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Regarding: Entity Combinations-Exchange Transactions - Exposure Draft # 41

By : Dr. Joseph S. Maresca CPA, CISA

Colleagues,

Thank you for the opportunity to critique this submission. Details follow:

Summary: The purpose of the exposure draft is to specify the accounting treatment for entity combinations from exchange transactions. The standard deals with public sector exchanges *not under common control*. ED 41 is to be applied with examples B1, B2 accounting treatments adopted from IFRS 3. This entity combination occurs when the entity acquires an operation from another and gives directly in exchange an approximate amount equal to the value in cash or other consideration. Impliedly, public sector exchanges under common control will be the subject of continuation in part exposure drafts which (when completed) will constitute the whole of the guidance. If this segmentation is intended, the exposure drafts should be labelled as "interim guidance" with a final exposure draft issued later encompassing "common control" and "not under common control" continuations in part. Significant intercompany elimination transactions may be required for entity combinations under common control.

Critique:

P. 9 indicates that contingent liabilities assumed in the entity combination be in the nature of present obligations both reliably measurable and recognizable. Generally speaking, an expert in the relevant financial instrument should be engaged together with the corporate legal counsel to set forth contractually the rights, duties, liabilities and potential recourse mix of the relevant transactions under consideration. P. 10,11 Disclosure to shareholders should include potential or foreseeable consequences of derivative transactions and the concept of reversibility of projected derivative transactions by the Courts. In derivative transactions, the most cautious approach is to "let the buyer beware".

P. 13 # 17 At acquisition date, the acquirer shall classify the identifiable assets acquired and liabilities assumed on terms of the contract or binding arrangement concurrent with economic conditions at the acquisition date. Again, the parties should write a contract that specifies the rights, duties, responsibilities and recourse for the transaction. In particular, recourse should be clarified for contingent liability transactions or reasonably foreseeable contingent liability transactions.

A question arises as to whether or not embedded liabilities should be separated from the host. First, an expert opinion may be needed to opine on the rights, duties, liabilities and recourse for the transaction. If immaterial, embedded derivatives may be assumed by the host. If material, embedded derivatives could be problematic to accomplishing the combination.

For example, baskets of large sub-prime mortgages could be problematic to separate in an entity combination due to valuation difficulties and the lack of a ready market. There are secondary sources of guidance for

derivative transactions in the USA ; namely, the Comptroller of the Currency, Securities and Exchange Commission disclosure in the 10K, the National Association of Securities Dealers , as well as the industry experience and disclosure of comparable companies in the trade and business. Increasingly, better information is becoming available on TARP transactions.

Readers should look to guidance of the foreign bourses on non-USA based derivatives and complex financial products. The relevant Court venue should be specified for dispute resolution of derivative transactions with transnational contingency implications.

P. 19 #45,46 discusses contingent consideration. Measurability is best determinable by consulting with management, the general counsel and relevant financial or compensation experts in the art of the transactions which generate the contingencies.

There needs to be a rule structure for the determination of contingent consideration; namely, the agreement or contract should specify the following rule structure for contingency consideration

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- (1) the contract should provide clarity and transparency on the uniform measurement , rights, duties, liabilities and recourse of the parties.
- (2) the Court venue should be specified in the contract for dispute resolution, articulation and measurement
- (3) the compensation mix should be set forth i.e. straight salary, bonus, stock option, deferred compensation, savings/investment, fringe benefits or the compensation supermarket

P. 40 (g) discusses consideration again. There needs to be a more inclusive mix of incentives to include guidance on bonus determination, below prime loans to executive management, stock options , non-cash compensation and compensation in business downturns .

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