations of the investee with such a small original investment (i.e., arguably not much value attributed to it). In summary, we wish to make the Board and the SEC aware that diversity in practice may result in the application of the control premium, but such diversity may not necessarily indicate incorrect application of the guidance.

If the FASB and SEC disagree with these observations or believe that guidance is necessary on this matter, the Board should endeavor to provide timely guidance on this matter. We understand that the FASB's Valuation Resource Group discussed a similar issue at its meeting on September 23rd.

5. Pre-Existing Earn-out Obligations and Acquired Contingencies of Target

In certain situations, an acquirer may purchase an acquiree that had previously acquired a target business of its own. If the acquiree has an earn-out obligation (i.e. contingent consideration arrangement) as a result of its prior acquisition activity, the acquirer must determine how to account for the acquired earn-out. This acquired pre-existing earn-out could be accounted for as: (1) a contractual contingency under paragraphs 24 and 62 of SFAS 141(R), for which one must recognize a liability measured at fair value on the acquisition date, and, when new information is obtained, it must be subsequently adjusted to the higher of the acquisition date fair value or the current amount that would be recognized under SFAS 5, or (2) a contingent consideration arrangement, which must be accounted for under paragraph 65 of SFAS 141(R): recognized at fair value and subsequently marked to fair value each reporting period (assuming liability classification). If either treatment is acceptable to the SEC and the FASB, we are comfortable that preparers and auditors will be able to resolve this issue without the issuance of additional guidance.

The issues raised in this letter do not represent an all-inclusive list of implementation issues (and we also are aware that the EITF is addressing certain matters). This letter also does not address concerns with respect to the interaction between SFAS 141(R)/160 and SEC Staff Accounting Bulletins (e.g., Staff Accounting Bulletin No. 51, Accounting for Sales of Stock by a Subsidiary, Staff Accounting Bulletin No. 61, Adjustments to Allowances for Loan Losses in Connection with Business Combinations), which we understand are being addressed by the SEC Staff. However, it is representative of issues that are emerging as practitioners begin to plan for adoption of these standards. While we are reluctant to press for additional guidance to address the concerns expressed in this letter, and by other constituents related to these standards, we are nonetheless concerned that some of the issues being raised reflect on the underlying principles behind the standards and their operationality in practice. Accordingly, we believe they warrant further consideration in advance of being applied in practice. We would be happy to assist the Board with that reconsideration in any way we can.

If you have any questions regarding the attached, please feel free to contact either of us.

Sincerely,

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FASB Board Members Conrad Hewitt, Securities and Exchange Commission