



October 31, 2005

Mr. Lawrence Smith, CPA
Director, Technical Application & Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: June 30, 2005 Exposure Draft (ED) of a Proposed Statement of Financial Accounting Standards, Business Combinations (a replacement of FASB Statement No. 141)

Dear Mr. Smith:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the ED and is providing the following comments for your consideration.

GENERAL COMMENTS

TIC generally concurs with the provisions of the ED but has a number of concerns and recommendations for improvement. TIC foresees possible unintended consequences of the contingent consideration and contingent assets and liabilities provisions of the proposal. Not only would the contingency estimates be difficult for small companies to determine—raising cost/benefit questions for these businesses--but they would also create unintended opportunities for earnings management as well as misunderstandings by financial statement users.

TIC disagrees with the Board's proposed accounting related to "bargain purchases." Except in rare circumstances, it is not appropriate to earn a profit from buying a business. TIC believes this notion weakens GAAP, encourages abuse and will confuse financial statement users.





TIC also requests the adoption of a cost/benefit simplification measure for the calculation of the fair values of certain receivables, payables and accruals as of the acquisition date. Further, TIC disagrees with the Board's conclusion that comparative information for prior periods presented in financial statements should be adjusted for the effects of measurement period adjustments. TIC also requests greater clarification on how—and where—some transactions would be reported in the financial statements.

SPECIFIC COMMENTS

Question 5—Is the acquisition-date fair value of the consideration transferred in exchange for the acquirer's interest in the acquiree the best evidence of the fair value of that interest? If not, which forms of consideration should be measured on a date other than the acquisition date, when should they be measured, and why?

TIC believes the acquisition-date accounting for contingent consideration outlined in the ED will have unintended adverse consequences for preparers and users of many private company financial statements. The ED will significantly change the recognition and measurement principles for contingent consideration. Under SFAS No. 141, paragraph 27, contingencies based on earnings would not be recognized until "the contingency was resolved and additional consideration was distributable." The additional liability would be an element of the cost of the acquired entity. Under the proposal, the contingent consideration would be recognized and measured at fair value at the acquisition date. Any subsequent changes in the fair value of the contingent consideration (classified as liabilities) would be recognized in income unless the liabilities fall within the scope of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities.

TIC sees practical issues with this accounting change. Contingent consideration is difficult, if not impossible, to measure in a nonpublic environment. If the buyer and seller were able to estimate the value of such consideration with any degree of reliability, they would do so and include such estimate in the purchase price, removing the need to have consideration that is contingent. By its very nature, we conclude that contingent consideration cannot be estimated with any degree of reliability. TIC has reviewed the Board's Basis for Conclusions regarding contingent consideration contained in paragraphs B74 – B86, but the anticipated difficulties in measuring these contingent payments outweighed the arguments presented by the Board.

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

The ED would compound the measurement and cost issues if the fair value of the contingent consideration must be remeasured at each balance sheet date for which financial statements are presented. Paragraph B208 of the ED cites field testers who shared this view in the





context of nonfinancial contingent consideration obligations. TIC is also concerned about the additional costs for preparers to have the fair value calculations audited or reviewed given the significant uncertainty surrounding contingent consideration estimates.

As noted in response to question 5 above, TIC has concerns regarding the estimation process and the consequential impact on understandability by users. TIC believes that buyers will be concerned with future significant income statement charges resulting from underestimating contingent consideration which could have an adverse impact on loan covenants and other credit sources. Accordingly, buyers will be biased to have very conservative assumptions in the estimation process that will likely cause significant profits in future periods when (in most cases) the contingency is ultimately resolved. Financial statement users will not get a true picture of what the buyer has paid for. Accordingly, we urge the Board to retain the current guidance in SFAS No. 141 related to contingent consideration. We believe existing guidance is simpler and reduces the risk of manipulation by preparers and misunderstanding by financial statement users.

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?

Similar to the responses above, TIC is concerned with cost/benefit considerations and the estimation process for contingencies. Again, TIC believes buyers will conservatively estimate these amounts which will likely cause significant profits in future periods when (in many cases) the contingency is ultimately resolved. TIC believes these fair value income statement swings will confuse or mislead users that are more focused on evaluating credit worthiness and cash flows.

For receivables and payables that are recorded at fair value and embody a present value element (among other valuation elements), TIC believes the Board should offer guidance on the income statement classification of the ultimate settlement difference of receivables' and payables' fair values to actual amounts; that is, whether the difference should be classified as interest, gain or loss on settlement or something else.

TIC believes, conceptually, that the Board should attempt to address its concerns and issues with SFAS No. 5 theory first, before continuing its piecemeal dismantlement. TIC believes the accounting model should be conceptually sound and consistently applied. Accordingly, TIC urges the Board to first update its conceptual model, develop principles that are consistent with this model, and introduce standards that are consistent and follow such concepts and principles. The current accounting model (existing GAAP) contains various confusing and inconsistent standards.

Question 9-Do you believe that these exceptions to the fair value measurement principle





are appropriate? Are there any exceptions you would eliminate or add? If so, which ones and why?

TIC requests the Board consider, for nonpublic entities, a cost/benefit simplification measure for certain acquired working capital items such as receivables and payables. That is, if such items are expected to be settled within one operating cycle after the acquisition date, then the effect of discounting could be ignored. This would be consistent with Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*, which exempted from its scope "receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year." TIC recommends the Board's decision on this issue be explicitly stated in the final standard to avoid future practice questions on this topic.

The Board may also wish to clarify fair value accounting for the following accruals:

- SFAS No. 43, Accounting for Compensated Absences,
- SFAS No. 112, Employers' Accounting for Postemployment Benefits, and
- Certain accruals with delayed payments (i.e., over three months), such as warranties, property taxes in arrears, etc.

TIC is uncertain why the items covered in SFAS No. 87, Employers' Accounting for Pensions, and SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, are treated differently than those in SFAS No. 43 and SFAS No. 112 since they are all employee benefits.

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?

TIC believes the revaluation gain or loss should be included in the income statement, however its presentation should be separate, if significant, on the face of the income statement.

Question 11—Do you agree with the proposed accounting for business combinations in which the consideration transferred for the acquirer's interest in the acquiree is less than the fair value of that interest? If not, what alternative do you propose and why?

TIC disagrees with the Board's proposed accounting where the consideration is less than the accumulation of values acquired pursuant to proposed guidelines (which may not be the same as the fair value of the business interest acquired).

TIC believes that true bargain purchases are not just unusual, but instead rare. TIC believes (except in these rare circumstances) that the seller of a business in a non-related-party





transaction seeks to obtain the maximum economic benefit upon the disposal transaction. In the Board's proposed standard, *Fair Value Measurements*, fair value is defined as the "price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties." Accordingly, for the FASB's proposed accounting to be appropriate, the seller would have had to sell the business to a buyer for consideration that did not provide the maximum economic benefit. This position is not reflective of reality and the proposed accounting may be materially misleading. Except in rare circumstances, such as a forced sale, it is not appropriate to earn a profit from buying a business. TIC believes this notion weakens the accounting model, encourages abuse and will confuse financial statement users.

Furthermore, TIC notes the Board's inconsistent logic as related to recording a loss. That is, the bargain purchase "excess" would be recognized in income at the acquisition date, but "overpayments" for an acquiree would not be recognized as losses at acquisition. The ED states that, "The Boards...concluded that it is not possible to measure such an overpayment reliably...." TIC believes it may be equally difficult to measure the true excess of the bargain purchase as well.

If the Board does not change this proposed accounting, we urge the Board to require the buyer to disclose the specific reasons for the gain, which could only be recognized under the following circumstances:

- Seller had a forced sale or otherwise elected to accept an offer that yielded less than optimum economic proceeds from sale,
- Contracted values changed since the original exchange values were in sync (see question 12 below),
- Accounting effects occurred due to the fact that some of the assigned values are not based on fair value.

TIC prefers the existing accounting guidance in this area for "bargain purchases" in that the effect of the various appraisal and valuation estimates (for noncurrent and nonfinancial assets) are "adjusted" before a gain is recorded. We do not believe appraised values should supersede a current exchange transaction that meets the FASB's definition of fair value.

Question 12—Do you believe that there are circumstances in which the amount of an overpayment could be measured reliably at the acquisition date? If so, in what circumstances?

Overpayments could result from delays in the closing process for the acquisition. TIC believes an overpayment could occur if the buyer were contractually obligated to "close" a transaction in circumstances where the value of the consideration given or the value of the business acquired changed between the date the "deal" was priced (exchange values set) and



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the date the deal closed. Due to regulatory and other considerations, the duration between these dates could be extensive, especially with larger organizations. TIC believes in circumstances such as this, a gain or loss for the change in values (consideration given and business acquired) should be recorded. TIC believes the measurement process to determine the value of the consideration and business at the contractual commitment date should be the same process used at the acquisition date.

Overpayments could also result from strategic errors on the part of the buyer in structuring and valuing the acquisition. TIC does not believe that the nature of these overpayments could be reliably measured.

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?

TIC does not believe adjusting prior period amounts during the measurement period is cost beneficial. Accordingly, TIC prefers existing literature on this subject. If the Board retains the proposed guidance, TIC requests the Board to allow a nonpublic company cost/benefit exemption from adjusting prior period balances.

Question 16—Do you believe that an intangible asset that is identifiable can always be measured with sufficient reliability to be recognized separately from goodwill? If not, why? Do you have any examples of an intangible asset that arises from legal or contractual rights and has both of the following characteristics:

- a. The intangible asset cannot be sold, transferred, licensed, rented, or exchanged individually or in combination with a related contract, asset, or liability
- b. Cash flows that the intangible asset generates are inextricably linked with the cash flows that the business generates as a whole?

TIC believes that intangibles should be reliably measurable to be recognized separately from goodwill and that this is not "always" the case. TIC notes FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, states that if "insufficient information" exists to calculate expected cash flows, recognition may be prohibited. FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, paragraphs 75-76, discusses "reliability" in terms of the level of "distortion" that is acceptable in financial statements. TIC believes that distortion level may be measured, in part, in terms of the susceptibility of an account to abuse. TIC believes intangibles are at a relatively high risk for bias and abuse to occur in the measurement process. The cost involved in developing and auditing/reviewing the estimates would be excessive compared to the benefits derived.





Question 17—Do you agree that any changes in acquirer's deferred tax benefits that become recognizable because of the business combination are not part of the fair value of the acquiree and should be accounted for separately from the business combination? If not, why?

Yes. There are various effects of the acquiree on the acquirer (i.e., restructuring, synergies, etc.) that are accounted for separately from the business combination.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Stephen M. McEachern, Chair

PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees

John M. Mc Enlin

