On January 23, 2001 the Financial Accounting Standards Board ("FASB"), the independent board responsible for establishing and interpreting generally accepted accounting principles, voted unanimously to effect an important change in the accounting treatment of "business combinations," which include most mergers and acquisitions. Specifically, in a move widely opposed by the business community, the FASB determined that all business combinations should be accounted for using the "purchase method" of accounting rather than the widely favored "pooling of interests method" of accounting. Certain proposed changes in the implementation of the purchase method of accounting, however, should allay the concerns of most in the business community who opposed the change in methods.

The significance of the change in methods, and the basis of the business community’s opposition to the change, derives from the manner in which goodwill is treated under each method, and the consequent effect on reportable earnings. Under the "pooling of interests method," the balance sheets (assets and liabilities) of the two "combining" companies are simply added together, item by item. Any premium paid over the market value of the assets or "goodwill" is not reflected in the merger or acquisition and, as such, does not need to be amortized and expensed on a going forward basis. In contrast, under the "purchase method," any premium paid over the fair market value is reflected on the acquirer/survivor's balance sheet as goodwill which would ordinarily be amortized and expensed over a twenty (20) year period. Thus, the "pooling of interests method" has no effect on reported earnings, while the purchase method generates goodwill amortization expenses and a consequent drag on reported earnings. For this reason, the pooling of interests method was widely favored by the business community.

The FASB’s desire to eliminate the pooling of interest method of accounting for business combinations was predicated upon its interest in "improving the quality of information provided to investors and users of financial statements." In a prepared statement, the FASB explained that "the purchase method, as modified by the board during deliberations, reflects the underlying economics of business combinations by requiring that the current values of the assets and liabilities exchanged be reported to investors." Without the information that the
purchase method provides, investors are left in the dark as to the real cost of one company buying another and, as a result, are unable to track future returns on the investment."

The elimination of the pooling of interests method in favor of the purchase method, however, may not result in the impact on earnings once feared by the business community. An important compromise appears to have emerged regarding the treatment of goodwill when accounting for business combinations under the purchase method.

Specifically, as part of its general rulemaking, the FASB has tentatively decided to use a "nonamortization approach" to account for purchased goodwill. Under that approach, goodwill would still be recognized for accounting purposes, but it would not be amortized and expensed as originally proposed. Rather, goodwill would be subject to a test for "impairment." For example, when expectations for the reporting unit have been significantly reduced, goodwill of the reporting unit will have to be tested. Goodwill would have to be written down and expensed against earnings only if, after that test, the recorded value of goodwill exceeded its implied fair value.

This revised treatment of goodwill should lessen the impact of a termination of the pooling of interests method and provide the structure for an acceptable compromise.

The FASB’s final statement on the matter will not be released until late June.

Practice:

Corporate Law