October 24, 2005

Technical Director
Director@fasb.org
File Reference No. 1204-001
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Dear Technical Director:

We are pleased to submit our comments on the Exposure Draft of the Proposed Statement of Financial Accounting Standards - Business Combinations, a replacement of Financial Accounting Standards Board ("FASB") FASB Statement No. 141 (the "Exposure Draft"), issued by FASB on June 30, 2005.

Our firm has significant experience in providing valuation advisory services to both public and private companies of all sizes in connection with purchase price allocations for financial reporting purposes. Our comments have been prepared by valuation practitioners and professionals in our firm who serve on our Technical Guidelines Committee for our Tax and Financial Reporting Valuation Services Practice Area.

In general, we commend FASB for pushing forward this initiative to clarify and refine the various elements of FASB Statement No. 141, Business Combinations and other accounting guidelines with respect to the purchase of assets.
If you would like to discuss any of our comments or solicit any additional feedback from us, please feel free to contact either Lorre Jay at (212) 497-4184, Marc Asbra at (310) 712-6537 or John McIntosh at (415) 273-3644.

Sincerely,

John McIntosh
Vice President
Houlihan Lokey Howard & Zukin

Marc Asbra
Vice President
Houlihan Lokey Howard & Zukin

Lorre Jay
Director
Houlihan Lokey Howard & Zukin
Comments Specific to Exposure Draft Questions 1 to 19

Question 1 – Definition of a Business Combination
We agree that the definitions of a business combination are appropriate.

Question 2 – Definition of a Business
We would encourage FASB to provide specific examples of what would not constitute a business under this Exposure Draft. Additionally, Paragraph A6 is somewhat confusing in that if the acquirer intends to operate a set of assets as a business, in what specific “market participant” circumstances would this type of acquisition not be accounted for as a Business Combination?

Question 3 – Measuring the Fair Value of the Acquiree, Less than 100% interest
We agree with the Exposure Draft that it is appropriate to recognize a less than 100% acquisition involving control using the consideration paid as a default proxy for measuring fair value of the assets acquired, liabilities assumed and goodwill, and to recognize on the balance sheet the assets, liabilities and goodwill acquired as if a 100% interest had been obtained (accounting for any portion not purchased as a minority interest). However, we believe it would be helpful to provide more clarification on what the disclosure is for a less than 100% acquisition in Appendix A, along with an example and explanation of the reason for the measurement of the non-controlling and controlling portion of the goodwill.

Question 4 – Guidance for Measuring the Fair Value of the Acquiree
In general, we agree that paragraphs A8-A26 provide appropriate guidance; however, the examples may imply that the acquisition of a controlling interest will represent the acquisition of 100%. For example, in a tender offer situation (A12-A13) the form of a public tender determines whether the un-tendered minority can legally and practically elicit a higher price per share than the shares tendered. This would increase the 100% value because of the increased cost of the remaining un-tendered shares. Although it’s difficult to have an example represent every possible situation, we would like the example to acknowledge that measuring 100% of the fair value of the target based on a purchase of less than 100% should consider whether the unpurchased shares could be bought at a premium or discount to the purchased shares.

Question 5 Acquisition Date Fair Value
We agree that the acquisition date fair value of the consideration transferred in exchange for the acquirer’s interest in the acquiree is the best evidence of fair value. The date that the assets, liabilities and/or equity securities are legally transferred from one party to another is the best date upon which to measure fair value. The question of which side of the transaction (buyer’s consideration given or target’s consideration received) is also recognized appropriately based on which side of the transaction is the most reliably measured.
Question 6 – Accounting for Contingent Consideration after the Acquisition Date

We encourage FASB to clarify both the initial recognition and subsequent measurement of contingent consideration classified as equity. It is unclear as to why equity contingent consideration should not be remeasured on a periodic basis. Additionally, it is unclear how contingent consideration that is to be paid in a pre-determined number of shares of stock based on achieving certain pre-determined performance metrics should be measured on the acquisition date. As an example, what would be the accounting for contingent stock (equity) consideration if the specified financial performance metric was not met and the contingent stock consideration was not issued? Finally, we do not believe recording a gain when the contingent consideration paid is less than what was measured at the acquisition date is prudent or faithful accounting. Booking a gain would signal the acquirer had achieved something beneficial when in effect they just overestimated the performance of the company they acquired (and fortunately do not have to pay for their overestimation). Additionally, goodwill would need to be adjusted for any subsequent true-up of actually contingent consideration paid as compared to what was estimated previously.

Question 7 – Transaction Costs

We agree that transaction costs sometimes vary and, although common, do not represent a fair value addition to the net assets acquired. You cannot, for example, turn around and sell the asset acquired for the price you paid for the asset plus the transaction costs.

Question 8 – Proposed Changes to the Accounting for Business Combinations

We agree that the proposed changes in accounting for receivables, contingencies, restructuring costs and research and development expenses are appropriate. However, in some situations, a company may impair its ability to settle a contingent claim if it fairly estimates value for that contingency (litigation contingencies) and provides the disclosures in its public filings. The Exposure Draft should either make an exemption for litigation contingencies or offer a qualified exemption for those instances where measurement and disclosure may cause material economic damage to the company.

Question 9 – Exceptions to Fair Value Measurement

We agree that the exceptions to the fair value measurement are appropriate (assets and liabilities related to deferred taxes, assets held for sale, and employee benefits). The benefit of current accounting outweighs the potential benefit, if any, from introducing a fair value measurement standard. We would also add deferred revenue to the list to avoid any inconsistency between accounting measurement and fair value, which would produce completely different answers.
**Question 10 - Recognition of Income Gain/Loss on Noncontrolling Equity Investment When Control is Obtained**

We disagree with the write-up of a minority equity investment once control is obtained. Any gain/loss that is recorded for accounting purposes should in every case possible reflect an actual transaction involving a purchase and sale of the security (unless the security is marked-to-market quarterly). In this case, there has been no sale of the purchased security, only an additional purchase of more securities. Any gain recorded due to the acquisition of more stock would be non-cash and superficial. The cost basis from which any gain or loss should factor in a realized gain upon sale and should be measured against what it cost to buy the stock.

An alternative would be to factor into the fair value of the target the reduced cost for the minority ownership purchased previously. This then becomes the cost basis for allocating the purchase price. No gain or loss would be recorded. Ultimately, if the acquirer sells the business, the total cost of obtaining it including the blended cost of multiple purchases of securities, would form the basis of comparison for recording a gain.

**Question 11 - Bargain Purchase**

We agree that the proposed accounting for bargain purchases is very helpful in defining the priority and write-down procedure. However, guidance on economic obsolescence should also be added. Economic obsolescence results from external factors (such as location) that render an asset obsolete, no longer competitive, unattractive to purchasers or investors, or of decreasing usefulness. From a fair value perspective, economic obsolescence is typically evidenced by a fair value of the business that is less than the fair value of the sum of the net assets acquired. It may result from functional obsolescence in which the asset is less able to perform the function for which it was designed, or technological obsolescence in which new technology has been introduced into the market that renders the asset obsolete. Oftentimes, the purchase price is so far below both the historical cost and the fair value of the assets acquired that a write-down from fair value (considered independently of the factors causing the economic obsolescence) is required.

A bargain purchase would typically be rare and perhaps due to seller duress or factors unrelated to the fair value of the net assets acquired. In this situation, it is appropriate to reduce the goodwill component. However in economic obsolescence situations, the fair value of the net assets (considered independently of the factors that caused the economic obsolescence) may be substantially overvalued. We recommend additional guidance in situations involving economic obsolescence to consider a write-down of all assets affected and not just goodwill.

**Question 12 - Amount of Overpayment Reliably Measured**

The amount of an overpayment, although likely rare, in some circumstances can be reliably measured. The greater question is the determination when an overpayment has actually been made. If there is evidence of an auction process in which the acquirer made payments above and beyond its own economic rationale for the transaction due to perhaps defensive or survival reasons, there may be evidence to support an overpayment. However, in most situations the
outcome of an auction process is not always disclosed or known to the buyer, and therefore the
determination that an overpayment has been made is also unknown. To the extent there is
clarification around the concept of a market participant buyer, then perhaps the non-market (or
over-market) participant buyer behavior will be easier to recognize. However, until such market
participant buyer is more fully defined (and in most situations is a moving target and hard to
define), then the ability to determine when an overpayment has been made will be difficult.

Question 14 – Assessing What is Part of the Exchange for the Acquiree

We encourage the FASB to clarify if the settlement gain/loss in Paragraph A92 is to be
determined based on the risk-adjusted net present value of the favorable/unfavorable amounts
(particularly with respect to long-term contracts and perpetual licensing agreements). Also, in the
same paragraph we would request clarification as to the intent of noting “an unfavorable contract
is not necessarily a loss contract for the acquirer”.

We encourage FASB to clarify the thought behind why contingent payments based on
percentages of earnings should be accounted for separately from the business combination
(Paragraph A99 – Formula for determining consideration). We respectively submit that many
deal earnout payments are based on a percentage of future earnings and are considered by the
acquirer to be part of the purchase consideration paid (versus employee compensation).

We would request clarification as to the intent behind treating the excess fair value (i.e.,
difference between new awards and old awards) as an expense in post combination results
(versus part of the deal consideration paid). Additionally, it is not clear if this expense would be
immediate or recognized over the remaining service period.

Additional Comments on Exposure Draft

Definition of “Marketplace Participant”
The Exposure Draft clearly states that fair value measurements should be based on “marketplace
participant” assumptions. While the concept of marketplace participants has been generally
acknowledged and applied by valuation specialists and auditors since the adoption of SFAS 141,
no widely accepted criteria exist for identifying such marketplace participants at a reasonable
cost. Additional clarification in The Exposure Draft as to the definition of a “marketplace
participant” and how much due diligence is expected in considering this matter would be useful
to all constituents.

Acquisitions of Less than 100 Percent and Recognition of Goodwill
Example #4 and paragraph A63 illustrate the measurement of goodwill in an acquisition
involving less than 100 percent of Target Company ("TC"), and the allocation of that goodwill
among the controlling and noncontrolling interests in TC. It is unclear from our reading of The
Exposure Draft as to why an allocation of goodwill between the controlling and noncontrolling
would be required, as well as how such amounts would be recorded within the context of
consolidation accounting. By definition of the acquisition method, Acquirer Company (“AC”) would have control of TC and presumably record on its balance sheet 100 percent of the
goodwill created in the transaction. A summary of the allocated balance sheet accounts
Valuation of Preexisting Assets Between Acquirer and Acquiree

Paragraphs 41 and A93 state that preexisting contractual agreements between TC and AC would be considered identifiable intangible assets that shall be recognized separately from goodwill as part of the business combination accounting. While the fair value of such contractual agreements may be measured in a manner similar to other identifiable intangible assets, The Exposure Draft is unclear as to the procedures used for subsequently testing an asset for impairment that will essentially be terminated following the acquisition.

For example, assume AC had the contractual right to use TC's patent in return for annual royalty payments based on future sales of AC's product. AC would essentially be buying itself out of a commitment to pay future royalties to TC, whereas a marketplace participant would be acquiring a patent license agreement with the expectation of receiving future royalty payments from AC. From either buyer's perspective, the fair value of the contract could be measured based on the present value of future royalty payments made (or avoided) to TC. As AC will essentially terminate the patent license agreement following the acquisition, projected cash flows from the terminated agreement may not be reasonably measured for subsequent impairment testing.

How does the FASB propose such situations be handled? Is it the FASB's belief that subsequent impairment testing will focus on the "economic benefit" of the asset, that is, "future income" from the perspective of the marketplace participant buyer, but "cost savings" from the perspective of AC?

On a related matter, the language used and examples provided in The Exposure Draft regarding preexisting assets between TC and AC specifically mention contractual-related intangible assets. If the FASB intends such provisions to also include non-contractual assets (i.e., non-contractual customer relationships), clarifying language should be added to the text, including a discussion of the relevant remaining economic life for use in the initial determination of fair value and subsequent impairment testing.

Effective Settlement of Preexisting Relationships between AC and TC

Paragraphs A91 through A97 provide useful illustrations regarding the fair value measurement and subsequent accounting for the effective settlement of a preexisting relationship between AC and TC. Although the procedures are clear, the accounting results under these circumstances appear to contrast with FASB's presumed intent to have consistency among business combination accounting for AC and any other marketplace participant.

As described in paragraphs A94 through A96, AC would record a settlement loss of $5 million related to the unfavorable portion of its preexisting supply contract with TC, along with a $3 million intangible asset related to the at-market portion of the contract. A marketplace participant buyer, however, would only record an intangible asset with a fair value of $8 million, which would be amortized over the remaining useful life of the contract. Although the amount of goodwill recorded by AC and the marketplace participant would be the same, AC's ongoing earnings would be higher than any marketplace participant buyer due to the lower fair value of (including goodwill) in a manner similar to paragraphs A66 and A70 would be helpful to clarify FASB’s intent.
the contract and hence lower annual amortization expense. Additional clarification on FASB’s intent would be useful in this matter.

Contingent Consideration
Paragraph 26 (a) – Contingent consideration classified as equity shall not be remeasured. Please provide examples of contingent equity consideration. Please provide rationale for not remeasuring.

Paragraph 26 (b1) – Contingent consideration classified as liabilities. Please provide examples of contingent liability consideration that might be in the Scope of SFAS 133 and that might not be in the Scope of SFAS 133.

Operating Leases
In Paragraph 47, please provide examples of the acquirer being a lessor to an operating lease. Please provide clarification on if this sentence includes office space sub-lease arrangements (were the acquiree is the sub-lessor). If so, would the acquirer recognize the fair value of the future sub-lease income and corresponding sub-lease expense?

Examples of Contingent Liabilities That Are Identifiable
Notwithstanding the fact that specific examples of contingent liabilities may be presented/discussed in other applicable GAAP guidelines, it would be helpful to provide examples of specific contingent liabilities that are typically assumed in a business combination (similar to providing Examples of Identifiable Intangible Assets in Paragraphs A35-A61). The Board discussed specific examples of contingent liabilities in developing this standard. Therefore, specific insight, clarification and guidance would be helpful.

Measurement Period and adjusting provisional amounts of contingent liabilities and contingent consideration
Example 7: Lawsuit; Paragraph A72
Example 9: Contingent Payout Based on Future Earnings Paragraph A78
Additional examples of both specific contingent liabilities assumed and specific contingent consideration transferred would be helpful.

Contingent consideration, including subsequent accounting
Paragraph B74
The last sentence in this paragraph, “In contrast, the issuance of additional securities or distribution of additional assets at the resolution of contingencies based on security prices did not change the recorded cost of an acquiree”, should be either clarified or eliminated. The current context is unclear and may lead to confusion.

Paragraph B79
Notwithstanding the classification of contingent equity consideration based on SFAS 150 guidelines, it would be helpful to provide examples of contingent equity consideration that would be classified as equity and contingent equity consideration that would be classified as a liability.
Paragraph B80
If contingent consideration classified as equity is not remeasured, how would this equity amount be adjusted if the contingency is not met (or only partially met) and the equity consideration is not transferred?

Paragraph B81
Please provide contingent consideration liability examples observed by the Board that meet the definition of SFAS 133 and examples that do not meet that definition.

Measuring and Recognizing Assets Acquired and the Liabilities Assumed
Paragraph B104
Please provide examples of unrecorded liabilities of an acquiree that an acquirer might recognize under this Statement (that previously did not qualify for recognition in accordance with the “probability threshold” criterion of Statement 5).

Paragraph B105 (b)
Please clarify accounting treatment and/or guidance in circumstances where acquiree is both the lessee and the sub-lessor to an operating lease.

An item that is an asset or liability at the acquisition date
Paragraph B107
“Obligations” have been defined in a broad sense (beyond legal obligations). Would this definition require contingent assets and liabilities associated with certain customer contracts to be recorded separately (i.e., the future anticipated income to be received from the customer pursuant to a purchase order [or other similar customer contract to purchase goods or services from the acquiree in the future] to be recorded as an asset and the future anticipated costs to be incurred by the acquiree in providing the goods or services to be recorded as a liability)?

Determining that assets acquired and liabilities assumed are part of the exchange for the acquiree
Paragraph B116
With respect to defining transactions or arrangements designed primarily for the economic benefit of the specific acquiree or combined entity (rather than the acquiree or its former owners), we would suggest additional illustrative examples with respect to certain pre-exiting financial liabilities and obligations that the acquiree may have to the acquirer. As an example, often times, bridge financing or working capital loans are provided by the acquirer to the acquiree, even in advance of any substantial discussions to combine the respective businesses. Depending on the legal structure of the subsequently completed transaction, these obligations may continue (under a parent / subsidiary relationship) or may be extinguished (under an asset acquisition). How should such pre-existing obligations be treated (as part of or separate from the business combination)?
Contingencies that meet the definitions of assets or liabilities

Paragraph B122
Notwithstanding the definition of an asset or liability in Concepts Statement 6, illustrative examples of contingent assets and contingent liabilities that may be recognized in a business combination should be provided in this Statement.

Paragraph B124
Notwithstanding the proposed statement on fair value measurement, to effectively implement the recognition and measurement of contingencies assumed or acquired in a business combination, a certain level of measurement guidance should be provided in this Statement with respect to those contingencies that may recognized in a business combination.

Subsequent measurement of contingencies

Paragraphs B136 and B137
Please provide illustrative examples of those business combination contingencies that would be subject to Statement 5 post-combination recognition and re-measurement guidance (absent the fair value recognition and re-measurement guidance of this Statement) and those business combination contingencies that would be considered financial instruments and subsequently re-measured under other applicable GAAP guidance.

Operating Leases

Paragraphs B151
Please address situations were the acquiree is a sub-lessee of an operating lease. While outside the scope of this paragraph, would the “net amount” recognition approach be applicable to other acquiree obligations (performance obligations or otherwise) that give rise to both future economic benefits and future economic obligations or costs)?