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LETTER OF COMMENT NO. 17

File Reference: Proposed FSP FAS 141(R)-a, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies

Dear Mr. Golden:

We appreciate the opportunity to comment on the Financial Accounting Standards Board's (the Board) proposed FASB Staff Position No. FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* (the proposed FSP). McGladrey & Pullen, LLP supports the Board's objective of amending and clarifying FASB Statement No. 141(R), *Business Combinations* (Statement 141R) to address implementation issues that have been raised regarding the recognition and measurement of assets acquired and liabilities assumed in a business combination that arise from contingencies.

Overall we believe the proposed FSP is necessary to make the provisions of Statement 141R more operational to account for contingencies acquired in a business combination. We generally support the proposed FSP's overall method of accounting for pre-acquisition contingencies. However, while we believe that the proposed FSP would address some significant application issues that were identified by constituents, the most troublesome issue remains. The proposed FSP would require that efforts be made to report litigation-related contingencies at fair value as of the acquisition date. As a result, several of the concerns described in paragraph 4 of the proposed FSP. Therefore, we believe that the final FSP should explicitly state that all litigation-related contingencies should be accounted for in accordance with FASB Statement No. 5, *Accounting for Contingencies* (Statement 5).

Additionally, as observed by the Board member that expressed alternative views, we share this Board member's observation noted in paragraph C33 that the subsequent accounting for assets and liabilities arising from contingencies is extremely complex. The subsequent accounting complexities would be reduced if there were a single accounting model for the initial recognition and measurement, subsequent accounting, and disclosure of all contingencies, including those acquired or assumed in a business combination and those that arise in the normal course of business. Accordingly, we encourage the Board to put back on its agenda the project on recognition and measurement of all contingencies to create a model that can be applied by preparers with information the legal profession agrees can be provided and disclosed.

We have the following comments on the questions asked within the proposed FSP and also provide some comments pertaining to other matters

Question 1 – Will the proposed FSP meet the project’s objective to improve financial reporting by addressing application issues identified by preparers, auditors, and members of the legal profession about Statement 141(R) related to the initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination? Do you believe the amendments to Statement 141(R) in the proposed FSP are necessary, or do you believe the current requirements in Statement 141(R) should be retained?

We believe the proposed FSP addresses some, but not all, of the application concerns that have been raised by preparers, auditors and members of the legal profession. We generally support the proposed FSP’s overall method of accounting for pre-acquisition contingencies.

A number of questions were raised by constituents concerning how to distinguish between noncontractual and contractual acquired contingencies. The Statement 141R model as issued requires different recognition and measurement treatment depending on classification, but does not define these terms. Therefore, we agree with the removal of the distinction between contractual versus noncontractual contingencies provided for in the proposed FSP. This is an improvement that will alleviate potential diversity in practice.

However, we have concerns about the overall message intended about the accounting for litigation-related contingencies. The proposed FSP taken as a whole suggests that more litigation-related contingencies assumed in a business combination will be accounted for at fair value than under Statement 141. We don’t believe this will be the result since the concerns articulated in the Basis for Conclusions beginning at paragraph C6 will still apply. By their nature, litigation-related contingencies are affected by factors that are difficult to predict and estimate. We are concerned that management may be unable to reliably estimate the entity’s exposure to loss for many litigation-related contingencies.

Additionally, we are concerned about an auditor’s ability to obtain a reasonable level of assurance for auditing litigation-related contingencies. Management may have conversations with attorneys that are covered by attorney-client privilege. In such situations, information that management uses to develop its estimates of litigation-related contingencies is from a source to which the auditor does not have access.

Therefore, as previously suggested, we believe the final FSP should require all litigation-related contingencies to be accounted for under Statement 5.

Question 2 – In developing this proposed FSP, the Board decided to adopt a model that is similar to the requirements in FASB Statement No. 141, *Business Combinations*. However, the Board decided to provide additional guidance for assessing whether the fair value of an asset or liability arising from a contingency can be reasonably determined. Additionally, the Board decided to provide subsequent accounting guidance for assets or liabilities arising from contingencies initially recognized at fair value, which was not provided in Statement 141. Do you agree with the Board’s decision to provide this additional guidance, or do you believe the proposed FSP should carry forward the requirements in Statement 141 without reconsideration, including not addressing subsequent measurement and accounting? Alternatively, do you believe the proposed FSP should require that the initial and subsequent measurement of assets and liabilities arising from contingencies in a business combination be on the same basis (that is, assets and liabilities arising from contingencies initially recognized at fair value should subsequently be remeasured at fair value)?

As noted in our comments above, the subsequent accounting model is complex. We generally agree with the guidance of the proposed FSP for the subsequent measurement of those pre-acquisition contingencies

that are initially recognized at fair value. The decision trees provided in Appendix A of the proposed FSP were particularly helpful in understanding the proposed new requirements.

Paragraph 21 states that once a liability is subsequently measured by applying Statement 5, it will continue to be measured in accordance with Statement 5. This implies that the liability could be increased initially since it was higher than the acquisition-date fair value and then subsequently decreased to an amount lower than the acquisition-date fair value. If this is the intention, we suggest adding the phrase "even if lower than the acquisition-date fair value." to the end of the sentence.

Paragraphs 23 and 24 each require the same accounting. We suggest they be combined.

Question 3 – What costs do you expect to incur or not incur if the Board were to issue this proposed FSP in its current form as a final FSP? How could the Board further reduce the costs of applying the requirements without significantly reducing the benefits?

As auditors, we expect that the costs of auditing an entity's application of this proposed FSP will be less than if Statement 141R was not modified.

Question 4 – This proposed FSP includes guidance for assessing when the fair value of an asset or liability arising from a contingency in a business combination can be reasonably determined. Do you believe the guidance in paragraphs 10–13 provides clear guidance for assessing when fair value can be reasonably determined? If not, please explain what additional guidance is necessary?

We agree with the Board's decision to add guidance in this proposed FSP for assessing whether the fair value of a pre-acquisition contingency can be reasonably determined. There are certain circumstances in which the fair value of contingent asset or liability arising from a business acquisition cannot be reasonably determined. We believe a pre-acquisition contingency should be recognized and measured at fair value only when fair value can be reasonably determined. Accordingly, we believe the proposed FSP's guidance in those circumstances is appropriate. The Board's decision to provide further guidance regarding when the fair value of a pre-acquisition contingency can be reasonably determined will assist both financial statement preparers and auditors in the application of the requirements of the proposed FSP.

Question 5 – Constituents have raised concerns about liabilities arising from contingencies being recorded indefinitely when there is no clear resolution of the contingency because the acquirer does not believe settlement will ever be required and the liability is not subject to cancellation or expiration. Will the proposed amendment to Statement 141(R) that allows for the derecognition of a liability arising from a contingency when new information is obtained that indicates it has become remote that the obligation will be enforced address these concerns? Do you believe this guidance is operational?

Yes, we believe the guidance in the proposed FSP addresses the derecognition concerns regarding a contingent liability where new information is obtained that indicates that has become remote that the obligation will be enforced and that performance will not be required

We are concerned about applying the provisions of paragraph 20 when no new information is obtained, but the passage of time makes it clear that an obligation will not be enforced. We suggest explicitly stating that a passage of time may be considered as new information also.

Question 6 – Although not clear, the Board did not intend the subsequent measurement and accounting guidance in Statement 141(R) to require that a liability arising from a contingency be recorded at its acquisition-date fair value until the contingency is completely resolved in cases

where the acquirer is released from risk over time or the acquirer fulfills its performance obligation over time. Do you believe the clarifying guidance included in this proposed FSP is operational for the subsequent measurement and accounting of a liability initially recognized at fair value?

Yes, we believe the clarifying guidance in the proposed FSP is operational for the subsequent measurement and accounting of a liability initially recognized at fair value.

Question 7 – Constituents have raised concerns about disclosing potentially prejudicial information in financial statements. Do you believe the revised disclosure requirements in this proposed FSP sufficiently protect sensitive information while providing users with useful information about contingencies arising from a business combination?

We provide no comment on this question.

Other Items:

- Several places in the proposed FSP refers to “reasonably determine” the acquisition-date fair value. In other places the FSP refers to amounts that are “reasonably estimated”. These terms are used in other standards. We suggest that the final FSP clarify terms “reasonably estimated” and “reasonably determine” in this FSP and discuss the difference.
- Paragraph 8 references the framework of FASB Statement No. 157, *Fair Value Measurement*. We suggest including a clarifying comment as to whether the disclosure provisions of Statement 157 should be followed for the initial measurement.
- We do not understand in Example 1 (amended paragraph A64 of Statement 141R) how it could still be probable that a liability had been incurred when TC’s management asserted that its hiring and promotion practices complied with all applicable laws and regulations. We suggest providing an explanation to help clarify how the revised model should be applied.
- Consider changing the amended paragraphs 68(j)(3) and 72(c)(1) of Statement 141R to use the phrase “cash flows” instead of “outcomes.” Alternatively, if “cash flows” and “outcomes” are not interchangeable, provide clarification on what is meant by undiscounted outcomes.
- We suggest, in addition to the previous bullet, revising the amended paragraph 72(c)(1) of Statement 141R as follows:

Any changes in the range of outcomes (undiscounted) for both recognized and unrecognized assets and liabilities arising from contingencies (to the extent determinable for unrecognized assets and liabilities arising from contingencies) and the reasons for those changes.

This revision addresses the possibility, as implied by the amended paragraph 24B of Statement 141R, that information was not available to reasonably estimate the amount of future cash flows or a range of potential future cash flows.

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- Include in the amended paragraph 24 of Statement 141R that the guidance included in that and other paragraphs within that section does not apply to contingencies otherwise addressed in Statement 141R (e.g., contingent consideration, indemnifications). This was a helpful distinction made in paragraph 6 of the proposed FSP and making a similar distinction in paragraph 24 would also be helpful.

We would be pleased to respond to any questions the Board or its staff may have about any of the foregoing comments. Please direct any questions to Jay D. Hanson (952-921-7785).

Sincerely,

McGladrey & Pullen, LLP

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