October 28, 2005

Technical Director
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

VIA EMAIL: director@fasb.org

Re: File Reference: 1204-001

Dear Director:

Cisco Systems, Inc. ("Cisco") appreciates the opportunity to comment on the Financial Accounting Standards Board ("FASB" or "Board") Exposure Draft, Proposed Statement of Financial Accounting Standards, Business Combinations, a replacement of FASB Statement No. 141 ("Exposure Draft").

Overview and Summary

We understand that this Exposure Draft is part of a broad set of projects to promote the convergence of U.S. Generally Accepted Accounting Principles with International Accounting Standards. Fundamentally, we continue to be concerned that the Board is working simultaneously on the Conceptual Framework while at the same time continuing to develop specific standards. We believe that the Conceptual Framework should be given a higher priority than the standard setting process. The Board may then be able to more fully evaluate, assess, and understand the full implications of the principles and their impact on financial accounting and reporting. Once developed, the Conceptual Framework can provide the Board and users a logical roadmap to standard setting.

We have observed over the past several years that significant confusion exists with the issuance of new standards with preparers and users of financial statements. We assert that the development of a principles based approach cannot be achieved without first addressing the Conceptual Framework. We understand that the Board has placed a high priority on its need for convergence with the International Accounting Standards Board. However, convergence without addressing the fundamental framework will further exacerbate the confusion.

In addition, as we have noted in previous correspondence with the Board, we suggest that proposed standards with such broad implications such as the Exposure Draft be more fully vetted with preparers and users. We recommend the Board conduct field visits with preparers and engage users to understand their needs. As an example, we are not aware that users desire a fundamental change in the accounting for business combinations represented by the Exposure Draft. Consequently, the issuance of the Exposure Draft as a final standard may not represent an improvement in accounting and reporting from the user perspective. Additionally, there are practical implementation considerations...
that the Board should consider as it develops standards which may be easily identified through a field visit program.

We understand that it is the Board's belief that recognition of assets and liabilities at fair value improves relevance and reliability of financial information. However, the application of the fair value to non-financial assets raises significant reliability concerns. Recording subsequent changes in these measures in the financial statements implies a greater level of precision than actually exists. Specifically, we are concerned with several fundamental changes in accounting proposed in the Exposure Draft that will lead to financial information that is less comparable, reliable and transparent as a result of increased reliance on judgment of key assumptions that are subject to significant uncertainty or as a result of inconsistent standards.

We specifically address the proposed accounting treatment for:

1. Measuring the fair value of the acquiree, specifically contingent consideration,
2. Measuring and recognizing the assets acquired and the liabilities assumed, specifically restructuring or exit costs and in-process research and development ("IPR&D") costs and

The proposed accounting treatment for recognizing contingent consideration seems to disregard the underlying cause of the contingency, which is that the fair value of the acquiree is not readily determinable. Using a valuation model to estimate fair value involves assumptions that are subject to significant uncertainty and could result in recognition of amounts that are remotely probable of occurring. Further, the proposed accounting treatment would create inconsistencies, including for example, the treatment of contingent consideration related to an asset acquisition which would continue to be evaluated in accordance with FAS 5 Accounting for Contingencies.

The proposed accounting treatment for restructuring or exit costs and for in-process research and development costs seems to be contrary to other proposals in this Exposure Draft and to existing literature. For example, the Exposure Draft proposes recognition of contingencies at fair value. This could result in contingencies that are recognized which are determined to only have a remote probability of occurring while also resulting in not recognizing costs that are determined to be more than likely of occurring. Also the proposals are inconsistent with other existing literature which provide for the capitalization of costs necessary to bring an asset into its intended use (FAS 34 Capitalization of Interest Cost) and which provide for the immediate expense recognition of research and development costs (FAS 2 Accounting for Research and Development Costs). Similarly the proposed accounting treatment for in-process research and development is inconsistent with current accounting treatment for research and development acquired outside of a business combination and for subsequent costs incurred on the same projects acquired in the business combination. Also the valuation and impairment tests of capitalized in-process research and development costs would involve the use of assumptions that are subject to significant uncertainty. The accounting for IPR&D was addressed with the issuance of the AICPA Practice Aid, Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries. In our view, the issues, considerations and conclusions in that document appropriately address the treatment for IPR&D.

Finally, the proposed accounting for business combinations achieved in stages is inconsistent with existing revenue and gain recognition principles and would result in reported results that are not representative of the underlying economic substance of the transaction.

These factors would cause the Board's proposals to result in less reliable, comparable and transparent financial information. We have provided our detailed comments to several specific issues posed in the Exposure Draft in Attachment A of this letter.
We thank the Board for the opportunity to provide our comments on this critical issue. If you have any questions regarding our letter or would like to discuss our views in further detail, please feel free to contact me directly at (408) 526-7815.

Sincerely,

Prat Bhatt
Director, Corporate Accounting and Reporting
Cisco Systems, Inc.
Attachment A  
Responses to Specific Issues set forth in the Exposure Draft

Definition of a Business

Issue 2: Are the definition of a business and the additional guidance appropriate and sufficient for determining whether the assets acquired and the liabilities assumed constitute a business? If not, how would you propose to modify or clarify the definition or additional guidance?

We support the proposed definition of a business that would require an integrated set of activities and assets be “capable” of being conducted and managed for the purpose of providing a return to investors or other economic benefits. Many companies, including development stage companies, are in economic substance, businesses. The Exposure Draft appears to appropriately consider these situations.

Measuring the Fair Value of the Acquiree

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

Contingent consideration is either 1) a purchase price adjustment or 2) additional compensation and the proposed accounting changes would likely affect both situations. Contingent consideration is often the necessary result of parties in a transaction that could not come to an agreement regarding the fair value of a business. The Board’s proposal to recognize contingent consideration as part of the consideration transferred by the acquirer at its fair value as of the acquisition date implies that the estimate of fair value is reliably determinable. The Board’s proposal is contrary to the frequently underlying cause for contingent consideration, which is that the fair value is not reliably determinable. As a result of the underlying uncertainty of fair value, companies in similar circumstances could report widely ranging financial results. This would result in financial statements that are less reliable and comparable.

Although we recognize that the Board believes that the proposed accounting treatment for contingent consideration is more appropriate because any changes in the estimate of fair value are the result of post-combination events, we believe that subsequent changes in estimate as a result of post-combination events simply validate or refute the assumptions underlying estimates of fair value at the acquisition date. Therefore, these changes in estimates should affect and be recognized as changes in the consideration transferred (i.e. the acquisition price). We are also concerned about the resulting inconsistency between the proposed accounting treatment for contingent consideration in a business combination versus an asset acquisition. We are concerned this would result in reduced comparability and reliability of financial information.

Furthermore, we believe that the proposed subsequent accounting treatment would cause counter intuitive results. For example, if an acquired business resulted in better than expected financial results, the resulting impact on the acquirer’s financial statements would be a charge to income. Conversely, if an acquired business resulted in poorer than expected financial results, the impact on the acquirer’s financial statements would result in a gain.
We recommend companies continue to evaluate and recognize contingent consideration following the current approach, and recognize as an additional element of the purchase consideration when the contingency is resolved and the additional consideration is issued or becomes payable (FAS 5, Accounting for Contingencies approach, in which contingencies are evaluated based on the probability of occurrence). We believe this would be a better alternative than the Exposure Draft's proposal that could result in recognition of a contingency that is considered remotely likely to occur in the financial statements at the acquisition date. We believe this proposal would result in financial results that are not reliable.

Measuring and Recognizing the Assets Acquired and the Liabilities Assumed

Issue 8: Do you believe that these proposed changes to the accounting for business combinations are appropriate? If not, which 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?

We do not agree with the proposed changes to the accounting for business combinations with respect to costs associated with restructuring or exit activities. We recognize that the Board's objective is to achieve accounting treatment for restructuring or exit activities consistent with other authoritative literature (FAS 146, Accounting for Costs Associated with Exit or Disposal Activities). However, this proposal is inconsistent with other proposed requirements to recognize contingencies and other liabilities at fair value at the acquisition date. As part of an acquirer's assessment of the acquiree, decisions are made about the business, including employee and contract termination decisions, which are more than likely to occur. Under the Exposure Draft, if at the time of the acquisition, the proposed requirements have not been met, recognition of these liabilities would not be permitted, even though they are more than likely to occur. Furthermore, the proposed accounting treatment is inconsistent with existing accounting guidance for other assets, where costs incurred to bring an asset to expected service are capitalized as part of the cost of the asset. We do not believe this proposal would serve to meet the Board's objective of more reliable and transparent financial information.

We believe that restructuring or exit activities should continue to be recognized in accordance with EITF 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination.

We also do not agree with the Board's proposal to capitalize in-process research and development costs as an intangible asset. We believe this would result in capitalized IPR&D which could have a low probability of success. The nature of research and development is that the ultimate outcome is uncertain and the process is continuous. As a result, we believe that IPR&D does not meet the definition of an asset as set forth in the Conceptual Framework.

Further, the proposed change will result in significant inconsistencies in the accounting treatment of research and development. Only IPR&D acquired in a business combination will be capitalized as an indefinite lived intangible asset. The proposed accounting treatment is inconsistent with IPR&D acquired outside of a business combination and with internal research and development costs. The proposed treatment is also inconsistent with subsequent costs incurred to develop the same IPR&D projects acquired in the business combination. We believe these inconsistencies in the accounting treatment of research and development costs would result in financial information that is less reliable and comparable, as widely different reported results would result.

This accounting proposal also involves the use of a valuation model to estimate fair value and introduces judgments about impairment and useful life which involves assumptions that are subject to significant uncertainty. As stated previously, we believe that this uncertainty and the judgmental nature of the assumptions make it difficult to reliably estimate fair value of IPR&D.
The accounting for IPR&D was addressed with the issuance of the AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries*. In our view, the issues, considerations, and conclusions in that document appropriately address the treatment for IPR&D. We suggest that due to the uncertain nature of IPR&D and the questionable future benefits, these costs continue to be expensed at acquisition.

**Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations**

**Issue 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?

We do not agree with the proposed accounting treatment that would require a remeasurement of a noncontrolling equity investment at fair value as of the acquisition date and recognize any unrealized gains or losses in income. While we recognize that this proposal is consistent with the Board's ongoing efforts towards recognition of fair value amounts in financial statements, we do not believe the resulting financial information would be more reliable or transparent because it would result in widely different reported results of a transaction that is, in substance, very similar, depending on whether the acquirer completed the acquisition in steps or not. As a result, the Board's proposals would not serve the Board's objective of improved financial information. Further, the recognition of "holding" gains or losses as the result of step acquisitions or partial disposal transactions would be contrary to existing basic financial accounting concepts with respect to recognition of revenue and gains. We believe this would result in misleading financial information as it is possible for a company to obtain control without increasing its interest, for example as a result of a contractual arrangement (i.e. lapse of minority veto rights) or as a result of the application of FIN 46(R) *Consolidation of Variable Interest Entities*.

We propose that previously held equity interests should not be remeasured at the time control is obtained and that step acquisitions of equity interest should continue to be recognized as equity transactions and gains should not be recognized on previously held equity interests.