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# Understanding Accounting for Business Combinations: An Instructional Resource

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**ABSTRACT:** In explaining Statement No. 141, *Business Combinations* (SFAS No. 141, FASB 2001b) and Statement No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142, FASB 2001c), accounting textbooks do not adequately describe the theoretical choices the FASB considered or the economic and political context in which the FASB developed these statements.

This instructional resource fills that gap. It compares purchase, pooling of interests (hereafter, pooling), and fresh start accounting, as well as various methods of accounting for goodwill under purchase and fresh start accounting; it also discusses the economic and political context in which the FASB deliberated. A simple example (and a separate more complicated homework problem) compares the effects of these methods on post-combination financial statements. The Teaching Notes discuss how to use this instructional resource to introduce these subjects and integrate them with other subjects covered in advanced financial accounting and merger and acquisition courses.

**Keywords:** business combinations; goodwill; purchase accounting; pooling accounting; and fresh start accounting.

## INTRODUCTION

Accounting for business combinations and goodwill are important subjects in advanced accounting and merger and acquisition courses. We believe that student understanding of these subjects is enriched by explaining the theoretical accounting choices and the economic and political contexts in which the Financial Accounting Standards Board (FASB) developed Statement No. 141, *Business Combinations* (SFAS No. 141, FASB 2001b), and Statement No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142, FASB 2001c), the controlling pronouncements. Unfortunately, accounting textbooks inadequately explain these choices and contexts.<sup>1</sup> This instructional resource fills that gap.

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<sup>1</sup> Advanced financial accounting textbooks emphasize current U.S. GAAP and largely ignore political issues. They focus on purchase accounting as prescribed by SFAS No. 141 and goodwill impairment testing without amortization as prescribed by SFAS No. 142. Coverage of pooling accounting is limited, and there is virtually no coverage of fresh start accounting, goodwill amortization, immediate goodwill write-off at acquisition, or non-recognition of goodwill.

It enriches student understanding by illustrating the different post-combination financial statement effects of (1) three possible methods of accounting for business combinations (purchase, pooling, and fresh start accounting) and (2) four possible ways of accounting for goodwill under purchase and fresh start accounting (impairment testing with amortization, impairment testing without amortization, immediate write-off, and nonrecognition). These were the principal alternatives the FASB considered in developing SFAS Nos. 141 and 142. By showing how different post-combination financial statement effects potentially affect economic decisions, this instructional resource helps students understand why the business community lobbies the FASB for accounting standards it favors.

SFAS No. 141 (FASB 2001b, para. 13) prescribes purchase accounting and prohibits pooling and fresh start accounting. International Financial Reporting Standard No. 3, *Business Combinations* (IFRS No. 3, International Accounting Standards Board [IASB] 2004) is similar but not identical to SFAS No. 141.<sup>2</sup> Nevertheless, aspects of pooling accounting continue to affect current financial reporting. Combinations accounted for by that method prior to the effective date of SFAS No. 141 are not restated. It is still required for combinations of companies under common control and for certain combinations of mutual enterprises and not-for-profit organizations.<sup>3</sup> Additionally, vestiges of pooling accounting are manifested in the prevailing consolidation practice of valuing net assets of partially owned subsidiaries partly at book value (and partly at fair value). Perhaps most important, pooling accounting approximates the carryover of old tax bases in tax-free reorganizations and, thereby, impacts deferred tax accounting.

Similarly, aspects of fresh start accounting continue to affect current financial reporting. It is sometimes used to account for brand new companies and for admissions of partners into existing partnerships; it is also being considered by the FASB as a way to account for certain multiparty combinations and joint venture formations (see SFAS No. 141, FASB 2001b, paras. B32 and B85), and is still in theory a viable conceptual alternative to purchase accounting for combinations of similar size companies.

### PURPOSE OF INSTRUCTIONAL RESOURCE

This instructional resource supplements usual textbook materials for instructors who wish to explain the economic and political context in which the FASB developed SFAS Nos. 141 and 142. It also provides a conceptual overview of the principal alternatives the FASB considered when developing SFAS Nos. 141 and 142: purchase, pooling, and fresh start accounting, and the possible treatments of goodwill under purchase and fresh start accounting. A simple comparative example illustrates these alternative methods and contrasts their effects on post-combination balance sheets and income statements; it also illustrates how management would project the post-combination financial statements as part of its decision to undertake a combination. A more complex homework problem also contrasts these three methods.

We believe that students better understand why the FASB prescribes purchase accounting with goodwill recognition and impairment testing when the other methods it considered are set forth systematically in words and in a comparative example. We also believe that students better understand how current generally accepted accounting principles (GAAP)

<sup>2</sup> In June 2005, the FASB (2005) and the IASB (2005) jointly developed, but issued separate Exposure Drafts (EDs) that propose a slightly revised purchase accounting for business combinations. The intent of both EDs is to harmonize American and international accounting standards by prescribing one set of procedures to implement purchase accounting.

<sup>3</sup> The FASB tentatively concluded to prohibit pooling accounting for both. See FASB (2005a, paras. B13–B17, B45–B47).

are developed when the political and economic contexts in which the FASB deliberated these issues are addressed rather than ignored.

Additionally, we believe that understanding pooling accounting furthers student comprehension of each of these aspects of current GAAP:

- (a) consolidation of previously pooled subsidiaries;
- (b) certain aspects of goodwill impairment testing under SFAS No. 142;
- (c) carryover tax basis of nontaxable combinations;
- (d) combinations of companies under common control; and
- (e) valuation of net identifiable assets of partially owned subsidiaries.

Finally, we believe that contrasting purchase, pooling, and fresh start accounting also makes students more aware of the conceptual inconsistencies of conventional historical cost valuations under purchase accounting. Additional discussion of these learning goals is found in a separate section at the end of this instructional resource.

### THEORETICAL OVERVIEW OF PURCHASE, POOLING, AND FRESH START ACCOUNTING

This section provides a theoretical overview of purchase, pooling, and fresh start accounting. The following section illustrates how these three methods impact the post-combination balance sheet, and the section thereafter discusses the possible ways of accounting for goodwill.

#### Purchase Accounting Theory

Under purchase accounting, a business combination is reported as a basket purchase of an acquired company by an acquirer company. Accordingly, a new basis of accountability arises for the net assets of the acquired company. In theory, purchase accounting could be applied using a top-down approach, which results in recognizing goodwill, or a bottom-up approach, which results in not recognizing goodwill.<sup>4</sup>

- (1) *Top-down approach*: The acquirer company records the acquired company at fair value—that is, at fair value of consideration given, or fair value of consideration received, whichever is more clearly evident.<sup>5</sup> That fair value is then allocated to identifiable assets acquired and liabilities assumed, and goodwill is recognized for the residual (SFAS No. 141, FASB 2001b, paras. 35–43).
- (2) *Bottom-up approach*: The acquired company is valued at the fair value of its identifiable assets and liabilities, and no goodwill is recognized, consistent with the accounting for the acquisition of a group of assets that does not constitute a business.<sup>6</sup> This approach is virtually equivalent to the recognition and immediate write-off of goodwill at acquisition.

<sup>4</sup> To keep this instructional resource within manageable bounds, negative goodwill is not addressed or illustrated here, but it is considered in the homework problem.

<sup>5</sup> Extant GAAP provides limited but inconsistent guidance for determining fair value and that guidance is dispersed among many pronouncements. FASB Statement No. 157, *Fair Value Measurement* (FASB 2006), develops a consistent framework for determining fair value.

<sup>6</sup> Under FASB Emerging Issues Task Force Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business* (EITF No. 98-3, FASB 1998c), a business is a self-sustaining integrated set of activities and assets conducted and managed to provide a return to investors, and consists of (1) inputs, (2) processes applied to those inputs, and (3) resulting outputs that are used to generate revenues. When a company acquires a group of assets without the processes or outputs, it does not acquire a business, and the transaction is reported at fair value without recognizing goodwill.

Regardless of these two possibilities, there is no new basis of accountability for the existing net assets of the acquirer company. As with other purchase transactions, existing assets of the acquirer company continue to be carried forward at historical book values. Accordingly, the balance sheet of the combined company reflects mixed asset values at acquisition: current fair value of net assets of the acquired company, and historical book value of net assets of the acquirer company—an example of adding proverbial apples and oranges. Additionally, because purchase accounting presupposes the realization convention, revenues are recognized at the time of sale, not at the time of purchase. Therefore, the earnings of the combined enterprise include the earnings of the acquirer company for the entire period plus the earnings of the acquired company since acquisition; and only the retained earnings balance of the acquirer company is carried forward.

### Pooling Accounting Theory

Pooling accounting views certain acquisitions for stock as the joining together of two or more groups of stockholders to share the risks and rewards of combined ownership. Because no stockholder group is eliminated in a pooling, the resulting enterprise is viewed as a continuation of two or more constituent companies in combined form, not as a new entity.<sup>7</sup> And because it is not viewed as a new entity, a new basis of accountability is not justified for the net assets of either constituent company. Rather, the net assets of both constituent companies continue to be reported at historical book values, and no new goodwill is recognized (AICPA 1970a, para. 51).<sup>8</sup> By definition, pooling accounting was not applicable to acquisitions for cash or debt securities, for these acquisitions necessarily involve an elimination of an important ownership interest.

Under pooling accounting, the net assets of the acquired company and the common stock issued by the acquirer company are reported at the book value of the acquired company (that is, at the acquired company's owners' equity). This value is then allocated among the owner equity accounts of the acquirer company consistent with the par value of the shares issued and the retained earnings balance of the acquired company, and additional paid-in capital is charged or credited for the residual. Accordingly, the retained earnings balances of the constituent companies are usually pooled or combined as if the constituent companies were always combined.<sup>9</sup>

Because pooling accounting presupposes that the combined enterprise is a continuation of two or more constituent companies in combined form and not a new entity, post-combination earnings equal the sum of the earnings of the constituent companies for the entire period plus (or minus) any operating economies (additional expenses) resulting from the combination. Similarly, earnings of prior periods are restated as if the constituent companies were always combined.

<sup>7</sup> In theory, pooling combinations did not involve a buyer or seller and, therefore, were combinations, not acquisitions. However, financial analysts and journalists routinely ignored such theory quibbles as unrealistic and referred to most pooling combinations as acquisitions. (The exception was the so-called merger of equals.) For this reason, as well as to enhance clarity, we refer to all combinations as acquisitions involving an acquirer and an acquired company. Whether some combinations qualified for pooling accounting under prior practice is a separate issue beyond the scope of this instructional resource.

<sup>8</sup> See Accounting Principles Board Opinion No. 16, *Business Combinations* (APB No. 16, AICPA 1970a, para. 51). However, the net assets of each constituent company were acquired at different times; therefore, their book values reflect historical cost prices at different times. Accordingly, carrying forward book values under pooling accounting still results in aggregations akin to adding proverbial apples and oranges. Of course, this is an inherent feature of historical cost (as opposed to fair value) accounting.

<sup>9</sup> There is a constraint on combining retained earnings under pooling accounting under APB No. 16 (AICPA 1970a, para. 53): retained earnings of the combined entity may be less, but never more, than the sum of the retained earnings of the constituent companies.

A major criticism of pooling accounting relates to its use of historical book values rather than current fair values to record the combination transaction. Because historical book values are usually lower than current fair values, no step-ups to fair value of acquired net assets are reported under pooling accounting; accordingly, increases in depreciation, amortization, and impairment charges on those assets are not reported. As Holson (1999, C6) notes, pooling accounting enabled managers to make huge acquisitions, record them at a fraction of their cost, report less expense in subsequent periods, and leave barely a trace of what may have been an ill-advised or excessively costly acquisition in post-combination financial statements.

Another major criticism of pooling accounting was that similar combination transactions were reported differently, depending on whether pooling or purchase accounting was used to record them (see e.g., Sutton 1996). For example, when Company X issued shares in exchange for the shares of Company Y, the resulting combination would be recorded at old book value if it satisfied the detailed tests for pooling accounting. If any pooling test was not satisfied, or if Company X issued the same number of shares for cash and used the proceeds to buy the shares of Company Y, then the combination would be recorded under purchase accounting at current fair value, which was usually much higher than the old book value.

### Fresh Start Accounting Theory

Fresh start accounting has been suggested as a conceptually more desirable alternative to either purchase or pooling accounting, especially for combinations of similar size companies, so-called *mergers of equals*. Perhaps its most prominent advocate is Wyatt (1963), who refers to it as *fair value pooling*.

According to Wyatt (1963, 82), a combination of similar-sized companies creates a new entity materially different from either of the previous separate companies. He proposes fresh start accounting for such a combination, arguing that:

there may be nothing inherent in prior carrying values to warrant their continued usage subsequent to the combination. Rather, it is possible that [all] the assets of the resultant entity should be accounted for based on their "cost" to the new entity. Since the accounting unit is, in effect, a new entity ... [it] would report no earned surplus [retained earnings] until such time as its operations generate earnings. (Wyatt 1963, 82)

Thus, under fresh start accounting, *all* the assets and liabilities of *both* the acquirer company and the acquired company are reported at fair value as of the combination date. Additionally, no retained earnings are carried forward, because the combination is viewed as a new entity without an earnings history.

Neither the FASB nor the predecessor Accounting Principles Board (APB) adopted fresh start accounting. The FASB (SFAS No. 141, FASB 2001b, paras. B83–B84) concluded that any advantages of fresh start accounting were outweighed by the disadvantages of having two methods of accounting for business combinations. It was especially concerned with the difficulties of drawing unambiguous and nonarbitrary boundaries between purchase accounting and fresh start accounting, without which managers might purposely structure combination transactions to qualify for one or the other.<sup>10</sup> However, a variation of fresh

<sup>10</sup> Structuring transactions to qualify for one accounting method rather than another is popularly referred to as *accounting arbitrage*. For example, if financial managers sought to avoid fresh start accounting, then they might direct one constituent company to dispose of one or more segments before a combination is consummated, so that it is not of similar size to the other company.

start accounting is used to record the establishment of certain brand new companies. Moreover, the FASB (and IASB) is considering mandating fresh start accounting for new entities, especially for multiparty business combinations and joint venture formations (see also SFAS No. 141, FASB 2001b, B85; Watrin et al. 2006, 25).

### COMPARATIVE EXAMPLE

The following simple example illustrates and contrasts the three basic methods of accounting for business combinations—purchase accounting, pooling accounting, and fresh start accounting—and their effects on post-combination balance sheets and income statements. For simplicity, the example involves just two companies. The acquirer company is denoted as Akquirer Corporation (Akquirer), and the acquired company is denoted as Zeller Corporation (Zeller). To enhance comparisons of the three methods, the constituent companies are of similar size, and the combination involves a stock-for-stock exchange. Accordingly, the combination potentially qualifies for pooling accounting under prior GAAP or fresh start accounting as proposed by Wyatt (1963). Whether the criteria are satisfied for either pooling or fresh start accounting is a separate issue not addressed here. To enhance clarity, the combination occurs on 1 January 20x5; both companies report on a calendar-year basis; both companies depreciate plant assets straight-line over ten years; and income taxes are ignored. Exhibit 1 presents financial data for both companies just prior to the combination.

The combination is motivated, at least in part, by a desire to eliminate duplicate personnel and thereby reduce payroll costs by \$2,000. Akquirer is more highly regarded by investors than Zeller, as evidenced by a higher price-earnings ratio. Its shareholders retain a majority of the shares, and its management retains control of the combined enterprise. For these reasons, Akquirer is deemed to be the buyer, and Zeller is deemed to be the seller under purchase accounting. Akquirer acquires Zeller through an exchange of common stock, followed by a statutory merger of Zeller into Akquirer. The stock-for-stock exchange ratio is the inverse of the ratio of the market price per share of each company just before the combination.

The comparative example presupposes fair values in excess of book values for both net identifiable assets and common stock, as well as positive goodwill.<sup>11</sup> These were the economic circumstances typical of most companies at the time of the FASB deliberations in the late 1990s when it developed SFAS Nos. 141 and 142.<sup>12</sup> Under these circumstances, projected post-combination earnings of the combined company usually is highest under pooling accounting, lower under purchase accounting, and lowest under fresh start accounting. Initially, we illustrate goodwill amortization under purchase and fresh start accounting over 20 years. These were the principal methods the FASB considered initially in accounting for business combinations before expanding its deliberations to consider the subsequent accounting for goodwill. Thereafter, we examine two other ways to account for goodwill under purchase and fresh start accounting: (1) nonamortization, and (2) immediate write-off at acquisition, the equivalent to nonrecognition. To further enhance the comparisons, we assume throughout that any recognized goodwill is not impaired.

<sup>11</sup> Unlike this comparative example, the more complicated homework problem includes differences between fair values and book values of patents and long-term debt. It also asks the student to consider how deferred income taxes (question 5), negative goodwill (question 6), and parent-subsidiary relationships (questions 7 and 8) would affect the financial reporting.

<sup>12</sup> The Bureau of Labor Statistics year-end producer price index went from 126.2 for 1995 to 134.9 for 1999, and Standards & Poor's year-end 500 stock index went from 615.913 at the close of 1995 to 1,469.25 at the close of 1999.

**EXHIBIT 1**  
**Underlying Data**

Akquirer Corporation and Zeller Corporation combine on 1 January 20x5. Both report on a calendar year basis. Their 31 December 20x4 balance sheets and 20x4 income statements are as follows:

	<u>Akquirer</u>	<u>Zeller</u>
<b>31 December 20x4 Balance Sheets</b>		
Cash	\$3,000	\$2,000
Accounts receivable—net	1,000	3,000
Inventory	6,000	5,000
Plant assets—net	25,000	20,000
Total assets	<u>\$35,000</u>	<u>\$30,000</u>
Current liabilities	\$4,000	\$3,000
Bonds payable	6,000	7,000
Total liabilities	<u>\$10,000</u>	<u>\$10,000</u>
Common stock, par \$1 per share	\$2,000	\$1,000
Additional paid-in capital	6,000	7,000
Retained earnings	17,000	12,000
Total stockholders' equity	<u>\$25,000</u>	<u>\$20,000</u>
Total liabilities plus stockholders' equity	<u>\$35,000</u>	<u>\$30,000</u>
<b>20x4 Income Statements</b>		
Sales revenues	<u>\$23,000</u>	<u>\$20,000</u>
Expenses:		
Depreciation	\$2,500	\$2,000
Other	12,500	12,000
Total expenses	<u>\$15,000</u>	<u>\$14,000</u>
Net income	<u>\$8,000</u>	<u>\$6,000</u>
Number of common shares outstanding	2,000	1,000
Earnings per common share	\$4.00	\$6.00
1 January 20x5 price per share	\$60.00	\$75.00
1 January 20x5 price earnings ratio	15.0	12.5
Book value per common share	\$12.50	\$20.00
Rate of return on assets	22.86%	20.00%
Rate of return on equity	32.00%	30.00%

Except for plant assets and goodwill, the fair values and book values of the assets and liabilities are identical. The current fair values of plant assets and goodwill are as follows:

Plant assets—net	\$32,000	\$23,000
Goodwill	88,000	52,000

The two companies combine in order to achieve anticipated operating economies of \$2,000 per year. Zeller Corporation is absorbed into Akquirer Corporation through an exchange of Akquirer for Zeller common shares in a 5:4 ratio, with all shareholders of Zeller Corporation participating. Plant assets are depreciated straight-line over ten years to zero salvage value, goodwill is amortized straight-line over 20 years but is not impaired, and income taxes are ignored.

The market price per share of Zeller is \$75.00, a substantial premium over the \$20 book value per share. Given the \$60 market price per share of Akquirer, the stock-for-stock exchange ratio is \$75/\$60 or 5:4.<sup>13</sup> Akquirer issues 1,250 shares in exchange for all 1,000 Zeller shares. The market value of Akquirer's 1,250 shares and the market value of Zeller's 1,000 shares both equal \$75,000 on the combination date. Additionally, Zeller's purchased goodwill is positive \$52,000, equal to the difference between this \$75,000 market value and the \$23,000 fair value of its identifiable net assets, as shown in Exhibit 2. Similarly, the \$120,000 market value of Akquirer's 2,000 shares exceeds the \$32,000 fair value of its identifiable net assets by \$88,000, the internally developed implied goodwill of Akquirer just before the combination transaction, as also shown in Exhibit 2.

### POST-COMBINATION BALANCE SHEET EFFECTS

The post-combination balance sheets under all three accounting methods are presented in comparative format in Exhibit 3.

#### Recording the Combination under Purchase Accounting

Under purchase accounting, Akquirer reports Zeller's net assets at fair value at acquisition and recognizes goodwill. Accordingly, Akquirer records plant assets at \$23,000 and

**EXHIBIT 2**  
Calculation of Goodwill

	<u>Akquirer Company</u>	<u>Zeller Company</u>
Fair value of identifiable assets:		
Cash	\$3,000	\$2,000
Accounts receivable—net	1,000	3,000
Inventory	6,000	5,000
Plant assets—net	<u>32,000</u>	<u>23,000</u>
Total Assets	\$42,000	\$33,000
Fair value of liabilities:		
Current liabilities	\$4,000	\$3,000
Bonds payable	<u>6,000</u>	<u>7,000</u>
Total Liabilities	<u>10,000</u>	<u>10,000</u>
Fair value of net identifiable assets	\$32,000	\$23,000
Purchase price [1,250 shares @ \$60]		<u>75,000</u>
Implied fair value [2,000 shares @ \$60]	<u>120,000</u>	
Excess—goodwill	<u><u>\$88,000</u></u>	<u><u>\$52,000</u></u>

<sup>13</sup> To make the illustration easier to follow, we ignore the time span between the date of the initial merger proposal, the date the merger is agreed upon by the two companies, and the date the merger is completed. We also ignore the change in the market price of the shares of each company over this time, and the premium most acquirers pay to acquire control of another company. For example, in the context of this illustration, assume that Akquirer Corporation proposed a 5:4 exchange of shares when its stock was trading at \$54 per share and Zeller Corporation stock was trading at \$50 per share. This situation implies a \$17,500 control premium, because Akquirer Corporation proposes to issue 1,250 of its own shares with a fair value of \$67,500 in exchange for Zeller Corporation stock with a fair value of \$50,000 just before the proposal. In an ebullient market, the price of both companies' shares might increase, say from \$54 to \$60 for Akquirer Corporation, and from \$48 to \$60 for Zeller Corporation, as assumed here, when the shares are actually exchanged.



**EXHIBIT 3**  
**1 January 20x5 Projected Balance Sheet**

	<u>Purchase</u>	<u>Pooling</u>	<u>Fresh Start</u>
Cash	\$5,000	\$5,000	\$5,000
Accounts receivable—net	4,000	4,000	4,000
Inventory	11,000	11,000	11,000
Plant assets—net	48,000	45,000	55,000
Goodwill	52,000		140,000
Total assets	<u>\$120,000</u>	<u>\$65,000</u>	<u>\$215,000</u>
Current liabilities	\$7,000	\$7,000	\$7,000
Bonds payable	13,000	13,000	13,000
Total liabilities	<u>\$20,000</u>	<u>\$20,000</u>	<u>\$20,000</u>
Common stock, par \$1 per share	\$3,250	\$3,250	\$3,250
Additional paid-in capital	79,750	12,750	191,750
Retained earnings	17,000	29,000	
Total stockholders' equity	<u>\$100,000</u>	<u>\$45,000</u>	<u>\$195,000</u>
Total liabilities plus stockholders' equity	<u>\$120,000</u>	<u>\$65,000</u>	<u>\$215,000</u>

goodwill at \$52,000, representing write-ups of \$3,000 and \$52,000, respectively, for a write-up of \$55,000 over the total book value of these items on Zeller's books. These write-ups will result in \$300 of additional (or incremental) depreciation for each of the next ten years and \$2,600 of goodwill amortization for each of the next 20 years. Acquirer makes the following journal entries to record the acquisition of Zeller under purchase accounting:

Investment in Stock of Zeller	75,000	
Common Stock		1,250
Additional Paid-in Capital		73,750
To record exchange of stock.		
Cash	2,000	
Accounts Receivable	3,000	
Inventory	5,000	
Plant assets	23,000	
Goodwill	52,000	
Current Liabilities		3,000
Bonds Payable		7,000
Investment in Stock of Zeller		75,000
To record statutory merger.		

The post-combination balance sheet under purchase accounting is presented in the first column of Exhibit 3.

On the acquisition date, Acquirer records Zeller's net assets on its books at current fair value, whereas its original net assets continue to be reported at historical book value. This is a characteristic of any purchase transaction reported at historical cost. It does not reflect any new inconsistency in asset valuation unique to business combinations. New assets purchased by Acquirer are recorded at current fair value, whereas old assets are reported at historical book value.

### Recording the Combination under Pooling Accounting

A new basis of accountability does not arise under pooling accounting. For this reason, the \$8,000 historical book value of the net assets on Zeller's books is carried over to Akquirer's books, and the \$75,000 current fair value is ignored.<sup>14</sup> The \$8,000 sum of the \$1,000 par value and the \$7,000 additional paid-in capital of Zeller's 1,000 shares exceeds by \$6,750 the \$1,250 par value of the 1,250 shares issued by Akquirer. Accordingly, Akquirer combines the retained earnings of the two companies, and credits the \$6,750 excess to additional paid-in capital. Akquirer makes the following journal entries to record the acquisition of Zeller under pooling accounting:

Investment in Stock of Zeller	20,000	
Common Stock		1,250
Additional Paid-in Capital		6,750
Retained earnings		12,000
To record exchange of stock.		
Cash	2,000	
Accounts Receivable	3,000	
Inventory	5,000	
Plant assets	20,000	
Current Liabilities		3,000
Bonds Payable		7,000
Investment in Stock of Zeller		20,000
To record statutory merger.		

The post-combination balance sheet under pooling accounting is presented in the second column of Exhibit 3.

### Recording the Combination under Fresh Start Accounting

Fresh start accounting presupposes that a business combination results in a new entity without an earnings history, with all assets and liabilities reported at fair value, and no retained earnings. Assuming that its books continue to be used, Akquirer makes the following journal entries to record the combination under fresh start accounting:

Investment in Stock of Zeller	75,000	
Common Stock		1,250
Additional Paid-in Capital		73,750
To record exchange of stock.		
Cash	2,000	
Accounts Receivable	3,000	
Inventory	5,000	
Plant assets	23,000	
Goodwill	52,000	
Current Liabilities		3,000
Bonds Payable		7,000
Investment in Stock of Zeller		75,000
To record statutory merger.		
Plant assets	7,000	

<sup>14</sup> As noted earlier, most critics considered use of the \$8,000 book value to record Zeller's net assets on Akquirer's books to be the most compelling argument against pooling accounting, for it ignores the much larger \$75,000 fair value established in the exchange transaction.

Goodwill	88,000	
Appraisal capital		95,000
To record write up of Acquirer plant assets and goodwill from historical cost to fair value.		
Appraisal Capital	95,000	
Retained Earnings	17,000	
Additional Paid-in Capital		112,000
To reclassify appraisal capital and retained earnings of Acquirer as additional paid-in capital.		

The first two entries are identical to those under purchase accounting. As in purchase accounting, Acquirer records Zeller's assets and liabilities at fair value. Accordingly, Acquirer records Zeller's plant assets at \$23,000 and Zeller's goodwill at \$52,000, representing write-ups of \$3,000 and \$52,000, respectively, resulting in \$300 of additional depreciation for each of the next ten years, and \$2,600 of goodwill amortization for each of the next 20 years. The third entry records a write-up of \$7,000 of Acquirer's plant assets and \$88,000 of Acquirer's goodwill, resulting in \$700 of additional depreciation for each of the next ten years, and \$4,400 of additional goodwill amortization over the next 20 years. The fourth entry reclassifies Acquirer's appraisal capital and retained earnings as additional paid-in capital, consistent with the view that a new entity has no earnings history.

The post-combination balance sheet under fresh start accounting is presented in the third column of Exhibit 3.

### SUBSEQUENT ACCOUNTING FOR GOODWILL UNDER PURCHASE ACCOUNTING

There are at least four conceivable methods of accounting for goodwill under purchase accounting:

- (1) Recognition, amortization, and impairment testing;
- (2) Recognition, nonamortization, and impairment testing;
- (3) Recognition and immediate write-off; and
- (4) Nonrecognition.

The theory underlying each alternative is discussed in the next four subsections.

#### Recognition, Amortization, and Impairment Testing of Goodwill

Under prior practice (AICPA 1970b, paras. 22–24), goodwill was recognized as an asset, amortized to expense over no more than 40 years, and subject to periodic impairment testing and write-down if appropriate. Straight-line amortization was presumed unless another amortization method was demonstrably more appropriate (AICPA 1970b, para. 30). The underlying reasoning of the APB was that few, if any, intangible assets last forever, although some may seem to last indefinitely. Amortizing goodwill is required, according to APB No. 17 (paras. 22–23), because goodwill inevitably loses value at some future date. Since that date is indeterminate, the amortization period is arbitrary. When there is no evidence of limited life or decreased value, amortizing goodwill on an arbitrary basis may recognize expense and asset decrease prematurely, but delaying amortization until a loss is evident may recognize expense and asset decrease after the fact. As a practical solution, APB No. 17 (para. 23) set minimum and maximum amortization periods and required impairment testing when appropriate.

### Recognition, Nonamortization, and Impairment Testing of Goodwill

SFAS No. 141 (FASB 2001b, paras. B102–B139) concludes that goodwill meets the definition of an asset meriting recognition in the accounts. Additionally, SFAS No. 142 (FASB 2001c, paras. 74–79) concludes that goodwill may lose value sporadically or precipitously but rarely loses value systematically (i.e., straight-line) over time. Under SFAS No. 142 (FASB 2001c, para. 18), therefore, goodwill is tested periodically for impairment and written down if impaired, but is not amortized.

### Recognition and Immediate Write-off of Goodwill

Through the years, several prominent accountants (see, e.g., Spacek 1964; Catlett and Olson 1968) have argued that when the fair value of consideration given exceeds the fair value of net identifiable assets received in a business combination, the difference should be recognized as goodwill but written off at acquisition.<sup>15</sup> For example, Catlett and Olson (1968, 90) posit that almost all combinations entail the purchase of one company by another. But they note that unlike other assets, goodwill does not exist apart from a business and cannot be sold separately from a business or clearly delineated business segment (Catlett and Olson 1968, 20 and 90). For these reasons, Catlett and Olson (1968, 36) argue that goodwill should not be reported as an asset. Rather, they argue that a complete accounting for goodwill should involve its recognition and immediate write-off at acquisition against stockholders' equity (Catlett and Olson 1968, 90). Catlett and Olson (1968, 89) also justify immediate write-off of purchased goodwill as consistent with non-deferral of internally generated goodwill.<sup>16</sup>

In response to Catlett and Olson (1968), many prominent practitioners and academicians (see, e.g., Kripke 1968, 141–142; Paton 1968, 147–149; Seidman 1968, 151–154; Storey 1968, 164–165) objected to immediate goodwill write-off, as did the APB in 1970 and the FASB in 2001. Neither APB No. 16 nor SFAS No. 141 permits immediate goodwill write-off at acquisition; additionally, the FASB and IASB will not permit immediate write-off if their separate EDs (FASB 2005a; IASB 2005) are ultimately finalized. Importantly, a fundamental conclusion of both the FASB and the IASB is that goodwill meets the definition of an asset that should not be written down unless impaired.

### Nonrecognition of Goodwill

Other prominent writers advocate nonrecognition of goodwill under purchase accounting when the consideration given is the stock of the acquirer company. For example, Kripke (1968, 136–140) questions the assumption that the fair value of the stock issued is more

<sup>15</sup> Indeed, immediate write-off of goodwill against additional paid-in capital (or retained earnings) was a generally acceptable principle in the United States from 1917 to 1953 (see Federal Reserve Board 1917; AICPA 1944, para. 6; AICPA 1953, chap. 5, para. 9), but neither APB No. 16 nor SFAS No. 141 permits it. Immediate write-off was also acceptable in the United Kingdom, Germany, and The Netherlands before public companies adopted IFRS No. 3 in 2005. For example, until 1997, the Accounting Standards Committee of the United Kingdom and Ireland (Accounting Standards Committee [ASC] 1984, chap. 21, paras. 41–42) *permitted* the capitalization of purchased goodwill as an asset but recommended immediate write-off against stockholders' equity. However, the successor Accounting Standards Board (ASB 1997, para. 16) mandated capitalization of purchased goodwill as an asset.

<sup>16</sup> Immediate write-off of goodwill at acquisition is similar—though not identical—to immediate write-off of in-process research and development acquired in a business combination under FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by Purchase Accounting* (FASB 1975). Unlike the immediate write-off of goodwill against additional paid-in capital, however, the write-off of in-process research and development is to expense. But for all subsequent periods, the overall effects of writing off in-process research and development cost on financial position and earnings are identical to immediate goodwill write-off. In 2005, the FASB (2005a, paras. 40–41, A27) tentatively concluded that it will require capitalization of in-process research and development cost acquired in business combinations.

readily apparent than the fair value of the net assets received in such combinations. He especially questions the reasonableness of basing the valuation of a large number of shares on the price of relatively few shares traded before and after the combination transaction. Rather, Kripke (1968, 140) favors recording such combinations at the fair value of the net identifiable assets received from the acquired company using a bottom-up approach without recognizing goodwill.

Following Kripke's (1968) position, Acquirer would make the following journal entries to record the acquisition of Zeller under purchase accounting without recognizing goodwill:

Investment in Stock of Zeller	23,000	
Common Stock		1,250
Additional Paid-in Capital		51,750
To record exchange of stock.		
Cash	2,000	
Accounts Receivable	3,000	
Inventory	5,000	
Plant assets	23,000	
Current Liabilities		3,000
Bonds Payable		7,000
Investment in Stock of Zeller		23,000
To record statutory merger.		

Nonrecognition of goodwill under this bottom-up approach is acceptable under current GAAP for acquisitions of groups of assets in transactions that are not business combinations under EITF No. 98-3 (see FASB 1998c), as noted earlier. Another precedent for not recognizing goodwill is the bonus method of accounting for the admission or withdrawal of a partner. But nonrecognition of goodwill is not permitted under current U.S. GAAP for combinations of either public or nonpublic companies.<sup>17</sup> Nevertheless, nonrecognition of goodwill under the bottom-up approach remains in theory an alternative way to address the goodwill issue.

The effects on the post-combination financial statements of not recognizing goodwill under a bottom-up approach are identical to its recognition and immediate write-off against additional paid-in capital under purchase accounting using the top-down approach. For this reason, both methods are illustrated together in subsequent sections of this instructional resource.

### **SUBSEQUENT ACCOUNTING FOR GOODWILL UNDER FRESH START ACCOUNTING**

The same goodwill issues arise in fresh start accounting as in purchase accounting. Under a top-down approach, goodwill is recognized for the excess of the fair value of each constituent company over the fair values of its net identifiable assets; conceivably, the combined goodwill could be subject to impairment testing and amortized (as under APB No. 17), subject to impairment testing but not amortized (as under SFAS No. 142), or written off immediately as a reduction in owners' equity. Under a bottom-up approach, goodwill of neither constituent company would be recognized. Rather, the combined entity is reported at the fair value of net identifiable assets of each constituent company; this is

<sup>17</sup> For example, when a nonpublic company issues stock as payment for another nonpublic company, SFAS No. 141 (FASB 2001b, para. 23) holds that the fair value of the acquired company should be estimated, either by estimating the fair value of the stock issued or the fair value of company acquired (including goodwill), consistent with the top-down approach.

equivalent to recognizing goodwill and immediately writing it off against additional paid-in capital.

Recognizing goodwill (the top-down approach) assumes that the goodwill of each constituent company is measurable and merits recognition as an asset of the combined entity. It is consistent with the spirit of the Wyatt (1963) monograph, which favors full accountability of *all* of the assets entrusted to management, and with the APB and FASB conclusion that goodwill is an asset that should be reported on the balance sheet. Under extant GAAP, push down accounting recognizes goodwill based on a top-down approach, as does the *goodwill implied method* to record the admission or withdrawal of a partner.<sup>18</sup>

Not recognizing goodwill (the bottom-up approach) is consistent with Catlett and Olson's (1968, 65) observation that "[n]ew businesses ordinarily do not capitalize goodwill values which may exist or arise in the formation of the business." It is also consistent with the nonrecognition of internally developed goodwill. But by not recognizing goodwill, the bottom-up approach does not achieve a full accountability of all of the assets entrusted to management in a business combination. Indeed, it might recognize *less* net assets for the combined entity than under purchase accounting, which recognizes goodwill of the acquired company.<sup>19</sup>

#### POST-COMBINATION INCOME STATEMENT EFFECTS WITH GOODWILL AMORTIZATION UNDER PURCHASE AND FRESH START ACCOUNTING

Because of the importance many public companies seem to attach to "making the numbers" and meeting Wall Street earnings expectations (see, e.g., Levitt 1998; Berenson 2004), the most important differences among the three accounting methods are probably projected net income, earnings per share (EPS), and return on investment for the years following the business combination.<sup>20</sup> Exhibit 4 illustrates the projected income statements under purchase, pooling, and fresh start accounting, with goodwill amortization under the first and third methods. Exhibit 5 compares projected post-combination net income, EPS, and return on investment under pooling accounting and under purchase and fresh start accounting (1) with goodwill amortization, (2) without goodwill amortization, and (3) with nonrecognition of goodwill.

Assume the same revenue and expense transactions in 20x5 as in 20x4 except for the \$2,000 of operating cost economies due to reduced payroll costs (and the incremental depreciation and goodwill amortization due to the write-up of plant assets and goodwill under purchase and fresh start accounting). Consistent with these assumptions, projected revenue and projected other expenses are the same under all three methods. More specifically, projected revenue is \$43,000, equal to the \$23,000 projected revenues for Akquirer and the \$20,000 projected revenues for Zeller; and projected other operating expenses is \$22,500, equal to the \$12,500 projected other operating expenses for Akquirer, plus the

<sup>18</sup> Under push down accounting, the purchase price paid by a parent company for a subsidiary is used ("pushed down") as the new basis of accountability for the assets and liabilities of the acquired subsidiary, and goodwill is recognized. Under the goodwill implied method, the amount contributed (paid) to an incoming (withdrawing) partner is used to infer the amount of goodwill attributable to all the partners.

<sup>19</sup> This results whenever the write-up from cost to fair value of net identifiable assets of the *acquirer company* under a bottom-up approach to fresh start accounting is less than the goodwill of the *acquired company* recognized under purchase accounting.

<sup>20</sup> The following discussion presupposes that, for a given economic cost, management prefers an accounting method that reports less rather than more future expense. The ostensible exceptions involve timing issues, not total expense recognition issues. For example, management might seek to accelerate losses to implement big-bath accounting, or it might prefer to defer earnings when earnings thresholds in bonus plans will not be met or when bonuses are capped (see, e.g., Healy and Wahlen 1999).

**EXHIBIT 4**  
**20x5 Projected Income Statements**

	<u>Purchase</u>	<u>Pooling</u>	<u>Fresh Start</u>
<b>20x5 Projected Income Statement</b>			
Sales revenues	\$43,000	\$43,000	\$43,000
Expenses:			
Depreciation	\$4,800	\$4,500	\$5,500
Other	22,500	22,500	22,500
Goodwill amortization	2,600		7,000
Total expenses	<u>\$29,900</u>	<u>\$27,000</u>	<u>\$35,000</u>
Net income	<u>\$13,100</u>	<u>\$16,000</u>	<u>\$8,000</u>
<b>20x5 Projected Income—Short-Cut</b>			
Net income—Acquirer Corporation	\$8,000	\$8,000	\$8,000
Net income—Zeller Corporation	6,000	6,000	6,000
Operating economies	2,000	2,000	2,000
Decremental (incremental) depreciation	(300)		(1,000)
Goodwill amortization	<u>(2,600)</u>		<u>(7,000)</u>
Net income	<u>\$13,100</u>	<u>\$16,000</u>	<u>\$8,000</u>

\$12,000 projected other operating expenses for Zeller, less the \$2,000 of anticipating operating economies. Given the ten-year remaining useful life of plant assets, projected depreciation expense is one-tenth of plant assets or \$4,800 under purchase accounting, \$4,500 under pooling accounting, and \$5,500 under fresh start accounting. Similarly, given the 20-year write-off, goodwill amortization is one-twentieth of goodwill or \$2,600 under purchase accounting and \$7,000 under fresh start accounting. Accordingly, projected net income is \$16,000 under pooling accounting, \$13,100 under purchase accounting, and \$8,000 under fresh start accounting. Thus, pooling accounting typically results in the highest post-combination measures of financial performance.

The same projected post-combination net incomes may be derived using a short-cut analysis, also illustrated in Exhibit 4. Thus, post-combination net income for 20x5 is \$16,000 under pooling accounting, equal to the \$14,000 sum of the pre-combination earnings of the two constituent companies plus the \$2,000 operating cost economies. It is \$13,100 under purchase accounting, due to the \$300 additional (incremental) depreciation and \$2,600 goodwill amortization.<sup>21</sup> Finally, under fresh start accounting, post-combination net income for 20x5 is \$8,000, due to incremental depreciation of \$300 on Zeller's plant assets and \$700 on Akquirer's plant assets, and amortization of \$2,600 on Zeller's purchased goodwill and \$4,400 on Akquirer's implied goodwill.<sup>22</sup> Other summary amounts under the three methods are presented in Exhibit 5.

<sup>21</sup> Under purchase accounting, Zeller's plant assets are recorded on Akquirer's books at their \$23,000 fair value, \$3,000 more than their \$20,000 book value on Zeller's books. This \$3,000 step-up will result in additional depreciation expense of \$300 per year for each of the next ten years, the remaining life of these assets.

<sup>22</sup> Similarly, under fresh start accounting, Akquirer's plant assets are stepped up \$7,000, from \$25,000 book value to \$32,000 fair value. This \$7,000 step-up will result in additional depreciation expense of \$700 per year for each of the next ten years.

**EXHIBIT 5**  
**Summary Statistics**

	<u>Purchase</u>	<u>Pooling</u>	<u>Fresh Start</u>
Total assets	\$120,000	\$65,000	\$215,000
Total liabilities	20,000	20,000	20,000
Total stockholders' equity	<u>\$100,000</u>	<u>\$45,000</u>	<u>\$195,000</u>
Number of shares	3,250	3,250	3,250
Book value per common share	\$30.77	\$13.85	\$60.00
<b>Panel A: With Goodwill Amortization</b>			
Net income (see Exhibit 4)	<u>\$13,100</u>	<u>\$16,000</u>	<u>\$8,000</u>
Earnings per common share	\$4.03	\$4.92	\$2.46
Rate of return on assets	10.92%	24.62%	3.72%
Rate of return on equity	13.10%	35.56%	4.10%
<b>Panel B: Without Goodwill Amortization</b>			
Net income (see Exhibit 4)	\$13,100	\$16,000	\$8,000
Addback: Goodwill amortization	<u>2,600</u>		<u>7,000</u>
Net income without goodwill amortization	<u>\$15,700</u>	<u>\$16,000</u>	<u>\$15,000</u>
Earnings per common share	\$4.83	\$4.92	\$4.62
Rate of return on assets	13.08%	24.62%	6.98%
Rate of return on equity	15.70%	35.56%	7.69%
<b>Panel C: No Goodwill</b>			
Total assets with goodwill (see Exhibit 3)	\$120,000	\$65,000	\$215,000
Subtract: Goodwill	<u>52,000</u>	<u>0</u>	<u>140,000</u>
Total assets without goodwill	<u>\$68,000</u>	<u>\$65,000</u>	<u>\$75,000</u>
Total owners' equity with goodwill (see Exhibit 3)	\$100,000	\$45,000	\$195,000
Subtract: Goodwill	<u>52,000</u>	<u>0</u>	<u>140,000</u>
Total owner's equity without goodwill	<u>\$48,000</u>	<u>\$45,000</u>	<u>\$55,000</u>
Net income without goodwill amortization	<u>\$15,700</u>	<u>\$16,000</u>	<u>\$15,000</u>
Earnings per common share	\$4.83	\$4.92	\$4.62
Rate of return on assets	23.09%	24.62%	20.00%
Rate of return on equity	32.71%	35.56%	27.27%

Exhibit 5 also shows projected EPS and return on investment under the different methods.<sup>23</sup> Before the combination, Acquirer's EPS is \$4, as indicated in Exhibit 1. EPS is highest under pooling accounting (\$4.92), followed by purchase accounting (\$4.03), and fresh start accounting (\$2.46), as indicated in Panel A of Exhibit 5. Before the combination,

<sup>23</sup> To make the comparisons clear and concise, pre-combination rates of return are computed using 31 December 20x4 assets and equity, and post-combination rates of return are computed using 1 January 20x5 assets and equity. Space limitations preclude presenting data needed to compute rates of return using average assets and equity.



return on assets (ROA) is 22.86 percent for Acquirer, as indicated in Exhibit 1. Post-combination ROA is highest under pooling accounting (24.62 percent), followed by purchase accounting (10.92 percent), and fresh start accounting (3.72 percent), as indicated in Panel A of Exhibit 5. These differences reflect the effects on both the numerator and the denominator of the ROA ratio. Relative to pooling accounting, the earnings numerator is lower under purchase and fresh start accounting than under pooling accounting due to the increased depreciation and goodwill amortization charges, whereas the asset denominator is higher due to the asset write-ups. The double effect is even more pronounced for projected return on equity (ROE). Before the combination, ROE is 32 percent for Acquirer. Post-combination ROE is highest under pooling accounting (35.56 percent), followed by purchase accounting (13.10 percent), and fresh start accounting (4.10 percent), as also indicated in Panel A of Exhibit 5.

These projections are situation-specific, but they illustrate why the business community favored pooling accounting—pooling accounting usually resulted in higher earnings than purchase accounting with goodwill amortization (see, e.g., MacDonald 1997; Davis 2000). They also illustrate why the business community presumably disliked fresh start accounting with goodwill amortization even more than purchase accounting with goodwill amortization—it usually resulted in still lower earnings whenever there was modest appreciation of plant assets and rapid appreciation of goodwill. These were characteristic of the relatively stable price levels and surging stock markets of the late 1990s when the FASB deliberated most of the issues, as noted earlier.

Within this context, the effect of the accounting method on post-combination net income is potentially significant, and often affects the very combination decision. For example, as part of a proposal to combine, management often touts the prospects of higher income for the combined enterprise than the incomes of the constituent companies operating independently. Presumably, it often avoided combinations where post-combination net income would be lower than the sum of the pre-combination net incomes of the constituent companies. This shortfall in post-combination net income was more likely under purchase accounting due to the usually increased depreciation and goodwill amortization than under pooling accounting. Prior to SFAS No. 141, many combinations were structured to qualify for pooling accounting notwithstanding premiums paid to so qualify (see Ayers et al. 2002, 6–7; Lys and Vincent 1995). Indeed, prior to SFAS Nos. 141 and 142, many combination transactions would not have occurred without pooling accounting (Boegler and Lewis 1998; Weil 2000).

This relationship between pre- and post-combination net income is illustrated in the context of the previous example, as follows: Assume that Acquirer's management avoids combination transactions resulting in projected post-combination net income below a \$14,000 threshold, equal to the sum of the pre-combination net incomes of Acquirer (\$8,000) and Zeller (\$6,000). Presumably, management would have avoided the combination were it reported under purchase (fresh start) accounting due to the incremental depreciation and goodwill amortization charges. As indicated in the first and third columns of Exhibit 4, the \$13,100 (\$8,000) projected post-combination net income under purchase (fresh start) accounting is *less* than the \$14,000 threshold. On the other hand, presumably top management would *not* have avoided the combination were it reported under pooling accounting; as indicated in the middle column in Exhibit 4, the \$16,000 projected post-combination net income under pooling accounting is *more* than the \$14,000 threshold.

**POST-COMBINATION INCOME STATEMENT EFFECTS  
WITHOUT GOODWILL AMORTIZATION UNDER PURCHASE  
AND FRESH START ACCOUNTING**

As Exhibit 4 illustrates, goodwill amortization expense substantially depresses post-combination earnings under purchase and fresh start accounting relative to pooling accounting. This depressing effect would be avoided were goodwill not amortized and not impaired. As indicated in Panel B of Exhibit 5, without goodwill amortization or impairment loss, projected post-combination earnings increase by \$2,600 (\$7,000) to \$15,700 (\$15,000) under purchase (fresh start) accounting. Similarly, ROA increases to 13.08 percent (6.98 percent) and ROE increases to 15.70 percent (7.69 percent) under purchase (fresh start) accounting, as also indicated in Panel B of Exhibit 5.

Without goodwill amortization, earnings under purchase and fresh start accounting increase substantially and approach earnings under pooling accounting, as shown in Panel A of Exhibit 5. However, rates of return increase far less and do not approach those under pooling accounting, because goodwill is still included in the denominator. Thus, ROA increases to 13.08 percent (6.98 percent) and ROE increases to 15.70 percent (7.69 percent) under purchase (fresh start) accounting, as also indicated in Panel B of Exhibit 5.

Although not as high as under pooling accounting, post-combination earnings is much greater under purchase (or fresh start) accounting without goodwill amortization than with goodwill amortization. Significantly, because post-combination earnings equals or exceeds the \$14,000 threshold under purchase (or fresh start) accounting, presumably the financial accounting would not motivate top management to avoid the combination. Moreover, unlike pooling accounting, which was used under prior practice only for combinations meeting detailed criteria, purchase accounting would be used and fresh start accounting might be used for all combinations.

**POST-COMBINATION INCOME STATEMENT EFFECTS WITH GOODWILL  
WRITE-OFF AT ACQUISITION (OR NONRECOGNITION) UNDER PURCHASE  
AND FRESH START ACCOUNTING**

Another possible way to avoid the depressing effect of goodwill amortization on projected post-combination earnings is by writing off goodwill against additional paid-in capital at acquisition. This is equivalent to its nonrecognition under the bottom-up approach. Of course, goodwill amortization expense (and goodwill impairment loss) is avoided if goodwill is written off or not recognized in the first place. As indicated in Panel B of Exhibit 5, projected post-combination earnings is \$15,700 (\$15,000) under purchase (fresh start) accounting without goodwill amortization or impairment loss.

Writing off goodwill reduces total assets and total owners' equity and increases ROA to 23.09 percent (20.00 percent) and increases ROE to 32.71 percent (27.27 percent) under purchase (fresh start) accounting, as indicated in Panel C of Exhibit 5. These rates of return under purchase and fresh start accounting now approach those under pooling accounting because goodwill is no longer in the denominator. Thus, the effects on projected post-combination earnings and rate of return of immediate goodwill write-off or nonrecognition are even more favorable than recognition and nonamortization.

**FASB'S CONVOLUTED DELIBERATIONS**

The FASB was concerned with the existence, under prior practice, of two different methods of accounting for business combinations: purchase accounting with goodwill amortization and pooling accounting. Similar combinations were reported differently depending on whether they qualified for pooling accounting. Another major concern of the FASB

was that 40-year goodwill amortization under prior practice was too slow given the rapid changes in an increasingly competitive economy. But the principal concern of the FASB was with how pooling accounting understated the cost of most acquisitions and the related amortization of that cost to expense in subsequent periods (see, e.g., Sutton 1996). Eliminating pooling accounting would make the accounting for business combinations more uniform and comparable.

As noted earlier, under prior practice, many business combinations were structured to qualify for pooling accounting due to the favorable earnings impact (see, e.g., Lys and Vincent 1995; Ayers et al. 2002; Davis 2000). Some pooling advocates (see, e.g., Information Technology Association of America [ITAA] 1999; Golub 2000; Laub 2001) argued that prohibiting pooling would depress post-combination earnings, and thereby discourage investment in economically desirable combinations and adversely affect aggregate economic activity. On the other hand, some pooling critics (see, e.g., Roll 1986) suggested that pooling accounting encourages economically undesirable combinations because of its favorable effect on earnings.

There is some merit to both arguments. More importantly, both arguments underscore how financial accounting standards potentially influence economic decisions with far-reaching economic ramifications; they do not merely determine how business transactions are recorded and summarized (cf., Zeff 1978). The FASB was not deliberating the issues solely on the basis of financial accounting theory.

Because the accounting for business combinations and goodwill affect economic decisions and economic interests, some members of the business community lobbied the FASB for the accounting treatment they viewed as most beneficial to their interests. The FASB was under enormous political pressure to retain pooling accounting and not speed up goodwill amortization under purchase accounting (see, e.g., Tie 1999). Some members of the business community even lobbied Congress to pass legislation forbidding the FASB from prohibiting pooling accounting (see, e.g., Bridis 2000; Norris 2001). As a result, the development of SFAS Nos. 141 and 142 reflected a complicated political process that, in turn, reflected these different economic interests (see, e.g., Bridis 2000; Cheney 2000; Guerrero 2000; Granof and Zeff 2002).

Ideally, the accounting for business combinations should be neutral (cf., FASB 1980, paras. 98–110; see also Herz 2005). It should be incidental to, and not a determinant of, how business combinations are structured. By design, however, the development of generally accepted accounting standards reflects a political process as well as *a priori* reasoning by standard setters based on financial accounting theory. As Healy and Palepu (2003, 22) note, the FASB's due process in setting new accounting standards is "closely scrutinized and at times overruled by the SEC and the political establishment. Setting standards through this process can be slow, difficult and political. *Moreover, when standards are passed as a result of intensive negotiations, they often reflect the middle ground*" (emphasis added).

Additionally, standard setting by the FASB tends to develop in an evolutionary rather than in a revolutionary manner, as the FASB itself has noted at least since 1987 (see, e.g., SFAS No. 95, FASB 1987, para. 120). The FASB's task was to develop a solution that was both conceptually sound and acceptable to most of the business community.

Besides its anomalous financial statement results, pooling accounting required extremely detailed rules needing constant updating due to the many ways in which combinations could be structured (see Sutton 1996; Johnson and Yokley 1997; MacDonald 1997; Smith 1997). Early in its deliberations, the FASB decided against revising criteria for pooling accounting and focused instead on finding a means of narrowing the differences in

financial reporting results between pooling and purchase accounting (see Action Alert 97-10, FASB 1997).

Fresh start accounting involves recognizing fair values at the combination date of all the assets and liabilities of both constituents, including goodwill under the top down approach. This is an even more revolutionary change from prior practice than just requiring purchase accounting and prohibiting pooling accounting. Presumably, it was entirely unacceptable to the business community, because it usually would report more expenses and therefore lower earnings than under purchase accounting. Furthermore, the FASB would have to develop unambiguous and nonarbitrary boundaries between purchase accounting and fresh start accounting. It, too, was rejected by the FASB as it was by the APB.<sup>24</sup>

Immediate goodwill write-off at acquisition is equivalent to its nonrecognition. This treatment results in less expense recognition, and presumably would have been acceptable to many in the business community (see MacDonald 1999). But it contradicts the FASB's fundamental conceptual conclusions—that goodwill is an asset, that it meets the four criteria of the conceptual framework (SFAC No. 5, FASB 1984) for recognition as an asset, and that it should not be written off unless impaired (see also Action Alert No. 98-01, FASB 1998a). Accordingly, the FASB rejected immediate goodwill write-off, as did the APB before it.<sup>25</sup>

Midway in its deliberations, the FASB decided on a conceptual basis to require purchase accounting with goodwill recognition and to prohibit pooling accounting (see, *Status Report*, May 18, 1999, FASB 1999b). But the success of any new pronouncements depended heavily on their acceptability by the business community (see Weil 2000).

What was the FASB to do to make purchase accounting both conceptually sound and more acceptable to the business community? Early in its deliberations, the FASB tentatively concluded that goodwill with a limited and determinable useful economic life would be amortized over that life, whereas goodwill with an indeterminable useful economic life would not be amortized but would be reviewed for impairment (see Action Alert No. 98-05, FASB 1998b). Subsequently, the FASB (*Status Report*, February 25, 1999, FASB 1999a) tentatively concluded to require goodwill amortization, with the presumption that the amortization period should be ten years and under no circumstances more than 20 years—considerably shorter than the 40-year maximum period permitted under APB No. 17. This revised conclusion would have resulted in still larger goodwill amortization charges and further depress projected post-combination earnings relative to prior practice. Presumably, the revised conclusion would have been even less palatable to the business community than purchase accounting under prior practice. It did not reach the Exposure Draft stage.

Instead, on September 7, 1999, the FASB issued an Exposure Draft (FASB 1999c, paras. 42 and 52) proposing 20-year goodwill amortization, with goodwill amortization (and any impairment loss) reported net-of-tax after net operating income (or “below the line”). That is, the net-of-tax goodwill charge would be presented as a deduction after a new subtotal for post-tax net income from continuing operations before the goodwill charge, as if net-of-tax goodwill amortization (and impairment loss) is not especially relevant to income measurement, or at least not to core earnings. This second proposal was favorably greeted by many in the business community (see, e.g., Ameen and Bible 2000), although

<sup>24</sup> However, as noted earlier, the FASB (SFAS No. 141, FASB 2001b, para. B85) held out the possibility that it might mandate fresh start accounting for multiparty combinations and joint venture formations.

<sup>25</sup> Early in its redeliberations following the issuance of a 1999 Exposure Draft, the FASB reconfirmed that goodwill should be initially recognized as an asset (see Action Alert 00-16, FASB 2000a), and that it would no longer deliberate immediate goodwill write-off (see Minutes of July 19, 2000 FASB meeting, FASB 2000b).

some expressed reservations about possible confusion from mandating another earnings measure (see, e.g., Fink 1999; Baroody 1999). Some supporters (see, e.g., Fink 1999) favored the same below-the-line, net-of-tax presentation of several other expenses, such as depreciation and amortization, in order to approximate cash basis earnings. Critics (see, e.g., Leisenring 1999) of this second proposal ridiculed it for this very reason. They noted that there was no theoretical justification for reporting some expenses before income taxes above the line and other expenses after income taxes below the line. The FASB reconsidered and withdrew this part of its proposal.

Time was running out. As a result of resignations and retirements, the FASB was scheduled to have two new members starting July 1, 2001 and a third starting September 1, 2001. With three new members in a reconstituted FASB, all the basic issues might have to be re-deliberated. In a burst of activity rarely observed before or since, the FASB issued a revised Exposure Draft (FASB 2001a). Based on additional information developed during its deliberations (see Johnson and Petrone 2000), the FASB (2001a, paras. 9, 60–67) concluded that goodwill amortization is not representationally faithful and should be prohibited. That is, goodwill amortization does not reflect economic reality because goodwill rarely loses value systematically over many years. Rather, the FASB reasoned that goodwill has an indefinite life and often does not lose value at all but, when it does, it loses value sporadically and sometimes precipitously (see SFAS No. 142, FASB 2001c, paras. B79–B83; Johnson and Petrone 2000). Consistent with this new reasoning, the FASB concluded that a practical solution would be to require periodic goodwill impairment testing but prohibit goodwill amortization. Goodwill would be expensed only when impaired.

This middle ground position met the FASB objective to narrow the differences in financial reporting results between pooling and purchase accounting under prior practice (see Action Alert 97-10, FASB 1997). According to Weil (2000, A2), this position was also favored by many of those who had lobbied against the FASB's initial proposal to prohibit pooling accounting and require purchase accounting with faster goodwill amortization. Critics of this middle-ground position maintained, however, that the earnings of acquisition-minded companies could become even more inflated than under pooling accounting. Weil (2000, A2) quotes Abraham Briloff, Emeritus Emanuel Saxe Professor of Accountancy at Baruch College and a longtime critic of pooling accounting, that "[t]he FASB has capitulated to the pragmatic world of the companies that want to provide the highest levels of earnings numbers they can generate."

Edmund Jenkins, then FASB chairman, acknowledged the criticism, but noted that goodwill amortization is arbitrary (see Weil 2000, A2). He also noted that the FASB experienced heavy resistance to its initial proposal banning pooling accounting outright, including attempts by some members of Congress to legislatively prohibit the FASB from banning pooling accounting. Chairman Jenkins justified the FASB's middle-ground position as an improvement in the accounting for business combinations: "This answer [middle-ground position] is well grounded in terms of [the] economics of the [business combination] transaction and the information and transparency needs of investors." Thus, the FASB concluded that it came up with the best answer within the context of its conceptual framework and the political and economic environment in which it deliberated the issues.

As evident in Panel B of Exhibit 5, purchase accounting without goodwill amortization presumably would be much more acceptable to the business community.<sup>26</sup> In the first column of Panel B, projected post-combination net income is \$15,700 without goodwill amortization, \$1,700 more than the \$14,000 sum of the pre-combination net incomes of \$8,000 for Acquirer and \$6,000 for Zeller. This is not as desirable a result as the \$16,000 projected post-combination net income under the beloved pooling accounting, but is better than the \$13,100 projected post-combination net income with goodwill amortization under prior practice. As also indicated in the first column of Panel B, ROA (13.08 percent) and ROE (15.70 percent) similarly increase under purchase accounting without goodwill amortization compared to what they would be (10.92 percent and 13.10 percent, respectively) with goodwill amortization. Thus, SFAS Nos. 141 and 142 are a middle-ground position between the prior practice of purchase accounting with goodwill amortization and pooling accounting with neither goodwill recognition nor amortization.

### CONCLUSION

This instructional resource compares the financial statement effects of the three methods of accounting for business combinations and four methods of accounting for goodwill that the FASB considered when it developed SFAS Nos. 141 and 142. It shows why projected post-combination earnings is usually highest under pooling accounting, lower under purchase accounting, and lower still under fresh start accounting. It also shows how accounting for business combinations and goodwill might impact the decision to combine in the first place, and thereby affects the economic interests of many members of the business community.

Both financial accounting theory and practical considerations were important to the FASB in developing SFAS Nos. 141 and 142. The FASB sought to develop an accounting for business combinations and goodwill that is more consistent with financial accounting theory than prior GAAP. But many in the business community were satisfied with the accounting for business combinations and goodwill under prior practice, and lobbied the FASB to retain the *status quo*. The success of any new FASB pronouncements depended heavily on their acceptance by the business community. Ultimately, the FASB developed a middle-ground solution; it prescribed a revised purchase accounting without goodwill amortization and prohibited pooling accounting. We believe that students better understand SFAS Nos. 141 and 142 by knowing the choices the FASB considered when it developed these pronouncements, as well as the political and economic contexts in which it deliberated.

### HOMEWORK PROBLEM

- (1) Consider the homework problem in Exhibit 6, which involves a combination of Company A and Company Z that is similar to the combination of Acquirer and Zeller.

**Required:** Prepare 1 January 20x5 projected balance sheets and 20x5 projected income statements for the combination of Company A and Company Z consistent with (a) purchase accounting with goodwill amortization under APB Opinion Nos. 16 and 17; (b) pooling accounting; (c) fresh start accounting (top-down approach) without

<sup>26</sup> Presumably, its acceptability was enhanced by requiring a one-time income statement classification of goodwill impairment loss as a cumulative effect of a change in accounting principles incident to the transition from APB No. 17 to SFAS No. 142. This way, many companies recognized huge goodwill impairment losses without reducing net income from continuing operations when they adopted SFAS No. 142.

**EXHIBIT 6**  
**Homework Problem**  
**Business Combinations**

Company A and Company Z are to combine on 1 January 20x5. Both report on a calendar year basis. Their 31 December 20x4 balance sheets and 20x4 income statements are as follows:

	<u>Company A</u>	<u>Company Z</u>
<b>31 December 20x4 Balance Sheets</b>		
Cash	\$8,000	\$6,000
Accounts receivable—net	14,000	15,000
Inventory—LIFO	10,000	9,000
Plant assets—net	50,000	30,000
Patents	6,000	8,000
Total assets	<u>\$88,000</u>	<u>\$68,000</u>
Current liabilities	\$20,000	\$9,000
Bonds payable—due 31 December 20x6	20,000	21,000
Total liabilities	<u>\$40,000</u>	<u>\$30,000</u>
Common stock, par \$1 per share	\$5,000	\$3,000
Additional paid-in capital	7,000	10,000
Retained earnings	36,000	25,000
Total stockholders' equity	<u>\$48,000</u>	<u>\$38,000</u>
Total liabilities plus stockholders' equity	<u>\$88,000</u>	<u>\$68,000</u>
<b>20x4 Income Statements</b>		
Sales revenues	<u>\$42,000</u>	<u>\$34,000</u>
Expenses:		
Depreciation	5,000	3,000
Patent amortization	1,500	2,000
Other	19,000	15,000
Total expenses	<u>\$25,500</u>	<u>\$20,000</u>
Net income	<u>\$16,500</u>	<u>\$14,000</u>
Number of common shares outstanding	5,000	3,000
Earnings per common share	\$3.30	\$4.67
1 January 20x5 price per share	\$50.00	\$60.00
1 January 20x5 price earnings ratio	15.2	12.9

Except for inventory, plant assets, patents, goodwill, and bonded debt, the current fair values and book values of the assets and liabilities are identical. The current fair values of these latter items (except for goodwill) are as follows:

Inventory	\$12,000	\$13,000
Plant assets—net	70,000	40,000
Patents	8,000	32,000
Bonded debt	22,000	17,000
Goodwill [could be omitted here]	180,000	100,000

*(continued on next page)*

**EXHIBIT 6 (continued)**

The two companies combine in order to achieve anticipated operating economies of \$5,000 per year. Company Z is absorbed into Company A through an exchange of six common shares of Company A for every five common shares of Company Z, with all shareholders of Company Z participating. Plant assets are depreciated straight-line over ten years to zero salvage value, patents are amortized straight-line over four years, bond discount or premium is amortized straight-line over the remaining life of bonded debt, goodwill was amortized over 40 years under old GAAP and is not impaired, LIFO inventories will not be liquidated, and income taxes are ignored.

**Required**

Prepare 1 January 20x5 projected balance sheets and 20x5 projected income statements for the combination of Companies A and Z, consistent with (a) purchase accounting with goodwill amortization under APB Opinion Nos. 16 and 17; (b) pooling accounting; (c) fresh start accounting (top-down approach) without goodwill amortization; and (d) purchase accounting without goodwill amortization under FASB Statement Nos. 141 and 142. Use the short-cut method to prove out projected post-combination income.

goodwill amortization; and (d) purchase accounting without goodwill amortization under FASB Statement Nos. 141 and 142. Assume that Company A's books will continue to be used regardless of the method of accounting for the combination. Also assume the same revenue and expense transactions in 20x5 as in 20x4 except for the operating economies, and no subsequent LIFO inventory liquidations. Prove out the projected income statements by calculating projected post-combination net income under (a), (b), (c), and (d) using the short-cut method. Use the template in Exhibit 7. You may find it useful to prepare journal entries to record the combination on Company A's books under (a), (b), (c), and (d), but you are only required to submit the projected balance sheets, projected income statements, and projected short-cut calculations of post-combination net income.

**Note:** In this homework problem, book values differ from fair values of inventory, patents, and bonded debt (as well as plant assets and goodwill) for both companies at acquisition, and you have to calculate goodwill. All of Company Z's assets and liabilities will be recorded at fair value under purchase accounting, but at book value under pooling accounting. Under purchase accounting, the step up (or step down) to fair value of Z Company's patents will result in more (or less) patent amortization expense, just as the step up (or step down) to fair value of plant assets results in more (or less) depreciation expense. Similarly, the step up (or step down) to fair value of Company Z's bonded debt will result in the write-up (or write-down) of bonded debt; this, in turn, results in a liability valuation adjustment analogous to original issuance bond premium (or discount), to be amortized as decremental (or incremental) interest expense. (Because there is no income statement separate line item for interest expense, it is presumed to be buried in the other expense line item.) However, the step up to fair value of Company Z's LIFO inventory will not affect subsequent expense because we assume no LIFO inventory liquidation. Under fresh start accounting, similar step ups (or step downs) are made to Company A's assets and liabilities, with similar effects on post-combination projected net income.

- (2) How is intercompany comparability of financial statements affected if, five years ago on 1 January 20x0 under old GAAP (long before SFAS No. 141 became effective), one company acquired a target company reported as a pooling of interests, whereas



**EXHIBIT 7  
Homework Problem  
Business Combinations: Partial Solution**

	<b>APB Nos. 16 and 17 Purchase Accounting</b>	<b>Pooling Accounting</b>	<b>Fresh Start Accounting</b>	<b>SFAS Nos. 141 and 142 Purchase Accounting</b>
<b>1 January 20x5 Projected Balance Sheet</b>				
Cash	\$14,000	\$14,000	\$14,000	\$14,000
Accounts receivable—net	29,000	29,000	29,000	29,000
Inventory—LIFO	_____	_____	_____	_____
Plant assets—net	_____	_____	_____	_____
Patents	_____	_____	_____	_____
Goodwill	_____	_____	_____	_____
Total assets	\$ _____	\$ _____	\$ _____	\$ _____
Current liabilities	\$29,000	\$29,000	\$29,000	\$29,000
Bonds payable	_____	_____	_____	_____
Premium (discount) on bonds payable	_____	_____	_____	_____
Common stock, par \$1 per share	_____	_____	_____	_____
Additional paid-in capital	_____	_____	_____	_____
Retained earnings	_____	_____	_____	_____
Total liabilities plus stockholders' equity	\$ _____	\$ _____	\$ _____	\$ _____
<b>20x5 Projected Income Statement</b>				
Sales revenues	\$76,000	\$76,000	\$76,000	\$76,000
Expenses:				
Depreciation	\$ _____	\$ _____	\$ _____	\$ _____
Patent amortization	_____	_____	_____	_____
Other	_____	_____	_____	_____
Bond discount (premium) amortization	_____	_____	_____	_____
Goodwill amortization	_____	_____	_____	_____
Total expenses	\$ _____	\$ _____	\$ _____	\$ _____
Net income	\$ _____	\$ _____	\$ _____	\$ _____
<b>20x5 Projected Income (Short-Cut)</b>				
Net income—Company A	\$ _____	\$ _____	\$ _____	\$ _____
Net income—Company Z	_____	_____	_____	_____
Operating economies	_____	_____	_____	_____
Decremental (incremental) depreciation	_____	_____	_____	_____
(Incremental) patent amortization	_____	_____	_____	_____
Goodwill amortization	_____	_____	_____	_____
Bond (discount) premium amortization	_____	_____	_____	_____
Net income	\$ _____	\$ _____	\$ _____	\$ _____



- another similar company acquired at the same cost a similar size target company in the same industry reported as a purchase?
- (3) How is the outcome of goodwill impairment testing under SFAS No. 142 affected when a reporting unit includes a previously pooled company?
  - (4) What is meant by *companies under common control*? How is pooling accounting relevant to transfers of net assets or exchanges of equity interests between companies under common control?
  - (5) Return to the original example of the combination of Acquirer and Zeller in this instructional resource. How is the tax treatment of nontaxable combinations similar to pooling accounting? Assume that book bases equal tax bases before the combination and a 40 percent tax rate. What is the amount of goodwill and deferred tax liability recognized under purchase accounting at the acquisition date for the combination of Acquirer and Zeller?
  - (6) What would be the share-for-share exchange ratio for the combination of Acquirer and Zeller if, *ceteris paribus*, Zeller shares were selling at \$15 (rather than \$75) per share when the combination was negotiated? How would the accounting for the combination change under purchase accounting?
  - (7) After you read the textbook reading assignment on consolidated financial statements for *wholly* owned subsidiaries, return to the original example of the combination of Acquirer and Zeller in this instructional resource. How would the financial reporting of this combination change if, following the 5:4 exchange of stock for stock, there is no statutory merger, but Zeller becomes a wholly owned subsidiary of Acquirer?
  - (8) After you read the textbook reading assignment on consolidated financial statements for *partially* owned subsidiaries, return to the original example of the combination of Acquirer and Zeller in this instructional resource. Why is the valuation at acquisition of net identifiable assets of partially owned subsidiaries under the parent company theory of consolidated financial statements (the prevailing GAAP today) equivalent to part-purchase, part-pooling accounting? How relevant are the resulting dollar amounts? What change does the FASB propose in this area?

## CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

### Learning Objectives

This instructional resource serves as an introduction to the basic theory issues underlying accounting for business combinations and goodwill. The follow-up homework problem requires students to prepare projected post-combination balance sheets and income statements under purchase, pooling, and fresh start accounting in a more complex setting, and also to consider other related theory issues.

### Evidence of Classroom Validation

Our objective in assigning this instructional resource is to have a convenient vehicle to discuss the basic issues of accounting for business combinations and goodwill in no more than one-and-one-half 100-minute class sessions. Both of us have successfully used this version (or earlier versions) of this instructional resource at two different universities and two other colleagues have also used it, one at a third university. We find that this approach enhances the learning experience in both undergraduate and graduate advanced financial accounting courses as well as in mergers and acquisitions courses by being the primary reading assignment in lieu of the typically much longer and more detailed chapter on accounting for business combinations in most advanced financial accounting textbooks; however, students are also directed to peruse that textbook chapter but to skip the numerical examples and some of the other details.

The undergraduate students are from two urban universities, one public and one private, usually 21 to 23 years old, with SAT scores between 1100 and 1350. The graduate students are from three urban universities, one public and two private, and typically just two or three years older, especially the M.S. (as opposed to M.B.A.) students, with GMAT scores between 550 and 680. At the public university, there is no clear-cut dividing line between full-time versus part-time students at either the senior undergraduate or master's level; many of these students are foreign-born and many work to support themselves or their families, even those who are full-time students. At the private universities, relatively fewer students are foreign-born and fewer work to support themselves or their families, but many work part-time.

### TEACHING NOTES

Teaching notes are available only to full-member subscribers to *Issues in Accounting Education* through the American Accounting Association's electronic publications system at <http://www.atypon-link.com/action/showPublisherJournals?code=AAA>. Full-member subscribers should use their personalized usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed.

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