Available online at www.sciencedirect.com
ScienceDirect
Procedia - Social and Behavioral Sciences 189 (2015) 356 – 361
Procedia
Social and Behavioral Sciences

XVIII Annual International Conference of the Society of Operations Management (SOM-14)

On the Implications of Fair Value Based Merger Accounting

Prince Doliya[a*], J P Singh[a]

[a]*Department of Management Studies,Indian Institute of Technology Roorkee 247667, Uttrakhand, India*

Abstract

Accounting for business combinations appeared formally for the first time in statute books in the United States in 1970 when Accounting Principles Board (APB) promulgated Opinion No. 16 (Business Combinations) and Opinion No. 17 (Intangible Assets). The US Financial Accounting Standards Board (FASB hereinafter) subsequently issued SFAS 141(R) and SFAS 160. This paper attempts to analyze merger accounting in the context of the aforesaid standards and related provisions as they stand en presnti underscoring the role therein of fair value accounting and measurements. Additionally, a critical evaluation of the pooling & purchase methods of merger accounting is presented in an effort to explain the relative aversion of accounting bodies to the pooling method. Contextual SFAS, IFRS and Indian standards on business combinations that mandate the use of the acquisition method are also elaborated.

Peer-review under responsibility of the scientific committee of XVIII Annual International Conference of the Society of Operations Management (SOM-14).

Keywords: Financial reporting; Fair value measurements; Business combinations: Purchase and pooling methods of merger accounting; Acquisition method: SFAS 141(R); SFAS 160; IFRS 3.

---

* Corresponding author. Tel.: +91-9720514765
E-mail address: princddm@iitr.ac.in/doliya.prince@gmail.com

Peer-review under responsibility of the scientific committee of XVIII Annual International Conference of the Society of Operations Management (SOM-14).
doi:10.1016/j.sbspro.2015.03.232

1. Introduction

The pioneering step towards setting up a formal accounting framework for business combinations in the United States was taken by the Accounting Principles Board (APB) in 1970, when it introduced Opinion No 16 (Business Combinations). This standard allowed two different methods for accounting for business combinations viz. (i) Pooling of interests Method and (ii) Purchase Method (Andrews, 2009). Pooling of interests is meant to be used for similar level mergers. In this kind of mergers, voting rights are transferred from one party to the other. The assets and liabilities of the transferor are added to the transferee party's balance sheet. In this method, historical values are used for reporting and this results in higher depreciation, amortization and lower net income. Another implication of this approach is that since no actual transaction takes place on-field, there is no question of recognition of goodwill. Further, as the net profit of both the companies gets added by using simple additive principle, an immediate improvement in profit position occurs. Due to all these factors, "pooling" method is the method of choice among entrepreneurs for business combinations' reporting. However, the cardinal flaw of "pooling" is that an unrealized enhancement in profitability is reflected in reported statements,

As mentioned earlier, APB 16 allowed two different methods for business combinations' reporting. This led to inconsistency in merger reporting. Not just inconsistency, FASB also observed that in most of the mergers/ other business combination events, intangible assets (i.e. goodwill) reported the highest economic valuations in consolidated statements. To resolve these issues, FASB, in 1984, constituted the Emerging Issues Task Force (EITF). After recommendations from EITF, FASB promulgated SFAS 141 that introduced some path-breaking changes in merger accounting like prohibiting the "pooling" method for reporting. SFAS 142, subsequently, introduced impairment testing for some specific intangibles e.g. goodwill. SFAS 142 also curtailed automatic amortization of intangibles with indefinite life and mandated annual impairment testing in lieu thereof. All these changes enhanced transparency and comparability of reported statements to some extent, but there remained some issues that were yet to be resolved.

However, based on post implementation feedback from various interested sectors, FASB, in 2007, revised SFAS 141 and promulgated SFAS 141R, which was later incorporated into ASC 805 in furtherance of the Codification program/ FASB also enacted SFAS 160 (Non controlling interest in consolidated financial statements), that introduced the philosophy of fair value in accounting for business combinations. Gill & Roshan (2007) have stated that in the last few years, FASB has shown strong inclination to move towards principle-based approach (e.g. IFRS) from the rule-based approach (e.g. GAAP).

2. Pooling & Purchase Methods: A Relative Evaluation

The salient features of "pooling" have already been highlighted. In essence, "pooling" of interests requires consolidation of assets and liabilities after the merger of both companies. The expenses of the merger are charged to the consolidated income statement (APB 16, FASB). In the "purchase" method, the first step is the identification of acquired and acquiring firms as separate entities. FASB underlines the fact that acquiring firms ought to pay out cash or assets that are used in the common combination of larger acquisition firms (FASB 1992). The "purchase" method is a two-step process, in which, acquirer needs to record the acquisition price paid to the owners of acquired firms in its books. Firstly, acquirer's books are recorded with the assets and liabilities of the acquired firm at their market values. Secondly, any positive or negative variation between the market value of assets (Assets-Liabilities) and consideration paid is recorded as goodwill or negative goodwill.

After recording, goodwill is amortized equally over its estimated life against the consolidated firm's net profit. Amortization of this acquired goodwill is allowed up to forty years (FASB 1992). This acquired goodwill is the actual worth of the acquired firm if the acquired assets and liabilities are accurately measured at market value (as per going concern) i.e. "goodwill" represents the excess worth of the acquired firm as a whole entity over the market worth of the constituent assets and liabilities to the acquiring firm. Goodwill can also be interpreted to represent the promising products that are developed by the acquired firms. Goodwill can represent the amount that acquirer is willing to pay for economic benefits (economies of scale) or non-economic (combined managerial efficiency) expected from the merger (Brealey and Myers, 1996).