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History repeats itself: The acquisition method and nonrecurring charges

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Abstract

The Financial Accounting Standards Board issued Statement No. 141 (R) that replaces Statement of Financial Accounting Standard No. 141, *Business Combinations*. The new standard mandates use of the acquisition method, which requires expense treatment for acquisition-related transaction costs. Expense treatment is a departure from purchase accounting procedures, but is consistent with past guidance of Accounting Principles Board Opinion No. 16 for the pooling-of-interests method. Restoration of historical and controversial accounting procedures resurrects past outcomes. This study utilizes econometric techniques to predict outcomes of the acquisition method. Evidence indicates that expensing acquisition-related costs may improve transparent reporting. The results, based on 638 business combinations from 1994 through 1998, support the expectation that expense treatment for acquisition-related costs increases the likelihood that these costs appear more frequently and are greater in magnitude.
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1. Introduction

1.1. The historical controversy

The controversy over which accounting method is more appropriate for business combinations reaches back to the 1940s. This study predicts outcomes of the acquisition method for business combinations by examining the archival data in the context of this long historical debate. Accounting is in a constant state of change, representing a continuous improvement in methods and procedures of the past (Carnegie & Napier, 1996). Historical research illuminates methods and procedures that have failed. When accounting regulators resurrect failed methods of the past, undesired outcomes will repeat.

The controversy began when the American Institute of Certified Public Accountants (AICPA) eased the restrictions for the pooling method by allowing firms similar in size to use the method. Accounting Research Bulletin (ARB) No. 40, *Business Combinations*, expanded the criteria to include business similarity and management continuity in the combining firms. Later ARB No. 48, *Business Combinations*, relaxed the size criterion and pooling use skyrocketed as the stock market advanced and stock consideration proliferated. History repeated itself in the 1990s as most of the dollar volume of business combinations used the pooling method under the auspices of Accounting Principles Board Opinion (APB) No. 16, despite stringent qualification criteria.

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Coincidently, during the recent mega-merger period of the 1990s, Securities and Exchange Commission (SEC) Chairman, Arthur Levitt, gave his famous "The Numbers Game" speech. In this speech, he highlighted the abuses in merger accounting and "in particular the creation of large liabilities for future operating expenses to protect future earnings." These reserves were overstated and ignored by analysts only to be reborn into income when future earnings fell short.

The U.S. Congress thwarted the Financial Accounting Standards Board (FASB)'s attempt in the late 1990s to eliminate pooling, even with the SEC's support for a pooling ban; a history repeated from the APB's failure to eliminate pooling in the early 1970s. Not until 2001 did the FASB succeed in prohibiting pooling. However, the saga is not yet over, as the new standard supersedes purchase accounting and requires use of the acquisition method for business combinations.

In June 2005, the FASB issued an Exposure Draft (ED) that replaces Statement of Financial Accounting Standard (SFAS) No. 141, *Business Combinations* (FASB, 2001, 2005), which superseded APB No. 16. The ED is a joint effort with the International Accounting Standards Board (IASB) to "converge to a common set of high-quality financial accounting standards on an international basis." The final standard is effective for business combinations on or after 15 December 2008. The FASB prohibits earlier application, but the IASB permits it.

SFAS No. 141 (R) (FASB, 2007) permanently prohibits the use of the pooling method and requires use of the acquisition method for all acquisitions including use by mutual entities, and requires expensing of acquisition-related costs. The new standard requires accounting for restructuring charges that do not meet the definition of a liability under SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, not be part of the business acquisition cost. A target firm needs to have an exit plan in place before the acquisition date to fulfill the liability recognition criteria. Transactions in contemplation of the business combination that benefit the combined entity are not part of the acquisition accounting and therefore expensed. SFAS 141 (R) states "…costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method."[1]

Expense treatment for acquisition-related costs is a departure from APB No. 16 and SFAS No. 141, which permit capitalization of acquisition-related costs when the purchase method is used. The acquisition method restores the expense treatment that the pooling method required under APB No. 16. The acquisition method is also consistent with the International Financial Reporting Standard (IFRS) No. 3, *Business Combinations* (IASB, 2004), which requires expense treatment of acquisition-related restructuring.[2]

Unlike the past, replacement of SFAS No. 141 has gone without much fanfare.[3] Respondents to the ED disagreed with the FASB's proposal to require expense treatment for acquisition-related costs, which represents a significant departure from a cost accumulation model. Respondents repeatedly express that acquirers consider transaction costs as an integral component of the consideration and warn of earnings volatility in the acquisition year. Respondents did not expose the similarity between the acquisition and pooling methods' treatment of acquisition-related costs, the later being historically hailed as the nemesis of business combination accounting.

1.2. Transparency and business combination accounting

Turner (2006) explains that lack of transparency is the common thread that ties together the major accounting scandals of recent days. When coupled with lax oversight in the backdrop of a sustained upturn in the stock market, Turner likens the scenario to a bad car wreck. The endless restatements of option backdating and the scandals of Enron, WorldCom, and Sunbeam, to name a few, serve as an opportunity to learn from the past mistakes of lax and murky accounting. In these situations, accounting regulators reacted to consequences with reforms, but not without significant cost.

There is little empirical evidence that addresses the transparency of acquisition-related costs with the use of the pooling method for business combinations.[4] The pooling method permits expense treatment for the removal of duplicate

[1] See paragraph 13 on page 5 of SFAS No. 141 (R).

[2] IFRS No. 3 superseded International Accounting Standard (IAS) No. 2. IAS No. 22 permitted the use of pooling and purchase methods (IASC, 1983).

[3] See letters of comment to the FASB found at http://www.fasb.org/ocl/fasb-getletters.php?project=1204-001.

[4] The terms mergers and acquisitions, and business combinations in this study represent the acquisition of the controlling interest in another corporation.

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