Roundtable on Accounting for Intangible Assets Acquired in a Business Combination, June 14, 2000, Senate Committee on Banking, Housing, and Urban Affairs.

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Introduction: The Pooling Method is Per se Misleading.

The purchase method restates the value of assets to their current fair market value. Fair market value of assets generates *reliable, relevant* accounting data whenever unrelated parties combine their interests. Arm's length bargaining between unrelated parties as to what fraction each shall hold of the combined business provides reliable accounting data as to value. As the Accounting Principles Board said,

> "[A] business combination is a significant economic event which results from bargaining between independent parties. Each party bargains on the basis of his assessment of the current status and future prospects of each constituent as a separate enterprise and as a contributor to the proposed combined enterprise. The agreed terms of combination recognize primarily the bargained value...
> Accounting Principles Board Opinion No. 16, ¶19 (1970).

Fair market value of assets provides relevant accounting data: Investors must make decisions as to whether to buy or sell stock or other business interests by looking to current costs. Historical cost, as of some unidentified point possibly decades ago, provides no relevant or material data for the benefit of investment decisions and should be abandoned whenever reliable more current data is available.

The pooling method of accounting is per se misleading, if anyone believes it, because arm's length bargaining takes away the extraordinary bargains that the pooling method falsely claims. Assume, for instance, a simplified hypo of a company, Company C, started in Founder's garage with $100,000 capital, which distributes all profits annually. Company C, for simplicity, has no debt. Founder's company then grows to the point that it generates $10 million cash dividends per year. Under the historical cost convention, the founder has a return on capital of $l0 mil/ $100,000 or 10,000% annually, which is indeed a quite an extraordinary investment return. Now assume an acquiring company comes along and determines that a 10% discount rate is appropriate for the risks, and so pays Founder $l00 million for the business by issuing the founder $100 million worth of acquiring company stock.

By issuing stock of $100 million, the acquirer has incurred a $100 million cost for Company C. Stock for the issuer is just a proxy for the net present value of the future cash the purchaser will distribute. Fair market value is nothing but a proxy for that cash, as judged by the hard critic of the market place. The Founder may have a cost of only $100,000 for the capital inputs into the business, but the acquirer has a cost of $100 million. The acquiring company does not have 10,000% return. The $10 million net income the business generates is just a normal 10% return on the acquirer's $l00 million investment made in the form of stock.

The pooling method of accounting would allow the acquirer to step into the shoes of the Founder and report that the acquirer has only $100,000 cost for the business assets of Company C as a whole. That method is misleading. Founder's initial $100,000 investment does not matter to the acquirer. The acquirer has paid $l00 million in stock for Company C. It needs to report to its shareholders a 10% profit, not a $10,000% annual profit from Founder's business. If it uses up its investment or costs, it needs to report to its shareholders that it has used up the true $100 million of capital, not just

$10,000. If it wastes its $100 million by destroying Company C, it must reveal that to its owners and the investing public. Incompetent managers will be able to show a profit to their shareholders, quite misleadingly, if they can state their costs at the original $10,000, even when they are losing money badly if they must accurately state their costs at the true $100,000,000.

The pooling method of accounting is so misleading that it needs to repealed whenever there is enough arm's length bargaining to indicate the fair market value of the business assets. An incorporation of an old and cold partnership, with no change in proportional interests, might not provide arm's length bargaining to give reliable figures for value. If there is any material change in interests, however, then assets should be stepped up to new bargain-set value. Setting initial asset values at current higher fair market value is consistent with the tradition of accounting conservatism, because if any when the capital costs are used up and expire, the subsequent credits (reductions) of the accounts will show the subsequent business as consuming very valuable assets. Standards might also state that assets should not be stated above fair market value, with a warning in audit standards to be wary of stated fair market value when bargains appear collusive or when it is in the interests of the parties over state value collusively.

Bargaining between two equal size business entities will ordinarily provide non-collusive arm's bargaining generating reliable and relevant accounting data. There is thus no case for a special exception to purchase accounting for cases where the two entities are of roughly equal size. In both cases, the asset accounts need to be restated to their current bargain-set value and cost.

It is becoming popular to argue for the continuation of the pooling method on the ground that the smart or efficient market can judge the value of company, without regard to the accounting method the company uses. The smartness of the market is not technically a justification for bad accounting. Misleading accounting makes it more expensive for the market to discover the correct value of the stock or less likely to reach the correct value. Accounting should be using methods that help the market reach true value of stock, quickly and cheaply, not raising hurdles which the smart market might or might not get over. Accounting needs to be the ally of the market in reaching proper price. In any event, those proponents who rely most on the market seem to be most willing to defraud it.

Specific Questions

1. What is the nature of goodwill and how should it be measured?

Goodwill is the extra value paid for a firm that can not be attributed to any specific assets. For example, Company C founded in the garage with $100,000 might rent everything and have no balance sheet assets. The acquirer was willing to pay $100 million for it because it generated $10 million cash a year, just like $100 million in the bank. Going concerns almost always have goodwill because they are worth more than the sum of their specific assets. A going concern is living organism, able to recruit and train people, buy materials, add value, sell and distribute the product. If Company C rents its office and all equipment, then substantially all of its $100 million value might be good will. In the next century as we move increasing to wealth in the form of information, many more companies will have nothing but goodwill.

Current accounting refuses to treat self-developed good will as an accounting asset. In the abstract Company C was worth $100 million to Founder as well as to the acquiring company, but generally accepted accounting principles ("GAAP") only recognizes the $100 million as a cost or asset when there is an arm's length purchase. Consistently, GAAP treats research and development is treated as lost when made and having no value, even for the Micosofts, Intuits, Nikes, Coca-Colas and Amazons that have intangible assets worth billions. GAAP refusal to recognize the value of research and development and other intangibles means that many companies have a net worth, as appraised by the stock market, that is 20-30 times higher than the net worth as appraised by GAAP. But accountants feel that they have no choice but to retreat from more accurate descriptions because they have no reliable tools for auditing intangibles and determining their value. GAAP respects the value of intangibles only when there is a third party negotiation in an acquisition that validates the value of the intangible. The good will is then measured anchored on the sound base of the price that the acquirer and acquired shareholders negotiate at arm's length.

2. Does Goodwill Depreciate?

Some assets, such as factories and cars, inevitably become worthless over time. Some assets, such as land, location or corporate stock, may fluctuate in value but do not inevitably expire over time. Current GAAP requires that goodwill be treated as if it expired over 40 years, and one-fortieth (2-1/2%) of the cost of the good will asset must be debited against earnings in every year. AICPA Accounting Principles Board, Opinion No. 17, Intangible Assets ¶9 (1970). FASB is considering increasing the write-off to as much as 5% of the cost year, by mandating a 20 year life.

Goodwill does not *inevitably* disappear. There are two economically-equivalent forms for acquiring a business: purchase of stock or purchase of assets. GAAP treats the cost of stock as nondepreciating, even though the fluctuations in value of stock can be extraordinary. If business assets rather than stock are purchased, however, GAAP the cost of business beyond that attributable to any specific expiring assets, is the goodwill asset, amortized over 40 years. GAAP indeed forces amortization even for acquired businesses that are getting more valuable and not expiring.

Moreover, many intangible assets, such as employee or customer base are replenished by costs treated as expenses under current GAAP. The logic of the "mass asset rule" justifies making intangibles non-amortizable in some cases. Under the mass asset rule, the initial acquisition cost of an intangible such as customer or employee bases is treated as non-amortizable and the costs of adding replacement customers or employees is treated as an immediate expense. The customer or employee base is then like a leaky bucket that is being replenished. While indeed existing employees or customers are departing, the water level as a whole is constant or rising because of the new customers or employee being added. The debit balance of the asset on the accounting books is a combination of two errors -- ignoring the depletion of the initial cost and ignoring the investment or asset aspects of the new costs -- but the combination of the two errors leaves the accounting debit balance as an accurate description of a water level that is not dropping. See, e.g., Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not*, 56 TAX NOTES 629 (1992).

Acquired companies do in fact sometimes drop in value, notwithstanding the mass asset rule. The water level of the whole represented by Company C customers and employees might well be dropping. For example, if the founder of C proves to be irreplaceable and leaves Company C and earnings then drop from $l0 million a year to $100,000, then Company C is then like only $1 million in the bank, not $100 million and $99 million of the acquiring company's cost has disappeared. Acquired companies do sometimes drop in value. But it is not inevitably so.

Mandatory amortization of goodwill over a period of not more than 40 years was proposed by the SEC in 1970 because the SEC could not be confident that management would write off goodwill that had in fact expired. The SEC worried that management would not always write down the value of the intangible assets when earnings in fact deteriorated and that a mandatory write off of 2-1/2% per year was necessary to rein in management discretion. The SEC also proposed the mandatory write off in order to curb accounting incentives for corporate takeovers. Hamer Budge (SEC Commissioner), *Accounting Questions in Corporate Acquisitions,* SECURITY MARKET AGENCIES, HEARINGS BEFORE THE *SUBCOMM.* ON COMMERCE & FINANCE, H. INTERSTATE & FOREIGN COMMERCE COMM., 91st Cong., 1st Sess. at 18 (Feb. 25, 1969).

3. Can goodwill appreciate in value, and, if so, how should the appreciation of goodwill be measured and accounted for?

In the abstract, a balance sheet reflects value, just as the balance of one's bank account reflects its value. But booking the appreciation in the value of any assets is inconsistent with the historical cost convention, which has been a fundamental premise of GAAP since the Depression. Valuation of goodwill requires valuation of the entire company, not just marketable assets within the company. Accountants have never understood their professional skills to be valuation of the whole company. Basing accounting on the valuation of the entire company by recognizing the appreciation of internally developed goodwill would indeed be a revolution, with unknown consequences, for the accountants.

4. Can events that trigger a diminution in the value of goodwill be identified? If it can be determined that the value of the goodwill asset has been impaired, how should the impairment of goodwill be measured and accounted for?

If Company C is no longer like a $100 million bank account, because its earnings drop below $10 million, then some part of the $100 million acquisition cost for C has been lost. If, for instance, Company C is maintained as a separate division or subsidiary with separate books, then a decline in C's earnings to $1 million per year would be an impairment of the $100 million acquisition cost and should be the occasion for writing off 90% of the acquirer's $100 million cost. The $90 million impairment or loss should reduce current earnings. Under current fundamental concepts, by-passing the income statement is a breach of the fundamental principles because it hides bad news from the owners and potential investors.

Commonly, however, the diminution in the earnings of Company C can not be identified after the acquisition. If Company C is broken up and its resources fully integrated into the acquirer's other operations, than there will not be any separate accounting books for C and no feasible way of determining whether acquirer's costs are continuing to be fully productive of 10% return.

The inability to determine Company C's post-acquisition earnings if the assets are broken up and spread throughout the acquirer means that the acquirer can avoid the adverse effects of an impairment test by breaking up the assets. The acquirer can and inevitably will plan to avoid any impairment loss it might be required to report. It will be impossible to police or prevent such planning. In fact, breaking up the assets of a money losing subsidiary or division is normal salvage operation. Moreover, it is also possible that breaking up the assets of Company C enhances its value *above* the initial $100 million acquisition cost.

Two strategies seem possible given the impossibility of applying an adverse impairment test to company C.. First, FASB might rely on an overall impairment test, asking whether the acquirer, including its many divisions including Company C assets, has a market value equal to reported goodwill. Secondly, FASB could provide that a breakup of Company C assets would be the loss of the goodwill or going concern value of Company C, but not a loss of specific assets which can be reliably identified.

(1) Overall goodwill. For publicly traded companies, FASB could sometimes rely on the market value of the acquirer as a whole to determine whether the acquirer has good will value. If the market judges that the value of the entire firm is worth more than the sum of the debit balances of acquirer assets, then the market is determining that the acquirer has goodwill value. If the market capitalization is lower than the accounting net worth, however, then that means that the smart market has determined some of the companies accounting assets have in fact expired. The market price overall is the summation of the vectors of greedy outsiders who put their money where their valuation is, and we can rely on their opinions as a basis for good accounting. If the GAAP net worth equals market capitalization, we have achieved Nirvana of having accounting accurately describe the company. A rule that the firm must take losses to write down assets so that accounting and market worth are the same can provide some control on assets stated at more than there real worth. Use of market valuations works, however, only for firms traded on a broad public market that is monitored by analysts who are fully informed of all useful investment information.

It is also possible to use accounting earnings as a pale substitute for market value as a measure of overall firm capital. If we assume 10% return, for example, then we can assume that the assets have expired when the accounting earnings drop. If the acquirer's earnings drop to $1 million then the acquirer would be required to write off any good will assets that it maintains on its books until its total assets are $10 million. Testing would be done annually. A loss year, in fact, would mean that all remaining goodwill would be taken as a loss.

Applying an impairment test to the acquirer's overall position would also be a completely different kind of test than just determining whether the investment in Company C has been impaired. An overall test would also give some incentive to making acquisitions instead of furthering internal developments. The acquirer is not allowed to treat self-developed good will as an asset, but it does get to treat costs of goodwill in an acquired company as an asset. Under an overall impairment test, the acquirer would be able to use its overall earnings or value to avoid the impairment loss, even if Company C has disappeared. That treatment gives the acquirer an incentive to buy other companies, rather than develop internally, just to get its self-developed goodwill treated as an asset. A fundamental principle in the area seems to be that there be no accounting incentives for acquisitions.

An overall test for impairment, moreover, would mean that an acquiring firm might have a cascading effect if it begins to loss money. A drop in market value or accounting earnings would require a very large charge to earnings. If accounting affects market value, a loss in earnings or a diminution of market value would have further losses occasioned by its initial drop in value or earnings. Accounting then would have a destabilizing effect, to the extent it is relied on.

(2) Write-off upon integration. Given the unattractiveness of overall impairment tests, it seems necessary to require that all of Company C's goodwill be written off when Company C's assets are broken up and integrated into the acquirer, such that separate books can no longer be reasonable accurate for Company C.

A break up of Company C will sometimes be a value-enhancing act, raising the value of C above its $100 million cost. Requiring a hefty $100 million write off by breaking up the assets might well put an accounting penalty on break ups that will prevent what would be strongly value-enhancing acts.

A distinction might be attempted between intangible assets that can be expected to survive a break up and assets that will disappear when Company C assets are broken up. Thus upon a break up of Company C, any remaining "going concern" or residual goodwill value would be written off, but intangible assets that survive the integration would be maintained on the acquirer's books. Thus if Company C has a valuable trademark or logo, that value would survive integration. Some of the surviving assets might be long term and some short term. Much of the value of Company C might reside in the Founder and be lost when he retires. The acquirer would be required to identify surviving intangibles and their expected lives at the time of the break up.

If break up is a loss event, moreover, then acquirers would be less likely to break up assets to avoid the loss and then it might be more reliable to rely on the continuing books of Company C to see if the $100 million investment has been impaired.

(3) Mixed approaches. Reliance on management assessments of which intangible assets are lost and which survive is only partially justified. Management will undertake transactions that will put its performance in the best light and will characterize ambiguous facts in the manner most favorable to the evaluation of management. There are very limited telltails distinguishing long lived intangible assets that might survive a break up of Company C -- customer base or employee base for instance – from assets that will not – going concern for example – and also from assets that will disappear quickly – the Founder perhaps.

Given the difficulties and drawbacks of applying impairment tests, it makes sense to back up an impairment test with a mandatory amortization rule. It would not be draconian to require a write off of 2%- 2-1/2% of the cost of goodwill per year – i.e., by assuming a straightline amortization over 50 years or 40 years. FASB then could add an impairment text on top of the mandatory amortization . The combination of the two tests seems stronger than either approach alone. An impairment test will justify a longer mandatory amortization life because the amortization schedule will not bear all of the burden of capturing loss of value. A mandatory amortization life will mean that some of the imperfections of impairment tests become more tolerable.

I thank the Committee for the opportunity to participate in this roundtable.