The Financial Accounting Standards Board  
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FASB Statement No. 141 was issued in June 2001. Given that Statement No. 141 has only been a part of U.S. generally accepted accounting principles ("GAAP") for a relatively short period of time and that the Board deliberated for five years prior to the issuance of this standard, we were somewhat surprised by the large number of changes to existing GAAP proposed by the Exposure Draft.

We recognize that Statement No. 141 carried forward, without reconsideration, certain of the principles contained in APB Opinion No. 16. We further recognize that a number of the proposed changes are to address perceived deficiencies associated with the guidance promulgated by APB Opinion No. 16 and/or to converge with International Financial Reporting Standards ("IFRS"). However, we ask the FASB to be careful in avoiding “change for the sake of change”. In particular, and as discussed in more detail later in this letter, we believe that some of the changes posed in the Exposure Draft will not improve the relevance or reliability of financial reports and would present companies with operational challenges in complying with the new requirements, presuming they are approved as currently written in the Exposure Draft.

Irrespective of our overarching concern expressed above, we do commend the FASB for preparing a well-considered document. We, in fact, support a number of the principles advocated by the Exposure Draft, including:

- Designating the acquisition date as the date for valuing equity securities issued by the acquiring company as purchase consideration (instead of using the
average market price of the acquirer’s securities a few days before and after the date the transaction is agreed upon and announced; [paragraph 21(a) of the Exposure Draft]

- Requiring that costs incurred in connection with a business combination – such as legal fees, due diligence expenses, printing costs, and others – be excluded from the calculation of purchase price (in most cases, such costs would be expensed as incurred); [paragraph 27 of the Exposure Draft]

- Excluding from the business combination any portion of the transaction price that is not an element of the purchase consideration for the target company, as described very well in paragraphs B111-B117 of the Exposure Draft (we also appreciate that this aspect of the Exposure Draft would incorporate in one location the existing guidance in EITF 04-1);

- Recognizing, as of the date of acquisition, 100% of the fair value of net assets (including goodwill) in the acquired entity, including the portion attributable to the minority owners; [paragraphs 19-20 of the Exposure Draft]

- Restating comparative financial statements for any adjustments to the provisional amounts recorded in connection with the business combination; [paragraphs 62-68 of the Exposure Draft] and

- Requiring comprehensive and relevant disclosures [paragraphs 71-81 of the Exposure Draft].

On the other hand, we do have concerns about specific aspects of the Exposure Draft, some of which we consider to be “fatal flaws”.

The next section of this letter discusses our most significant concerns with the contents of the Exposure Draft. Following this discussion, we present other suggestions for improvements and peripheral comments regarding the Exposure Draft.

If you have any questions or require further information regarding the views expressed in this letter, please contact Scott Ehrlich, President and Managing Director of Mind the GAAP, LLC, at (773) 732-0654 or by e-mail at sehrlieh@mindthegaap.com.

**Significant Concerns**

The majority of our “fatal flaw” observations, detailed in Items 1-8 below, relate to aspects of the Exposure Draft which are unnecessarily complex or not “user-friendly”. We strongly believe that new accounting standards should be clear and comprehensible
to preparers and users of the financial statements. Furthermore, standard setters should give due weight to the practical aspects of implementing and operationalizing new accounting requirements. This is especially important when choosing between alternative accounting methods. We believe that where the outcomes are reasonably similar, a simpler approach should take precedence over a theoretically “pure” but difficult-to-implement methodology.

1. Simplify the language throughout the Exposure Draft

Please make any final standard resulting from the Exposure Draft more understandable by using plain English where possible.

The language used in the Exposure Draft tends to be overly complex. Having closely followed the Exposure Draft’s development over the past few years, we consider ourselves highly familiar with the content contained therein as well as the Board’s deliberations surrounding business combinations accounting. Consequently, we were surprised and disappointed to encounter many examples of poor drafting contained in the Exposure Draft. If this language was difficult for us to interpret, we believe that practitioners that have not followed the Board’s process as closely will be completely confounded rather than enlightened by the concepts in the Exposure Draft.

As an example, the guidance in paragraph 36 on the subsequent accounting for contingencies is very confusing. Our interpretation of paragraph 36 is that all contingencies should be marked-to-market after initial recognition, except for contingencies pertaining to insurance contracts, as defined in Statement No. 60. If our understanding is correct, paragraph 36 should simply state that requirement.

Paragraph 27 is another example of unclear language used in the Exposure Draft. Please find below the actual text from paragraph 27, as well as our proposed revisions.

**Actual Text**
Costs the acquirer incurs in connection with a business combination (also called acquisition-related costs) are not part of the consideration transferred in exchange for the acquiree. For example, such costs include finder’s fees, advisory, legal, accounting, valuation, other professional or consulting fees, general administrative costs, including the costs of maintaining an internal acquisitions department, and costs of registering and issuing debt and equity instruments.

**Proposed Revision**
Any costs that an acquirer incurs in connection with the business combination – such as finders’ fees, advisory costs, legal, accounting, or other professional consulting fees – should be expensed as incurred, except that:
- Costs of registering equity instrument used to consummate the acquisition should be charged directly against additional paid-in capital.
The acquirer shall not include such costs in the measure of the fair value of the acquiree or the assets acquired or liabilities assumed as part of the business combination. The acquirer shall account for acquisition-related costs, separately from the business combination, in accordance with generally accepted accounting principles.

Other examples of poor drafting occur in paragraphs 47, A48, D17(m), just to name a few examples.

In contrast, there are some instances of "plain English" within the Exposure Draft. For instance, the language in paragraphs B156-B160 describes some complexities of business combination accounting simply and precisely, and provides strong reasoning for these requirements (grounded in principles consistently applied throughout the Exposure Draft). We consider paragraphs B156-B160 to be good models of drafting, and advocate similarly clear language in all instances throughout the Exposure Draft.

2. Stop Taking Short Cuts!

Provide complete and specific cross-references to the specific accounting literature applicable in each instance. Better yet, summarize the pertinent requirements of other GAAP that are referenced in the Exposure Draft.

The Exposure Draft contains numerous non-specific and, consequently, unhelpful references to other GAAP. For example, paragraph 25 of the Exposure Draft refers to "other generally accepted accounting principles" for guidance on classifying contingent consideration arrangements as either liabilities or equity.

This short-cut approach incorrectly assumes that readers will know the pertinent details of the GAAP applicable in each instance. In our view, these short-cuts tarnish the quality and usability of the Exposure Draft by requiring readers to "fill in the missing blanks". We do not intend to suggest that copious information from other GAAP should be replicated within the Exposure Draft. However, there is ample opportunity to improve the usability of the Exposure Draft by avoiding "short-cut references" to other generally accepted accounting principles and instead providing information about which standards may be applicable, as well as summary information about such standards. Here are some examples to illustrate our point:

- The cost of raising new debt used to fund an acquisition should be recorded as a deferred charge, in accordance with APB Opinion No. 21
o Paragraph 27 states that acquisition-related costs should be accounted “in accordance with generally accepted accounting principles”.
   *In this instance, the reader’s understanding would be enhanced by stating that, except for costs of issuing debt or equity instruments, acquisition-related costs should be expensed.*

o Paragraph 26(b)(1) contains a generic reference to Statement No. 133.
   *It would be simpler if the Exposure Draft clarified that unless a financial instrument qualifies for hedge accounting (which should be rare), fair value changes would be recognized in the income statement. In fact, the whole of paragraph 26 could be re-written to indicate that any changes in fair value of contingent consideration should be recorded in income, unless in the exceptional circumstance in which the contingency qualifies for hedge accounting under Statement No. 133.*

o Paragraph 37 refers to the recognition criteria in Statement No. 146.
   *Providing a summary of the Statement No. 146 recognition criteria would assist the reader’s understanding in how to apply this paragraph. Alternatively, it might be easier to reword the entirety of paragraph 37 to simply state that in no circumstances should the acquirer recognize a liability relating to restructuring or exit activities as part of the acquisition method of accounting, unless in the extremely rare circumstance that the acquired business incurred a liability for such restructuring activities prior to the business combination date. Moreover, it should be noted that if such a restructuring or exit activity was undertaken at the request or on behalf of the acquirer, then the acquirer should consider whether the acquisition date preceded the date consideration was exchanged, as discussed in paragraph 18 of the Exposure Draft.*

In recognition of today’s complex environment, we believe that every effort to increase the usability and clarity of final accounting standards is a responsible and worthwhile endeavor.

3. Accounting for Contingent Consideration

*We do not agree that obligations for contingent consideration should be measured at fair value on the acquisition date. Moreover, we disagree that equity-classified contingent consideration should not be remeasured after the acquisition date.*

We recognize that contingent payment arrangements, such as earn-outs, are part of the economics of many business combinations. However, we have serious concerns as
to whether the proposed accounting for contingent considerations will result in information that is relevant for users of the financial statements. To illustrate:

Assume a Buyer agrees to pay $1 million to the seller if the target company meets specified revenue targets over the next four years. There is a 50% likelihood that the target company will meet these revenue targets. Assuming a discount rate of 6%, a liability of $396,000 for contingent consideration would be recorded at the date of acquisition under the Exposure Draft, as shown in the table below.

<table>
<thead>
<tr>
<th>Payout is triggered</th>
<th>Probability-weighted average</th>
<th>Discounted amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>$500,000</td>
<td>$396,000</td>
</tr>
<tr>
<td>(50% x $1,000,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payout is not triggered</td>
<td></td>
<td></td>
</tr>
<tr>
<td>50%</td>
<td><em>(total)</em></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In our view, the liability recognized of $396,000 is either overstated by $396,000 or understated by $604,000 (ignoring the time value of money). This is because the future cash outflow will ultimately amount to either $1,000,000 or zero – there are no potential outcomes where the obligation would be settled for $396,000 (or even $500,000 on an undiscounted basis). Accordingly, it does not make sense to us to recognize a liability for an amount which, under any circumstances, will never be paid as this is grossly misleading to users of the financial statements.

We also believe that this proposed accounting will have the unintentional effect of motivating some companies to be extremely conservative in their estimates of the likelihood that a contingent consideration payment will materialize. By assigning a high probability that the liability-classified contingent consideration will be paid, an acquirer can avoid, for the most part, recording subsequent charges through the income statement if the contingency does result in a payment. Alternatively, if the contingency does not result in a payment, the liability recorded will be reversed, resulting in income to acquirer in future periods.

Finally, we disagree that contingent consideration classified as equity should not be remeasured subsequent to the acquisition date. Specifically, we are concerned that the guidance in the Exposure Draft prohibits the purchase price from being “trued-up” to the actual value of consideration issued in circumstances in which the contingent consideration will be equity-settled. We further believe that all contingent consideration arrangements, irrespective of the type of instrument used at settlement, are obligations, should be classified as liabilities, and should be accounted for in an identical manner.
4. Accounting for Preacquisition Contingencies

We do not agree with the recognition and measurement proposals for acquired contingent assets and liabilities.

We acknowledge the Board's attempts to replace the Statement No. 5 recognition thresholds by incorporating uncertainty regarding a contingency into the measurement (rather than recognition) requirements of the Exposure Draft (paragraph B127). However, we do not consider the proposed approach an improvement on Statement No. 5. Rather, we believe that these proposals compromise, rather than enhance, the reliability of information about preacquisition contingencies because of the subjective estimates involved in incorporating uncertainty into fair value calculations. The element of subjectivity is especially high for contingent events that are unlikely to occur. To illustrate:

Assume a Buyer acquires a Target that is in the midst of a court case. The court case will be settled in the three months following the acquisition date. There is a 15% chance that the Target will lose and have to pay $1 million in penalties. However, there is an 85% chance that the Target will win the court case, with no payout required.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Likelihood of occurrence</th>
<th>Probability-weighted average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Favorable result- no penalty</td>
<td>85%</td>
<td>-</td>
</tr>
<tr>
<td>Unfavorable result – $1 million penalty</td>
<td>15%</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

In the above example, a preacquisition contingency would be recognized at the date of acquisition, even though a future cash outflow is unlikely to occur. Further, the liability would be measured at $150,000, even though any future payout would be either $1 million or zero. In our view, this illustrates the fatal flaw of the recognition and measurement approach prescribed in the Exposure Draft. Specifically, companies will be forced to recognize liabilities for preacquisition contingencies that are unlikely to result in losses. Moreover, such liabilities will be recorded in amounts that have no relationship whatsoever to any potential future cash outflows. We believe that these accounting consequences are highly misleading for users of an acquirer's financial statements.

As a further consequence of the guidance contained in the Exposure Draft, nearly every single preacquisition contingency recognized will result in some type of net income charge (or gain) in post-acquisition periods. Just as with the accounting for contingent liabilities.
consideration, we believe that companies will be extremely conservative in their initial estimates regarding the likelihood that a contingent loss will materialize. By assigning a high probability that a contingent loss will occur, an acquirer can avoid, for the most part, recording subsequent charges through the income statement if the contingency does result in a payment. Alternatively, if the contingency does not result in a payment, the liability will be reversed and the acquirer will record future gains in the income statement.

It is disturbing to note that, taken as a whole, paragraphs 35 and 36 provide both the incentive and opportunity for companies to manipulate future earnings by excessively provisioning for contingent liabilities and/or under-recognizing contingent assets.

As an aside, we would like to voice our support for the approach outlined in Statement No. 5, even though this standard has been "abandoned" by the Exposure Draft. Statement No. 5 contains pragmatic and principles-based standards for recognizing and measuring contingencies. Accordingly, we disagree with the Board’s conclusion in paragraph B134 that a Statement No. 5 approach would be a "step backwards". Indeed, we hold the view that the previous changes in Statement No. 141 to recognize certain gain contingencies when probable and reasonably estimable were without merit, and, themselves, a step backwards.

5. Accounting for Tax Contingencies

Reversals of valuation allowances for deferred tax assets acquired in a business combination should first be credited to goodwill, even if these reversals occur more than one year following the acquisition date.

Paragraph D17(d) of the Exposure Draft states that valuation allowances for deferred tax assets that are reversed after one year following the acquisition date shall reduce income tax expense. In contrast, under EITF 93-7, reversals of provisions for other types of tax contingencies are adjusted against goodwill, no matter how long after the acquisition date these contingencies are resolved. In our view, valuation allowances for deferred tax assets are of the same ilk as provisions for other types of tax contingencies. Consequently, the same accounting should apply in both cases. Moreover, the ability to credit valuation allowances against income tax expense (as called for in the Exposure Draft) presents an incentive and opportunity for companies to excessively provide for valuation allowances at the acquisition date. For these reasons, we recommend that all reversals of valuation allowances for deferred tax assets acquired in a business combination should first reduce goodwill, irrespective of when these reversals occur.
6. Inconsistency in Accounting for Business Combinations versus Asset Acquisitions

Resolve the disparities between the accounting for business combinations versus asset acquisitions.

As outlined in paragraph C7 of the Exposure Draft, the accounting for asset acquisitions differs in some respects from the accounting for business combinations. We strongly agree with the views expressed by some Board members, as discussed in paragraph B39, that the guidance in the Exposure Draft should be expanded to address the accounting for asset acquisitions. Said another way, the current Business Combinations project presents a timely opportunity to conform the accounting for business combinations and asset acquisitions wherever possible. In particular, we believe that the accounting for acquisition-related costs and in-process research and development assets should be made consistent irrespective of whether a transaction involves a business combination or the acquisition of assets.

Furthermore, we agree with the Board’s tentative decision, as outlined in paragraph B93, that costs of issuing debt and equity instruments should be expensed. We believe that the Board should codify this decision now rather than wait for the conclusion of the debt/equity project.

7. Fair Value Measurement

Consider whether it would be more appropriate, in the case of accounting for business combinations, to define fair value in reference to the acquiring entity rather than hypothetical third-parties. Moreover, please provide further guidance on determining the fair value of other acquired assets, notably inventory.

Overall, we agree with the general principle that all assets and liabilities should be measured at fair value. However, we believe that the requirement to measure fair value by reference to “knowledgeable, willing, unrelated parties” is not practical in the specific case of business combination accounting. To illustrate:

Parent purchases a Subsidiary to acquire its intellectual property and customer list. Subsidiary also owns equipment; however, the equipment will not be used post-acquisition based on Parent’s new business strategy for Subsidiary. However, this equipment will not meet the criteria to be considered held for sale in accordance with Statement No. 144. Assume that market information for Subsidiary’s equipment indicates that the equipment has a fair value of $200,000. Under the Exposure Draft, Subsidiary’s equipment must be recorded at $200,000 at the date of acquisition.
In reality however, Subsidiary’s equipment will contribute no value whatsoever to the group in the post-acquisition period. Effectively, this equipment is impaired as of Day 2. As such, we do not believe that measuring Subsidiary’s equipment at $200,000 provides relevant or reliable information to users of the combined company’s financial statements.

In our view, it would be more appropriate to determine fair value by reference to the entity-specific information, rather than what hypothetical unrelated parties would pay for an asset in the marketplace. In determining the purchase price, the acquiring entity surely employed entity-specific measures in determining what to pay for the acquired entity as a whole. Therefore, there will be a mismatch when allocating total purchase consideration to acquired net assets if the acquirer is forced to use values marketplace participants would ascribe to assets that have little value to the acquirer.

Furthermore, the Exposure Draft implicitly assumes that market information about fair values is readily obtainable. For the majority of non-financial assets and liabilities, this presumption is the exception rather than the norm. In practice, it is a resource-consuming effort for companies to estimate fair value measures that would exist in a supposed marketplace. We believe it is arbitrary that companies should undertake this effort as part of acquisition accounting, only to record impairment charges shortly thereafter.

The Exposure Draft should also provide further guidance on the fair value measurement of specific assets and liabilities. This is important for ensuring consistency of fair value measurement in practice. In particular, we seek clarification as to how inventory acquired in a business combination should be measured (for example, at wholesale value, retail value, replacement cost, or some other measure), and the underlying rationale.

Finally, while we agree with the scope exceptions to fair value measurement as outlined in paragraphs 42 to 51, we remain unconvinced that employee benefit plans should be excluded from fair value measurement principles. Under Statement No. 87, for example, pension accounts are often recorded on a net basis. Moreover, the “true” obligation under a pension plan can be obfuscated by unrecognized transition obligations, past service costs, and other “smoothing” mechanisms. Therefore, we believe that it would be beneficial to users of the financial statements to remeasure the fair value of assumed employee benefit obligations (as well as related acquired employee benefit plan assets) at the time of a business combination to provide users with relevant and reliable information about assumed employee benefit obligations.
As an aside, we are very supportive of the guidance contained in the Exposure Draft on valuation allowances, as outlined in paragraph 34.

8. Gain or Loss on Business Combinations Achieved in Stages

Gains or losses on previously held investments in noncontrolling interests of an acquired business should be recognized in other comprehensive income instead of income.

We agree that an acquirer’s previously held investment in the acquiree should be remeasured at fair value on acquisition date. This is consistent with recognizing the full fair value of the target company’s assets and liabilities on the date control is obtained (i.e., “fresh-start accounting”) and is well articulated in paragraphs B156-B160 of the Exposure Draft. However, we believe that the resulting “holding” gain or loss should be recorded in other comprehensive income instead of the income statement. This approach is analogous to the accounting treatment for available-for-sale securities, as required by Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. We believe that this approach would better highlight to users of the financial statements the appreciation in value associated with a previously held noncontrolling investment and would avoid a temptation of an acquiring company to “overpay” to gain a controlling interest in a company simply to recognize a purported “holding gain” in the income statement.

Other Matters

- We recommend that paragraph 2(a) make reference to the accounting guidance for corporate joint ventures in APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, and AICPA Accounting Interpretation No. 18 The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18.

- We suggest that the contents in paragraph E6 explain that the Exposure Draft’s definition of “business”, as stated in paragraph 3(d), would conflict with the SEC’s definition of business as outlined in Article 11 and Regulation S-X. Further, section E6 should also clarify that the Exposure Draft will disallow the accounting policy choice under Staff Accounting Bulletin Topic 5H, “Accounting for Sales of Stock by a Subsidiary” (SAB No. 51) which currently permits the controlling shareholder to recognize gains on dilution of its interests in a subsidiary when that subsidiary issues new shares of stock that are not subscribed by the controlling shareholder in proportion to its current holdings.
We note that the fourth line in paragraph 11 should refer to paragraph D28, and not to paragraph D29 as currently stated.

We suggest that in paragraph 12(c)(2), the word “minority” should be replaced by “noncontrolling”, to be consistent with the terminology used throughout other parts of the Exposure Draft.

We suggest that paragraph 30 be rewritten as it is not entirely accurate in its present form. Specifically, as outlined in paragraph D17(q), there are situations where it may be appropriate for an acquirer to reduce a pre-existing deferred tax valuation allowance as a result of the business combination.

We note that paragraph 76(a) requires disclosure of measurement period adjustments made to assets and liabilities previously recognized on acquisition date [emphasis added]. However, paragraph 64 may require the recognition of previously unrecognized additional assets or liabilities during the measurement period, subject to specific criteria. Therefore, we recommend expanding paragraph 76(a) to require disclosure of any additional assets or liabilities that were recognized during the measurement period.

We suggest that paragraphs A64 and A67 be deleted. The table and calculations in paragraphs A64 and A67 are overly complex and hard to follow. In contrast, the explanations in paragraphs A65 and A69 simply and succinctly illustrate the calculations that are required.

As discussed in paragraph B150, the Exposure Draft will modify Statement No. 109 in respect of recognizing deferred tax assets on goodwill basis differences. We request that the Board clarify the transition requirements applicable to this change. Specifically, we ask for guidance on whether catch-up adjustments are required for goodwill basis differences arising from previous business combinations, or whether this change will only apply to prospective business combinations.

Finally, we also seek clarification of the rationale behind the last two sentences in paragraph D17(m). Specifically, we fail to understand why deferred taxes should not be recognized in both instances.

Thank you once again for the opportunity to comment on the Exposure Draft.

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Making the complex understandable