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Understanding the evolution of SFAS 141 and 142: An analysis of comment letters

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ABSTRACT

This study analyzes the evolution of the Financial Accounting Standards Board (FASB)'s Statement of Financial Accounting Standards (SFAS) 141 and 142, through a detailed analysis of comment letters submitted to the FASB on Business Combinations Exposure Drafts 201 and 201 (Revised). Comment letters, an integral part of the standard-setting process, contain valuable insights on the views of parties affected by FASB's pronouncements – issuers, professional accountants and auditors, securities analysts, and others. The content analysis indicates that a majority of corporate respondents opposed the abolition of the pooling-of-interests method, not on theoretical grounds, but on the grounds that abolishing pooling would bring adverse economic consequences to their firms and industries. Letters also show strong differences in views across various groups of respondents. On the question of how goodwill should be treated once recognized, the amortization-with-impairment approach garnered significantly more support from the entire pool of respondents than the impairment-only approach, and the dominant view among most respondents, particularly audit firms, was that an impairment-only approach would not be reliable enough to be feasible in practice. These views are in sharp contrast to the FASB's eventual adoption of the impairment-only approach in SFAS 142, *Goodwill and Other Intangible Assets*, which suggests that the evolution of this standard was subject to forces not fully evident from, or reflected in, the comment letter process.

1 Introduction

The Financial Accounting Standards Board (FASB)'s issuance of Statements of Financial Accounting Standards (SFAS) 141, *Business Combinations*, and SFAS 142, *Goodwill and Intangible Assets*, dramatically altered the accounting for business combinations under U.S. GAAP. SFAS 141 eliminated the pooling-of-interests method of accounting for business combinations, while SFAS 142 eliminated amortization of goodwill and replaced it with a periodic impairment review approach.

Statements 141 and 142 have been subject to much debate and controversy. For example, Watts (2003) asserts that "SFAS 142 may be an error in judgment by the FASB… . The likely result is that goodwill impairment will be used for earnings management and produce overstated net assets and un-conservative earnings". Massoud and Rayborn (2003) assert that "Companies will now have to make annual impairment tests at the operating unit level. This process allows for momentous, critical judgments by management and their appraisal teams. Unfortunately, companies might choose points in time so as to recognize impairment losses in a manner that best "fits" their operating results". The impact of Statements 141 and 142 on accounting practice, combined with the extent of controversy surrounding their issuance, makes it important to understand the forces that shaped the evolution of these standards.

The FASB has indicated that it regards comment letters to be an integral part of standard setting. The FASB describes this process as "*a search for new information and*

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persuasive arguments regarding the issues; it is not intended to be simply a 'nose-count' of how many oppose or support a given view" (Financial Accounting Standards Board, 2007). The FASB issued two exposure drafts (EDs), 201 and 201R, respectively, in its business combinations project, and both received in excess of 200 comment letters from many types of respondents, reflecting a spectrum of views on the issues raised. These letters could be a valuable source of information on factors influencing the form and content of the final pronouncement.

This study aims to answer the following questions: first, what types of entities participated in the comment letter process? Second, what were the dominant views on each of the changes proposed, and did these views differ by categories of respondents? Third, what kinds of arguments were advanced in support of each position, and did the arguments differ by categories of respondents? Fourth, how effective were the arguments, i.e., to what extent were the views expressed in comment letters reflected in changes between the exposure draft and the final standard?

Answering these questions makes the following contributions. First, it acts as a case study of the accounting standard-setting process in recent times, contributing to the literature on standard setting that examines lobbying through comment letters. This literature has taken two broad approaches so far: first, examining the incentives of firms that lobby, usually by comparing observable characteristics across firms that choose to lobby and those that do not (e.g., Deakin, 1989; Francis, 1987; Fried, 2012; Ramanna, 2008; Saemann, 1997). This analysis, by necessity, is usually restricted to financial statement issuers. Another approach is to examine qualitatively the views and opinions expressed by all categories of commenters, with a view to understanding *how* various types of respondents attempt to persuade the FASB and what arguments are effective (Kaplan & Pany, 1992; Larson, 2008; Yen, Hirst, & Hopkins, 2007). This study attempts to provide this understanding for one of the most critical and controversial standard-setting issues of the FASB era. Second, by providing an understanding of the views expressed by various preparer and user groups, this study not only informs current research on the consequences of SFAS 141 and 142 and on the usefulness of financial statements under these regimes, but also suggests directions for future research.

2 The evolution of accounting for goodwill

The Accounting Principles Board (APB) Opinion 16, *Business Combinations*, and Opinion 17, *Intangible Assets*, both issued in 1970, shaped the accounting for business combinations and goodwill for subsequent decades. Opinion 17 prescribed that all intangible assets – identifiable or unidentifiable, had to be amortized over their expected useful lives. If an asset's useful life could not be reasonably determined, it had to be amortized over a maximum of 40 years.

As APB Opinions 16 and 17 came at the end of a decade that saw frequent mergers and acquisitions, these pronouncements were preceded by "unprecedented corporate lobbying" (Zeff, 2005a, 2005b), with branches of government getting involved. The Big 8 firms, who were all represented on the APB, were divided on the issues in Opinions 16 and 17. The promulgation of these opinions led to severe criticism of the APB by the Big 8, and was partially responsible for the creation of the FASB – a new, independent, full-time standard-setting body to replace the APB.[1]

After establishing its initial technical agenda of seven projects in early 1973, the FASB issued a call for public comment on the need for amending or replacing standards issued by its predecessors. After receiving more than 100 lengthy comment letters on business combinations, this topic was added to the Board's agenda in November 1973, with the goal of amending the controversial Opinions No. 16 and 17. While a Discussion Memorandum was eventually issued in 1976, action was deferred until after the completion of the Conceptual Framework project. The business combinations project was, however, not reinstituted even after the concepts were in place (Van Riper, 1994). In 1981, the Board removed the inactive project from its agenda.

The late 1990s saw increasing resources expended by the FASB and SEC in clarifying issues related to pooling-of-interests, and concerns about its abuse. The business combinations project was formally re-added to the Board's technical agenda in August 1996, at the behest of SEC Chief Accountant Michael Sutton, who stated that his staff spends nearly 40 percent of its time dealing with interpreting the complicated pooling-of-interests criteria under Opinion No. 16 (Beresford, 2001). He later stated: "*It was an area of practice… where things that are very much alike economically get accounted for differently because of minutiae at the edge. And so, we're having very significant economic effects reported in financial statements that really aren't based on economics; they're based on whether or not you met a certain criteria – a transaction that is structured in a certain way*." (Sutton, 2005).

Against this background, the FASB issued ED 201: *Business Combinations and Intangible Assets* on September 7 (Financial Accounting Standards Board, 1999). Other motivations for the ED were the international harmonization of accounting standards (the G4+1, an international association of standard-setters, had also recently issued a proposal on business combinations) and ensuring comparability among financial statements of firms that had undertaken similar transactions. The major proposals of the ED were to eliminate the pooling-of-interests method and shorten the maximum amortization period of goodwill to 20 years. The FASB's rationale for eliminating pooling and requiring purchase accounting was that only purchase accounting was consistent with the historical cost-model for transactions in which assets are acquired and liabilities incurred; it allows financial statements users to better understand the cost of acquisitions and their subsequent performance (Moehrle & Reynolds-Moehrle, 2001). The FASB also argued that transactions in which control over the combined entity was shared truly equally were a rarity. There was also a belief, supported by empirical evidence, that

[1] The Accounting Principles Board was a senior technical committee of the American Institute of Certified Public Accountants. In the pre-FASB era, the APB was the primary body charged with "narrowing the differences in accounting practice".