Investors Technical Advisory Committee
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Via Email

FSP141RA

January 15, 2009

LETTER OF COMMENT NO. 11

Russell G. Golden
FASB Technical Director
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed FSP FAS 141R-a: *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies*

Dear Mr. Golden:

I am writing on behalf of the Investors Technical Advisory Committee ("ITAC"). The purpose of the ITAC is to provide independent technical advice, from the investors' perspective, to the Financial Accounting Standards Board ("FASB") and its staff. The ITAC comprises individuals from the investment profession possessing strong technical accounting knowledge.[1]

The ITAC appreciates the opportunity to express its views on the proposed FSP FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies*, ("Proposed FSP") The objective of external financial reporting is to meet the information needs of investors who provide their capital to companies and directly bear risk as a result, and who cannot obtain the information needed to evaluate their investments in any other way. Thus, the gold standard for a financial reporting standard is whether its application, when honestly and earnestly implemented by preparers, results in full transparency of transactions and events affecting the company's net assets. By full transparency, we mean clear, complete, unbiased, up-to-date, and understandable information. Not only does the Proposed FSP *not* meet this gold standard, but we believe it represents a substantial step backward and away from the recent trend of FASB pronouncements toward greater clarity and transparency.

In short, this proposal essentially unwinds the substantial improvements introduced by Statement 141(R) which required greater fair value information, prepared in accordance with Statement No.157, *Fair Value Measurements,* regarding assets and liabilities acquired in business combinations, particularly those involving significant uncertainties

[1]This letter represents the views of the Investors Technical Advisory Committee ("ITAC") and does not necessarily represent the views of its individual members, or the organizations in which they are employed, or the views of the Financial Accounting Standards Board or its staff. For more information about the ITAC, including a list of current members and the organizations in which they are employed, see http://www.fasb.org/investors_technical_advisory_committee/itac_members.shtml.

("contingencies"). Moreover, the Proposed FSP's amendments add more complexity to an already complex standard. We believe that the following provisions in paragraph 24, part a, of Statement No. 141(R) provided the correct financial reporting for such transactions, although we do not believe the reporting should have been limited to contracts:

> *The acquirer shall recognize as of the acquisition date* ***all*** *of the assets acquired and liabilities assumed that arise from contingencies related to contracts...***measured at their acquisition date fair values.*** [Emphasis added.]

The Basis for Conclusions, paragraph C2, in the FSP provides a summary of the Board's thinking in the development of Statement 141(R) and part a of paragraph 24:

> *The 2005 Exposure Draft for Statement 141(R) proposed that an acquirer recognize all assets and liabilities arising from an acquiree's contingencies if they meet the definition of an asset or a liability in Concepts Statement 6* ***regardless of whether a contingency meets the recognition criteria in Statement 5. The Board concluded that to faithfully represent the acquirer's economic circumstances resulting from the business combination at the acquisition date, in principle all identifiable assets acquired and liabilities assumed should be recognized separately from goodwill, including assets and liabilities arising from contingencies at the acquisition date.*** [Emphasis added.]

We believe that this simple and straightforward logic was correct, that all assets acquired and liabilities assumed in an acquisition including contingencies should be recognized at fair value. Statement No. 157 provides for the measurement of assets and liabilities involving one or more significant uncertainties in Level 3.

We also believe that where such measurements involve significant uncertainty, the measures should be revised (remeasured) each period until the uncertainty or contingency is resolved or determined to have ended and be accompanied with sufficient disclosure to enable investors to better assess the complete cost of the acquisition.

Unfortunately, the various criteria in Statement No. 5 are not only inconsistent with those in Statement No. 157, but are in direct conflict with them. Hence, Statement No. 5, *Accounting for Contingencies*, cannot be regarded as an alternative to Statement No. 157, or even as a fall back to that standard.

Despite these drawbacks, the Proposed FSP would again allow preparers to rely upon the provisions of Statement No. 5 for any and all such contingencies. Issued well over three decades ago (March 1975) Statement No. 5 is not only among the oldest FASB standards, it is also among the poorest in quality. The recognition and measurement criteria embodied in this standard allow managers excessive latitude to decide when, and even ***if***, information regarding highly significant risk exposures will be provided to capital providers, and what form that information will take. For example, managers and their legal counsel have discretion to decide when the "reasonably determined," "probable" and "reasonably estimable" thresholds are not met and thus, no recognition will be required in the financial statements. These infirmities with a key financial reporting standard were recognized almost as soon as it was issued, and have led to repeated calls over the intervening years by investors and others for a project to be placed on the FASB's agenda to reconsider Statement No. 5 in its entirety and to provide for high quality financial reporting for contingencies and other significant uncertainties.

As a consequence, the ITAC and other investors were greatly heartened when the FASB announced in September 2007 that a full reconsideration of Statement No. 5 would be formally undertaken and a project was placed on the agenda. We were also encouraged by the development of FASB proposals to increase disclosures to bridge the information gap until a new standard for recognition and measurement of contingencies could be completed.[2]

It is not surprising that preparers and their legal counsel objected to the provision of increased transparency for these significant risk exposures, asserting their long-standing claim that providing such information to those who directly bear the risk from their investments could prove prejudicial to the outcomes of such proceedings and that this risk should trump the investors' desire and, in our view, also entitlement for information about the highly material risks that they bear. Preparers and their legal counsel resorted as well to the same arguments in opposing the new disclosures on contingencies that the FASB had proposed. What is disturbing to the ITAC is that in both cases it appears that the FASB chose not to rule in favor of greater transparency for investors, but rather to yield to the demands of preparers and their legal counsel for greater obscurity for these significant risks.

Perhaps, it is worth remarking at this juncture that the current market financial crisis, which is affecting the livelihoods and well-being of millions around the globe, was allowed to grow and fester at least in part as a result of the dark corners created by inadequate and substandard transparency in financial reporting for certain financial instruments,[3] including on and off- balance sheet positions associated with highly contingent and uncertain exposures and risks. It has become evident that markets do not function efficiently or even near-effectively if investors are not well-informed about the risks to which companies are exposed, what the implications of this exposure are for the realization of future cash flows and the riskiness and timing of those cash flows. This fundamental principle has been recognized in law for more than seven decades, since the passage of the Securities Exchange Act of 1934.

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[2] *See* Letter from Lynn Turner, Member, Investors Technical Advisory Committee, to Technical Director, Financial Accounting Standards Board 1 (Aug. 15, 2008), http://www.fasb.org/ocl/1600-100/52585.pdf.

[3] *See* Letter from Michael Moran, Members, Investors Technical Advisory Committee, to Robert H. Herz, Chairman, Financial Accounting Standards Board & Sir David Tweedie, Chairman, International Accounting Standards Board 2 (Sept. 17, 2008), http://www.iasb.org/NR/rdonlyres/A76C7FF2-E5F0-4585-8322-E7C44539E025/0/CL29.pdf.

In fairness, it is possible that the Board felt that the current state of U.S. law, regulation, and so-called treaties regarding clients and the privileged status of information they receive from legal counsel gave them little choice but to retreat from the greater transparency they had proposed. That is, the Board may have been convinced that the information that is required to be provided to investors under the Securities Acts may have been trumped by other provisions or practices relating to client/attorney privilege. If that is the case, then we believe that an urgent need exists for the relevant authorities to reconsider the existing legal provisions or practices in this area and make the changes necessary so that investors will have the information that they need (and we believe clearly should be entitled to receive) to price the capital they provided, or are considering providing, to companies. Consider for example, the information needs of prospective investors who are about to invest in companies with potential but "privileged" exposures. The only alternative for the investors is to add a contingency/uncertainty risk premium to the cost of capital for **all the** companies, reducing their efficiency and effectiveness in the competitive global markets.

<u>**Specific Questions**</u>

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?*

As we have made clear, we believe that all assets and liabilities arising in a business combination, including those for which some significant uncertainty exists, should be measured at fair value at the acquisition date. As the uncertainty is resolved over time, possibly a period of years, we believe that the asset or liability should be remeasured at fair value with the gains or losses recognized currently in income. We also believe that clear and complete disclosure in the notes of information regarding the assets or liabilities, including the nature of the uncertainties, will provide the information that investors and other capital providers require. We do *not* believe that resorting to a sub-standard method of accounting that the Board itself has recognized as sufficiently flawed to require a complete reconsideration as a full agenda item is a reasonable or credible alternative to full fair value measurement.

2. *In developing the 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 and 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)?

By definition, this proposed FSP addresses only those uncertainties that are considered to be material to the acquisition or to the acquirer's operations. Thus, we are convinced that a rebuttable presumption should exist that an acquirer believed that a reasonable fair value estimate could be made of significant uncertainties, including contingencies, before the deal was closed and the consideration to be given in exchange for the assets and liabilities was determined. To believe otherwise suggests that acquirers and sellers are not rational economic decision makers and will at all times assume any risks without regard to their potential consequences. Thus, we believe that managers should be required in all cases to provide at acquisition their best estimate of the fair value of assets and liabilities acquired, including those involving significant uncertainties.

Following the acquisition date, we believe that the standards should require remeasurement each period for those assets and liabilities involving significant uncertainties until the uncertainties are resolved. Full roll-forward disclosure should be provided in the notes for such assets and liabilities until all uncertainties are resolved. This information is necessary to enable investors and other capital providers to adequately evaluate the prospective profitability, cash flows and risks associated with their investments.

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?*

We believe that the loss in information could result in substantial losses to investors in the form of mispricing of securities and misallocation of capital.[4] The current market crisis is a case study in the costs to investors when sufficient information regarding risks and uncertainties is not provided in a timely fashion to investors. At the limit, as we've seen in the current market, investors will choose to withhold their capital from the markets entirely, reducing liquidity to a critical level and impairing the proper functioning of markets.

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[4] *Cf.* Proposed FASB Staff Position FAS 141(R)-a, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* ¶35 (Fin. Accounting Standards Bd. Posted Dec. 15, 2008) ("this Board member believes that the proposed subsequent accounting for assets and liabilities arising from contingencies initially recognized at fair value is not likely to provide decision-useful information for capital providers and, therefore, fails any reasonable cost-benefit test for improved financial reporting").

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.*

See our responses above.

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 the guidance to be operational?*

We believe that this problem may be associated with a historical cost/FASB Statement No. 5 setting but will not be a serious concern in a full fair value Statement No. 157 framework with reassessment of the value of the item each period. The reason is that when the probability of future settlement becomes sufficiently small (remote), the resulting measurement will decline to the point that the measure is no longer significant (materiality threshold) and will not require explicit guidance.

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?*

See our responses above.

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?*

As we have made clear above, many if not all measurements in accounting carry a measure of uncertainty. When this uncertainty involves probabilities and outcomes distributions with potentially negative consequences of a highly significant nature, both preparers and their counsel have a natural tendency to delay recognition and measurement or disclosure of the news, including that which might be construed to be "prejudicial," until the last possible moment, when no remaining uncertainties exist. We have observed repeated instances of this behavior over the last decade with the numerous collapses of major companies and even market sectors, resulting in sudden massive losses to capital providers. The failure to provide adequate information to capital providers about such potentially material negative consequences, information needed to permit them to evaluate the potential risks and uncertainties surrounding their investments in a timely fashion, means that investors will be pricing securities based upon false and misleading information. We believe that to knowingly provide false and misleading information to investors *for any reason whatsoever* amounts to a fraud committed against the investors, is detrimental to the functioning of markets and cannot be permitted for any reason. To do otherwise is to destroy the very faith and confidence that are fundamental to the markets that serve the global economy.

In closing, we urge the Board to abandon this proposal and instead focus its efforts on developing a new standard to not only eliminate the fatal flaws in Statement No. 5 but to provide the much needed transparency for transactions and events involving significant uncertainty, including contingencies. We believe that the changes in financial reporting in the proposal would result in less transparency for business combinations, frequently highly material events with long baseline consequences for the operations of acquirers and those who provide capital to them. We believe that moving from a superior financial reporting to one that the Board has already concluded is sufficiently impaired to require a complete reconsideration is poor public policy and should not be allowed to occur.

If you have any questions, please feel free to contact the undersigned or any ITAC member.

Sincerely,

Rebecca McEnally

Rebecca McEnally
Member
Investors Technical Advisory Committee