
The evolution of purchase accounting rules in general, and the recognition and amortization of intangible assets in particular, were motivated by ever-increasing merger and acquisition activity in the second half of the twentieth century. Accounting rule-makers definitively addressed the issue in 1970, with the issuance of Accounting Principles Board (APB, the predecessor organization to the FASB) Opinion No. 16, *Business Combinations*. APB Opinion No. 16 provided stricter requirements for recognizing a business combination as a pooling of interests than had existed up to that point.

Purchase accounting required that the cost of an acquisition, that is, the fair value of the assets acquired in a transaction, be reflected on the books of the surviving entity. A purchase price that exceeded the fair value of the recorded assets of the enterprise meant recognizing the existence and value of acquired intangible assets and amortizing them as appropriate. Pooling of interests was an exception; then the balance sheets of combining entities were merged.

Prior to the release in 1970 of APB Opinion No. 17, *Intangible Assets*, generally accepted accounting principles (GAAP) recognized intangible
assets as having either a **limited** or **indefinite** life; the former were amortized over their remaining useful lives and the latter were not amortized at all. APB Opinion No. 17 states that “the value of intangible assets at any one date eventually disappears and that the recorded costs of intangible assets should be amortized.”¹ This required that all intangible assets be amortized over a period not to exceed 40 years.² With SFAS No. 142, the treatment of indefinitely lived intangible assets has come full circle.

The need for accounting rules that bring order and consistent reporting to the merger and acquisition arena has become increasingly important. The impact of mergers and acquisitions (M&A) on the economy and financial reporting is a critical issue. In recent years this need has grown dramatically. As shown in Exhibit 1.1, *Mergerstat Review*³ reported 9,566 deals were announced in 2000 compared with 2,074 in 1990. That’s an average annual increase of 16.5 percent for the 10-year period. In terms of total deal value, shown in Exhibit 1.2, the total value of the deals in 2000 was $1,325.7 billion, compared with $108.2 billion in 1990, an average annual increase of 28.5 percent. Clearly, the importance of accurate and consistent accounting for business combinations has never been greater.

Until SFAS Nos. 141 and 142 were enacted, guidelines for accounting for business combinations were codified in APB Opinion Nos. 16 and 17.

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**Exhibit 1.1** Net Merger and Acquisition Announcements

[Graph showing net merger and acquisition announcements from 1990 to 2000.]

APB Opinion No. 16 recognized two distinct methods of accounting for business combinations—the *purchase* method and the *pooling of interests* method. As described in APB Opinion No. 16, “The purchase method accounts for a business combination as the acquisition of one company by another;” whereas “The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities.”

In a purchase:

The acquiring corporation records as its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill. The reported income of an acquiring corporation includes the operations of the acquired company after acquisition, based on the cost to the acquiring corporation.

In a pooling:

No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the
combined corporation at their recorded amounts. Income of the com-
bined corporation includes income of the constituents for the entire fis-
cal period in which the combination occurs. The reported income of the
constituents for prior periods is combined and restated as income of the
combined corporation.7

The principle distinction in the accounting treatment of a purchase
compared with a pooling is that in a purchase the fair values of the
assets of the acquired corporation were recorded on the books of the
purchaser, while in a pooling, no step-up of assets to fair value was
recognized. Further, the fair values of assets recognized under pur-
chase accounting were subject to periodic amortization under APB
Opinion No. 17.8

The pooling of interests method was applied only to business combi-
nations involving the exchange of stock. Importantly, APB Opinion No.
16 set forth 12 specific conditions, all of which had to be met for a busi-
ness combination to be classified as a pooling of interests:

1. Each of the combining companies must be autonomous and must not
   have been a subsidiary or division of another corporation during the
two-year period prior to the initiation of the combination plan.
2. Each of the combining companies is independent of the other comb-
   ining companies.
3. The combination is effected in a single transaction or is completed
   in accordance with a specific plan within one year after the plan is
   initiated.
4. The surviving (or resultant parent) corporation must issue only com-
   mon stock with rights identical to those of the majority of its out-
standing voting common stock, in exchange for “substantially all”
(90 percent or more) of the voting common stock of the other (com-
bining) companies outstanding.
5. Each of the combining companies must maintain substantially the
   same voting common stock interest.
6. The combining companies may reacquire shares of voting common
   stock only for purposes other than business combinations.
7. The ratio of the interest of an individual common stockholder to
   those of other common stockholders in a combining company must
   remain the same.
8. The voting rights of the common stock interests must be exercisable
   by the stockholders.
9. The combination must be resolved at the date the plan is consummated, with no pending provision of the plan relating to the issue of securities or other consideration.

10. The combined corporation must not agree directly or indirectly to retire or reacquire all or part of the common stock issued.

11. The combined corporation must not enter into other financial arrangements for the benefit of the former stockholders of a combining company.

12. The combined corporation must not intend to dispose of a significant part of the assets of the combining companies within two years after the combination, except to eliminate duplicate facilities or excess capacity and those assets that would have been disposed of in the ordinary course of business of the separate company.9

The pooling of interests method provided certain benefits to the merged enterprise, including no recognition of amortization charges over the life of the acquired assets. However, compliance with the 12 specific conditions severely limited deal flexibility for the merger partners.

Proponents of pooling argued:

... an exchange of stock to effect a business combination is in substance a transaction between the combining stockholder groups and does not involve the corporate entities. The transaction therefore neither requires nor justifies establishing a new basis of accountability for the assets of the combined corporation. Those who endorse the purchase method believe that the transaction is an issue of stock by a corporation for consideration received from those who become stockholders by the transaction. The consideration received is established by bargaining between independent parties, and the acquiring corporation accounts for the additional assets at their bargained—that is, current—values.10

Arguments for purchase accounting included:

Those who favored the purchase method of accounting believe that one corporation acquires another company in almost every business combination. . . . Proponents of purchase accounting hold that a business combination is a significant economic event, which results from bargaining between independent parties. . . . The agreed terms of combination recognize primarily the bargained values and only secondarily the costs of assets and liabilities carried by the constituents. . . . Accounting by the purchase method is essentially the same whether the business combination is effected by distributing assets, incurring liabilities, or is-
suing stock because issuing stock is considered an economic event as significant as distributing assets or incurring liabilities. . . . The purchase method adheres to traditional principles of accounting for acquisition of assets.11

The rules allowing the participants in a business combination to choose between two conceptually opposite accounting methods lasted 30 years, ending with SFAS No. 141.

Just as SFAS Nos. 141 and 142 interact and should be read and applied in tandem, so too were APB Opinion Nos. 16 and 17. APB Opinion No. 17 classified intangible assets as **identifiable** and **unidentifiable**. In addition, APB Opinion No. 17 mandated that intangibles be classified as having either a **limited** or **unlimited** life. Prior to this opinion, management had significant latitude in handling intangible asset amortization. APB Opinion No. 17 decreed that all intangible assets, whether identifiable or unidentifiable, must be amortized. Any intangible asset for which a remaining useful life could not be reasonably ascertained was amortized over a period not to exceed 40 years.12 APB Opinion No. 17 also set forth a number of factors to be considered in estimating the remaining useful lives of intangible assets.13

**HISTORY OF THE FASB DELIBERATIONS**

In August 1996, the FASB announced its project to reconsider APB Opinion Nos. 16 and 17. The FASB took on the project for five main reasons:14

1. The Financial Accounting Standards Advisory Counsel (FASAC) had consistently urged assigning a high priority to the revisions of standards affecting business combinations, most recently at its July 1996 meeting.
2. The FASB and the Securities and Exchange Commission (SEC) were devoting increasing resources responding to inquiries from the auditing profession relating to clarification of APB Opinion Nos. 16 and 17 to specific fact situations.
3. These interpretations increasingly led to perceived flaws and deficiencies, particularly when two transactions are not significantly different, but are accounted for by methods producing dramatically different financial statement results diminishing their integrity.
4. The Board continued to recognize the need for international com-
parability of accounting standards that would enhance the movement of capital flows globally. The FASB had been working with the Australian Accounting Standards Board, The New Zealand Financial Standards Board, the United Kingdom Accounting Standards Board, the Canadian Institute of Chartered Accountants, and the International Accounting Standards Committee with the goal of achieving international convergence with respect to the methods of accounting for business combinations. As part of this cooperation, the FASB issued a position paper, *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*, on December 15, 1998. They received 267 responses.

5. The Board had come to believe that the pooling of interests method created an unlevel playing field domestically and internationally for acquirers who may or may not be able to apply that method.

Over the period of deliberation, there was much activity with many presentations invited by the FASB. Ed Jenkins, Chairman, testified before Congress on this project three times in the year 2000. Further, he participated in oversight hearings before and round table discussions held by the Senate Committee on Banking, Housing and Urban Affairs. In September 2000, the Board met with a team of representatives from the American Business Conference (including representatives from Cisco Systems, Merrill Lynch and Co., TechNet, and the United Parcel Service) to discuss a proposed impairment test that would apply to purchased goodwill. In May 2000, the Board met with a team of representatives from the investment banking community and several public accounting firms to discuss the residual income valuation model (technically known as the Multi-Period Excess Earnings Model) to measure and account for goodwill. In January 1999, the Board and staff met with representatives of the AICPA Business Valuation subcommittee, authors Michael J. Mard, CPA/ABV, ASA and James R. Hitchner, CPA/ABV, ASA for an educational meeting on identifying, valuing, and lifing purchased intangible assets. Methodologies were presented along with over 500 legal case citations in which the central issue was the valuation of intangibles. This included the U.S. Supreme Court case, *Newark Morning Ledger Co. v. U.S.*

With all of this activity and the international reach created by the FASB leadership, Congress had to get into the act. On October 3, 2000, representative Christopher Cox (R-California) introduced a bill
in the House of Representatives that would, if enacted, postpone proposed improvements to the transparency of business combinations. The bill was ultimately opposed and the challenge to the leadership of the FASB receded.


While the Board was ferreting through these deliberations over many years, academia got into the act too. A study by professors Hopkins, Houston, and Peters entitled *Purchase, Pooling and Equity Analysts’ Valuation Judgments*, concluded empirically that accounting does matter. The professors provide evidence that analysts’ stock price judgments depend on the method of accounting for a business combination as well as the number of years that have elapsed since the combination. Analysts’ stock price estimates are lowest when a company applies the purchase method of accounting and ratably amortizes the acquisition premium (goodwill). Time is correlated with the analysts’ price estimates only when the company applies the purchase method and ratably amortizes goodwill. However, when a company uses the purchase method and writes off the acquisition premium (such as in-process research and development [IPR&D]), analysts, stock price judgments are not statistically different from their judgments applicable to a company applying a pooling of interests method. As stated by the Hopkins, Houston, and Peters study:

The controversy over accounting for business combinations has dogged regulators and standard setters for more than half a century. The heart of the controversy centers on the noncomparable financial statements that result from the two generally accepted methods of accounting for business combinations: purchase and pooling of interests.

The purchase method is consistent with the accounting rules typically applied to assets purchased in the ordinary course of business. The target’s net assets are reported in the consolidated balance sheet at the fair value of the consideration (usually cash or stock) exchanged for the target’s common shares. The difference between the fair value paid for the target and the book value of the target’s net assets is called the ac-
counting acquisition premium (AAP). The AAP is first allocated to the fair values of the target’s identifiable net assets. Any remaining (unallocated) AAP is classified as goodwill and amortized over a period not to exceed 40 years.

In contrast, pooling requires the acquirer to record the historical book values of the target’s net assets. The AAP is not recorded in combinations that qualify for pooling treatment; therefore, they generally report higher net income relative to otherwise identical combinations that apply the purchase method. In addition, pooling requires the acquirer to recognize the target’s net income for the entire year in which the business combination occurred, regardless of the actual transaction date. Under pooling, prior years’ financial statements are restated to combine the financial statements of the two companies as if they have always been a single economic unit. This unusual mixture of book-value recognition and prior-period restatement originated almost a century ago “for combinations in which a strong degree of affiliation existed between the combining entities prior to the combination” (FASB 1998, Appendix p. 3). Since that time, this treatment has been extended to combinations of entities without prior affiliation.17

The impact of the accounting method on earnings per share can be dramatic and may lead to perceived distortions, not necessarily because of the method of accounting, but rather because different players are involved. As Hopkins, Houston, and Peters state:

Although the use of the purchase or pooling accounting is not a choice, *per se*, companies that otherwise would be required to use purchase accounting appear to be willing to incur significant direct and indirect costs to qualify for pooling treatment. Empirical and anecdotal evidence suggests that companies incur significant costs to meet APB 16’s pooling criteria. For example, while Nathan (1988) did not find higher acquisition premia for firms applying the pooling method, Robinson and Shane (1990), David (1990), Vincent (1997), and Ayers et al. (2000a) suggest that poolings result in higher acquisition premia than purchases. Ayers et al. (2000a) estimate that 15 percent of the acquisition premium in poolings is attributable to the cost of obtaining pooling treatment. Similarly, Lys and Vincent (1995) suggest that ATT, in its acquisition of NCR, incurred approximately $50 million of incremental costs to qualify for pooling treatment.

These higher premia suggest that either fundamental differences exist between the companies that qualify for pooling versus purchase accounting, or acquirers are willing to pay an additional amount for the
future accounting benefits afforded by pooling. Based on a sample of firms using the pooling method, Ayers et al. (2000b) estimated that EPS [earnings per share] would have been 18.5 percent lower, and median ROE [return on equity] and market-to-book ratios 22 percent lower, had these firms used the purchase method. Consequently, if investors do not adjust for the post-acquisition accounting differences between purchase and pooling, then structuring business combinations to qualify for pooling-of-interest treatment (and avoiding the AAP’s drag on reported income) may benefit combining companies. However, if a business combination is structured as a tax-free reorganization, then application of the two methods results in identical past, present, and future direct cash flows. There, for otherwise identical companies, an efficient-markets perspective suggests that applying different business-combination accounting methods should not affect stock prices.18 [Emphasis added]

The Hopkins, Houston, and Peters study concluded:

. . . analysts’ price judgments were lowest when the company applied purchase accounting and ratably amortized goodwill. Analysts estimated higher prices when the company applied either pooling-of-interest accounting or purchase accounting with immediate write-off of the acquisition premium as in-process research and development.

The results of the timing manipulation supported our salience-based predictions. Analysts’ stock price estimates were lowest when the company acquired its subsidiary three years before the current fiscal year, applied the purchase method, and ratably amortized goodwill. When the business combination occurred in the most recent fiscal year, purchase accounting with goodwill amortization resulted in stock-price judgments that were (1) higher than when the company applied the same method of accounting to a three-year-old business combination, (2) lower than each case (i.e., one year and three years after the combination) of pooling-of-interest accounting, and (3) lower than each case of purchase accounting with immediate write-off of the acquisition premium as in-process research and development. In addition, regardless of the timing of the business combination, analysts’ price judgments did not statistically differ between pooling-of-interest accounting and purchase accounting with immediate write-off of the acquisition premium as in-process research and development.

. . . We extend both Hopkins (1996) and Hirst and Hopkins (1998) by demonstrating that fundamental variation in accounting method—in this case, accounting for business combinations—has a predictable effect on analysts’ stock-price estimates and the amount of value-relevant net income included in their valuation models. . . . Our results suggest
that analysts are more likely to remove from reported net income the effects of large, one-time charges. . . . Compared to ratable amortization that causes prolonged reduction of reported earnings, analysts are more likely to discount the effects of a non-cash charge if it is presented as a one-time item.\textsuperscript{19}

The result of the Hopkins, Houston, and Peters study is demonstrated in Exhibit 1.3.

**Exhibit 1.3** Analysts’ Common Stock Price Judgments by Business-Combination Accounting Method and Business-Combination Timing Conditions\textsuperscript{20}

(a) Analysts estimated the price of a company’s common stock (PRICE) after receiving information about the company and its industry, including an income statement, balance sheet, statement of cash flows, statement of changes in owner’s equity, and a summary of significant accounting policies. We held constant all information, except the information directly related to the two independent variables.

(b) The method of accounting for the business combination varied between subjects as (1) pooling of interests (“POOL”), (2) purchase with the accounting acquisition premium (AAP) capitalized as goodwill and amortized over six years (“PURCH-GW”), or (3) purchase with the AAP expensed as in-process research and development (“PURCH-RD”). Because the business combination was consummated via a tax-free exchange of common shares, cash flows were identical across accounting methods.

(c) The business combination occurred either at the beginning of the most recent fiscal year (“RECENT”) or at the beginning of the three-years-prior fiscal year (“PAST”).

(d) We also constructed a set of PURCH-GW materials that incorporated the FASB’s proposed reporting format for presentation of goodwill amortization (i.e., PAST/FASB-GW). Except for modifying the income statement location of goodwill (i.e., immediately preceding net income) and providing a per-share amount for pre-amortization income, the materials were identical to those presented to PAST/PURCH-GW analysts.

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IMPLICATIONS

The implications of the new rules on future merger and acquisition activity are not so clear. As companies report the results of goodwill impairment testing, major write-downs will certainly result. On January 7, 2002, AOL Time Warner announced it expected to take a goodwill write-off of up to $60 billion\footnote{History of Mergers and Acquisitions and Financial Reporting} (almost half the amount recorded pursuant to the merger) as a result of impairment testing under SFAS No. 142. A look at the company’s closing stock prices indicates that this news did not impact the closing price significantly:

<table>
<thead>
<tr>
<th>Day</th>
<th>Date</th>
<th>Closing Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Friday</td>
<td>January 4, 2002</td>
<td>$31.95</td>
</tr>
<tr>
<td>Monday</td>
<td>January 7, 2002</td>
<td>32.68</td>
</tr>
<tr>
<td>Tuesday</td>
<td>January 8, 2002</td>
<td>32.00</td>
</tr>
</tbody>
</table>

The 52-week high for AOL Time Warner stock was $58.51. At the above dates the stock was trading near its 52-week low. Thus, a devaluation of AOL Time Warner stock had already occurred in the minds of investors and the company and its accountants had decided the impairment was permanent. In other words, the economic or business dog wagged the accounting tail, as it should.

While the landscape of accounting for mergers and acquisitions has changed significantly, the effect of the rules on M&A activity is uncertain. CFO.com reports “Wall Street seems to be considering the reporting changes something of a non-event.”\footnote{The Times} An article in The Times indicated analysts believe the total write-off could reach $1 trillion.\footnote{The Times} The Times further reported the statement of Bob Willens, an accounting analyst with Lehman Brothers, who said, “If you add it all up it’s pretty easy to get to $1 trillion... But I don’t think it will have much of an effect on stocks because it is already priced into the market.”\footnote{The Times}

While the consensus seems to be that the recognition of goodwill impairment losses will reflect rather than drive reductions in stock prices, the new accounting rules are expected to have an effect on deal activity. A case in point is the battle for control of Wachovia Corporation. Chief financial officer Robert Kelly of First Union Corporation said the new rules’ framework “provides us with a lot more flexibility than pooling.”\footnote{History of Mergers and Acquisitions and Financial Reporting}

The demise of pooling will allow combining companies to be more
creative in structuring deals. PriceWaterhouseCoopers predicted that the disappearance of pooling will have the following impact on future deals:

- Flexibility to sell noncore assets—pooling rules contained restrictions on the disposal of acquired assets
- Increased use of cash in deals—pooling rules forbade cash consideration
- Treasury stock repurchases will become more popular—the old pooling rules restricted the reacquisition of stock
- Greater flexibility in structuring compensation programs—the pooling rules restricting a company’s ability to cash out, alter, or grant new equity awards are no longer relevant
- More contingent consideration—the old pooling rules prohibited earnouts

Bear Stearns has predicted:

We also expect to see an increase in M&A activity, particularly in industries that have been sensitive to earnings dilution. While not producing the same financial reporting results as a pooling, purchase accounting without goodwill amortization will greatly level the playing field for both acquirers and targets.

Bear Stearns further explains:

With the elimination of pooling and its 12 criteria, there will also be more flexibility to structure transactions efficiently. Not only will companies that are, or had been, a subsidiary or a division of another company any time in the last two years become more attractive, companies will no longer be compelled to buy all or retain all of the target. In addition, it eliminates a barrier to “hostile” transactions.

The following chapters explain and illustrate the accounting rules in greater detail. But what can we expect of their impact on the world that creates the need for such rules? Is there any consensus on the future effect of the two Statements on M&A activity?

As mentioned earlier, the AOL impairment example would suggest that investors are not greatly swayed by impairment charges in earnings announcements of companies that had combined under the old rules. Observers are already cautioning that, “The facts and circumstances
surrounding each goodwill impairment charge will need to be evaluated for their investment significance.” Ms. McConnell of Bear Stearns writes:

In the past, a goodwill impairment charge was often considered the sign of a bad acquisition, a miscalculation of the value of the target (i.e., the acquirer overpaid), or an unexpected deterioration in the fundamentals of the business acquired. Under the new rules, a goodwill impairment charge within a few years of the acquisition date may be an indication of any of these as well. However, as time goes by, it is less likely that an impairment is an indication of a bad acquisition or an overpayment. In fact, it is possible that the investment may have been recovered with an appropriate return but, because there has been no amortization, the goodwill remains on the balance sheet. A goodwill impairment many years after an acquisition is more likely to be an indication of the third condition, deterioration in the fundamentals of the business. As noted above, if the market has already anticipated this, the actual recognition of the loss will not have an additional impact on the stock price.30

Many think fears of a major impact are overblown. Sophisticated investors should easily grasp the earnings impact of the new pronouncements. Those who hold this view further argue that the effect of the new rules for GAAP will be blunted since more and more investors increasingly evaluate companies on measures based on cashflow or operating earnings. To the extent that earnings dilution still worries companies, the elimination of goodwill amortization charges will ease the fears of management that have been holding back from acquisitions because of the spectre of future accounting charges.

The Hopkins, Houston, and Peters study found that the accounting method did matter. But their study was completed in 1999, well before SFAS Nos. 141 and 142 were released, and acquirers still had a choice. Indeed, they had the prescience to test the proposed goodwill amortization-reporting protocol described in FASB’s business combinations exposure draft.31 When analysts were provided income statements that contained the improved disclosure, they generally provided higher stock price judgments than analysts who received income statements with traditional goodwill amortization.32

It does not appear that many commentators are predicting a general decline in stock prices due to the new reporting rules. It seems to be generally accepted that investors will adjust to the new reporting, especially
in industries that are valued using price/earnings ratios. Investors will make the necessary adjustments to more or less maintain stock prices. On the other hand, many observers believe that the elimination of pooling and its restrictions combined with a leveling of the playing field in terms of financial reporting will actually have a positive effect on future M&A activity. No one has a crystal ball and it is safe to say that the implementation of the new rules will not be problem-free. However, SFAS Nos. 141 and 142 are law, so financial executives and their advisors must obtain a clear understanding of them.