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ACCOUNTING FOR BUSINESS COMBINATIONS: SHOULD POOLING BE ELIMINATED?

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCE AND HAZARDOUS MATERIALS

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

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CONTENTS

Page

Testimony of:
- Bible, Peter R., Chief Accounting Officer, General Motors Corporation 89
- Dooley, Hon. Calvin M., a Representative in Congress from the State of California 62
- Goodlatte, Hon. Bob, a Representative in Congress from the State of Virginia 59
- Hoffman, Gene, Jr., President and CEO, EMusic.com 98
- Jenkins, Edmund L., Chairman, Financial Accounting Standards Board ... 69
- Lewis, William Frederick, President and CEO, Prospect Technologies 102
- Powell, Dennis D., Vice President, Corporate Controller, Cisco Systems 80

Material submitted for the record by:
- American Business Conference, letter dated May 3, 2000, to Hon. Michael Oxley 134
- Biotechnology Industry Organization, letter dated May 4, 2000, enclosing statement for the record 130
- Jenkins, Edmund L., Chairman, Financial Accounting Standards Board, letter dated May 23, 2000, enclosing response for the record 125
- National Association of Manufacturers, letter dated May 3, 2000, to Hon. Michael Oxley, enclosing material for the record 132
- Valuing the New Economy, a white paper presented by The Merrill Lynch Forum 136

ACCOUNTING FOR BUSINESS COMBINATIONS: SHOULD POOLING BE ELIMINATED?

THURSDAY, MAY 4, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:08 a.m., in room 2123, Rayburn House Office Building, Hon. Michael G. Oxley (chairman) presiding.

Members present: Representatives Oxley, Tauzin, Gillmor, Cox, Largent, Ganske, Lazio, Shimkus, Bliley (ex officio), Towns, DeGette, Barrett, Luther, Markey, Rush, and Dingell (ex officio).

Also present: Representatives Eshoo and Crowley.

Staff present: Brian McCullough, majority professional staff; David Cavicke, majority counsel; Linda Dallas Rich, majority counsel; Shannon Vildostegui, majority professional staff; Robert Simison, legislative clerk; and Consuela Washington, minority counsel.

Mr. OXLEY. The subcommittee will come to order. The Chair recognizes himself for an opening statement.

I would like to begin by reaffirming my belief in FASB as an independent private sector entity is best suited to set accounting standards. Few would want politicians without accounting expertise making highly technical accounting decisions. From time to time, however, FASB considers an issue which has broad public policy implications best brought to light through congressional hearings such as this. In such an instance, the Congress has a responsibility to foster open dialog on the issue. That is precisely why I have called this hearing today.

FASB proposes eliminating the use of pooling as a proper method of accounting for business combinations as well as making changes to the treatment of goodwill. Many of the same arguments have circulated for years both for and against pooling accounting as the treatment of goodwill. The debate has little changed. What has changed, however, is the context of the debate. In the information economy, the magnitude of the implications of eliminating pooling accounting has increased dramatically. Intangible assets of knowledge-based companies often account for most of the company's value or ability to generate revenue in the future.

Central to this debate is the information available to investors under each accounting method. Arguably, the benefits the elimination of pooling accounting will provide varies. The question we must answer is whether the information is better, more accurate,

and as useful under purchase accounting as the information provided under the current pooling method of accounting for these transactions.

The recording of goodwill is a good example of the different treatment intangibles receive under pooling and purchase accounting. Some argue pooling accounting distorts book value because it does not amortize goodwill. The values of the two companies are simply combined. Others argue purchase accounting artificially reduces stated income by requiring goodwill write-off without a negative economic event to support it. In fact, I can understand how many intangible assets appreciate rather than depreciate over time.

Distinct from which method is more accurate is the issue of whether requiring a shorter amortization period for goodwill or even require the write-off of goodwill and other intangibles will actually make mergers and acquisitions uneconomical for businesses. I suspect mergers will continue. However, the possibility that such a rule change would artificially slow economic growth without providing any marginal benefit gives me pause.

Though I do not begin to have a solution to this debate, I do urge those central to this debate to consider all of the options. Perhaps we need to further examine the changing nature of assets which is driving our economy. We need to consider whether eliminating pooling accounting is a negative economic impact that could diminish the competitiveness of U.S. businesses. Finally, we must evaluate whether the proposed changes will actually provide investors with more useful information about a company.

Today we will hear from those closest to the debate. I thank our panelists for appearing today and look forward to hearing what each has to say about this important issue.

The Chair's time has expired. I recognize the ranking member, the gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you, Mr. Chairman, for holding this hearing.

A number of concerns have been raised about the elimination of pooling as a method of accounting for business combinations. Eliminating pooling accounting, it is argued, could slow the pace of business combinations and hinder the growth of high-tech industry then by reducing the number of jobs its industry creates. High-tech companies in particular say that with pooling accounting, many of the mergers in the high-tech industry which have boosted our economy and the stock market might not have ever happened.

As a New Yorker and the ranking member of this Subcommittee on Finance, I am concerned about the potential adverse effects. On the other hand, a number of other companies, investors, consumer groups and accounting experts argue that pooling is flawed, that it distorts financial reporting, and that it adversely affects the allocation of economic resources by creating an unlevel playing field for companies that compete for mergers and acquisitions.

Still others have concluded that both the pooling method and purchase method of accounting for business combinations are flawed, and that we need to go back to, should go back to, the drawing board before moving forward.

There has been some concern lately about traditional accounting. This is because intangible assets have replaced traditional bricks and mortar as the backbone of business today. Information, knowl-

edge, and human capital are difficult, if not impossible, to value. They simply do not depreciate the same way tangible assets do. In fact, they often appreciate.

We should not be forcing companies with mostly intangible assets to apply the accounting method which does not accurately reflect the value of their assets. It seems to me we should be moving toward a framework that more accurately reflects the value of companies in this information day and age.

Consistency in accounting standards is a desirable goal and one that I support vigorously, but consistency will not be beneficial if investors cannot rely on the valuation that the consistent approach provides.

On that note, Mr. Chairman, I yield back.

Mr. OXLEY. The Chair recognizes the chairman of the full committee, the gentleman from Richmond, Mr. Bliley.

Chairman BLILEY. Thank you. I commend you, Mr. Chairman, for holding this hearing today.

The draft rule proposal issued by the Financial Accounting Standards Board will have a significant impact not only on high-tech and other companies, but also on our economy. I commend the FASB's work in seeking to ensure that accounting rules provide an accurate and fair picture of a company's financial status.

In this instance, important questions have been raised as to whether the Board's proposal would actually do that, or whether it would, on the contrary, make it more difficult for investors and creditors to understand the true status of a company that has resulted from a business combination.

It is not an easy job to get companies to clarify their financial status. The job has become increasingly difficult. Bricks-and-mortar assets share the same balance sheet as creativity, innovation and other intellectual assets. High-tech, biotech, financial, and other companies thrive on these intangible values. Measuring these intangible values is very difficult, and I recognize that FASB does not have an easy job to do.

An accounting framework that functions effectively in this new economy is an important goal we must achieve. There are good arguments both for and against the FASB proposal. Hundreds of comment letters were received, and the FASB heard from witnesses at hearings in California and New York. I am interested to know how this information has been received.

I am concerned by claims that FASB's proposal does more harm than good. If the proposed changes have a negative effect on our economy, then these changes become a public policy matter that Congress must consider. I hope that is not the case, but I do not think the picture is clear enough at this time to advocate the changes contemplated in the FASB proposal.

I look forward to hearing the views of our witnesses today, and I hope that we can begin to answer these important questions.

Thank you, Mr. Chairman.

Mr. OXLEY. I thank the gentleman.

The Chair recognizes the gentleman from Massachusetts Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much. Thank you so much for having this very important hearing here today so we

can air out the concerns that I think many of the people who are right now representing new economy districts such as mine, the concerns which are being raised by many of the companies which we represent.

The critics of FASB raise concerns that purchase accounting may fail to accurately value some of the mergers. These concerns have been particularly intense among many of the new economy companies whose worth may be less a function of their physical assets, earnings, or capital, and more a product of intellectual property or other more intangible assets and goodwill.

Some have advocated that eliminating pooling would discourage many new e-commerce startup companies from doing a merger because of the cost purchase accounting would impose on such a transaction.

Today, Mr. Chairman, you have wisely invited Ed Jenkins as well as a very distinguished panel of corporate leaders with varying perspectives on FASB's proposal to eliminate pooling. I greatly respect Ed Jenkins. I admire Ed Jenkins. I think he is an excellent head of FASB, and I welcome him here today.

I am going to be particularly interested in hearing constructive ideas on options that FASB may or should consider to address in terms of their concerns that had been raised about the impact of purchase accounting on the new economy, and at the same time assuring that investors get the full and fair disclosure which they deserve. I think this is an excellent forum to have that discussion in.

Obviously, we are, as a Nation, in a transformation that is reflected in the earliest stages by particular east coast and west coast congressional districts, but without question, it is time for us to have this important discussion.

Mr. Chairman, since we are on the subject of accounting, I would also suggest to the Chairman that we consider holding a further oversight hearing on another issue affecting the accounting profession, the disturbing conflicts of interest arising from the fact that some firms wish to simultaneously serve as consultants to or business partners of companies that they are also auditing simultaneously.

This practice is very disturbing to me. When my brother John was graduating from Boston College as one of the outstanding finance majors, I asked him why he was not an accounting major instead. He said to me, well, the finance majors play the game, and the accountants keep score. In this new era, accountants want to play the game and keep score at the same time, and it does build in tremendous conflicts that I believe this committee should look at.

I know that you, Mr. Chairman, and several other members of the majority have recently written to Arthur Levitt on this subject, criticizing him as he tries to clamp down on such practices, and I would hope that we could have a public hearing on that issue as well so that we can discuss the propriety of accountants also having financial interests in the firms they are allegedly auditing for public consumption. I think that would be important.

I look forward to this hearing. It is a central issue in the development of the new economy. I thank everyone who has come here

today. I think it is going to illuminate the understanding of the subcommittee.

Mr. OXLEY. The gentleman from Illinois Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. I will be brief. I have only been a Member for 4 years, two terms. I have never seen a submission of testimony this large before. It gives members a great excuse, those who have not covered it prior to the hearing. If more hearings would have this type of documentation, I would have better excuses for not doing all my homework, Mr. Chairman.

Mr. OXLEY. There are pictures in there, though.

Mr. SHIMKUS. We appreciate pictures.

I do have great respect for FASB, too. I understand the complexity of trying to determine market value in a new era of services, information services, and how do you value that. I am here to listen and learn. I thank my colleagues for appearing, and also the members of the next panel.

With that, Mr. Chairman, I yield back my time.

Mr. OXLEY. The Chair is now pleased to recognize the ranking member of the full committee, the gentleman from Michigan Mr. Dingell.

Mr. DINGELL. Mr. Chairman, thank you for that courtesy.

Mr. Chairman, I commend you for holding this hearing. It is a valuable one, and it will be a useful device in achieving the best judgments as to what should be done on the matters under consideration.

Mr. Chairman, there is probably no stronger defender of the Financial Accounting Standards Board, or FASB, and the independent setting of accounting standards than I have been over my congressional career. I say this even though I don't always agree on every last detail on every accounting standard that FASB has set.

Making us happy, however, is not their task. Their job is quite a different one. That is to promulgate standards of high quality that do not favor any particular interest group and maintain the credibility of our financial reporting system.

They have an even greater responsibility, and that is to see to it that our accounting system reports truthfully, factually, fairly, and correctly to all involved, to the companies, to the shareholders, to the regulators and everybody else.

Where we have not seen that happen, and I have seen several instances in this committee, including some railroad mergers where the reporting of the accounting system was not reliable, major scandals and major troubles occurred.

The unparalleled success of our capital markets are due in no small part to the high quality of the financial reporting and accounting standards promulgated by FASB. I would note that this is very much in contradistinction to what we have seen with regard to some of the foreign accounting systems and some of the standards that are promulgated through their mechanisms, referring very specifically to countries in and around the Pacific Rim and in Asia.

If I have any criticism of FASB, and I would note that I do, it is that they seem to have a political tin ear and to make a lot of

powerful enemies. Their decisionmaking process is supposed to be neutral and thorough and open and informed, and it is all of that.

They do have a tough job to do. I respect that, and I welcome them here today, as I do all of our witnesses.

On the substance of this hearing, I have not made up my mind as to what is the right answer. I am not an accounting expert. I would note that my experience in accounting is bottomed somewhat on the practice of law and the fact that I once took a mail order course in accounting to understand what I was dealing with when I addressed this particular subject in the practice of law.

The 1970 compromise by the FASB to allow both purchase and pooling accounting for business combinations has been highly controversial, strongly dissented from, and showed serious fault lines during the merger boom of the 1980's.

After several years of deliberation and debate, at the urging of affected parties, FASB has issued an exposure draft that proposes replacing the pooling of interests method with the purchase method for almost all business combinations.

Currently companies can use pooling if they meet 12 criteria. I suspect if there is a criticism of what has happened heretofore, it has been that the industry has gotten the assumption, correctly or incorrectly, from FASB that they have arrived at a decision that this is what is going to occur, and that nothing further is going to be done on the matter. I think that is unwise, and certainly politically so.

Under the purchase method, an acquiring company records the value of the acquired company at the cost it actually paid. Under pooling of interests, the combining companies simply add together the book value of their assets, leaving investors with no way to determine what price was actually paid or tracking the acquisition's subsequent performance.

In an example cited at page 5 of FASB's prepared remarks involving a $10 billion transaction that was accounted for under the pooling method, the book value of the company being acquired was only $500 million. The acquisition was reported as $500 million in the financial statements of the acquired company, and $9.5 billion in value simply disappeared. Where did it go?

Despite no real change in cash-flows, the pooling method also creates a false measure of increased earnings, say its critics. Dramatically different results are produced by the two accounting methods, making it difficult for investors to compare companies, or indeed even to understand whether or not the accounting system is producing a reliable and truthful result. This will have another curious result, and that is possible serious competitive advantages or disadvantages.

High-tech companies and financial institutions oppose the FASB proposal, saying if pooling is eliminated or curtailed, it will destroy their industries, the M&A market, the stock market, and the U.S. economy. It seems every time anybody has a bad case, they come in and make these charges. The Congress and everybody else is supposed to panic.

It may well be that this is the case. If that is so, then maybe we had better take a hard look at these high-tech companies and see whether they have any real viability at all.

Other companies such as General Motors, whose chief accounting officer will testify today, the respected rating agency Moody's Investors Service, and the Council of Institutional Investors, the Consumer Federation of America, and other groups representing investors and consumers support the FASB proposal.

Me, I think that we probably ought to just support the gathering of the truth and seeing to it that accounting, accounting standards, and things of this kind tell us the truth. Perhaps maybe if we get that, we will have accomplished our purpose in this particular matter.

In May 1999, a study by Goldman Sachs concluded that the proposed accounting standards will not have a material adverse impact on future business consolidations, although the study identified some industries that might be adversely affected.

I would ask unanimous consent, Mr. Chairman, that that be inserted in the record.

Mr. OXLEY. Without objection.

[The information referred to follows:]

United States

Accounting/ Portfolio Strategy

May 28, 1999

Purchase versus Pooling: The Debate on Business Combinations

Industry Details

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- **Some investors are concerned that the FASB's preliminary decisions to eliminate pooling of interests and the immediate writeoff of in-process R&D could adversely affect future M&A activity.**
- **Our detailed survey of investment research analysts suggests that these potential accounting changes will not have a material adverse effect on future business consolidation. However, our analysts have identified some industries that may be adversely affected. These include advertising, healthcare information technology, medical devices, and precious metals.**
- **Most of our analysts anticipate acceptance of a cash earnings valuation approach and a more intensified focus on alternative valuation metrics, such as return on invested capital and EVA®.**
- **Trends in global M&A activity continue to be robust. The fundamental factors driving worldwide consolidation are intact, and we do not foresee a notable slowdown in business combinations as a consequence of possible accounting changes.**
- **Our detailed Appendix, which begins on page 19, provides industry-specific information.**

Important disclosures appear on the back cover.
Electronic Document Available via *Investment Research* on *GS Financial Workbench*™

Table of Contents

Main Points 1
Introduction 2
The Three Issues: (1) Future M&A Activity, (2) Individual Company Valuations, and (3) Corporate Reporting Policies 4
Trends in M&A and Equity Supply 7
Individual Company Valuation and Future M&A Industry Trends: Our Industry Analysts' Perspectives 12
Impact on Corporate Reporting Policies: Understanding the Technical Details of the Potential Accounting Changes 14
Appendix 19

Main Points

- The FASB reached a preliminary decision in April to eliminate pooling of interests to account for business combinations. The Board also favors a shorter goodwill amortization period and will likely eliminate the immediate writeoff of in-process R&D. Some investors are concerned that these changes could adversely impact future business consolidation.

- Only a few of our industry analysts believe that the accounting changes under consideration may have a dramatic effect on future M&A activity in the industries they cover, which include advertising, healthcare information technology, medical devices, and precious metals. Most analysts anticipate acceptance of a cash earnings valuation approach if the FASB changes are ultimately adopted.

- This report should help investors assess the possible impact of these potential accounting changes on future (1) M&A activity, (2) individual company valuations, and (3) corporate reporting policies.

- Global merger activity has more than tripled to $1.9 trillion in 1998 from $419 billion in 1990. The fundamental factors driving M&A activity are intact: robust corporate cash flow, a positive regulatory environment, focus on internal reengineering, an attractive financing environment, and the desire to improve market share and overall competitiveness.

- Our detailed Appendix, which begins on page 19, provides industry-specific information.

Introduction

FASB Votes Tentatively to Eliminate Poolings and the Immediate Writeoff of In-Process R&D

The Financial Accounting Standards Board (FASB) reached a preliminary decision in April to eliminate pooling of interests to account for business combinations. In doing so, the FASB *tentatively* decided that the purchase model is preferable to allowing more than one framework to be used when businesses combine. The FASB also determined that a shorter goodwill amortization period may be appropriate. For instance, it believes that the useful life of goodwill should never exceed 20 years (goodwill is currently amortized over a period not to exceed 40 years). This followed a tentative judgment in February to eliminate the immediate writeoff of in-process R&D (IPR&D). The FASB now believes that IPR&D should be capitalized and amortized over its estimated useful life.

Industry Conclusions

Future M&A Activity Is Not Expected to Slow Dramatically

Acceptance of Cash Earnings Valuation

In general, only a few of our analysts believe that the accounting changes being considered by the FASB will have a dramatic effect on future M&A activity in the industries they cover. These include advertising, healthcare information technology, medical devices, and precious metals.

Most analysts conclude that the potential accounting changes will not have a material adverse effect on future M&A activity. These analysts emphasize that managements' decisions to consolidate are influenced primarily by the (1) strength of the operating and financial fundamentals underlying the transaction in question and (2) strategic factors (such as, synergies, improving competitiveness, market share gains, and others).

Industry Examples

The Appendix includes substantial industry-specific comments that are difficult to summarize here. A few interesting examples include the following:

- In some industries, namely brokerage and medical devices, our analysts anticipate a "flurry" of poolings to precede ultimate implementation of the business combination changes under consideration by the FASB.
- The majority of our analysts anticipate a more intensified focus on a cash earnings metric or supplemental valuation measures, such as return on invested capital and economic value added (EVA®), if the FASB rule changes are ultimately adopted.
- In some sectors, such as energy, where there has already been considerable consolidation, our analysts do not expect the accounting changes to have a material impact because so much M&A activity has already occurred.
- In contrast, our analysts believe that industry consolidation is far from complete in other sectors, such as asset management.

Industry Details: Our Industry Analysts' Views

Contents of the Detailed Appendix

We have surveyed 60 industry analysts in our Investment Research Department regarding the possible impact that these potential changes in accounting could have on (1) future M&A activity in their covered industries and (2) individual company valuations. Their detailed commentary and analyses are presented in the Appendix, which includes

- a description of the current valuation metric(s) that are used in each sector;
- an assessment of whether a cash earnings (i.e., earnings before goodwill) measure will be accepted if the potential accounting rule changes are ultimately adopted;
- the most popular accounting framework employed by combined enterprises since 1991 (i.e., purchase versus pooling);
- the expected impact that these accounting amendments could have on future M&A activity;

- a list of the 10 most popular "pooling" industries, which account for about 25% of total S&P 500 market capitalization and slightly less than 30% of the total dollar value of worldwide transactions completed since the beginning of 1996; and

- textual commentary by analysts on the unique aspects of their industries that should be considered by investors.

In addition, our analysts provide guidance as to how they plan to evaluate the possible resultant dilutive impact of amortized goodwill and IPR&D on reported earnings in sectors where equity valuation is driven by measures such as P/E multiples, P/E-to-growth models, or reported earnings momentum approaches. Note that the issues under discussion are extremely complex and open-ended given the fact that the FASB has yet to release Exposure Drafts (EDs) on the potential accounting changes that could apply to either business combinations or IPR&D. The opinions expressed reflect the independent views of Goldman Sachs analysts based on the FASB's progress to date on these topics.

The Issues: (1) Future M&A Activity, (2) Individual Company Valuations, and (3) Corporate Reporting Policies

The technical aspects of the potential changes in accounting for business combinations and purchased intangibles, such as goodwill and IPR&D, are of great interest to the accounting community. More important, analysts and investors need to assess their possible impact on future (1) M&A activity at both the macro- and microeconomic levels, (2) individual company valuations, and (3) corporate reporting policies.

(1) M&A Activity (Detailed Discussion Begins on p. 7)

Global merger activity has increased dramatically since 1990. The aggregate value of worldwide acquisitions completed in 1990 totaled about $419 billion. The U.S. dollar value of mergers that were executed globally more than tripled to $1.9 trillion as of year-end 1998. We estimate that 1999 mergers totaled about $479 billion through the end of April (see Figure 1). The current pace of M&A activity suggests that managers and owners continue to perceive attractive underlying value in equities.

Many of these acquisitions have been executed by larger-capitalization firms that are attempting to (1) gain access to facilities without construction delays, (2) improve the operating efficiency of their ongoing businesses, (3) increase the returns generated by the overall enterprise through synergies, and (4) improve their competitiveness or market share through consolidation.

Concerns About Future M&A Activity

There are concerns that the changes in accounting for business combinations and purchased intangibles that the FASB is considering could have a material impact on the level of future consolidation. For instance,

- how, if at all, will the potential changes in accounting described above impact future M&A activity at both the aggregate and industry levels?
- will corporate managements be less willing to complete an acquisition if the resultant dilutive impact on reported earnings is material?
- will the underlying economic fundamentals and strength of the strategic alliance continue to drive managements' decisions to complete these transactions?
- do we expect the potential changes in accounting for business combinations to have a disparate impact on different industries?
- if so, what industries are at risk?

This report will attempt to answer these key questions.

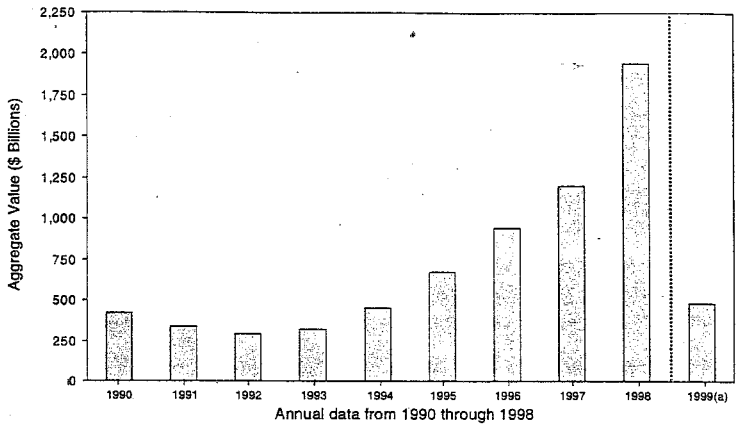
(2) Individual Company Valuations (Detailed Discussion Begins on p. 12)

In addition, some analysts and investors have expressed concerns about the potential impact these accounting changes could have on resultant individual company valuations and equity analysis. In some industries, P/E-to-growth models, relative P/E multiples, and reported earnings momentum approaches are used as the primary valuation metrics to assess the fair value of individual companies. In addition, pooling of interests has been the most popular business combinations accounting framework used to execute sizable acquisitions in a number of sectors.

Concerns About Individual Company Valuations

The potential elimination of both (1) poolings and (2) the immediate writeoff of IPR&D, in combination with a shortened amortization period for goodwill, could affect the valuation of individual corporations in some cases. In sectors where valuation is not derived from cash flow, EBITDA, or cash earnings models, and/or pooling-of-interests has been the most popular accounting framework used to account for an acquisition, analysts and investors must decide how to evaluate the resultant dilutive impact of amortized goodwill and IPR&D on reported earnings. For example,

Figure 1: Value of Worldwide Completed Merger Activity



(a) Data reflected through April 30, 1999.
Source: Securities Data Company.

- how will historical comparisons be impacted?
- are lower stock price multiples merited in some cases?
- should analysts "look through" the transaction cost or goodwill premium and begin to value companies based on a cash earnings or earnings before goodwill (EBG) basis?
- does the goodwill and IPR&D charge have inherent information content that should not be ignored?
- will transaction costs (i.e., the goodwill premium) be driven down as a result of these potential accounting rule changes?
- will there be a more intensified focus on supplemental valuation measures, such as cash earnings, return on invested capital, and EVA®?

We have surveyed 60 analysts in our Investment Research Department on these issues. Their comments and analyses, which are presented in a detailed Appendix, clarify many of these key questions at the micro level. In general, our analysts do not believe that the potential changes in accounting for business combinations and purchased intangibles (i.e., goodwill and IPR&D) currently considered by the FASB will have a material adverse effect on future M&A activity in the industries they cover; however, in some industries, including advertising, healthcare information technology, medical devices, and precious metals, our analysts expect future consolidations to slow dramatically from current levels if the FASB rule changes being considered are ultimately implemented.

(3) Corporate Reporting Policies
(Detailed Discussion Begins on p. 14)

The accounting changes being considered by the FASB on business combinations and purchased intangibles, including goodwill and IPR&D, will also change corporate reporting practices and policies. An understanding of the technical details of the potential rule amendments is essential for relevant investment decision-making purposes. This report also highlights the details of the modified principles that the FASB is currently examining.

Trends in M&A and Equity Supply

The Current Merger-Market Environment

As we have mentioned, worldwide merger activity has been extremely robust since 1990. Executed global transactions more than tripled between 1990 and 1998 (see Figure 1). And thus far in 1999, the strong merger market fundamentals appear to be intact. In addition, there has been a high volume of billion-dollar deals completed since 1992. For example, in 1992, only 37 mergers valued at $1 billion or more were executed. This increased to 153, 221, and 291 in calendar 1996, 1997, and 1998, respectively (see Figure 2).

Since 1992, the volume of announced mergers has been fairly evenly split between the United States and the rest of the world. There was, however, a slight uptick in announced U.S. merger volume as a percentage of global volume in 1998 (see Figure 3).

Economic Factors Driving M&A Activity

Many factors drive both domestic and cross-border consolidations, including

- robust corporate free cash flow;
- positive regulatory changes and strategic imperatives in a number of industries, including banking and financial services, energy and natural resources, media/telecom, and retail;
- a focus on the benefits of internal reengineering at a number of firms;
- more intense pressure placed on corporate managements to deliver consistent earnings growth or meet investors' consensus expectations;
- the desire for some companies to improve market share and overall competitiveness by engaging in domestic or cross-border acquisitions; and
- an attractive financing environment in which interest rates are relatively low, U.S. corporate balance sheets are strong (low debt-to-equity ratios), and the investment-grade and bank-debt markets are strong.

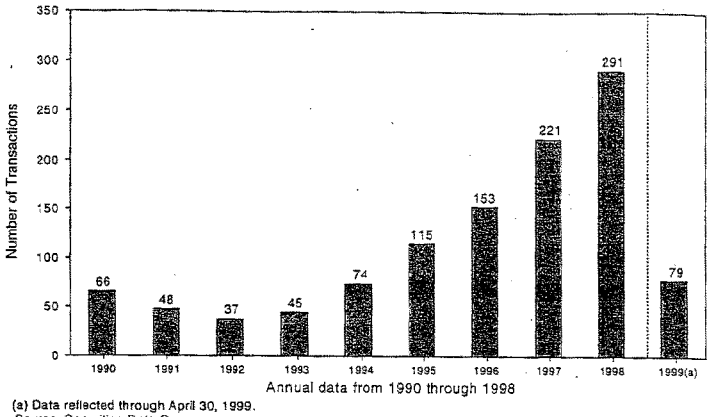
These fundamental factors remain intact within the United States. ***As a result, we expect aggregate domestic and cross-border consolidations to continue. We do not believe that potential changes in accounting for business combinations will have a material impact on future M&A activity at the macro level in the intermediate term.*** Factors that could slow or derail the pace of global M&A activity include (1) a notable increase in interest rates, (2) a dramatic downturn in equity prices, (3) an economic downturn or recession, (4) a liquidity squeeze or credit crunch, (5) a large number of failed deals, and (6) increased regulatory obstacles.

Trends in U.S. Equity Supply

The trend in U.S. equity supply is another proxy that reflects changes in (1) the pace of new equity issuance as well as (2) the reduction in shares due to factors such as cash mergers, LBOs, and share repurchases. Corporations have continued to shrink equity supply through M&As, LBOs, and share repurchase programs. Much of the gross new issuance has been executed by smaller-capitalization companies; larger, more established firms have been active in withdrawing shares from the secondary market.

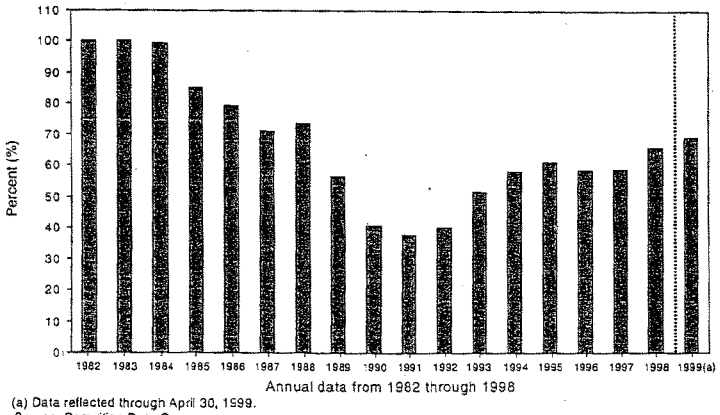
Gross new issuance of shares fell to $74 billion in 1998 from $122 billion and $118 billion in 1996 and 1997, respectively, largely as a result of unusually volatile equity prices combined with heightened investor risk aversion. At the same time, the gross reduction in shares during 1998 increased to $328 billion from $241 billion in 1997. Companies reduced shares outstanding for several reasons, including support during periods of market volatility and options exercise. Thus, the net change in shares was ($254) billion in 1998 compared with ($123) billion in 1997 (see Table 1).

Figure 2: Number of Billion-Dollar Deals Completed Worldwide



(a) Data reflected through April 30, 1999.
Source: Securities Data Company.

Figure 3: Announced U.S. Merger Volume as a Percentage of the Worldwide Total



(a) Data reflected through April 30, 1999.
Source: Securities Data Company.

Table 1: Change in Shares
(billions, at annual rate)

Year	Gross Change in Shares(a)	Gross New Issues	Net Change in Shares
1968	$ (3.7)	$ 4.6	$ 0.9
1969	(3.4)	8.4	5.0
1970	(3.4)	8.6	5.2
1971	1.4	13.2	14.6
1972	(0.5)	14.1	13.6
1973	2.2	10.8	13.1
1974	(0.5)	6.3	5.7
1975	(2.2)	10.9	8.7
1976	1.1	11.1	12.2
1977	(7.4)	12.0	4.6
1978	(7.0)	10.4	3.4
1979	(17.5)	12.0	(5.5)
1980	(10.4)	22.5	12.1
1981	(35.2)	24.6	(10.7)
1982	(23.8)	30.1	6.2
1983	(28.6)	51.6	23.0
1984	(96.1)	22.6	(73.5)
1985	(104.2)	35.5	(68.7)
1986	(128.9)	61.8	(67.0)
1987	(108.5)	53.4	(55.1)
1988	(146.2)	42.5	(103.7)
1989	(147.4)	32.2	(115.2)
1990	(68.6)	23.4	(45.1)
1991	(19.0)	65.3	46.3
1992	(5.5)	78.4	73.0
1993	(36.8)	111.1	74.3
1994	(83.7)	60.2	(23.5)
1995	(127.1)	73.2	(53.9)
1996	(185.4)	122.0	(63.4)
1997	(240.9)	117.9	(123.0)
1998	(328.4)	74.0	(254.4)
1998: 1	(193.8)	72.8	(121.0)
2	(219.9)	100.0	(119.9)
3	(331.0)	44.8	(286.2)
4	(568.9)	78.4	(490.5)

(a) U.S. corporate demand for shares stemming from cash mergers, LBO's, and share repurchases.

Source: Federal Reserve Bulletin and Flow of Funds Accounts.

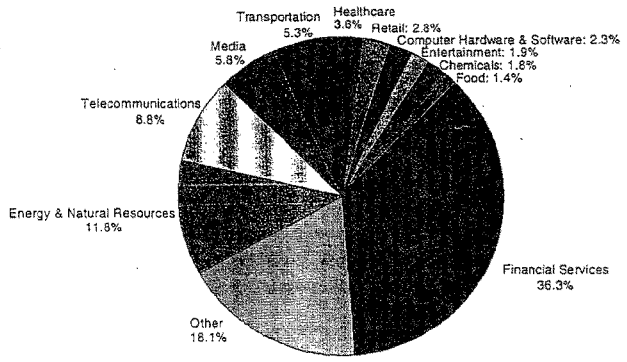
Micro Backdrop: Analyzing M&A Activity at the Industry Level

In order to accurately assess the impact that the potential (1) business combinations and (2) purchased intangibles accounting rule changes could have on different industries, it is necessary to analyze M&A trends at the micro level. ***In particular, many of the consolidations completed in the last 12 months have occurred in industries where either favorable regulatory changes are being introduced (i.e., financial services and telecommunications) or weak business/economic conditions have increased the need for companies to form strategic alliances to retain their competitiveness (i.e., energy and natural resources).*** Figure 4 reflects the worldwide deals completed by industries since May 1998.

It is also important to analyze the means by which corporations have executed M&A transactions over time. For example, have cash or stock transfers been used most frequently? Have the majority of deals involved combination currencies, such as cash and stock? Or have debt, stock options, and warrants accounted for the acquisition currency of choice in most transactions?

Not surprisingly, the trend has changed since the late 1970s and over the course of the current economic expansion. In 1992, 22% of all mergers were completed using cash, 40% reflected stock transfers, 37% deployed a combination of cash/stock, and 1% used debt and other securities. ***At year-end 1997, cash surpassed stock as the most popular "currency" used to execute business combinations; it accounted for 40% of the total.*** Acquisitions executed as share transfers reflected 32% of all deals, while 27% of the remainder employed a "combination" currency; debt and other securities were used in the remaining 1% of the total transactions completed (see Figure 5). These aggregate data correspond to our analysts' assessments of the most popular business combinations model used since 1991 in various industries, as we will discuss.

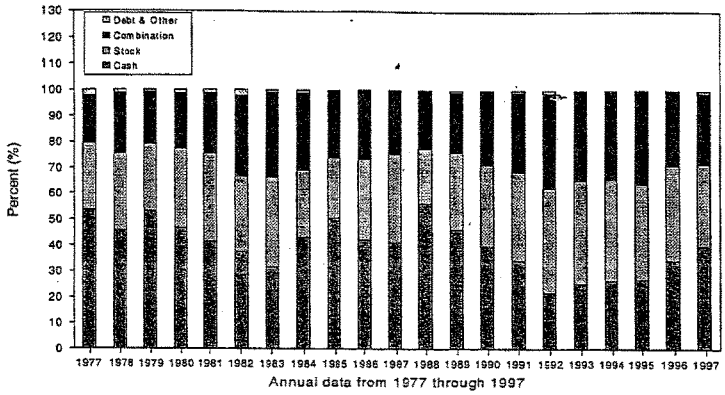
Figure 4: Percentage of Worldwide Transactions Completed by Industry



Actual data shown from 5/1/98 through 4/30/99

Source: Securities Data Company.

Figure 5: Breakdown of "Transaction Currencies" Used in the United States



Source: Merger Stat Review.

(2) Individual Company Valuation and Future M&A Industry Trends: Our Analysts' Perspectives

The potential elimination of both (1) poolings and (2) the immediate writeoff of IPR&D, combined with a shortened amortization period for goodwill, could theoretically impact future M&A activity in some industries as well as the valuation of individual corporations in some cases. In selected industries, equity valuation is driven by metrics other than cash flow, EBITDA, or cash earnings. In others, pooling of interests has been the most popular accounting framework used to account for an acquisition. ***Analysts and investors need to determine whether they should "look through" the goodwill or IPR&D charges if these accounting changes are ultimately adopted. They must also consider whether future M&A activity will be adversely impacted by the elimination of poolings in sectors where this approach has been used most often.***

The Appendix Reflects Our Analysts' Detailed Analyses and Commentary

Our Investment Research Department analysts have provided detailed commentary and analyses of how they plan to evaluate the possible resultant dilutive impact of amortized goodwill and IPR&D on reported earnings in sectors where equity valuation is driven by measures such as P/E multiples, P/E-to-growth models, or reported earnings momentum approaches. They have also evaluated the possible impact of these potential accounting changes on future consolidation trends in the groups they cover.

In addition, our analysts have listed the primary valuation measures used to analyze companies in their industries. They also indicate the degree to which a cash earnings or cash multiple concept (i.e., earnings before goodwill) may be embraced by investors and analysts on adoption of the possible changes in accounting guidelines. And last, they indicate whether the purchase or pooling model has been the most popular framework used since 1991.

In general, our analysts do not believe that the potential changes in accounting for business combinations currently considered by the FASB will have a material adverse effect on future M&A activity in the industries they cover. In most cases, they believe that corporate consolidation decisions are influenced primarily by the (1) strength of the economic fundamentals underlying the transaction in question and (2) strategic factors (i.e., synergies, improving competitiveness, market share gains).

Purchase versus Pooling Statistical Industry Breakdown

Our analysts indicate that the purchase approach is already the most commonly used accounting model in business combinations. Interestingly, of the 60 analysts surveyed, 34 indicated that the purchase model was used most often to account for acquisitions in their industries, which reflect about 35% of the total market capitalization of the S&P 500. Poolings were most popular in 10 sectors, which account for about 25% of total S&P 500 market capitalization and slightly less than 30% of the total dollar value of worldwide transactions completed since the beginning of 1996. A combination of purchase and pooling acquisitions was completed in 16 groups. These industries reflect a smaller portion of the total size of the S&P 500 at about 20%. In industries where a blend of purchase-versus-pooling consolidations was executed, analysts indicated that poolings accounted for most of the larger acquisitions, while purchase transactions applied to many of the relatively smaller deals.

The majority of analysts surveyed believe that a cash earnings or cash multiple model would be accepted in their industries if the FASB business combinations accounting changes are ultimately adopted as detailed. In four of the ten industries where the pooling model has been used most frequently, however, analysts indicated a reluctance to "look through" or ignore the goodwill charge completely. These include computer on-line services, data networking, semiconductors, and precious metals. In their opinion, the goodwill premium or transaction cost has value-added importance and can be used to assess whether an acquirer has overpaid for a target firm. In the remaining six "pooling" industries, four analysts indicated that the investment community would accept a cash earnings metric, while two indicated that use of this valuation measure has been case specific (see Table 2). ***Some analysts anticipate a reduction in the goodwill premium or transaction cost paid in larger acquisitions.***

Table 2: Most Popular "Pooling" Industries

Assessing the Use of Cash Earnings and Future M&A Trends

Industry/Analyst	Acceptance of Cash Multiple	Concern About Potential Accounting Change on Future M&A Activity
Computers – On-Line Services/ Michael Parekh, Rakesh Sood, Jamie Friedman	No	Low
Data Networking/Ajay Diwan	Slowly becoming a trend	Low
Electronics - Semiconductors/ Gunnar Miller	Not currently	Low
Financial Services - Banks/ Lori Appelbaum	Yes(a)	Moderate
Financial Services - Banks/ Sally Pope Davis	Yes: case-specific(b)	Moderate
Financial Services - Brokers/ Richard Strauss	Yes	Moderate
Fin'l. Svces: Specialty, Thrifts/ Bob Hottensen and Michael Hodes	Yes(c)	Low
Healthcare Information Technology/Steve Savas	Yes: specific to the more mature firms	High
Metals - Precious/ Daniel McConvey	Not currently. In future, may see an increased focus on EBG if goodwill charges are material	High
Retail - Supermarkets/ John Heinbockel	Yes	Low

(a) Few banks experience dilution to reported earnings of greater than 5%-10% from goodwill charges. Those that do disclose relevant information that enables analysts and investors to derive cash earnings.
(b) Cash EPS is used if it represents more than a 10% difference from GAAP EPS. The relevance of cash earnings for valuation purposes is not clear in all cases.
(c) In cases where there are material amounts of noncash expenses, analysts and investors have tried to add back goodwill and other accruals to derive a better proxy to assess a firm's future earnings and capital generation prospects.

Source: Goldman Sachs Investment Research Analysts.

3) Impact on Corporate Reporting Policies: Understanding the Technical Details of the Potential Accounting Changes

A thorough analysis of the technical details underlying the potential changes that could be made to the current guidelines governing both (1) business combinations and (2) purchased intangibles, including goodwill and IPR&D, is essential. The following sections provide the necessary background information.

Accounting for Business Combinations: Technical Details

The FASB added the long-term project on business combinations to its agenda in mid-1996 in an effort to review existing accounting guidelines governing M&As. Current rules are stipulated under APB Opinion No. 16, "Business Combinations" and No. 17, "Intangible Assets."

The FASB's primary objective is to formulate an accounting standard that establishes financial accounting and reporting guidelines for business combinations and purchased intangibles. ***It is also (1) considering the possibility of narrowing the differences in accounting results between the pooling and purchase methods, (2) reviewing the need for two separate and distinct methods of accounting for business combinations, and (3) assessing the need for improved harmony between U.S GAAP and international accounting standards.***

The FASB's project has focused on

- the factors that determine a business combination;
- the determination of when the pooling-of-interests or purchase method should be applied;
- income statement recognition and the timing of purchase-method accounting adjustments; and
- accounting for goodwill and other identifiable intangible assets.

The FASB Attempts to "Level the Playing Field"

In undertaking this project, the FASB has addressed several ongoing concerns that have resulted from the disparate treatment reflected under the purchase-versus-pooling accounting models, including the

- ongoing need for interpretation by accounting regulators to determine what mergers qualify for pooling treatment;
- continued move toward harmonization of international accounting standards;
- lack of financial statement comparability between companies that have applied the purchase-versus-pooling models;
- widespread popularity of the pooling framework, despite the rigorous application of 12 criteria and the fact that the ***economic*** reality of a purchase or pooling business combination is identical. For example, (1) operating cash flow, (2) taxes, and (3) earnings before interest, taxes, depreciation, and amortization (EBITDA) are equal (ignoring deferred tax accounting) under both methodologies; and
- different equity market response (in favor of pooling of interests) that is often generated by purchase-versus-pooling treatments.

Improving the Comparability of International Accounting Guidelines

The FASB has coordinated this project with other international standard setters in an attempt to harmonize further international accounting guidelines. Many accounting regulators believe that there is a continued need to enhance cross-border financial reporting practices. The need for improved international standardization has not been the primary catalyst influencing the FASB's ultimate decisions related to this project.

For example, although U.S. GAAP permits both purchase and pooling to account for business combinations, the purchase method is commonly

used in most other countries. Outside the United States, the pooling-of-interests approach is generally applied under exceptional circumstances (i.e., cases in which the acquirer cannot be readily identified). In addition, many countries require companies to amortize goodwill over a much shorter period (i.e., five years) compared with the U.S. practice (i.e., 40 years).

Preliminary Conclusions Reached by the G4+1

In February 1999, members of the G4+1 (i.e., Australia, Canada, New Zealand, the United Kingdom, and the United States) published a position paper that focused on the methods of accounting for business combinations. The G4+1 concluded that a single-model framework is preferable to a dual-model approach. In particular, it identified the purchase model as the most analytically robust methodology to apply to combined enterprises. The "fresh-start" model was considered in rare cases in which an acquirer is not readily identified. The G4+1 is currently seeking public commentary on these preliminary conclusions.

The FASB's Progress to Date

To date, the FASB has examined several alternatives to the current business combinations accounting model. It has analyzed the merits of narrowing the differences between pooling and purchase acquisitions under a dual-method framework or modifying the conditions specified for pooling-of-interests accounting. The FASB has also considered implementing a single-method approach, in which the pooling model would be eliminated and replaced with (1) SAB 48 (i.e., transfer of assets by promoters and shareholders) or recapitalization transactions, or (2) a "discernible elements" model.

The "Discernible Elements" Approach: Questions of Operationality

A "discernible elements" approach would require the acquiring firm to (1) identify and document the discernible elements of goodwill, (2) allocate a portion of goodwill to each element, and (3) determine the useful lives of each of those elements. Goodwill would be amortized over the weighted average of the useful lives of its discernible elements. (The FASB has determined that under a purchase business combination, goodwill would be amortized over its useful life, if that life is determinable.) If an element does not have a determinable life, it would not be amortized. After reviewing the results of a field test, the FASB tentatively concluded in October 1998 that the "discernible elements" model is not operational; too much subjectivity would be involved in applying this approach, compromising the reliability of the information presented.

Since July 1998, the FASB has been focusing its attention on developing a single model to account for business combinations. Such a framework should reduce the differences in accounting outcomes between the purchase and pooling methods, rather than simply modifying the conditions specified for pooling-of-interests accounting.

Current Model under Discussion

In April, the FASB voted unanimously to eliminate pooling of interests as a method of accounting for business combinations. The FASB tentatively decided that the purchase method is preferable to allowing more than one model to be used when businesses combine. The change will be effective for business combinations initiated ***after*** the FASB issues a final standard on this issue, which is expected in late 2000. (The FASB plans to release a formal proposal on business combinations during the third quarter.)

The single-model framework that the FASB is currently considering would entail (1) retention of the purchase model with some modifications; (2) a shortened goodwill amortization period, in which the useful life of goodwill would not exceed 20 years (goodwill is currently amortized over a period not to exceed 40 years); (3) improved disclosures related to goodwill, including a breakout of goodwill amortization as a separate line item in the net income or comprehensive income statements, as well as supplemental footnote disclosures reflecting the allocation of the transaction cost to the underlying assets and liabilities of the target firm; and (4) an impairment review of goodwill required no later than two years after the acquisition date in some cases.

Differentiating Between the Purchase and Pooling-of-Interests Models

APB Opinion 16 specifies that corporations may apply two approaches to account for a business combination: the (1) purchase or (2) pooling-of-interests methodology. This rule stipulates that a business combination that satisfies 12 specific criteria should be accounted for as a pooling; all other combinations should be accounted for as an acquisition of one or more companies under the purchase method.

Pooling of Interests

The 12 conditions that must be met for pooling to apply can be divided into three broad categories: (1) attributes of the combining companies, (2) the method or manner of combining the interests, and (3) the absence of planned transactions that are inconsistent with the combination. ***Unlike purchase accounting, pooling requires the continued use of the historical costs of the combining entities; it does not create goodwill.***

When two entities combine under a pooling, the rights, benefits, and interests of the owners of each entity are deemed to continue. The recorded assets and liabilities of the constituents are carried forward to the combined entity at the recorded or historical amounts. Goodwill (or the premium paid over the current fair market value of a target firm's separately identifiable net assets or book value) is not generated. ***Hence, companies can avoid the "earnings drag" resulting from the need to amortize or write off goodwill against income in future years; earnings are not reduced as a result.***

Purchase Accounting

Under the purchase method, the acquiring company merely records the price of the target firm, rather than pooling the two companies' assets. The acquiring entity must then write off goodwill over a period not to exceed 40 years.

In applying purchase accounting, firms are required to allocate the *purchase* price to the assets and liabilities of the acquired firm; all assets and liabilities are restated to their fair market values. The restated net fair value is compared with the purchase price. If the purchase price exceeds the fair market value, then it is attributed to either (1) goodwill or (2) identifiable intangible assets, when possible. If the restated net fair value exceeds the purchase price, then the writeup of property is reduced until equality is achieved. In addition, the common equity of the acquired firm is eliminated.

Accounting for IPR&D: Technical Details

FASB Decides Tentatively to Eliminate the Immediate Writeoff of IPR&D

In February, the FASB decided tentatively to eliminate the immediate writeoff of IPR&D. The board determined that IPR&D should be capitalized and amortized over its estimated useful life. The FASB has not yet released a formal proposal regarding this potential change, which will affect both IPR&D acquired (1) in a purchase business combination or (2) singly, or as part of a group of assets, in a separate transaction.

The FASB plans to release an ED this summer as either part of its business combinations proposal or as an amendment to FAS 2 and FIN 4, the current standards governing R&D and advertising costs. The ED will then be subject to public commentary for a 90-day period, followed by final FASB review. ***The FASB has not yet decided on an effective date for ultimate implementation of this potential accounting change, which could have a significant impact on some firms operating in the biotechnology, major drug/pharmaceutical, medical devices, and high-tech industries.***

Earnings Management: Recent SEC Action Related to IPR&D and Other Discretionary Accounting Areas

Many analysts and investors have begun to focus increased attention on the quality of reported earnings recorded by many U.S. corporations. Less-favorable global economic conditions and the resultant deceleration in corporate profit growth have contributed to a deterioration in earnings quality since mid-1997. This followed a multiyear period of dramatic improvement in aggregate reported earnings, spurred primarily by lower inflation, ongoing corporate restructuring, and moves by the FASB to encourage conservatism in corporate accounting (see Table 3). (We expect earnings quality to improve again in 1999.)

Table 3: Writeoffs Diminished as a Percentage of Reported EPS Through 1996

	S&P 500 Earnings Per Share			
	Reported	Writeoffs	Writeoffs as % of Reported	
1988	$23.75	$0.75	3.2%	
1989	22.87	2.98	13.0	
1990	21.34	3.41	16.0	
1991	15.91	6.29	39.5	
1992	19.09	5.56	29.1	Peak
1993	21.89	6.61	30.2	
1994	30.60	2.40	7.8	
1995	33.96	4.83	14.2	
1996	38.73	3.81	9.8	
1997	39.72	7.04	17.7	
1998	37.71	8.08	21.4	
1999E	43.00	6.00	14.0	
2000E	48.00	5.00	10.4	

Source: Standard & Poor's; Goldman Sachs & Co.

The heightened focus on earnings quality has increased the need for financial statement users to identify companies that achieve incremental increases in earnings resulting from strength in business fundamentals rather than accounting "gimmickry." The SEC raised the bar in mid-1998 by adding a project on earnings management to its accounting agenda. The SEC is concerned that in select cases, companies may be managing earnings to meet consensus earnings expectations or to smooth long-term profit trends.

In particular, the SEC is reviewing five areas of the accounting framework that are subject to management discretion and, hence, potential abuse: (1) recurrent restructuring charges, (2) reserve accounting, (3) revenue recognition polices, (4) "immaterial" misapplication of accounting principles, and (5) "creative" acquisition accounting and the treatment of IPR&D. The SEC wants to focus attention here, even if most corporations follow conservative approaches. There is concern that even a small number of flagrant abuses could undermine investor confidence in corporate data.

In January, the SEC, as part of its ongoing earnings management project, sent letters to about 150 companies that plan to report significant charges in 1998 related to asset impairments, restructuring activities, or IPR&D. The letters advise corporate managements that the SEC's staff may select their firms' annual reports for review if disclosure amendments are not made; restatements may also be required in some cases. Similar notices were distributed to some bank holding companies with respect to their provisions for loan losses (see our November 1998 accounting report, ***Earnings Management Revisited***, and our February 3rd comment for further details).

What's at Issue with Regard to IPR&D?

Under FAS 2 and FIN 4, all costs related to the R&D process must be expensed as incurred. This is the theory underlying the immediate writeoff of IPR&D; ***however, valuation guidelines related to IPR&D are flexible, and herein lies the problem. The SEC believes that some firms are engaging in a game of "goodwill arbitrage" by valuing in-process R&D at high levels to "fatten" the writeoff.*** Unreasonable valuations of purchased R&D may result because management doesn't always determine the fair value of IPR&D separately from all other acquired assets, such as brand names, customer relationships, and engineering and marketing resources. Purchase price allocations to IPR&D are typically based on appraisals that use an "income approach" to valuation; estimates of future revenues and costs can be misleading.

To minimize these valuation problems, the SEC is currently requiring companies to provide the appraisal method used to value IPR&D projects that are acquired, including material assumptions incorporated into these models. In periods after a significant writeoff, a firm must discuss the status of their efforts to complete the projects and the impact of any delays on expected investment returns, results of operations, and financial conditions.

Rationale Underlying the FASB's Proposed Change to Accounting for IPR&D

In reaching its preliminary decision regarding the potential change in accounting for IPR&D, the

FASB determined that IPR&D acquired in a purchase acquisition should be recognized as an intangible asset and amortized over its useful economic life, as are other identifiable intangible assets acquired in business combinations under Opinion 17. The FASB concluded that FAS 2 and FIN 4 are oriented toward internally generated, as opposed to purchased, intangibles. Because IPR&D is acquired in an arm's length transaction, it must be viewed as a purchased intangible; additional validation regarding its value is also required. Hence, in their current forms, FAS 2 and FIN 4 are misapplied to IPR&D.

Appendix : The Purchase versus Pooling Dilemma: Industry Review

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Advertising/Michael Beebe	P/E-to-growth; ATCF; FCF	Yes	Mix(a)	High	Initial concerns about the potential elimination of pooling of interests relates to the dilutive effect of purchase accounting on reported EPS. The ad agencies have developed a remarkable record of consistent double-digit EPS growth (i.e., 15%), which has resulted in meaningful improvement in relative multiples in the industry. In addition, acquisitions have contributed about 33% of total growth over time. If larger acquisitions result in material earnings dilution, then the current rate of EPS growth may not be sustainable.
Aerospace and Defense/ Howard Rubel	EBIT model	No	Purchase	Moderate	In some cases, purchase accounting enables companies to manage their earnings more effectively than the pooling model. For example, the purchase framework has enabled many firms in this industry to create substantial earnings réserves by (1) writing down inventories and increasing goodwill, (2) adjusting downward future lease expense and increasing goodwill, or (3) adding to the balance sheet pension income that was to be amortized over future periods, reducing goodwill. The first two "gimmicks" have the potential to hide adverse future cash flows. In general, the underlying economic fundamentals of acquisitions drive M&A activity. Hence, we anticipate that the potential elimination of poolings could result in additional earnings management and creative accounting. In addition, we are concerned that share prices may be adjusted downward if the goodwill amortization period is shortened. The majority of acquisitions in this industry have been accounted for by the purchase method because share prices were generally too low on a P/E basis.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Airlines/Glenn Engel	EV-to-EBITDA	No	Mix	Low	Few airline mergers have occurred since 1991; most M&A activity took place in the 1980s. For example, LUV acquired Morris Air in a pooling acquisition in 1993; most of the larger acquisitions have generally involved a combination of cash and stock, while the smaller deals have involved cash exchanges. P/E multiples in the industry are relatively low; as a result, stock is viewed as an expensive currency. The most significant obstacles to mergers in the industry relate to antitrust, more stringent international regulations, and labor concerns. Most acquisitions are completed for strategic reasons and not for near-term P&L benefit. Hence, we do not expect these potential accounting changes to have a material impact on future M&A activity.
Automobiles & Auto-Parts/	Enterprise value-to-EBITDA or cash flow	Yes	Purchase	Low	Since 1991, most of the acquisitions in this industry have been accounted for using the purchase model. Most management teams would prefer the pooling method, but in most cases, firms have not been able to satisfy the 12 criteria governing pooling of interests. One of the most common impediments relates to the disposition of a major portion of the combined entity's asset base. The 1999 Daimler-Chrysler merger, the largest in the industry, was accounted for as a pooling. The majority of acquisitions in this sector have been driven by strategic and financial considerations, not accounting treatment. Hence, we do not anticipate that the potential change in accounting will have a material impact on future M&A activity.
Beverages/Marc Cohen	Relative P/E multiple; Bottlers: EBITDA	Yes	Purchase	Moderate	The change in accounting for business combinations could have negative implications on reported earnings because of the shortened amortization period that the FASB is considering. However, we expect the marketplace to adjust fairly quickly to the higher level of dilution that could ensue. A more intense focus on a cash earnings concept could result.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Biotechnology/May-Kin Ho	P/E; NPV; cash earnings	Yes	Mix(b)	Low	Some biotechnology companies may be sold before implementation of the potential accounting changes because of fears of lower valuation.
Broadcast Media & TV/ Rich Rosenstein	ATCF; FCF	Yes	Purchase	Low	The only change in accounting that would impact this industry significantly would involve the immediate writeoff of goodwill. In general, the amortization of programming costs is treated as a cash expense for purposes of calculating EBITDA and other cash flow measures in the television business. Hence, we do not expect future M&A activity to be reduced materially if the FASB ultimately eliminates poolings. Most analysts and investors focus on cash flow and free cash flow per share figures for valuation purposes. Hence, the business combination framework does not impact valuation decisions. If the FASB allowed companies to write off goodwill immediately (or over a period of less than 10 years), then reported earnings would become, perhaps, the most popular valuation metric. In general, the goodwill asset recorded by broadcasters does not often require any investment to preserve its value; it typically reflects the "scarcity value" of a broadcasting license. Accordingly, we believe that a case could be made to reflect these scarcity values in a way that would not impact the income statement as dramatically as it currently does (i.e., by eliminating or reducing the amortization charge).

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Computers - Enterprise Hardware and Technical Software/Laura Conigliaro	P/E multiple; P/E-to-growth	Not at this time(c)	Purchase	Moderate	Although the pooling framework is preferable, most companies have been unable to satisfy the 12 criteria governing this model. The strategic value of the acquisition and the relative size of the goodwill charge tend to drive M&A-related decisions. There is a perception among analysts and investors that poolings are easier to analyze because this framework provides "apples-to-apples" comparisons. In general, relatively small- and mid-sized transactions are usually accounted for as purchase acquisitions; these deals are often completed to improve a firm's access to a particular technology. If poolings are eliminated, we expect technical software companies to reduce merger activity (i.e., mergers of equals) that would have been completed under the current dual-model framework. We do not anticipate any significant changes in merger activity in the enterprise hardware industry; most transactions are completed as purchase acquisitions, and goodwill is generally amortized over a period not to exceed 5 years. We expect the potential elimination of the immediate in-process R&D writeoff to have a greater impact on future M&A activity than the changes being considered for business combinations.
Computers - On-Line Services/ Michael Parekh, Rakesh Sood, Jamie Friedman	Price-to-sales; DCF	No	Pooling(d)	Low	Analysis is complex given significant levels of volatility in the industry. Many of the "money losing" companies tend to have small floats. Investors and analysts tend to focus on metrics other than reported earnings, including gross margin and trends in sales/marketing expenses. The amortization periods applied by companies appear to be arbitrary in some cases, hindering analytical comparisons.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Computers - PCs/Rick Schutte	Earnings momentum; gross margins	Yes	Purchase	Low	We do not expect the potential changes in accounting for business combinations to have a material impact on future M&A activity because most mergers are driven by the strength of the underlying economic fundamentals of the deal.
Computer Services/Greg Gould	Operating EPS or cash earnings	See comment	Mix(e)	Moderate	It's not clear if companies will notably reduce merger activity if poolings are eliminated. If investors focus on cash earnings, then M&A activity may not slow down. USWeb may be viewed as the industry example in that regard.
Computer Software/ Rick Sherlund	P/E-to-growth (Confidence in sustainability and rate of growth critical to valuation)	See comment	Mix(e)	Moderate	The computer software industry is one of the most acquisitive industries in the United States. Large transactions typically involve the acquisition of established, ongoing businesses, while small transactions are usually product-driven, with no substantial sales force or corporate infrastructure being acquired. Many of the smaller transactions are accounted for as purchase acquisitions; the acquirers prefer cash and have been able to write off significant portions of in-process R&D. We are concerned that if the FASB ultimately eliminates the immediate writeoff of IPR&D, then the future earnings of many of these companies could be depressed; we are not sure how this would affect equity valuation. Investors have not traditionally added back the amortization of intangibles in this sector. In general, if the level of earnings dilution from the amortization of intangibles is material (i.e., profits are negative), then investors have shown a willingness to "look through" these charges. However, if this is not the case, then valuations are impacted proportionately. More recently, we find that some analysts and investors are beginning to focus on a cash earnings (i.e., earnings before goodwill or IPR&D) basis. The Street appears to be moving toward a valuation model that excludes the impact of goodwill and other intangibles. The precedence has been set, and this trend may continue for the remainder of the current cycle; however, not all analysts have consistently embraced this valuation methodology to date.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Computers - Storage & Peripherals/Rick Schutte	Price-to-sales; P/E ratios	Yes	Purchase	Low	This industry is fixed asset-intensive and cyclical. Valuation decisions are driven by earnings momentum. Price-to-sales ratios are used to identify cyclical troughs; P/E multiples tend to signal cyclical peaks. We do not expect potential changes in accounting for business combinations to have a material impact on future M&A activity because most mergers are driven by the strength of the underlying fundamentals of the deal.
Construction - Homebuilding & Materials/Steve Dobi	Relative P/E multiple; EV-to-EBITDA(f)	Industry-specific(g)	Purchase	Low to Moderate	Most companies have been unable to satisfy the 12 criteria governing poolings. In addition, poolings constrain a company's ability to execute share buyback programs. A shortened amortization period would likely have a negative impact on future M&A activity in the building materials industry because of the potential earnings dilution that could ensue. This is of less importance for the homebuilders since (1) land inventory write-ups usually account for the "lion's share" of purchase premiums and (2) goodwill is usually amortized over the useful life of the land (i.e., less than 7 years). We do not expect the number of mergers to decline significantly as a result of the accounting changes currently being considered by the FASB; however, we believe that the overall dollar value of M&A transactions in the building materials industry could be constrained in the future.
Data Networking/Ajay Diwan	P/E-to-growth	See comment	Pooling	Low	Smaller acquisitions of private companies are often completed as purchase transactions. Cisco closes several of these deals per year. We do not anticipate that the potential elimination of poolings will have a material impact on M&A activity in this industry because most transactions are completed to "fill critical holes" in technology or product-line deficiencies. Many companies are concerned about the potential elimination of the immediate writeoff of in-process R&D. Currently, the industry does not use cash earnings to value companies. Goodwill is included in operating earnings from continuing operations. There is a trend toward excluding goodwill from earnings and valuing companies on a "cash" basis; this has been driven by the FASB's preliminary decision to eliminate pooling of interests.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Electrical Equipment/ Martin Sankey	Return on invested capital(h)	No	Purchase	Low	Most deals in this industry have been accounted for as purchases because they have been product-line acquisitions. Most firms in this group tend to have high levels of free cash flow, and they seek investment opportunities to deploy these excess funds - hence, the influx of cash deals. The focus on return on total capital as the primary valuation metric used to analyze acquisitions discourages poolings. While companies in theory would likely not object to a cash earnings concept, we believe that they would oppose such a metric in practice because of the level of detail that the FASB would demand (i.e., allocation of the transaction cost to the underlying assets and liabilities of the target enterprise).
Electric Utilities/Ernie Liu & Debra Bromberg	Relative P/E; total return (incl. forward 12-month dividend yield and 5-year estimated earnings growth rate)	No	Purchase	Low	We do not believe that the elimination of poolings or a reduction in the goodwill amortization period will have a material impact on future M&A activity. Due to major changes within the electric utility industry (i.e., deregulation, implementation of retail competition), we expect more consolidation to occur over the next several years. Purchase acquisitions have dominated poolings because acquisitive firms (1) do not want to increase dividend payouts, (2) may want to continue executing stock repurchase programs, (3) have weak stock price performance, or (4) want to participate in cross-border acquisitions. More recently, a number of natural gas companies have acquired electric utilities (i.e., KeySpan Energy/Long Island Lighting, Enron/Portland General Electric). A shortened goodwill amortization period would not have a material impact on future M&A activity: To date, acquisition premiums have been relatively low, and state utility regulators have generally allowed utilities to retain enough of the merger savings to offset the bulk, or all, of the transaction costs.

Appendix : The Purchase versus Pooling Dilemma: Industry Review -- Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Electronics - Semiconductors/ Gunnar Miller	Price-to-normalized earnings; P/E ratios at different stages of the cycle; price-to-sales; price-to-book value	See comment	Pooling	Low	In general, pooling of interests has been the preferable model to account for business combinations because (1) of concerns about the dilutive impact of goodwill, (2) easier comparisons are sometimes generated when a pooling involves a company with weak financial performance, and (3) pooling is viewed by many corporate managers and analysts as the "cleaner" methodology that produces fewer distortions than the purchase framework (i.e., Teradyne/Megatest, KLA/Tencor). We do not anticipate a material reduction in future M&A activity if the FASB ultimately adopts the potential changes to the current business combinations framework because mergers are basically driven by operating synergies, not accounting rules. To date, analysts do not appear to be willing to embrace an EBG or cash earnings metric for valuation purposes; however, this may change if a significant number of companies are successful in convincing analysts and investors to "look through" goodwill charges.
Engineering and Construction/ Chris Hussey	EV-to-EBITDA	Not at this time	Mix	Low	There has been little M&A activity in this sector in the 1990s. Of the few deals that have been completed, we have not detected a preference for either poolings or purchase acquisitions. We do not expect analysts and investors to accept a cash earnings concept (i.e., earnings before goodwill) if the FASB eliminates the pooling framework because there is no standard definition of cash earnings at this time, and it would be difficult to reconstruct historical comparisons.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Entertainment/Richard Simon & Richard Greenfield	EBITDA	No	Purchase	Low	The vast majority of transactions in the industry have been purchase acquisitions. Therefore, the elimination of pooling of interests is not material. For those EBITDA-valued companies, the goodwill amortization that arises from purchase accounting does not, in any event, affect valuation. EPS-valued companies that engaged in purchase acquisitions were generally not able to shift valuation from EPS to cash earnings unless the amortization period (i.e., Info-Seek-Disney) was very short-lived (i.e., two years). More recently, a multiple of free cash flow (after capital expenditures), which is also not affected by amortization, is viewed as an alternative valuation approach. Additionally, if rational valuations cannot be achieved by reported EBITDA or net earnings, then asset values are derived using different metrics.
Environmental Services/ Alan Pavese	EBITDA and cash flow multiples; P/E ratios	No	Mix	Moderate	There has been significant consolidation in the solid waste industry over the past several years; a little more than half of these transactions have been accounted for as poolings. In general, the primary driver of these deals relates to earnings accretion, which is often not attained under the purchase model. We expect business combinations to decline if the FASB eliminates poolings because it would become more difficult for acquirers to pay the same multiple for a purchase acquisition compared with a pooling of interests given the "drag" on earnings that could result from goodwill amortization.
Financial Services - Asset Managers/Richard Strauss	Cash EPS; EBG; EV-to-EBITDA; P/E-to growth; EBITDA/ share	Yes	Purchase	Low	Growth in this industry is largely driven by consolidation activity. To date, most of the mergers have been relatively simple and small in scope. Therefore, we do not expect the potential changes in accounting to have a material impact on future M&A activity.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Financial Services - Banks/ Lori Appelbaum	Reported EPS; cash earnings(i)	Yes(i)	Pooling(j)	Moderate	Merger activity may modify for a short-term period until there is greater acceptance of the purchase model.
Financial Services - Banks/ Sally Pope Davis	Cash EPS(k); CF earnings-to-equity, incl. goodwill	Yes: case specific(k)	Pooling	Moderate	In general, purchase acquisitions have been used for smaller deals. Poolings are preferred because they are (1) non-dilutive to reported EPS, (2) the resultant ROEs of the combined enterprise tend to increase, and (3) they are tax-free exchanges. We believe that the potential change in accounting could reduce future M&A activity; however, banks would be willing to execute purchase acquisitions if they were assured that analysts and investors would use cash flow as the primary valuation metric. When questioned, most banks indicated that the potential changes in accounting would not affect their consolidation decisions because they focus on cash flow and the strategic nature of the alliance and its underlying economic fundamentals.
Financial Services - Brokers/ Richard Strauss	Relative P/E; E-Brokerage: price-to-after tax earnings before marketing expense and market capitalization-to-revenues	Yes	Pooling	Moderate	The majority of merger transactions have been accounted for as poolings because of the large size of the deals and the substantial amount of goodwill that would have been generated, leading to material earnings dilution. "Mega mergers" may taper off as a result of the potential changes in accounting. We expect further consolidation in the industry over the next several years; a "flurry" of poolings may precede ultimate adoption of the new accounting guidelines, if they are implemented.

Appendix : The Purchase versus Pooling Dilemma: Industry Review -- Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Fin'l. Svces: Specialty, Thrifts/ Bob Hottensen and Michael Hodes	Thrifts: price-to-tangible book value Mortgage finance: reported earnings	Yes(l)	Pooling	Low	The pooling framework has been the most popular model used because it eliminates the dilutive impact on earnings that results from goodwill charges generated by purchase acquisitions. We do not believe that the potential elimination of pooling of interests or a shortening of the goodwill amortization period will have a material impact on future M&A activity; the economic and strategic logic underlying the need for a firm to consolidate is too strong. In cases where there have been material amounts of noncash expenses, investors have, in some cases, attempted to add back these charges to derive a better proxy for analyzing a firm's prospective earnings/capital generating capacity.
Healthcare Information Technology/Steve Savas	P/E-to-growth (for mature companies); price-to-sales (for earlier-stage or Internet-related companies)	Yes: specific to the more mature firms	Pooling(m)	High	If the FASB eliminates poolings, then we expect overall future merger activity in the HCIT industry to decline for many mid-size companies that don't have the necessary cash flow to continue to consolidate in niche areas. The new accounting changes may also create an opportunity for stronger non-healthcare technology companies to make acquisitions in this group. Small purchases and asset purchases would not be affected by the potential changes in accounting rules, and we expect them to continue. We also analyze the quality of firms' financial positions and reported earnings and distinguish between organic versus acquisition growth. We expect the larger-capitalization companies that have sufficient liquidity to continue to consolidate despite the potential accounting changes.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Healthcare - Medical Devices/ Larry Keusch	P/E ratios; P/E-to-growth; multiple of earnings plus non-cash amortization expense	Yes(n)	Purchase	Moderate to High	Despite the fact that most transactions have been accounted for as purchase acquisitions, roughly 41% of the total market value of all transactions have represented poolings. Poolings have been used in acquisitions that involve (1) high-growth companies of substantial size in which the resultant dilution on reported earnings could be material and (2) small companies with minimal cash flow. To date, many purchase acquisitions have represented (1) divestitures of subsidiaries of large diversified healthcare companies, particularly pharmaceuticals, (2) small to medium acquisitions of low-growth businesses with high fixed costs and attractive valuations, and (3) the acquisition by larger-capitalization companies with material cash balances of small-technology enterprises. Most acquisitions have involved robust P/E multiples; more recently, P/E ratios have contracted following the recent rotation in the equity market from high-growth to economy-sensitive stocks. There has been a significant amount of consolidation in this industry in recent years. There may be a "flurry of poolings" in the period leading up to the elimination of pooling of interests, if that potential accounting rule change is ultimately implemented.
Household Products, Personal Care:Cosmetics/ Amy Low Chasen	P/E ratio; EV-to-EBITDA	Yes: case-specific	Mix(e)	Moderate	Most of the large acquisitions have been accounted for as poolings because of the absence of earnings dilution. In this industry, goodwill often represents a significant portion of the overall purchase price. Examples of pooling acquisitions include Gillette/Duracell, Clorox/First Brands, and Kimberly-Clark/Scott. Many "fill-in" transactions have been accounted for as purchase acquisitions due to the lower cost of debt. Examples include Estee Lauder/Avdeda, Procter & Gamble/Tambrands, and Alberto-Culver/St. Ives. The elimination of pooling of interests could reduce the number of large mergers between companies of similar size. We do not anticipate that the potential accounting change will have a material impact on small-brand acquisitions.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Insurance - Life/ Joan Zief	Price-to-book relative to ROE	No	Purchase	Moderate	Most companies have been unable to satisfy the 12 criteria governing poolings. The elimination of pooling of interests could allow for greater ownership by non-U.S. companies of the life insurance industry's assets.
Insurance - P&C/Tom Cholnoky	Price-to-book	No	Purchase	Low	Most companies have been unable to satisfy the 12 criteria governing poolings. There appears to be a modest market penalty for high premiums; the market does not look through goodwill. To date, a cash earnings concept has been ignored. For example, EXEL recently completed a purchase acquisition that generated material amounts of goodwill. The Street continues to value the combined entity on a post-goodwill charge basis (i.e., GAAP operating earnings).
IT Servicing/Meg Saegebarth	P/E-to-long-term growth	No	Mix: see comment	Moderate	The computer services industry is highly fragmented and has been rapidly consolidating in the last few years. This has also been true in the IT services industry. For example, 123 deals were completed in 1996, 171 in 1997, and 223 in 1998. About 30% of all transactions have been accounted for as poolings. In general, companies apply the pooling framework if the acquisition is (1) large or (2) expensive. IT services firms prefer poolings because of material goodwill amortization charges that would result from purchase acquisitions. The majority of transactions have been accounted for as purchase acquisitions. Most are relatively small, ranging from $2 million to $30 million in revenues. Investors typically do not "look through" goodwill to compute earnings; some firms use "earnouts" to spread out the cash payments and associated amortization as acquirers reach specific hurdle rates. If the FASB eliminates poolings, it could slow the pace of merger activity; however, the fragmentation in the industry and the need for firms to expand geographically could override this concern. In particular, it may slow

Appendix : The Purchase versus Pooling Dilemma: Industry Review -- Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
IT Servicing/Meg Saegebarth - Cont'd					the pace of the larger transactions. We do not think that investors will "look through" the goodwill charge unless the amortization period is shortened to 5 years. The shares of active acquirers tend to trade at a discount to the long-term growth rate because of the (1) integration and (2) overpayment risk. Typically, pooling acquisitions trade at a deeper relative discount (i.e., 10%-15%).
IT Staffing/Meg Saegebarth	P/E-to-long-term growth	No	Purchase	Moderate	The majority of transactions have been accounted for as purchase transactions; 20% of acquisitions have been recorded as poolings. Companies tend to apply the pooling model in (1) large acquisitions (i.e., acquiring a company with $75 million or more in revenues) and (2) more expense acquisitions, such as those that involve IT solutions firms. A 30- 40-year goodwill amortization period is usually applied in purchase acquisitions. Investors typically do not "look through" goodwill to compute earnings. Acquiring firms are less inclined to overpay for a target company when purchase accounting is employed. The potential elimination of pooling of interests could slow down the pace of future M&A activity; however, the fragmented nature of the industry and the need for companies to expand geographically could override these concerns. Larger transactions may be reduced as well. In our opinion, the goodwill amortization period would have to be reduced to 5 years for investors and analysts to accept a cash earnings metric (i.e., EBG).
Machinery/Karen Ubelhart	EBITDA or operating EPS before goodwill	Yes	Purchase	Low	Most companies have been unable to satisfy the 12 criteria governing poolings. In some cases, companies purchased the assets of another firm and cash was preferred.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Media & Cable TV/Barry Kaplan & Louis Kerner	EBITDA; FCF	Yes	Purchase	Low	Examples of purchase acquisitions in the cable/satellite industry include Comcast/MediaOne, Adelphia/Century, Adelphia/Frontier, and @Home/Excite.
Metals - Nonferrous/ Amy Ginsburg Gassman	EV-to-EBITDA multiple; normalized price-to-cash flow	No	Purchase	Low	We do not believe that a single-model approach to accounting for business combinations would have a material impact on future M&A activity given the fact that underlying economic fundamentals drive acquisitions; transactions are based on the strategic benefits that can ultimately accrue to a firm.
Metals - Precious/ Daniel McConvey	DCF	Not currently. In the future, we may see an increased focus on EBG if goodwill charges are material.	Pooling	High	In general, gold mining companies trade at high multiples to NPV, earnings, and cash flow. In many cases, accounting for major large acquisitions under the purchase model could eliminate reported earnings. If the FASB ultimately eliminates poolings, then we expect much of the large merger activity to cease until a period of economic distress takes place, driving down valuations to book value. We believe that the valuation of individual companies would also decline; for example, Australia does not allow poolings, and valuations tend to be lower on a relative basis in that country as a result. Companies would also be less willing to engage in a transaction if the potential dilution on reported earnings from goodwill were material. In our opinion, a shortened goodwill amortization period would not have a material impact on future M&A activity. In analyzing acquisition opportunities, many gold mining companies seek targets that will be accretive to earnings, cash flow, and most important, internal rates of return (IRR). Long-term strategic considerations that are not easily quantified may also be examined.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Natural Gas/David Fleischer	P/E ratios; relative P/Es	Yes	Mix(e)	Low	We do not believe that there would be a significant reduction in merger activity if the FASB eliminates pooling of interests. Strategic acquisitions will continue to be completed and are not driven by accounting methodology. The potential exists for gas companies to be acquired in gas and electricity convergence deals; however, the slower growth rates of electric utilities make their stock "currency" less appealing to natural gas shareholders. Size and scope of capability create opportunities in the energy services industry, and we expect to see a pickup in merger activity in the future.
Oils: Canadian - E&P/ Greg Pardy	Cash flow multiples; debt-adjusted multiples	Do not anticipate a shift from the current valuation metrics	Purchase	Low	We do not expect the potential changes in accounting to affect future M&A activity. The purchase model has historically been the most common framework applied to business combinations. Valuations of combined entities are influenced by the nature of the assets acquired, the synergies that may accrue, and the strength of the strategic alliance. Many acquisitions in this industry have not improved valuations because the underlying economics of the deals were weak. In general, companies write up the value of their assets to fair value. Goodwill charges have been relatively small; you do see increases in depletion rates and other non-cash charges over time.
Oils - International/ Todd Bergman	Cash flow; reported earnings; EBG	Yes	Mix	Low to Moderate	To date, companies have recorded acquisitions using both the pooling and purchase accounting models. These include the BP/Amoco (pooling) and Exxon/Mobil deals (pooling), which were completed earlier this year. Two acquisitions in the pipeline, namely the BP Amoco/Arco and Repsol/YPF deals, will be accounted for under the purchase framework. The target companies in this industry have sold at a large premium to book value. There are currently few merger opportunities left in the international oils (U.S.-based) given the major acquisitions that have been completed or are in the process of being completed, to date. We do not expect the potential elimination of pooling of interests to impact future M&A activity among the refiners or European oil companies.

Appendix : The Purchase versus Pooling Dilemma: Industry Review -- Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Packaged Foods/Nomi Ghez	EBITDA or cash earnings	Yes	Purchase	Low	Cash earnings is used as the primary valuation metric for firms that record material goodwill charges.
Packaging: Containers/ Perk Thornton	EBITDA or EBIT multiples; price-to-sales	Yes	Purchase	Low	Sealed Air acquired the packing business of W.R. Grace in 1998 (i.e., Cryovac) and accounted for this transaction using the purchase model. A significant amount of goodwill was generated; investors and analysts have started to focus on cash earnings as the primary valuation metric in this case. This is the sole example of applica- of a cash earnings concept in the United States to date.
Paper and Forest Products/ Mark Weintraub	Asset value; EV-to-EBITDA	Yes: case-specific(i)	Purchase	Moderate	M&A activity could be modestly impacted if the FASB eliminates pooling because assessments of potential earnings accretion often influence management's willingness to complete an acquisition. Hence, a shortened amortization period (i.e., 10 to 20 years) could have a modest negative impact on future M&A activity as well. However, to date, companies that have recorded purchase acquisitions have not generated material goodwill charges.
Paper and Forest Products - Canada/Andrew Root	Cash flow; EV-to-EBITDA; EV-to-sales; price-to-normalized earnings	Yes	Purchase	Low	Currently, companies in the industry do not trade at a significant premium or discount to book value. Therefore, earnings dilution from goodwill is not usually material. The favorable economics underlying mergers are extremely compelling; a change in accounting treatment would not be a major impediment to the vast majority of acquisitions; however, when commodity prices or valuations are at or near a peak, M&A activity usually declines because most acquisitions are completed if they are "immediately accretive" to earnings.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Print and Image Management/ Lisa Fontenelli	Relative P/E multiples	Yes	Purchase	Low	Most recent acquisitions have involved the private market consolidation of smaller printers; this accounts for the popularity of the purchase method. Reduction of the goodwill amortization period may reduce private market multiples and could double the time over which accretion to earnings is reflected in the post-acquisition period.
Publishing/Michael Beebe	P/E ratios; multiples of EBITDA	Yes	Purchase	Low	A high degree of acceptance of a cash earnings concept as a standard of performance and value is anticipated.
Railroads/Craig Kloner	Long-term FCF (excl. Cap. Ex.); P/E-to-growth	No	Purchase	Low	Few railroads are left in this industry. Little consolidation activity is expected going forward.
Restaurants & Lodging/ Steve Kent	EV-to-EBITDA	Yes	Mix(e)	Low	
REITs/David Kostin & James Kammert	Existing & prospective cash flow; cash-yield-on cost (CYC) on invested capital	No: REITs don't generate goodwill	Purchase	Low	In analyzing REITs, the disparity in value between the consideration and the book values of the assets and liabilities is almost exclusively allocated to the real estate assets. Most, if not all, of the deals are viewed technically as reorganizations; the shares of the acquired company (a) are exchanged for the stock of the acquirer and/or (b) the target stock may get purchased in part for cash and/or stock. In general, real estate is written up to fair market value (FMV) because periodic depreciation expense rises as a result; this leads to lower taxable income, which reduces the actual amount of dividends the REIT must pay out (i.e., 95% of taxable earnings rule). More cash can then be retained in the business. As a result of writing the real estate up to FMV (i.e., the value of the consideration give in the transaction), goodwill is not generated; the real estate bears the entire writeup.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Retail - Department Stores/ George Strachan	EBITDA	Not available	Mix	Low	In general, M&A activity has been driven by the underlying strength of the transactions' underlying fundamentals and secular trends in the group. Therefore, we do not anticipate a material reduction in future M&A transactions as a result of the potential accounting changes.
Retail: Footwear/ Margaret Mager	EBG(o); cash flow	Yes	Purchase	Low	Although goodwill is a non-cash charge, it represents an investment incurred to pursue a business opportunity and should therefore not be overlooked when valuing a company or judging the effectiveness of an acquisition.
Retail - Hard Goods/Barbara Miller & Matt Fassler	Relative P/E; economic leading indicators	No	Purchase	Low	We do not expect the potential elimination of poolings to have a material impact on the majority of hard good retailers, with the exception of the automotive retailers. To date, the majority of transactions have been accounted for as purchase acquisitions; Autonation is the "exception to the rule." In general, goodwill charges have been immaterial.
Retail: Office Products & Specialty Retailers/ Matt Fassler	P/E ratios; EV-to-EBITDA; cash earnings	Yes, incl. multiples based on EBITDA	Mix(e)	Low	Some companies do not provide fully-transparent disclosures related to either tax-deductible or non-tax deductible goodwill charges.
Retail - Specialty & Specialty Apparel/Richard Baum	P/E-to-growth; relative P/E ratios; EBITDA multiples; EV-to-sales	One example(p)	Purchase	Low	There has only been one significant merger in this industry since 1990 (i.e., TJX's purchase of Marshalls from Melville for about $500 million). It was treated as a purchase. Given the lack of overall consolidation in this industry, we are not concerned about the impact that the potential elimination of pooling of interests could have on future M&A activity.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Retail - Supermarkets/ John Heinbockel	Reported EPS	Yes	Pooling	Low	The supermarket sector relies on consolidation for growth; there are few organic growth opportunities available. To date, the two largest deals in the industry have been accounted for as poolings (i.e., ABS/American Stores; Kroger/Fred Meyer). Substantial amounts of goodwill could result from the elimination of poolings; the resultant dilution on reported EPS would not be viewed favorably by analysts or investors. We do not believe that the potential change in accounting will have a material effect on this industry. The primary factors that drive acquisitions will continue to include managements' assessment of the strength of the strategic alliance, and its underlying economic fundamentals, the company's long-term business plan, and its future competitiveness.
Specialty Chemicals/ Kim Ritrievi	Relative P/E; EV-to-EBITDA	Yes	Purchase	Low	Most of the companies in this industry are substantial excess cash flow generators that have the ability to deleverage following an acquisition. The stocks have not traded at premium P/E multiples; equity as a currency has not been inexpensive as a result. The majority of transactions involve the sale of small- to medium-sized businesses rather than the outright sale of an entire company. As a result, purchase accounting is used for these smaller deals. We do not expect the potential changes in accounting to have a material impact on future M&A activity because most of the small and large deals to date have been purchase acquisitions. In addition, many companies focus on EVA as an internal management tool. This supplemental valuation metric indicates that many firms tend to use debt rather than equity to finance acquisitions currently. A shortened amortization period may force companies to be more selective in completing only those deals that have a higher probability of resulting in a lower cost structure or useful synergies.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

Industry/Analyst	Primary Valuation Metric(s)	Acceptance of Cash Multiple	Most Popular Accounting Framework Since 1991	Concern About Potential Accounting Change on Future M&A Activity	Additional Comments
Steel: Processors/Producers/ Larry Benn	Cash flow and EBITDA multiples	Yes	Purchase	Low	The majority of transactions have been accounted for as purchase acquisitions because they usually involve mergers of unequal partners. The most acquisitive companies tend to be service center/processors. The trend has been for larger firms (i.e., Reliance, sales of $1.5 billion) to acquire significantly smaller companies that have difficulty competing as independent entities.
Telecom: Equipment & Svces/ Mary Henry	Operating earnings; EBG; cash earnings	Yes	Mix(q)	Low	Business strategy is much more important than accounting methodology in this industry. Almost every merger is fueled by the need to fill product lines, add technology expertise, or enhance distribution channels. If poolings are eliminated, the mid-size deal range may be affected. Smaller acquisitions tend to be breakeven or marginally dilutive. The "mega merger" deals are usually driven by a compelling strategic technology story; investors tend to ignore the dilutive impact of the goodwill charge. Increasingly, technology companies do not allow accounting to dictate their business strategies, and investors are rewarding them accordingly. For example, Ciena eliminated 33% of its equity and all of its earnings this year to acquire two pre-revenue companies with strong product designs that complement its technology. Ciena's stock price was not penalized.
Tobacco/Marc Cohen	Relative P/E multiple	Yes	Purchase	Moderate	The change in accounting for business combinations could have negative implications on reported earnings because of the shortened amortization period that the FASB is considering; however, we expect the marketplace to adjust fairly quickly to the higher level of dilution that could ensue. A more intense focus on a cash earnings concept could result.
Transportation - Air Freight/ Jordan Alliger	EBIT or EBITDA multiple (after synergies are factored in)	Yes	Mix(e)	Low	Most of the transactions in the air freight industry have been accounted for as purchase acquisitions, in particular the smaller deals. The larger, strategic acquisitions tend to be poolings, although few of these deals have been completed. The potential elimination of pooling of interests could have a moderate impact on some of the larger, strategic acquisitions, which are infrequent.

Appendix : The Purchase versus Pooling Dilemma: Industry Review – Cont'd

Anticipated Impact of the Potential Accounting Standard Changes on Future M&A Activity and Cash Valuation

(a) Small acquisitions are accounted for under the purchase framework because they can be completed at 6-8 times EBITDA and are therefore not very dilutive. Larger transactions are accounted for as pooling of interests because they tend to be priced at higher relative multiples and usually offer less upside potential.
(b) Poolings have been used for acquisitions of smaller-capitalization companies to minimize the earnings "drag" that results from goodwill amortization. Larger-capitalization biotechnology companies tend to apply the purchase accounting model, although there are fewer examples of these acquisitions.
(c) There does not appear to be broad-based acceptance of a cash earnings or cash multiple concept at this time. Some of the lower-profile, smaller-capitalization companies in these industries have been focusing on such metrics; however, until and unless cash earnings are used to analyze transactions completed by the higher-profile, higher-quality, and larger-capitalization firms, we do not expect analysts and investors to "look through" the transaction costs generated by purchase acquisitions.
(d) Examples include the AOL/Netscape, Yahoo/GeoCities acquisitions. Some of the smaller mergers have been accounted for as poolings (i.e, MindSpring/SpryNet).
(e) Poolings have been used for larger acquisitions. In general, the smaller acquisitions have been accounted for under the purchase model.
(f) An EV-to-EBITDA multiple applies to the building materials industry only.
(g) A cash earnings concept may be used to value companies in the materials industry; this approach is less likely to be used for valuation purposes in the home-building industry.
(h) Primary valuation metric used to analyze acquisitions.
(i) Few banks experience dilution to reported earnings of greater than 5%-10% from goodwill charges. Those that do disclose relevant information that enables analysts and investors to derive cash earnings.
(j) Exceptions include Wells Fargo's acquisition of First Interstate and Nationbank's acquisition of Barnett.
(k) Cash EPS is used if it represents more than a 10% difference from GAAP EPS. The relevance of cash earnings for valuation purposes is not clear in all cases.
(l) In cases where there are material amounts of noncash expenses, analysts and investors have tried to add back goodwill and other accruals to derive a better proxy to assess a firm's future earnings and capital generation prospects.
(m) The overwhelming majority of acquisitions have been accounted for as poolings, which leverage the high P/Es of better growth companies in the sector. The only exceptions have been small acquisitions of private companies and asset purchases of a portion of a company.
(n) Acceptance of a cash earnings or cash multiple concept is possible if the FASB requires improved disclosures of transactions costs/goodwill charges.
(o) Earnings before goodwill.
(p) Ann Taylor completed an LBO in the early 1990s followed by its IPO. In late 1996, it purchased the Asian factories that produce its apparel. As a result of this transaction, a cash earnings concept is applied by some analysts to value this company.
(q) Pooling has been used for larger acquisitions. In general, the smaller acquisitions have been accounted for under the purchase model. Nortel's acquisition of Bay Networks reflects an exception to this rule; this transaction was accounted for as a purchase acquisition despite its size (i.e., over $6 billion) because pooling was not available to this Canadian company. Nortel has asked the Street to regard the acquisition of Bay Networks as a "virtual pooling" and exclude the impact of goodwill from reported EPS. Most sell-side analysts have concurred with this approach.

Note: ATCF = after-tax cash flow; FCF = free cash flow; DCF = discounted cash flow; ROE = return on equity; EBG = earnings before goodwill; EV = enterprise value; NPV = net present value.

Source: Goldman Sachs Investment Research Analysts.

Mr. DINGELL. I also note that most foreign countries prohibit pooling or allow it only as an exception.

For example, the United Kingdom and the International Accounting Standards Committee permit pooling only when both companies are the same size or the acquiring entity cannot be identified. Canada is considering a proposed standard much like FASB.

As the managing director of corporate finance at Moody's noted in his comment letter to FASB, "Moody's supports the objectives of accounting standards setters to improve the harmonization of accounting standards globally, and welcomes FASB's proposal to eliminate the pooling of interests method. We believe that a single method can improve analytic efficiency, especially in cases where a single transaction or essentially identical transactions would produce dramatically different accounting results, and thus enhance the ability of cross-border capital participants to compare, easily and accurately, alternative investments."

As I said at the beginning, I have not made up my mind on the FASB proposal. It raises a lot of questions, including those relative to the treatment of goodwill and the valuation of intangible assets. The FASB is in the process of sifting through better than 400 comment letters, along with the testimony it received in its public hearings, and is redeliberating all the issues.

I urge the Board to proceed cautiously and carefully in weighing the costs and benefits to try to achieve the greatest possible good. I would also urge my friends in the high-tech industry to work with FASB to develop a compromise or an approach that eliminates current biases and distortions and meets the legitimate concerns of all parties. On that note, I look forward to today's testimony on this important and complex matter.

Mr. Chairman, I again commend you and thank you for calling this hearing.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from California Mr. Cox.

Mr. COX. Thank you, Mr. Chairman. Thank you for holding this hearing today. It is obvious from the comments of the members of our panel thus far that it is very important for us to examine FASB's current proposal to eliminate pooling.

As a member of this subcommittee and a former securities lawyer, I am anxious to hear from our witnesses on their perceptions of the consequences, both intended and unintended, of FASB's decision to eliminate the pooling method for mergers.

I would not expect that Congress would want to legislate specific financial accounting rules for reporting companies, although that is clearly Congress's prerogative. I do believe it is important that several important concerns that have been raised about the current exposure draft have a complete airing in Congress. I also believe it is important that FASB's process be both deliberative and transparent.

The purpose of the 1933 and 1934 acts is full and fair disclosure in order to build and maintain confidence of the public in our capital markets. Congress in the 1933 and 1934 acts made it plain that the standards of financial reporting and financial statements issued under these acts are defined pursuant to congressional au-

thority. I prefer to see this authority exercised through delegation to the SEC and to the FASB.

When, as in this case, the consequences of a change in the rules go far beyond a determination of the quality of publicly disclosed financial information and would, in addition, have a potentially significant impact on the entire economy, Congress cannot abdicate its responsibility. So we are doing today the minimum, I think, that is required of us. We are beginning a hearing process.

Many questions remain as to why FASB is eliminating pooling at this time and in this way. Our current reliance—our current national reliance on pooling and purchase as the two means of accounting for goodwill intangibles is as reliable as a two-legged stool. What FASB appears to be proposing here, rather than an examination of how better to account for intangibles, is to cut out one of the two legs of the stool, giving us a one-legged stool.

I would hope that in this hearing process we can go beyond the exposure draft and examine some of the questions that our experience over the last 20 years has raised for us, because over that last 20 years market-to-book value ratios have increased threefold because of intangible assets.

As it has been pointed out by many of our colleagues here this morning, ideas and intangible assets are an enormous part of today's economy not because these things are illusory, but because they are very real and more important than some of the things that go into making book value a hallowed and very reliable method of accounting for many, many years.

I think Congress needs to keep our focus. Ideas and intangibles are driving this economy, and we are responsible, much more than FASB, to ensure that we do not derail the economy in the United States.

A recent U.S. Department of Commerce study found that the Internet economy is alone responsible for 35 percent of the real economic growth in the United States in the last 5 years. So I am interested in our witness's views as to how FASB's proposal to eliminate pooling will impact capital flows in this sector of our economy.

Last, Mr. Chairman, I would observe that the pooling method has been around for decades. It makes it puzzling, therefore, to me to understand why FASB is changing the rules at this particular time.

Not very long ago, in 1994 when already I had been in Congress for 6 years, the AICPA, the American Institute of Certified Public Accountants, through its Special Committee on Financial Reporting, addressed this very topic. This Special Committee on Financial Reporting of the AICPA included among its members the current FASB Chairman Mr. Jenkins.

Here is what their report said, the report from Mr. Jenkins and his colleagues just a few years ago: "While it is true that some users prefer the purchase method and some prefer the pooling method, most also agree that the existence of the two methods is not a significant impediment to users' analysis of financial statements. A project to do away with either method would be very controversial, require a significant amount of FASB time and resources, and in the end, is not likely to improve significantly the usefulness of financial statements."

So I would like to know why Mr. Jenkins has changed his view and what has happened in just these last few years to turn that statement on its head.

FASB does not make its decisions in a vacuum. The accounting rules it adopts can and in this case surely will have a significant impact on our economy.

Mr. Chairman, I thank the committee for holding this hearing on this important issue, and I look forward to hearing from our witnesses.

Mr. OXLEY. The gentleman from Illinois Mr. Rush.

Mr. RUSH. Thank you, Mr. Chairman.

Mr. Chairman, I look forward to today's hearing on U.S. accounting rules for business combinations.

This discussion is certainly a timely one. Today we have seen an unprecedented increase in market activity, which has in turn fueled the booming economy that we currently enjoy. Within the midst of such growth, there has also been a market increase in mergers and acquisitions.

This brings us to the problem at hand. The pooling of interests versus the purchase accounting method is intriguing for several key reasons. Before we have the pooling method, which reflects the uniqueness of the high growth economies in that today the merging of two high-tech companies does not necessarily involve the acquisition of depreciating machinery or office furniture.

Instead, in today's high-tech market, ideas themselves have value, and over time that value increases. However, this accommodation for this new asset apparently comes with a price. That price is transparency. While I am certainly in favor of measures which sustain and encourage market growth, I remain mindful that the United States has been at the forefront in encouraging transparencies of markets worldwide. I am of the belief that we should be consistent in our support of that policy on the domestic front.

Aside from this public policy concern, I am at present most concerned that when the economic climate in this country is not so robust, fiscally weak companies which undergo mergers will use the pooling method to, if you will, sucker in unwary investors.

There is little doubt in my mind that we need uniformity in the merger and acquisition information made available to the weekend warrior who signs onto E*TRADE or any other of the assortment of easily accessible trading venues. But it is important that in protecting the average investor, the very factor which has encouraged such high market participation is not damaged.

I am confident that with a sober discussion and analysis by FASB and others, there can be some reasonable compromise which will result in clear and uniform means by which investors can make crucial decisions. At the very least, there should be some examination of whether requiring the purchase method across the board will, as many argue, deliver a severe blow to our surging economy.

The challenge is up to the financial pundits to strike this important balance. I certainly hope that we and they will meet this important challenge.

Mr. Chairman, I yield back the balance of my time.

Mr. OXLEY. The gentleman from New York Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman, for holding the hearing. I want to thank you for assembling a great list of witnesses, including our colleagues and Mr. Jenkins, the FASB Chairman Mr. Jenkins.

I want to make mention of a couple of things. First of all, the gentleman from Michigan made reference to a factual setting which, ironically or coincidentally, is the same involving AOL and NetScape, the merger affecting the—the $900 billion merger, only $500 million of which was accounted by tangible assets.

That merger would likely never have occurred if they were forced to use purchase accounting because of the write-down of $9.5 billion over 20 years under purchase accounting. The economy would have been deprived of the synergy of that merger, like many others, Travelers and Citi and several others who may well have foregone the option of merging if they were forced to use purchase accounting.

There are some who argue that we need to have a single accounting method, we need to have harmony with our international neighbors. First of all, even among our international neighbors, and including the U.K., there are situations where pooling is allowed.

Second of all, why should we harmonize if we are not harmonizing based on the right principles? Why should they not harmonize with us if we have the superior model? If our economy is making all of the right moves, and the synergies that are being created by our combinations through IT and biotechnology are leading the world, why shouldn't they be following us?

There are people who say, why is it that we shouldn't use purchase accounting, because you can identify the value of the transaction better through purchase accounting? Hogwash. The market determines the value of mergers and acquisitions. In the end, the market knows far more than any accounting method and any law that we can create. We need to have some trust in them.

There are some people who say that the purchase method is a superior method for giving investors more information. Some would argue that the information is less relevant, that increasingly the market is looking for cash-flow valuations and not economic value analysis, neither of which rely on accounting methods.

There are people who say investors cannot tell how much is invested in a particular transaction, and they cannot track any subsequent performance. Again, the value in the end is determined by the market. Under any methodology, investors often find it very difficult to track subsequent performance based on individual combinations.

Some people say we should have one accounting method because companies who are merging should have only one accounting method. Why should they? Businesses even within the same sectors are often using maybe different accounting methods for different purposes, including inventory and depreciation and other costs.

In a May 2 letter from the Financial Accounting Foundation, which funds FASB and helps support its members, they opined something that I am concerned about. I will quote briefly, if I can: "at the present time, a few constituents are unfortunately encouraging Members of Congress to intervene in the independent private

sector standards-setting process. While full public debate of the technical merits of a proposed standard is encouraged and appropriate, we do not believe that the standard-setting process should be subject to governmental intervention when appropriate and extensive due process procedures have been followed by the FASB."

I would say, first of all, that I hope this does not have a chilling effect in terms of people who want to express their first amendment right to speak to Members of Congress, especially when economic impact is taken into account; it seems to me, to this Member, more some of us at the podium than those in FASB, with all due respect, first of all.

Second of all, I am concerned that the FAF and FASB say on one hand that their standard-setting process should be free from intervention by Congress, while on the other hand FASB is citing SEC staffing burdens as one of the reasons for eliminating pooling. Does that mean that it is wrong for us to inquire into FASB's process, but it is okay for the SEC to actually drive the process?

Third, I am interested in hearing from FASB how they proceeded in considering the elimination of pooling. I want to compliment them and commend them on the notice and comment process, but I would much prefer if they look at purchase accounting first, figure out how it can be improved to account for all the intangible assets that companies possess, especially in the IT and biotech sectors. I am interested in hearing why purchase accounting cannot be retooled for the new economy, and then we can consider the use of pooling.

I am hoping that FASB Chairman Ed Jenkins can touch on some of these when he testifies.

Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman's time has expired.

The Chair is now pleased to recognize the gentlewoman from California, who is technically not a member of this subcommittee, although we hope perhaps that will change soon. We are glad to have her with us. The Chair recognizes Ms. Eshoo.

Ms. ESHOO. Thank you very much, Mr. Chairman, first of all for extending your courtesy to me to join with your subcommittee today for this very important hearing, and I salute you for bringing this hearing into reality, because it is a discussion of an issue that we all believe, given the excellent opening statements of members of the subcommittee—it really is a hearing about our national economy, what has made it so, what has contributed to it, and the examination of the proposal that the FASB Board has brought about.

When I first came to the Congress in 1993, I introduced legislation relative to an FASB proposal. It was legislation that respected the independence of the Board, but it also was legislation regarding the potential decision of the FASB Board to prohibit a method of accounting for the value of stock options.

I believe that the conclusion that the FASB came to at the end of the 1994 was fortuitous because it was good for our national economy. It spoke to a method of offering stock options that I think has moved on to be very important for workers and for companies in our country.

Back then I might say that you could count on one hand the number of Members that even knew what an FASB was. Today

there are more and more Members that know and really look closely to what the FASB Board recommends. This hearing today again involves a potential decision of that Board, and I think that it is a proposal that needs to be examined very, very carefully.

There have been some very important developments that have taken place since I first came here and was introduced. There was a different Chairman of FASB at that time and some different issues.

Dennis Powell is going to be speaking today representing Cisco Systems. Since FASB made its stock option decision and its proposed standard on then business combinations, Cisco Systems has become one of the most admired, if not the most admired, businesses in America. I say this not just as an advertisement for Cisco. I think every member wants to examine very carefully what has given rise to what Cisco represents.

We also have Gene Hoffman who is going to be testifying today, president of EMusic, an Internet digital music company. When I was making the case back in 1993 and 1994 about stock options, I don't think Gene Hoffman's business even existed.

So these are not flukes of our national stage or national economy. As I respect the independence of FASB, I also believe that the Congress has a responsibility to weigh in about issues that affect or that we think could have a detrimental effect on our national economy.

Mr. Lazio has spoken to and quoted the Financial Accounting Foundation's letter that is here before each member of the subcommittee. I, too, would like to underscore that. I think it is very important for people to weigh in with their opinions, but I have to tell you that I feel a certain rub, because I don't think they are just a few constituents. Even if they were, if there were just a few constituents, I was elected to give voice to my constituents.

Members of the House of Representatives are very unique in that we enjoy, under the Constitution, direct representation. The Presidency does not enjoy that because the Vice President can move into the Oval Office based on the prerogatives of the Constitution. The members of the United States Supreme Court are appointed. If someone dies over in the U.S. Senate, or they decide to step down, there can be appointment. We and we alone under the Constitution of the United States of America enjoy direct representation, so if I die or step down or I am removed from office, there will be a special election held so that there will be a direct voice of the people of the 14th Congressional District of California.

So while I welcome the comments of the Financial Accounting Foundation, I have to say that in paragraph 5, I think they have a little overstepped their interpretation or their view of Members of the Congress.

Mr. Chairman, I really welcome this hearing today. Thank you for inviting me to join with the subcommittee for this hearing, not being a member of the subcommittee. I do hope to be a member in the next Congress. I was before the jurisdictions of the subcommittee were split in a previous Congress.

I hope that the Financial Accounting Board representatives will attempt at least to make the case as to why we would blend with a European standard when we are the envy of the entire world rel-

ative to our economy, how the proposed standard really serves our national economy well, who has been hurt by the pooling accounting standard that you are making the recommendation about, and see how those voices that have weighed in and questions—if, in fact, FASB sees today a better and a newer way of approaching this.

Some of my colleagues have suggested a compromise. I hope that you will cover that in your testimony. Thank you to everyone that is here today that is going to enlighten us.

Again, Mr. Chairman, thank you for your leadership. I could not mean that more.

[The prepared statement of Hon. Anna G. Eshoo follows:]

PREPARED STATEMENT OF HON. ANNA G. ESHOO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you, Mr. Chairman, for extending to me the courtesy of joining your subcommittee today for this hearing. I commend you for your leadership in holding this important hearing on this issue which is so critical to our economy.

Mr. Chairman, when I first came to Congress in 1993 I raised questions about the actions of the Financial Accounting Standards Board (often referred to by its acronym, FASB). I may have been the first Member of Congress to offer legislation addressing FASB and their proposal to prohibit a method of accounting for the value of stock options.

Back then, one could count on one hand how many Members of Congress knew what a FASB was, and still fewer knew that FASB was a *private* organization that exercised a strong influence on our economy through its standard-setting decisions. I spent just as much time explaining who FASB was to our Colleagues as I did explaining how its decision could have a tremendously negative impact on the New Economy and the technology industries that drive it.

Today this hearing is about an issue—again involving a potential decision by FASB. This time it doesn't involve prohibiting an accounting method for the valuation of stock options, but rather FASB's intention to prohibit an accounting method for business combinations and intangible assets.

I find myself again warning of the implications this decision could have and the potential negative impact on the New Economy and the industries that are still driving it. As Yogi Berra said, "It's *deja vous* all over again."

However, there have been some important developments between 1993 and today, and they are seated before this subcommittee this morning.

Mr. Dennis Powell is here today representing Cisco Systems. Since the time FASB made its stock option decision and its proposed standard on business combinations Cisco Systems has become the most admired business in America.

FASB's business is to set standards. Let me point out some standards Cisco has set: In the past three years, IndustryWeek chose Cisco as one of the best-managed companies in the nation; and Fortune ranked it as one of the best companies to work *for* in America.

We welcome Gene Hoffman, President of Emusic, an Internet digital music company. When I was making the case that FASB's proposal on stock options could hamper the growth of Internet companies, Mr. Hoffman's company didn't exist. Since 1993, an entire technology industry has been created by entrepreneurs like Mr. Hoffman.

I raise these examples to demonstrate that the issues we're discussing today are not dry and mundane theoretical questions. They are decisions that effect entire industries and our national economy.

This leads me to the issue of FASB's responsibility and the role it plays in setting accounting standards. During my legislative career, I've become familiar with the process FASB goes through in its standard-setting and I respect the work its leadership and staff does in developing proposals.

But I remain deeply concerned about FASB's perception regarding its process of private-sector standard setting, and the Federal government's role of steward of the nation's economic health.

FASB is not the exclusive forum for the due process given to business standards. What may appear to the leadership of FASB as threats of government intervention may, in fact, be the Federal government fulfilling its responsibility as guardian of the national economy.

Put simply: FASB is a private board and accountable to its leadership and its profession. The Congress is a public institution and accountable to the American people.

Again, Mr. Chairman, thank you for holding these hearings and allowing me the opportunity to participate. I look forward to an interesting and thoughtful discussion regarding these issues and I welcome all of the witnesses here today.

Mr. OXLEY. The Chair recognizes the gentleman from Iowa Mr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman. I will be brief because I want to hear the testimony. I am hear to listen and learn, primarily.

I was intrigued by a quote from Mr. Jenkins on page 3 of his testimony where he quotes an article by Floyd Norris called "Can Regulators Keep Accountants From Writing Fiction?"

He says, "Pooling accounting is ridiculous because it allows corporations to pretend that they paid much less for an acquisition than they did. Let's say company A buys company B for $100 million in stock and then a few years later sells company B for $50 million. In reality, it was a disastrous acquisition for company A. But, thanks to the magic of pooling, company A would have shown the original acquisition as costing not the $100 million it paid, but a number that would be far lower, say $20 million, reflecting the book value of company B. Presto, company A reports a profit of 30 million when it actually lost $50 million."

I don't know whether this is true or not. I am anxious to listen to the testimony and find out. I yield back.

[Additional statement submitted for the record follows:]

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Thank you Mr. Chairman.

We are here today to answer one question: Should Pooling of Interest be completely eliminated as an accounting method for Business Combinations?

Well, without a whole lot of thought, I can answer that question fairly easily. The answer is No, unless either purchase accounting as we know it is improved or we can all agree on an alternative method of accounting that does not suffer from the same shortcomings that purchase accounting suffers from.

I have four primary concerns with the FASB proposal to require all merging companies to use purchase accounting.

First, I am not convinced that purchase model accounting makes much practical sense in today's new economy. For new economy companies, intangibles make up a major portion of purchase price allocation not adequately addressed by purchase model accounting. Put simply, this method provides inadequate guidance on how to identify and value intangible assets. To the contrary, purchase accounting seeks to amortize goodwill to expense over a 20 year period in a way that just doesn't reflect economic reality.

So essentially, there is a real incompatibility between purchase accounting and the mechanics of many business combinations that are taking shape in our country.

If FASB's real concern is ensuring that companies are accurately valued for the benefit of capital market investors . . . a concern I might add that the SEC shares as well . . . then it should be promoting an accounting method that makes clear how best to appraise intangibles—technology, intellectual property, brand identification, patents, and the like—as opposed to asserting that purchase accounting must carry the day despite that it is defunct in its treatment of intangibles. Furthermore, if FASB wants accurate valuations, then it should propose something more creative than simply forcing companies to amortize goodwill over an arbitrary 20 year period—which we all know often results in synthetically, or artificially, reducing reported income.

The bottom line here then is that purchase accounting is designed for old world brick and mortar outfits, and therefore must be revamped itself before I will concede that it is a better alternative to pooling.

Second, I am afraid that eliminating pooling in favor of present-day purchase accounting will significantly reduce merger activity in this country. In 1998, there were 11,400 mergers in the Unite States alone which accounted for $1.62 trillion in aggregate value. Significantly, the pooling of interest method was used in 55% of these mergers.

Over half of the mergers in 1998 relied on the pooling method, and it certainly makes sense as to why. The ability for a company to deal in stock is what in fact has enabled many companies to grow, provide more jobs, and eliminate inefficiencies in our economy. Without the ability to offer stock in exchange for ownership interest in another entity, many acquiring companies would not even consider some of the business combinations that they have pursued or achieved to date. This to me is quite troublesome.

Third, I feel that eliminating pooling at this juncture imposes somewhat of a retroactive hardship on many businesses that have relied upon pooling for years. The two accounting methods in question have been around for years, and I think, have effectively served as alternatives to one another—kind of a natural Yen and Yang, if you will. Precisely because the economics of these methods is so different, companies have always been afforded the opportunity to make a business decision of going one way or another, depending on the nature of the deal in question. To take pooling off the table at this juncture, without any attempt to retain the flexibility afforded by a two method regime, amounts to nothing more than changing the rules on business mid-stream.

As a lawmaker, I have always had serious reservations about changing laws in a retroactive manner. My experience is that this usually leads to harming established industries and businesses in ways that Congress never intends.

Fourth, and finally, I have grave concerns about process in this debate. FASB contends that its administrative process is modeled after the APA, and that it fiercely adheres to that process. FASB also states that it will make no final decision about the proposal or consider whether to issue a final standard until it is satisfied that all substantive issues raised by all parties have been considered. Well, despite that most of the comments received, as far as I can tell, oppose making purchase accounting the sole method for business combinations, FASB continues to publicly make the case for the elimination of pooling.

In addition, its actions suggest that FASB is paying little mind to the interested parties' recommendations for either retaining pooling or improving purchase accounting in some reasonable fashion.

Furthermore, upon learning that some of its constituents were "unfortunately, encouraging Members of Congress to intervene in the independent private-sector standard setting process," the Financial Accounting Foundation (FAF) issued an open letter criticizing the very notion that Congress should have some say so in the process of deciding how American businesses disclose financial information. While I do not deny that FASB's independence is central to its mission, much like the Federal Reserve's, the FAF letter gives the impression that independence in this context means ABSOLUTE independence.

Well, I'm here to say that it is entirely appropriate for Congress to oversee the FASB and the SEC's supervision and delegation of its authority to set accounting standards. After all, this very authority is derived from the '34 Act, a piece of legislation that was drafted by this very Committee.

In the end, I hope that the FASB will take my concerns to heart and respond with a plan that makes the most sense for today's business world.

With that, Mr. Chairman, I yield back the balance of my time. Thank you.

Mr. OXLEY. The Chair is pleased to recognize our distinguished panel of Members, and as I understand it, you prefer to go first, Mr. Goodlatte, because you have a markup?

Mr. GOODLATTE. Mr. Chairman, if I may, we are in the middle of another issue of great interest to the Internet economy, and that is the tax moratorium extension that I know this committee has also held hearings on. If I can get back, my substitute is on the floor of the committee right now.

Mr. OXLEY. The Chair is pleased to recognize the gentleman from Virginia, Mr. Goodlatte.

STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. Chairman, I very much appreciate your holding this hearing and allowing me to testify this morning. As you know, the Internet has fueled our economic growth at such a rapid pace over the last 5 years.

According to the Department of Commerce, traffic volume on the Internet doubles every 100 days. By October of last year, U.S. Web pages averaged $1 billion cumulative hits per day. In comparison to other forms of communication, the U.S. Postal Service delivered 101 billion pieces of paper mail in 1998. Estimates for e-mail messages sent in 1998 ranged from $618 billion to 4 trillion. The impact of the Internet on our daily lives is mind-boggling.

For businesses, the impact is equally great. The Internet economy has grown to $507 billion in 1999 from $301 billion in 1998. It is expected to grow to $1 trillion in 2001 and $2.8 trillion by 2003. The Internet economy accounts for 2.3 million jobs, that was last year, 35 percent of the U.S. real economic growth between 1995 and 1998, and its share of the U.S. economy nearly doubled between 1977 and 1998, growing from 4.2 percent to 8.1 percent.

This development has been spurred by the ability of companies to innovate, and the growth of the new economy has occurred because startup companies have been able to combine creative thinking with low barriers to entry in the form of low costs and regulations. These characteristics of the new economy must be protected in order for small companies to continue reacting and adjusting.

One way in which these characteristics are threatened is the ongoing review by the Financial Accounting Standards Board of accounting rules governing business combinations. In today's rapidly growing technology and information markets, the need for maintaining an accounting system that is best suited to handle the growing trend of the technology sector mergers is key.

The pooling system of accounting has made possible some of the most important mergers of our time, creating innovative new companies and benefiting consumers. If the use of pooling had not been permitted, the unifications of NetScape and America Online, CitiCorps and Travelers, NationsBank and Bank of America and the Daimler-Chrysler merger quite possibly would never have taken place.

Current regulations allow many high-tech companies to use the pooling method by allowing corporations to easily merge without attaching a goodwill accounting charge. This charge is the amount paid in an acquisition that is added to the fair market value of a company's tangible assets.

If the Financial Accounting Services Board proposal is implemented, it would require that all mergers be viewed not as the melding of separate entities, but as a direct purchase, forcing companies to accept the purchase method of accounting. That would be a big mistake. This system may have worked for the bricks-and-mortar corporations of the past, but in the age of high-tech companies whose value lies in information, the purchase method of accounting has no place. Forcing these high-tech, high-performance companies to use the direct purchase accounting system will only

serve to stifle growth and limit our country's edge in this information age.

We should take every opportunity to support and ensure continued innovation and expansion in this technology sector that has done so much to energize our economy.

I support clear and understandable accounting rules, which do need adjustments from time to time. I agree with those who believe that we should thoroughly examine possible adjustments to current standards. However, the type of wholesale changes currently under consideration should be abandoned.

I therefore believe that the Commission designated by Geoffrey Garten, Chairman of the Securities and Exchange Commission, to study the role of intangible assets in the new economy should be allowed to complete its work. We should then examine the Commission's conclusions in the broader context of how intangible assets are reported in a rapidly changing economic environment.

I would urge the FASB to follow its stated mission to ensure that its standards "reflect changes in methods of doing business and changes in the economic environment." However, single-shot, piecemeal changes to accounting standards should not be the mode of operation. Pooling accounting is essential for small startups and new online businesses. These ventures act as a magnet for capital investment, lower costs, create new jobs, and fuel economic growth. Acting in a piecemeal manner to alter existing accounting principles could threaten this growth by limiting the availability of capital and restricting the expansion of this new sector of our economy.

I am hopeful that the FASB will step back, take a deep breath, and see the forest that is the new economy rather than the trees that are the individual accounting standards. I look forward to working with you and others who are concerned that our system of accounting standards should move along with the rest of the economy into the new century, Mr. Chairman.

I might add that while we are enjoying and experiencing tremendous dynamic growth with many of the companies in this new Internet economy, there are others who are struggling, others with good ideas, with good intellectual property, but who should nonetheless have the ability to make sure that if there is an appropriate merger that can strengthen their situation, as I think the AOL-NetScape merger is an excellent example, we should have the opportunity to do that with accounting principles that support that kind of combination and take into account that the value of intellectual property in this information economy is very, very different.

I am being signalled that my vote is needed in the Committee on the Judiciary. Thank you for allowing me to testify.

[The prepared statement of Hon. Bob Goodlatte follows:]

PREPARED STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Thank you for allowing me to testify before you this morning. As you know, the Internet has fueled our economic growth at such a rapid pace over the last five years. According to the Department of Commerce, traffic volume on the Internet doubles every 100 days. By October of last year, U.S. web pages averaged one billion cumulative hits per day. In comparison to other forms of communication, the U.S. Postal Service delivered 101 billion pieces of paper mail in 1998. Estimates for e-

mail messages sent in 1998 range from 618 billion to 4 trillion. The impact of the Internet on our daily lives is mind-boggling.

For businesses, the impact is equally great. The Internet Economy has grown to $507 billion 1999 from $301.4 billion in 1998. It is expected to grow to $1 trillion in 2001, and $2.8 trillion by 2003. The Internet Economy accounts for 2.3 million jobs last year, 35% of U.S. real economic growth between 1995 and 1998, and its share of the U.S. economy nearly doubled between 1977 and 1998, growing from 4.2 percent to 8.1 percent.

This development has been spurred by the ability of companies to innovate, and the growth of the new economy has occurred because start-up companies have been able to combine creative thinking with low barriers to entry in the form of low costs and regulations. These characteristics of the New Economy must be protected in order for small companies to continue reacting and adjusting. One way in which these characteristics are threatened is the ongoing review by the Financial Accounting Standards Board of accounting rules governing business combinations.

In today's rapidly growing technology and information markets, the need for maintaining an accounting system that is best suited to handle the growing trend of technology sector mergers is key. The "pooling" system of accounting has made possible some of the most important mergers of our time, creating innovative new companies and benefitting consumers. If the use of "pooling" had not been permitted, the unifications of Netscape and America Online, Citicorp and Travelers, NationsBank and Bank of America, and the Daimer Chrysler merger quite possibly would have never taken place.

Current regulations allow many high-tech companies to use the pooling method by allowing corporations to easily merge without attaching a goodwill accounting charge. This charge is the amount paid in an acquisition that is added to the fair market value of a company's tangible assets. If the Financial Accounting Standards Board proposal is implemented, it would require that all mergers be viewed not as the melding of separate entities, but as a direct purchase, forcing companies to accept the purchase method of accounting. This system worked for the bricks and mortar corporations of the past, but in the age of high-tech companies whose value lies in information, the purchase method of accounting has no place.

Forcing these high-tech, high performance companies to use the direct purchase accounting system will only serve to stifle growth and limit our country's edge in this information age. We should take every opportunity to support and ensure continued innovation and expansion in this technology sector that has done so much to energize our economy. I support clear and understandable accounting rules which do need adjustments from time to time, and I agree with those who believe that we should thoroughly examine possible adjustments to current standards. While we should should step back and determine the benefits and disadvantages of the various methods of business reporting, we should avoid the type of wholesale changes currently being considered.

I therefore believe that the commission designated by Jeffrey Garten, Chairman of the Securities and Exchange Commission, to study the role of intangible assets in the New Economy should be allowed to complete its work. We should then examine the Commission's conclusions in the broader context of how intangible assets are reported in a rapidly changing economic environment. I would urge the FASB to follow its stated mission—to ensure that its standards "reflect changes in methods of doing business and changes in the economic environment." However, single-shot piecemeal changes to accounting standards should not be the mode of operation.

Pooling accounting is essential for small start-ups and new online businesses. These ventures act as a magnet for capital investment, lower costs, create new jobs, and fuel economic growth. Acting in a piecemeal manner to alter existing accounting principles could threaten this growth by limiting the availability of capital and restricting the expansion of this new sector of our economy. I am hopeful that the FASB will step back, take a deep breath, and see the forest that is the New Economy, rather than the trees that are individual accounting standards. I look forward to working with you, Mr. Chairman, and others who are concerned that our system of accounting standards should move along with the rest of the economy into the new century. Mr. Chairman, thank you for having me here today.

Mr. OXLEY. Thank you. Thank you for your leadership on this issue.

Our very patient colleague and good friend, the gentleman from California, who has been here for a long time and listened to a lot of opening statements, we appreciate your patience, and the Chair

is now pleased to recognize the Honorable Cal Dooley from California.

STATEMENT OF HON. CALVIN M. DOOLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. DOOLEY. Thank you, Chairman Oxley. I was privileged to hear the statements of the various members of the committee. I really am in agreement with most of the sentiments that were expressed.

I would also at this time like to ask unanimous consent that two letters that myself and Anna Eshoo and others have sent to Chairman Levitt of the Securities and Exchange Commission as well as Chairman Jenkins of FASB be included in the record.

What might well appear to be an arcane accounting matter could prove to be something that has significant public policy implications. That is why I commend you for having this hearing today.

In many ways, the issue we are touching on today really is a reflection of how we are changing from an industrial-based economy to an information-based economy, and how many of the companies that are now providing the engine and the energy for the growth of jobs as well as the creation of wealth are doing so not necessarily by the production of hard assets and taxable assets that would characterize a lot of the older industries within the United States.

I think what we have to understand is some of the accounting systems that were developed back in the industrial age are no longer as effective in identifying and accounting for the real value of the companies in this new economy. There has not been an accounting system that has been developed that can accurately measure the precise value of human and intellectual capital. Yet, in the new economy businesses, it is human and intellectual capital that are the foundations and the most important elements in assessing a company's true worth.

I am concerned that FASB's decision draft takes the approach that you can define the value of goodwill and intangible assets. Furthermore, it goes as far to assume that they are wasting assets and that they should be depreciated, and that they will lose all value in a period of no more than 20 years.

Intellectual capital is critical to the success of any company. In this information age, many of these companies would be most adversely impacted by FASB's draft proposal. Their value is to be intellectually innovative, their ability to bring products to market very quickly, their ability to adapt and have market penetration, and it puts a premium on these companies that are the entrepreneur innovators that have the ability to match up and coordinate innovations quickly with well-executed product delivery effort.

I think we are at the point now where we have to be concerned about making a change in the way that we account for mergers and acquisitions that would have some significant adverse impacts. The potential impact, I think, was identified to some extent by an article that was in the Wall Street Journal today which talked about in the first quarter of this year, there was over $22 billion in investment and 1,557 startup companies. That was an increase over the first quarter of 1999 of $6.1 billion.

What I am concerned about is that if you make this change in accounting practices, you can have a significant adverse impact on the dollars. There is venture capital and risk capital going into these startups. These startups we are talking about, not every one is going to mature to the point that they are going to have IPOs. Some are going to be acquired or assimilated through mergers.

If we are not allowing pooling to be utilized, there is a great concern that the real intellectual capital, the goodwill that is identified with those companies, will not be able to be recognized. We will put downward pressure on the values of these companies that will make them less attractive to eventually be acquired or merged into others. What that has the potential of doing, I think, is harming the United States' clear superiority and having the greatest relative advantage in the technology sector.

FASB and others have talked about trying to make our system more consistent with other international standards. Why would we want to do that? It is clear that the United States is the leader in this area. I don't think we ever want to adopt a system that could impede the flow of venture capital into the technology sector, which is so very, very important. What we have to be concerned with in the public policy issue here is make sure we do not have a reform in our accounting practice which reduces or impedes the flow of capital into high-risk investments.

It also is going to have the impact of decreasing the ability of a lot of these startup companies to attract employees and human intellectual capital. I also think it has the risk of almost contributing to greater consolidations, because E*TRADE probably would not have purchased Teledyne if we did not have the ability to use pooling. It probably would have resulted in that company being purchased by one of the bigger financial institutions. I don't think that is something we want to encourage by adopting an accounting practice.

Just in closing, I also want to make it clear that pooling is not a system without some imperfections. It has some imperfections. We also at the same time have to acknowledge that purchase accounting also has some major imperfections.

Before we move forward with eliminating pooling, I think we have to step back and say, is it time for us to start from a broader context in trying to determine what is the most effective way to value our companies. I am very concerned we are taking a piecemeal approach here.

I also want to commend Mr. Jenkins for his openness and willingness to have a dialog with a lot of us who have spent a lot of time on this. I am hopeful through this issue and continued discussion and dialog that we can come up with a system that will ensure that we can continue to have the most robust venture capital system in the world which is leading to some of the greatest advancements in technology and the creation of some of the most exciting companies in the world.

[The prepared statement of Hin. Calvin M. Dooley follows:]

PREPARED STATEMENT OF HON. CAL DOOLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, Ranking Member Towns, distinguished colleagues and friends on the Finance Subcommittee, I want to thank you for the opportunity to appear before

you today to talk about a matter of great importance in the economy—the question of how companies account for mergers and acquisitions. I would also like to submit for the record two letters that a number of us have sent to Chairman Levitt of the Securities and Exchange Commission and Chairman Jenkins of the Financial Accounting Standards Board with our concerns about this issue.

As I am sure you are all aware, the tremendous performance we have seen in the technology sector in the past decade is attributable not only to the wealth of creative ideas in this country, but also to the capital that helps to turn those ideas into products and services and brings them to the market. It is the technology community's success at combining these two essential ingredients that has turned it into the powerful economic engine it is today. That engine, in turn, has helped to propel the entire economy into the longest expansion in U.S. history. Furthermore, it is changing the complexion of the economy. More and more, we are realizing the value of intangible assets, not just at Internet start ups, like "eGM" for instance, but at bricks and mortar companies like . . . GM! Put simply, *the "Old Economy" is becoming the "New Economy."*

FASB's Proposal

Mergers and acquisitions, or business combinations, are an important means by which ideas and capital are paired in the technology sector and throughout the economy. FASB, the Financial Accounting Standards Board, is currently considering a proposal that will alter the method by which many businesses account for business combinations. This proposal would require companies to account for all such combinations as purchases, with the acquiring company being forced to write off any goodwill included in the purchase price as a charge against earnings over the course of several years.

Naturally, this proposal poses serious concerns for the technology sector because of the large difference that often exists between technology companies" book and market values. This is a legitimate concern and I think that FASB, by only addressing part of the issue through the elimination of pooling, is still not addressing the core problem. If they are going to take on this issue, they need to take a more comprehensive approach.

Pooling and Purchase are Both Flawed

Experts can and do argue over whether, as FASB has determined in its Exposure Draft on Business Combinations, all business combinations are purchases and should be accounted for as such. What really concerns me and a number of others in Congress and the private sector is the process that FASB has followed. It is moving to force the use of purchase accounting for all mergers and acquisitions without giving due consideration to the fact that purchase does not adequately account for so many of the intangible assets that companies possess today. In other words, FASB is considering the elimination of pooling in a vacuum and neglecting to consider the fact that *many consider both pooling and purchase to be flawed and inadequate methods of accounting for business combinations.* This is an important point that has been lost in all of the rhetoric about how the tech sector is seeking special treatment from FASB by urging them to keep pooling, so I want to reiterate it: *pooling and purchase are both flawed and inadequate methods of accounting for business combinations.* This is especially true for companies with large amounts of intangible assets, such as financial and pharmaceutical companies. It's not just about the technology sector.

Given that many believe that neither method adequately accounts for many of the intangible assets one finds in today's businesses, the development of a method of accounting that *does* effectively deal with intangibles should be pursued *before* we scrap the old ones. The elimination of pooling without paying any attention to what's left over is like blowing up the old bridge that gets us across the river before the new one is built.

The Need for Oversight

FASB's process illustrates why it is so important that the Finance Subcommittee is exercising its congressional oversight authority today. I feel confident in saying that none of us here wants to compromise the integrity and independence of FASB. At the same time, however, it is appropriate for us to focus on the potential economic consequences of FASB's proposals; to think about whether or not the benefits of their proposals outweigh the costs; and to ask the hard questions. In the end, congressional oversight on contentious issues doesn't weaken the process, it strengthens it. What weakens the process and its product is when FASB stubbornly ignores the concerns of its constituents; and when the Financial Accounting Foundation, which oversees, funds, and appoints the members of FASB, characterizes con-

gressional interest and concern about a FASB project as "Explicit or implicit threats,..." as they have in a May 1, open letter.

I remain convinced that if FASB has ears to hear, we can still persuade them to address the serious concerns we have about the flaws in purchase accounting first before abolishing pooling.

In closing, I want to thank you again for allowing me to appear today to discuss this issue. I commend you for holding this hearing. I also want to commend FASB Chairman Ed Jenkins for his patience and thoughtfulness in dealing with others and me on this issue. In fairness to him, FASB is not a committee of one, and I know we all recognize that he has a tough job. I believe that his continued openness and willingness to discuss our concerns is key to coming to some sort of resolution on this matter.

Congress of the United States

Washington, DC 20515

January 20, 2000

Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt,

We are concerned that efforts by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) to change Generally Accepted Accounting Principles (GAAP) governing stock compensation and business combinations will stifle growth and innovation in the technology sector. As members of the pro-growth New Democrat Coalition, we have been actively involved in promoting policies that foster technological development and economic expansion. We worry that the proposals under discussion will hinder the ability of technology sector companies to attract and retain skilled workers and to innovate, striking at one of the key elements of the longest economic expansion in our nation's history.

It is troubling that FASB's proposed changes to GAAP will, from a practical standpoint, prevent technology companies from offering stock options as part of their compensation packages. By altering the treatment of repriced stock options and revising the definition of "employee" for accounting purposes, FASB's changes threaten the continued growth and success of the technology sector. Because most new technology companies lack the financial resources to offer competitive salaries, they rely on stock option packages to retain the high-skilled workers who drive their innovation and productivity. FASB's new treatment of stock options will result in companies losing employees, and reduced productivity; there will no doubt be a corresponding fall in their earnings and shareholder value. Furthermore, while FASB's proposal will be harmful to the technology sector and the economy as a whole, we believe it will result in disproportionate hardship for smaller companies throughout the U.S. economy. These companies will be forced to forego stock option repricing because of the expense, and may very well fail as a result.

We are also very concerned that FASB's proposal to require that all mergers and acquisitions be accounted for as purchases will hinder the technology sector's ability to develop. Because of the requirement that intangible aspects, including goodwill, be written off as "charges against earnings" over a period of years, and because of the large amounts of intangible aspects that technology sector companies often possess, purchase accounting makes mergers and acquisitions very difficult for them. FASB's proposal will almost certainly diminish market innovation because many companies will no longer be able to afford the cost of merging with other companies offering attractive, new technologies.

It is our understanding that there is a consensus in the technology community that FASB's agenda has merit, and that many leaders in the industry have suggested some specific, modest reforms to address FASB's concerns. We are hopeful that FASB will consider some of these alternatives so that this important worker retention incentive can continue to be used by the technology sector. We hope that the Board will give serious consideration to the technology sector's proposed solutions before issuing any final decision on stock compensation, and before FASB holds its planned field hearings on business combinations.

We thank you for your attention and look forward to your reply.

Sincerely,

cc: Edmund Jenkins, Chairman, Financial Accounting Standards Board

Congress of the United States

Washington, DC 20515

February 24, 2000

Mr Edmund Jenkins
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Jenkins:

Thank you for your recent letter regarding the New Democrat Coalition's concerns about FASB's efforts to change generally accepted accounting principles (GAAP) governing business combinations and stock options. Your comments and observations were very much appreciated. However, we are left with several thoughts and concerns that we wish to share with you.

Your letter suggested that our draft New Democrat Coalition letter encouraged FASB to abandon the important principles of objectivity and neutrality in its efforts to change GAAP. We want to assure you that this is not the case. Furthermore, we want to make clear to you that we do not advocate legislating accounting principles

We agree that neutrality is an important criterion by which to judge financial reporting standards. Your letter illustrated the importance of neutrality by recounting the "regulatory accounting" fiasco in the thrift industry. However, it is our understanding that those who oppose FASB's business combinations and stock options proposals have based their arguments on *existing accounting principles*, not on any need for "regulatory accounting." Members of the technology community are simply arguing against changes to long-standing accounting rules that would harm them disproportionately, and arguing for retaining a valid set of existing accounting rules that harms no one, until the numerous other issues surrounding accounting for intangibles are addressed.

We inferred from your letter that FASB's Rules of Procedure do not allow the Board to consider overarching policy issues, such as economic growth or the disproportionate economic impact of changed accounting standards on a growth sector of the economy. We note, however, that two of FASB's publicly stated reasons for eliminating pooling are policy-based: burdens on SEC staff and international harmonization of accounting standards We offer that economic impact is a valid concern.

With regard to your stock options repricing proposal, it is our understanding that FASB's initial stated concern about stock options was a perceived lack of uniformity among accounting firms as to when a plan became "variable." We also understand that your professional staff recommended that one repricing be allowed without triggering variable plan accounting, reasoning that a clear pattern of option repricing should exist before a "fixed" plan is deemed "variable." The technology community says it simply wants what FASB's own professional staff thought was appropriate under APB 25 -- one repricing. They also have said that they would go beyond your staff's recommendation by excluding top management from any repricing In this way, the people most in control of a company could obtain no benefit from a repricing

You stated in your letter that FASB was directly responsive to technology sector requests regarding the proposed definition of *employee* under APB Opinion 25 by including outside directors. While we applaud the Board's receptiveness on this issue, we are concerned that FASB's refusal to include all workers within the scope of APB 25 ignores the changing work

environment of the New Economy and significantly hampers the ability of companies to retain highly qualified workers. This is especially problematic in the tech industry where sufficient numbers of qualified workers simply do not exist.

With regard to the elimination of pooling accounting, your letter stated that at the root of FASB's project is the need to improve reporting on mergers and acquisitions in companies' financial statements, and that FASB's proposal would improve the consistency and comparability of companies' reports. The technology community has expressed concerns that eliminating pooling before FASB addresses the myriad problems associated with accounting for intangible assets will not improve financial statement consistency, comparability, or transparency. We are worried that FASB is missing the forest for the trees, and should be taking a holistic approach to intangibles issues rather than considering pooling in isolation.

You cited the AOL/ Time-Warner merger as a recent example demonstrating that the vast majority of business combinations are currently accounted for under the purchase method. We were interested to learn, however, that the largest pharmaceutical industry merger in history, the SmithKline Beecham/Glaxo Wellcome merger in the UK, will be accounted for as a "pooling" under that country's accounting rules. We were also interested to read Jim Barksdale's recent statement before FASB that, but for pooling accounting, the AOL/ Netscape merger never would have occurred. AOL also has filed comments with FASB stating that pooling should only be eliminated when the accounting standards throughout the world are unified. In the final analysis, we do not see the AOL/ Time Warner purchase accounting deal as indicative of anything more than the fact that the proposed merger failed (as most proposed mergers do) the multi-part pooling test.

Finally, FASB's own mission statement includes several precepts, one of which is that FASB is "To promulgate standards only when the expected benefits exceed the perceived costs." While we in Congress may not know a great deal about accounting theory, we certainly understand, and see the importance of, cost-benefit analysis. With all due respect, we question whether FASB has fully adhered to this principle on these issues.

We want to thank you again for taking the time to write to us. We appreciate your continued efforts to ensure the fair and accurate presentation of financial information, and look forward to working with you and your colleagues to resolve the technology community's concerns.

Sincerely,

Carolyn McCarthy

Charles A. Gonzalez Ron Kind

Ellen O. Tauscher

Mr. OXLEY. Thank you, Mr. Dooley, for your excellent testimony.

The committee will stand in brief recess while we empanel the next group.

[Brief recess.]

Mr. OXLEY. The subcommittee will reconvene.

Let me introduce our distinguished panel, second panel; Mr. Edmond L. Jenkins, Chairman of the Financial Accounting Standards Board; Mr. Dennis D. Powell, vice president, corporate controller from Cisco Systems, San Jose, California; Mr. Peter R. Bible, chief accounting officer for General Motors Corporation from Detroit; Mr. Gene Hoffman, Jr., president and CEO of EMusic, Redwood City, California; finally, Dr. William Frederick Lewis, president and CEO, Prospect Technologies, here in Washington, DC, on behalf of the U.S. Chamber of Commerce.

Gentlemen, welcome to all of you. Mr. Jenkins, we will begin with you.

STATEMENTS OF EDMUND L. JENKINS, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD; DENNIS D. POWELL, VICE PRESIDENT, CORPORATE CONTROLLER, CISCO SYSTEMS; PETER R. BIBLE, CHIEF ACCOUNTING OFFICER, GENERAL MOTORS CORPORATION; GENE HOFFMAN, JR., PRESIDENT AND CEO, EMUSIC.COM; AND WILLIAM FREDERICK LEWIS, PRESIDENT AND CEO, PROSPECT TECHNOLOGIES

Mr. JENKINS. Thank you, Mr. Chairman. I certainly appreciated all of the comments from the members of this committee this morning. Please be assured at the outset that those comments are important to me and to my fellow Board members at the FASB, and we will be considering them carefully as we proceed with our redeliberations on this important subject.

I am Edmond Jenkins, Chairman of the Financial Accounting Standards Board. Behind me is Kim Petrone, the project manager on the subject of today's hearing.

I am very pleased to be with you today. I plan to discuss something about the due process of the FASB and our proposed standard to improve the accounting for business combinations. I have brief prepared remarks, but I would respectfully request that my full statement and supporting materials, referred to as the biggest package ever, be entered into the public record.

Mr. OXLEY. With some trepidation, it is so ordered.

Mr. JENKINS. Thank you, Mr. Chairman. I wouldn't want to have to carry them all back.

Mr. Chairman, the FASB is an independent organization, one that is funded entirely by the private sector. Our mission is to set accounting and reporting standards to protect the consumers of financial information. Most notably, those consumers are investors and creditors. Those consumers rely heavily on credible, transparent, and comparable financial information for effective participation in our great capital markets.

To quote a recent letter from the Association of Investment Management and Research, the leading organization of investment professionals in the United States with over 40,000 members, "The 'lifeblood' of United States capital markets is financial information that is: (1) comparable from firm to firm; (2) relevant to investment

and financing decisions; (3) a reliable and faithful depiction of economic reality; and (4) neutral, favoring neither supplier nor user of capital; neither buyer nor seller of securities."

This notion of neutrality is a fundamental element in our standard-setting process. To create or tolerate financial reporting standards that bias or distort financial information to favor a particular transaction, a particular industry or special interest group undermines the credibility and value of that information and the proper functioning of the capital markets and impairs investors' capital allocation decisions.

It is important to remember that our standards affect all public and private nongovernmental organizations, not just companies in one or two industries.

Our decisionmaking process is thorough. It is open to public observation and provides numerous opportunities for all interested parties to actively participate in and express their views. The issues that the FASB addresses are necessarily difficult ones for which reasonable people can and do hold differing views. As you know, we have often made significant changes to our proposals in response to concerns that have been raised.

The subject of this hearing is our proposal to improve the accounting for business combinations. The current accounting in this area was established in 1970. That accounting requires that business combinations be reported using either of two very differing methods, the purchase method or the pooling of interests method. Those two methods produce dramatically different financially reporting results for essentially the same or similar economic transactions.

Under the purchase method, the acquiring company records the net assets of the acquired company at the price paid, including any intangible assets, that have so often been referred to this morning as the most important assets of the new economy companies, to the extent that they can be separately identified and reliably measured. The excess of the purchase price paid over the fair value of the acquired company's net assets is recorded as an asset called goodwill.

The purchase method is consistent with the accounting for all other acquired assets. All purchases, whether a piece of machinery or a patent or a royalty right, are recorded at the price paid and are generally charged against earnings over their useful economic life.

An alternative to the purchase method, the pooling method is only available if 12 specific criteria are met. A key criterion is that the consideration exchanged must take the form of stock rather than cash or debt. However, it is important to note that stock can also be used as consideration in a purchase accounting acquisition.

In contrast to the purchase method, under the pooling method the book values of the combining companies are simply added together. There is no recognition of the full price paid and, therefore, no charge in the recorded amount of the acquired company's net assets to reflect their fair value, no recognition of these important intangible assets not previously recorded, and no resulting goodwill, and thus the true cost of the transaction is not reflected in the income statement.

Congressman Ganske referred to the article in the New York Times by Floyd Norris. Congressman, let me confirm for you that this is a real transaction. The numbers have been changed, but it is a real transaction, and, in fact, under pooling of interests accounting, the company did record a profit of $30 million in our example when it really lost $50 million. That is a true example.

As you are aware, a key requirement of our proposal is that all business combinations would be accounted for under one method, the purchase method, and that the pooling of interests method should be eliminated.

The rationale for that proposed decision includes the following points: First, the pooling method ignores the values exchanged in a business combination, while the purchase method reflects them.

Second, having two disparate methods of accounting for essentially the same transaction makes it difficult for investors to compare companies that have used different methods to account for their business combinations.

Third, because future cash-flows are the same, whether the pooling or purchase method is used, a boost in earnings under the pooling method reflects artificial accounting differences rather than real economic differences.

The important point is that under either purchase or pooling accounting, the future cash-flows are the same, and the impetus to have an acquisition or not should really not be influenced at the end of the day by the method of accounting.

Fourth, under the pooling method, financial statement users cannot tell how much was invested in the transaction, nor can they track the subsequent performance of that investment in future years.

Congressman Dingell made reference to my testimony in the reference to the $9.5 billion that simply disappeared in the transaction. That is, as Congressman Lazio pointed out, the AOL-NetScape transaction, and there was, in fact, no reporting of the $9.5 billion in the financial statements of the combined company. Thus, it was impossible for investors to relate subsequent performance against 95 percent of the purchase price paid for the acquired company.

I would also like to emphasize a couple of things that our proposal does not do. First, our proposal does not preclude companies from entering into business combinations that are stock-for-stock transactions. Second, our proposal does not make significant changes to the current basic accounting model where accounting for intangible assets.

Congressman Goodlatte in his testimony referred to the Garten panel, the panel set up by Chairman Arthur Levitt to look at value creation in the new economy. I would like to read from the enabling article with respect to that panel because intangibles are nowhere mentioned in it.

"The purpose is to assemble a panel of experts and other thoughtful individuals to assess the capital markets' understanding of the recent changes in the economy attributable to technological innovation and globalization; it is to identify the changing forces now driving the value creation of business enterprises; it is to assess whether the investment community and the financial markets

adequately understand these changes based on the information currently being made available in the marketplace."

There is no recognition in that of intangibles whatsoever.

Since first adding our project on business combinations to its agenda in 1996, the Board has held over 40 public meetings. We have issued two preliminary documents, an exposure draft for public comment that has been referred to here this morning, and carefully analyzed and discussed at public meetings over 400 comment letters received from a broad range of companies, investors, and other constituents.

In February of this year, we held 4 days of public hearings to discuss the proposal with interested constituents. Over 40 individuals testified.

In April we began our redeliberations of all of the issues contained in the proposal. This redeliberation process will include numerous public meetings held over the next several months. At those meetings, the Board will carefully consider the comment letters, the public hearing testimony, what we learn from this hearing, and all other relevant information provided by interested parties. Let me assure you that no final decisions will be made until that process is completed.

We presently expect to complete our work and be in a position to issue a final standard by no earlier than the end of the year 2000. That estimate may change depending on the progress of our deliberations. We will not rush to a conclusion.

In closing, I want to be clear that the FASB understands and supports the oversight role of the subcommittee. We will carefully consider what we learn from this hearing, from the testimony of Congressmen Dooley and Goodlatte.

Let me assure you again, Mr. Chairman and members of this subcommittee, that our open due process and our independent and objective decisionmaking will be carefully and fully carried out. To do otherwise would jeopardize the very foundation upon which the FASB was created and for which it has proven invaluable to the U.S. capital markets and to investors and creditors, the consumers of financial information.

Thank you very much, Mr. Chairman.

[The prepared statement of Edmund L. Jenkins follows:]

PREPARED STATEMENT OF EDMUND L. JENKINS, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Summary

A key requirement of our proposal to improve the accounting for business combinations is that all business combinations would be accounted for under one method, the purchase method, and that the pooling-of-interests method ("pooling method") should be eliminated.

The proposal's requirement to eliminate the pooling method will benefit investors, creditors, and other financial statement users by providing more information and more relevant information about all business combinations. The proposal's provisions also will benefit those consumers by improving the comparability of financial reporting, thereby making it possible to more easily contrast companies that participate in business combinations.

The proposal will also benefit companies that prepare financial statements and the auditors of those statements by providing a single method of accounting for all business combinations. Having one method will reduce certain costs to companies and auditors, both monetary and nonmonetary, which are currently related to the existence of the pooling method. In addition, having one method benefits companies

by leveling the playing field for competition among companies in the business combinations market.

In April, we began our redeliberations of all of the issues contained in the proposal. As part of that process, we will carefully consider the comment letters, public hearing testimony, what we learn from this hearing, and all other relevant information provided by interested parties. No final decisions will be made until that process is completed.

Mr. Chairman, Members of the Subcommittee, I am Edmund Jenkins, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). With me is Kim Petrone, the project manager on the subject of today's hearing. I am pleased to be here today. I plan to discuss the due process of the FASB and our proposed standard to improve the accounting for business combinations ("Proposed Standard"). I have brief prepared remarks, and I would respectfully request that my full statement and supporting materials be entered into the public record.

What Is the FASB and What Does It Do?

The FASB is an independent private-sector organization. We are not part of the federal government and receive no federal funding. We are funded entirely from private-sector sources, primarily voluntary contributions and sales of publications.

Our mission is to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the economy because investors and creditors rely heavily on credible, transparent, and comparable financial information.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For over 60 years the SEC has looked to the private sector for leadership in establishing and improving those standards. Therefore, the FASB may be viewed as an independent private-sector alternative to government regulation.

The focus of the FASB is on consumers—users of financial information such as investors, creditors, and others. We attempt to ensure that corporate financial reports give consumers an informative picture of an enterprise's financial condition and activities and do not color the image to influence behavior in any particular direction.

To quote a recent letter from the Financial Accounting Policy Committee of the Association for Investment Management and Research, the leading organization of investment professionals in the United States with over 40,000 members:

> The "lifeblood" of United States capital markets is financial information that is: (1) comparable from firm to firm; (2) relevant to investment and financing decisions; (3) a reliable and faithful depiction of economic reality; and (4) neutral, favoring neither supplier nor user of capital, neither buyer nor seller of securities.

The notion of neutrality is a fundamental element of our standard-setting process. The FASB's Rules of Procedure explicitly require that the Board be objective in its decision making to ensure the neutrality of information resulting from its standards.

Neutrality is an essential criterion by which to judge financial reporting standards, because information that is not neutral loses credibility and value. For example, surely, we would all agree there would be little value to Congress or the federal government of purposely altered and manipulated information about the rate of inflation or about unemployment.

Similarly, to create or to tolerate financial reporting standards that bias or distort financial information to favor a particular transaction, industry, or special interest group undermines the proper functioning of the capital markets and impairs investors" capital allocation decisions.

As former SEC Chairman Richard C. Breeden stated in testimony before Congress almost a decade ago:

> The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to fair and accurate presentation, they fail in their purpose.

The FASB sets standards only if, in the Board's independent judgment after carefully considering the input from all interested parties, there is a significant need for the standard and the costs the standard imposes are justified by the overall benefits. The objective, and implicit benefit, of issuing an accounting standard is increased credibility and representational faithfulness of financial reporting. However, the value of that improvement to financial reporting is usually impossible to measure and the Board's assessment of an accounting standard's benefit to companies

that prepare financial reports and to investors and creditors that use financial reports is unavoidably subjective.

The US capital markets are the deepest, most liquid, and most efficient markets in the world. The unparalleled success and competitive advantage of the US capital markets are due, in no small part, to the high-quality and continually improving US financial accounting and reporting standards. As Federal Reserve System Chairman Alan Greenspan stated in a June 4, 1998 letter to SEC Chairman Arthur Levitt:

> Transparent accounting plays an important role in maintaining the vibrancy of our financial markets . . . An integral part of this process involves the Financial Accounting Standards Board (FASB) working directly with its constituents to develop appropriate accounting standards that reflect the needs of the marketplace.

What Process Did the FASB Follow in Developing Its Proposed Standard?

Because the actions of the FASB affect so many organizations, its decision-making process must be thorough. The FASB carefully considers the views of all interested parties—users, preparers, and auditors of financial information. Our Rules of Procedure require an extensive due process that was modeled on the Federal Administrative Procedure Act, but it is broader and more open in several ways. It involves public meetings, public hearings, and exposure of our proposed standards to external scrutiny and public comment. The Board makes final decisions only after carefully considering and understanding the views of all parties.

The FASB's due process for developing a new financial reporting standard is best illustrated by describing the process followed in developing the Proposed Standard:

- When we began the project in 1996, we established a business combinations task force comprising individuals from a number of organizations representing a wide range of the Board's constituents. (Attachment 12 lists the members and their affiliations.) The first public meeting of the task force was held in February 1997.
- In June 1997, we published for public comment a Special Report that contained some of the Board's initial tentative decisions about the project's scope, direction, and content. We received 54 comment letters in response to the Special Report.
- In November 1998, we held the second public business combinations task force meeting to discuss issues related to the project.
- In December 1998, we published for public comment, in participation with other members of an international organization of accounting-standard-setting bodies, a Position Paper that addressed a number of issues related to the methods of accounting for business combinations. We received 148 comment letters in response to the Position Paper.
- We held over 40 public meetings since 1997 to address the issues associated with the methods of accounting for business combinations and the accounting for goodwill and other purchased intangible assets and to consider constituent comments.
- After each meeting, we updated a paper that summarized all of the Board's decisions. The updated paper was available on the FASB webpage and was sent by mail to anyone who requested it.
- Our weekly newsletter, *Action Alert,* announced each meeting in advance and reported a summary of the results of each meeting. (In addition, press reports of some of the meetings were available in certain business publications.)
- The Board and staff discussed the project on business combinations and intangible assets with representatives of companies and trade associations and with investors and creditors at dozens of liaison meetings, public conferences, and forums throughout the US and the world.
- In September 1999, we published for public comment an Exposure Draft (the Proposed Standard) that contains proposed changes to the existing standards of accounting for business combinations and intangible assets. We received approximately 200 comment letters in response to the Exposure Draft.
- In connection with the issuance of the Exposure Draft, we prepared and issued the following explanatory documents to assist constituents in understanding the Board's proposed decisions: "September 1999 FASB Exposure Draft, Business Combinations and Intangible Assets: An Overview" (Attachment 4); "FASB Business Combinations Project: September 1999 FASB Exposure Draft, Business Combinations and Intangible Assets: Frequently Asked Questions" (Attachment 9); FASB Viewpoints, "Why Eliminate the Pooling Method?" (Attachment 7); and FASB Viewpoints, "Why Not Eliminate Goodwill?" (Attachment 8). All

of the documents were available on the FASB webpage and were sent by mail to anyone who requested them.

- We held four days of public hearings in February 2000 (two days in San Francisco and two days in New York City) to discuss the Exposure Draft with interested parties. More than 40 individuals and organizations testified.
- In March 2000, the business combinations task force met with members of the Board and staff to discuss a number of issues raised in the comment letters and at the public hearings.

What's Wrong with the Present Accounting for Business Combinations?

> There are few areas in the current accounting literature that need reform more than business combination accounting . . .
>
> JACK T. CIESIELSKI, *CPA, CFA, President, R.G. Associates, Inc., Investment Research/Investment Management, 11/29/99.*

The current accounting for business combinations is governed by the requirements of APB Opinions No. 16, *Business Combinations,* and No. 17, *Intangible Assets,* which were issued in 1970 by the Accounting Principles Board ("APB") of the American Institute of Certified Public Accountants.

Under APB Opinions 16 and 17, business combinations are reported using either of two very disparate methods—the purchase method or the pooling-of-interests method ("pooling method"). Those two methods produce dramatically different financial reporting results for essentially the same or similar economic transactions.

Under the purchase method, the acquiring company records the net assets of the acquired company at the price paid, including any intangible assets to the extent they can be separately identified and reliably measured. The excess of the price paid over the fair value of the acquired company's net assets is recorded as an asset called goodwill, which is subsequently charged against earnings over time.

The purchase method is consistent with the accounting for all other acquired assets—all purchases, whether a piece of inventory or a patent, are recorded at the price paid and are generally charged against earnings over their useful economic life.

In contrast to the purchase method, under the pooling method, the book values of the combining companies are simply added together. There is no recognition of the full price paid. There is, therefore, no change in the recorded amount of the acquired company's net assets to reflect their fair value, no recognition of intangible assets not previously recorded, and no resulting goodwill, and thus the true cost of the transaction is not reflected in the income statement. By not recognizing that cost, the future earnings of the newly combined company are artificially inflated.

In commenting on what's wrong with the pooling method, a September 10, 1999 article in the *New York Times* entitled "Can Regulators Keep Accountants from Writing Fiction?" by Floyd Norris, states:

> Pooling accounting is ridiculous because it allows corporations to pretend that they paid much less for an acquisition than they did. Let's say Company A buys Company B for $100 million in stock, and then, a few years later, sells Company B for $50 million. In reality, it was a disastrous acquisition for Company A. But thanks to the magic of pooling, Company A would have shown the original acquisition as costing not the $100 million it paid but a number that could be far lower—say, $20 million—reflecting the book value of Company B. Presto: Company A reports a profit of $30 million when it really lost $50 million.

In addition, an article entitled "Big Banks Debunked," by Amy Kover, in the February 21, 2000 edition of *Fortune* describes what's wrong with the use of the pooling method in several recent business combinations in the financial services industry:

> Used just for stock transactions, pooling of interest allows the acquirer to add to its books only the book value of the acquired company—not the full price it paid for the target. That's a pretty neat trick if you've paid a fat premium for an acquisition, as Banc One did for First USA (43% over the market value), First Union did for CoreStates (18% over), and NationsBank did for Barnett (37% over). In the magic of pooling-of-interest accounting, those premiums simply vanish.
>
> What's so useful about that? Well, because the acquisition appears to add little to the surviving company's equity base—even as it captures all the extra earnings from the acquired company—the new bank's return on equity looks as if it's on steriods. The effect is anything but trivial. For example, when Michael Mayo of Credit Suisse First Boston recalculated each bank's cash return on average tangible equity as if it had used purchase accounting, Bank One's 1998 return on equity went from 27% to 12%. At First Union, it fell from 35% to 11.8%. And Bank of America's 29% return on equity dropped to about 10.8%.

As Dale Wettlaufer of Legg Mason says, "The end result is that the cash return on tangible equity is a totally bankrupt measure."

To use the pooling method, 12 specific criteria must be met; a key criterion is that the consideration exchanged takes the form of stock rather than cash or debt. The vast majority of business combinations today, including the many stock-for-stock transactions that fail to meet one or more of the pooling method criteria, are accounted for using the purchase method.

As the pace of business combinations has increased over recent years, the availability of two different accounting methods for very similar transactions that produce dramatically different levels of information to the market has become more and more problematic. A study of business combinations of public corporations over the period 1992-1997 found that the quantity and dollar magnitude of pooling method transactions rose dramatically from 105 transactions valued at $16.9 billion in 1992 to 321 transactions valued at $213.8 billion in 1997 (Attachment 6). A letter from the Consumer Federation of America to the FASB commented on that phenomenon:

> Over the last decade, a tidal wave of merger activity has swept through nearly every corner of the American economy. According to the Federal Trade Commission, the number of federal pre-merger filings has nearly tripled since the beginning of the decade, from 1,529 in 1991 to an estimated 4,500 last year. The market value of those mergers has risen even more dramatically, from $600 billion in the previous peak year of 1989 to more than $2 trillion in 1998. And several factors, not least passage this year of the financial modernization legislation, lead us to conclude that this activity is unlikely to abate any time soon. Ensuring that investors get complete and accurate information about the effects of mergers is, thus, a timely and important issue for the Financial Accounting Standards Board to tackle.

Beginning in the early 1990s, the Financial Accounting Standards Advisory Council ("FASAC"), a group composed of over 30 senior-level individuals from business, public accounting, professional organizations, and the academic and analyst communities, consistently ranked a possible project on improving the accounting for business combinations as a high priority for the Board. (Attachments 10 and 11 provide a listing of the members of FASAC and their affiliations and a description of FASAC, respectively.) At the July 1996 FASAC meeting, members indicated overall support for adding a project on improving the accounting for business combinations to the Board's agenda.

The Board agreed with the recommendation of FASAC and, in the fall of 1996, decided to add to its agenda a project on accounting for business combinations. Among the more significant reasons that led the Board to reach that decision included the following:

- *The Board wanted to address perceived flaws and deficiencies in APB Opinion 16.* One significant flaw is the fact that two economically similar business combinations can be accounted for using different accounting methods that produce dramatically different financial results. The availability of two methods makes it difficult for financial statement users to compare the financial reports of companies that use different methods of accounting for business combinations.
- *Many believe that having two accounting methods affects competition in markets for business combinations.* Companies that cannot meet all of the conditions for applying the pooling method believe they face an unlevel playing field in competing for a target against those that can apply that method. Because companies that can use the pooling method do not have to account for the cost of the investment or its subsequent performance, some believe those companies are willing to pay more for a target than companies that cannot use that method.
- *There has been a continuous need to interpret APB Opinion 16.* Despite the fact that APB Opinion 16 was issued almost 30 years ago, the volume of inquiries about its application remains high, an indication that the existing literature might be in need of significant repair. Many of those inquiries are concerned with whether a specific transaction meets the criteria for use of the pooling method.
- *Because of the rapidly accelerating movement of capital flows globally, there is a need for financial reporting to be comparable internationally.* Part of the Board's mission includes promoting international comparability of financial reporting, and accounting for business combinations is one of the most significant areas of difference in accounting standards. In most parts of the world, the pooling method is either prohibited or used only on an exception basis.
- *Finally, the Board took note of the historical justification of the pooling method.* (Attachment 4 contains a summary of the history of the pooling method.) The Board observed that the pooling method has been regularly challenged since the

term pooling-of-interests was first coined in the 1940s. The APB considered eliminating the pooling method when APB Opinion 16 was developed in the late 1960s. Although the pooling method was retained, the slimmest possible majority approved Opinion 16—six members of the APB dissented from the decision. Three of the six dissenters to APB Opinion 16 stated:

> [Opinion 16] seeks to patch up some of the abuses of pooling. The real abuse is pooling itself. On that, the only answer is to eliminate pooling.

What Does the Proposed Standard Require and Why?

Three of the key requirements of the Proposed Standard and a brief summary of the Board's basis for those requirements are described below. Paragraphs 92-366 of the FASB's Exposure Draft provide a detailed description of the basis for all of the Board's decisions.

Proposed Requirement #1: The purchase method of accounting would be required for all business combinations. Use of the pooling method would be prohibited.

Basis: In current practice, the underlying economics of the transactions to which the pooling method is applied are often similar, if not identical, to the underlying economics of those transactions that are accounted for by the purchase method. Under the pooling method, however, investors and creditors are being provided with less information—and less-relevant information—than is provided by the purchase method. That is because the pooling method ignores the values exchanged in a business combination transaction, whereas the purchase method records those values on the face of the balance sheet. As a result, the pooling method does not provide users of financial reports with full information about how much was invested in the combination. More important, because the investment is not fully recorded in the financial reports, the pooling method does not provide investors and creditors with the information they need to assess the subsequent performance of that investment and compare it with the performance of other companies.

For example, in one very visible acquisition that was accounted for under the pooling method, the value of the stock issued as consideration by the acquiring company was about $10 billion. The book value of the company acquired was only $500 million. The acquisition, therefore, was reported at $500 million in the financial statements of the combined company, and $9.5 billion of value ($10 billion less $500 million) simply disappeared. There was no reporting of the $9.5 billion in the financial statements of the combined company; thus, it is virtually impossible for investors to relate subsequent performance against 95 percent of the purchase price paid for the acquired company.

The example is not unique, a study of a sampling of 756 pooling method transactions of public corporations entered into over the period 1992-1997 found that $267 billion of assets, constituting about 66 percent of the total acquisition price, went unreported in the financial statements (Attachment 6).

The information that the pooling method provides about individual assets and liabilities is also less complete and less comparable than that provided by the purchase method. It is less complete because the pooling method does not record any acquired assets or liabilities that were not previously recorded, including valuable trademarks, customer lists, and other intangibles, and thus ignores their presence, even though they were acquired at a cost and can be separately identified and reliably measured.

In contrast, the purchase method reveals those hidden assets and liabilities by recording them. Moreover, the acquired assets and liabilities that the pooling method does record are not measured on a basis that is comparable with how acquisitions generally are measured (that is, at the values exchanged in those transactions), as does the purchase method. Because the values exchanged are not recorded, subsequent rate-of-return measures are artificially inflated.

Proposed Requirement #2: The maximum goodwill amortization period would be reduced from the current 40 years to 20 years.

Basis: The Board based this proposed requirement on a number of factors. The Board observed that the rapid pace of technological change was shortening product life cycles and requiring enterprises to reinvent themselves more regularly in order to survive. Thus, in general, the average useful economic life of goodwill has been diminishing since 1970. That observation was supported by evidence provided by companies, including those that participated in limited field tests.

The Board also observed that in current practice the amortization period used by many companies, including those in the technology and financial services industries, is generally less than 25 years.

Finally, the Board observed the relatively recent decisions of several other national accounting standards-setting bodies that have addressed this issue. Those

bodies have generally concluded that goodwill should have a presumptive useful life of 20 years or an absolute maximum amortization period of 20 years.

Proposed Requirement #3: Companies would be required to present goodwill amortization as a separate line item on the income statement, preceded by a subtotal, to make the charge to earnings more transparent to investors and creditors.

Basis: The Board decided that goodwill amortization should be presented as a separate line item in the income statement because goodwill is a unique asset, the useful life of which cannot be determined precisely. In addition, some investors and creditors often weigh goodwill amortization differently from other expenses in their financial analysis, and the proposed presentation would benefit those users.

Intangible Assets: It is important to note that the Proposed Standard would not require the separate valuation, reporting, and amortization of intangible assets that are not reliably measurable, such as many forms of knowledge-based intangible assets so often associated with technology companies. A review of the comment letters and public hearing testimony reveals that this point has continued to be a source of some confusion for some constituents. To clarify, under current accounting standards and the Proposed Standard, only purchased intangible assets that can be separately identified and reliably measured, like many trademarks and customer lists, are required to be separately valued, reported, and amortized over their useful economic lives.

Unlike current accounting, however, the Proposed Standard does provide certain circumstances in which intangible assets are not amortized. The Proposed Standard provides that, if an intangible asset has an indefinite useful economic life and meets certain other criteria, the asset shall not be amortized until its life is determined to be finite. Thus, if an intangible asset was increasing in value, the Proposed Standard would provide circumstances in which that asset would not be amortized.

The Board is aware of, and the FASB staff is actively participating in and monitoring, various studies and research currently being planned or performed by various constituent groups that might be relevant to the accounting for intangible assets. In addition, the FASB staff is currently performing independent research in this area. The scope of our research involves determining whether changes in the US economy should result in changes in the type of information included in financial statements and the manner in which that information is presented and delivered to users. That research includes a review of the accounting treatment for intangible assets.

The Board will carefully evaluate the results of the studies and research of the constituent groups and FASB staff. We anticipate that those results might help us expand our understanding of financial reporting issues related to accounting for intangible assets. Those results might also assist in developing future formal agenda projects of the Board.

Who Will Benefit from a Change in the Accounting for Business Combinations and How?

The Proposed Standard will benefit the public—investors, creditors, and other users of financial statements—as well as companies that prepare and audit those reports.

The Proposed Standard's requirement to eliminate the pooling method will benefit investors, creditors, and other financial statement users by providing more information and more relevant information about all business combinations. The Proposed Standard's provisions also will benefit those consumers by improving the comparability of financial reporting, thereby making it possible to more easily contrast companies that participate in business combinations.

Many consumers have expressed support for elimination of the pooling method. As one example, a letter from the Financial Accounting Policy Committee of the Association for Investment Management and Research states:

> The FAPC is unequivocal in its support of the FASB's proposal that there be only one method of accounting for business combinations in the United States. We also agree that the purchase method is the one that reflects properly the economics of all business combinations, and that pooling-of-interests should be eliminated . . .
>
> The pooling method fails to revalue the assets and liabilities of the acquired enterprise at fair value and the excess, commonly called "goodwill," is not recorded. Hence, pooling does not faithfully represent the values of the assets and liabilities exchanged, nor does it reveal the actual premium paid by the acquirer in the transaction. Users of financial statements are thus impeded in their attempts to understand the underlying economics of the business combination.

Many companies that prepare financial reports also agree. Those companies that have written letters to the FASB supporting the elimination of the pooling method

include IBM Corporation, Eaton Corporation, American Electronic Power, General Motors, Caterpillar, Inc., IMC Global, and PPG Industries, Inc., to name a few. The IBM Corporation letter stated:

> IBM agrees with the FASB that all business combinations are acquisitions and, thus, we support the FASB's proposal to eliminate the pooling-of-interests method of accounting for a business combination. We believe that financial statement users are ill-served by the existence of two methods to account for the same economic transaction. We agree with the FASB that using the purchase method to account for all business combinations will increase the comparability of financial statements and will reflect the true economics of the transaction, that is, an arm's length investment that should be accounted for at the fair value of the assets and liabilities that are acquired.

The Proposed Standard will also benefit companies that prepare financial statements and the auditors of those statements by providing a single method of accounting for all business combinations. Having one method of accounting for all business combinations will reduce certain costs to companies and auditors that are currently related to the existence of the pooling method.

For example, the availability of the pooling method often puts companies and their auditors under pressure to employ that method because it typically produces higher reported earnings and rates of return subsequent to a business combination than the purchase method. Moreover, because the pooling method is applied retroactively, the comparative earnings reported for periods preceding the combination are also higher than under the purchase method—even before the companies were, in fact, combined.

As a result of those pressures, companies often must bear significant costs, both monetary and nonmonetary, in seeking to use the pooling method. In positioning themselves to try to meet the 12 criteria for applying that method, companies may refrain from engaging in appropriate economic actions that they might otherwise undertake, such as asset dispositions or share reacquisitions. They also may incur substantial fees from auditors and consultants in seeking to meet those criteria. The efforts to meet those criteria also may lead to conflicts between companies, auditors, and regulators with respect to judgments about whether the criteria have been met, thereby adding uncertainties and their attendant costs to the process and raising questions about the operationality of those criteria.

A report published by the Silicon Valley office of McKinsey & Company, an international consulting firm, stated:

> The fear that purchase accounting, by lowering reported earnings, will destroy shareholder value is a myth. In fact the opposite is true. Efforts to qualify for such treatment actually destroy value. FASB's proposal to eliminate pooling accounting is a blessing in disguise. Why? Because the transition to purchase accounting will require corporations to adopt more robust deal evaluation processes and enhance their shareholder communications.

Similarly, a letter to the FASB from the Financial Institutions Accounting Committee of the Financial Managers Society ("FIAC"), a group of 15 financial professionals working in executive level positions in the thrift and banking industries, stated:

> Formal research supports the proposition that reporting firms consume substantial resources in structuring transactions solely to achieve a favorable financial reporting outcome. Lys and Vincent (1995) report that AT&T paid at least $50 million (and possibly as much as $500 million) to achieve pooling-of-interests accounting for its acquisition of NCR. . . . A single method of accounting for business combinations would redirect these corporate resources into more productive areas.

In addition, having one method of accounting for business combinations benefits companies by leveling the playing field for competition among companies in the business combinations market. The ability—or inability—to use the pooling method often affects whether a company enters into a business combination and also affects the prices they negotiate for those transactions. Companies that cannot use the pooling method because they cannot meet the criteria required for its use (for example, criteria that prohibit certain share acquisitions) often conclude that they cannot compete for targets with those that can meet the criteria.

Many companies that cannot use the pooling method believe that companies that can use it often are willing to pay higher prices for targets than they would if they had to use the purchase method because they do not have to account for the full cost of the resulting investment. Thus, by using the pooling method, they can understate the income statement charges (primarily related to goodwill and other intangible assets).

In a letter to the FASB, KeyCorp explained:

> Since most publicly-traded companies are gauged by EPS performance, there is a strong incentive to use the "earnings-friendly" pooling method. The desire to avoid the earnings consequences of the purchase method has almost certainly resulted in uneconomic behavior. It is well understood in the investment banking community that a company is willing to "pay" more for a target if the pooling method is available for the resulting transaction. Clearly, there is a view that the pooling method results in a type of accounting arbitrage . . .

Even though using the pooling method rather than the purchase method might result in being able to report higher per-share earnings following the combination, the fundamental economics are not different because the actual cash flows generated following the combination will be the same regardless of which method is used. As a result, the added earnings reported under the pooling method reflect artificial accounting differences rather than real economic differences.

To the extent that the markets respond to artificial differences, they direct capital to companies whose financial reporting benefits from those differences and they direct capital away from companies whose financial reporting does not benefit. As a result, markets allocate capital inefficiently rather than efficiently. While inefficient allocation of capital may benefit some companies and even some industries, it imposes added costs on many others, depriving them of capital that they need and capital they could employ more productively. The outcome is detrimental to those companies—but more important, to the capital markets as a whole.

What Happens Next?

On April 12, 2000, the Board began the next significant stage of its work on the business combinations project. That stage will involve redeliberation of all of the issues contained in the Proposed Standard. As part of that redeliberation, the Board will carefully consider the feedback it has received through the comment letters, public hearing testimony, the testimony at this hearing, and any and all relevant information provided by interested parties.

The Board will hold as many public meetings as necessary to thoroughly discuss all of the feedback received and to decide what modifications or clarifications to the Proposed Standard are appropriate. The Board will not make any final decisions about the Proposed Standard or consider whether to issue a final standard until it is satisfied that all substantive issues raised by all parties have been considered.

The Board presently expects to complete its work and be in a position to issue a final standard by no earlier than the end of the year 2000. That estimate may change depending on the progress of the Board's redeliberations. Any final standard will be effective no earlier than the date of its issuance.

In closing, I want to be clear that the FASB understands and supports the oversight role of this Subcommittee. We will carefully consider what we learn from this hearing. Let me assure you, Mr. Chairman and members of the Subcommittee, that our open due process and our independent and objective decision making will be carefully and fully carried out. To do otherwise would jeopardize the very foundation upon which the FASB was created, and for which it has proven invaluable to the US capital markets and to investors and creditors—the consumers of financial information.

Thank you, Mr. Chairman. I very much appreciate this opportunity and would be pleased to respond to any questions.

Mr. OXLEY. Thank you, Mr. Jenkins. Once again we appreciate your cooperation and openness throughout this entire process. As the other member said, it has been a pleasure to work with you in such a manner.

Before I introduce our next witness, let me introduce our good friend Joe Crowley, from New York, who is not a member of the committee, but is interested in this subject and has agreed to be with us this morning. Welcome.

Mr. Powell?

STATEMENT OF DENNIS D. POWELL

Mr. POWELL. Good morning. Thank you for inviting me to this hearing.

I am vice president and corporate controller for Cisco Systems. Cisco is the worldwide leader in networking, with revenues cur-

rently approximating $17 billion per year. We are a multinational corporation with more than 28,000 employees and 200 offices in 55 countries. In the U.S. we have significant operations in California, Texas, Massachusetts, and North Carolina.

The two methods of accounting that we are discussing today, purchase and pooling of interests, have been generally accepted in practice since 1945. In 1970, the Accounting Principles Board studied and discussed the pros and cons of the two accounting methods and issued APB16 entitled "Business Combinations," which reaffirmed the validity of both the purchase and pooling of interests method.

This viewpoint was again reaffirmed in 1994 by a task force commissioned by the American Institute of Certified Public Accountants, as we heard earlier, to study the usefulness of financial reporting. This report, entitled "Improving Business Reporting, a Customer Focus," concluded after 3 years of study that a project to do away with either method would be very controversial, require a significant amount of FASB time and resources, and at the end is not likely to improve significantly the usefulness of financial statements.

So the arguments for and against the pooling and purchase methods of accounting haven't changed for the past 30 years. We are still debating the same issues.

However, the problems with the purchase method are still with us, but the implications today are much more severe than they were in 1970. In 1970, most of an acquisition price was allocated to tangible, hard assets. Today, for knowledge-based technology companies, most of the acquisition price is allocated to intangible assets and very little to hard assets.

For example, since 1993, Cisco has acquired over 50 companies amounting to over $19 billion. Of these acquisitions, only $900 million or 5 percent is attributed to hard assets; $18 billion or 95 percent of the acquisitions would be left to allocate to intangibles or goodwill. So the limitations of the purchase method have become much more problematic. Yet the new FASB proposal would force all acquisitions to be accounted for under the purchase method, without having solved its defects.

The most significant defect of the purchase method is the accounting for goodwill once it is recorded as an asset on the balance sheet. The FASB proposal requires that goodwill be treated as a wasting asset and requires that it be amortized over 20 years. This model incorrectly assumes that goodwill declines in value over time, which artificially reduces net income and misrepresents economic reality.

For example, we studied four technology mergers that occurred in 1996 and 1997. The results of the four companies in the study are summarized in attachment B to my testimony. As you can see from that exhibit, the purchase accounting model significantly reduced actual earnings by an average of 48 percent because of the amortization of goodwill. This would suggest that goodwill has declined in value. However, over the same period, goodwill actually increased from the date of the merger by an average of 43 percent.

Based on the above study, it is clear that in successful mergers, the presumption that goodwill is a wasting asset is not valid. Good-

will increases in successful acquisitions and declines rapidly in unsuccessful acquisitions. Goodwill does not decline radically over 20 years. The FASB model simply does not report true economic performance.

The FASB argues that the pooling of interests method provides investors with less information and less relevant information than provided by the purchase method because the pooling method ignores the values exchanged, whereas the purchase method records these values on the face of the balance sheet.

I disagree that the pooling method provides less information. At the time of a merger, the number of shares exchanged and the related share values are known, so the value of the transaction is known. Furthermore, the pooling method of accounting reports a more conservative balance sheet, reports the results of operations more accurately, and presents investors and creditors with more relevant information to assess subsequent performance of the combined entities than the purchase method.

If I could refer you to attachment C as an illustration, if companies A and B would combine, the pooling method would report a combined equity of zero dollars, in the example that I provided. However, the purchase model creates an inflated equity of $4,000, giving the impression that these two anemic companies have been made well simply by combining.

Furthermore, because the purchase method incorrectly assumes that goodwill reported on the balance sheet declines over 20 years, the combined companies' operations are artificially reduced from the actual performance under purchase accounting. The pooling method more faithfully reports true economic performance as illustrated in the attachment C.

Finally, application of the purchase method would mislead the reader of the financial statements, the combined financial statements, into believing that the revenues had increased 100 percent from $2,500 in year 1 to $5,000 in year 2. However, the pooling method would correctly reflect the true view that sales had been flat between the 2 years because this method requires that previously reported financial statements be restated to report the combined operations as if they had always been together. In this case, both years 1 and 2 would reflect sales of $5,000.

In summary, the pooling method reports a more conservative balance sheet, more accurate income, and a better comparison of operations and a truer picture of sales trends.

In conclusion, the U.S. accounting rules for business combinations, which includes both the pooling and the purchase methods, has for the past 50 years generated and supported the strongest capital markets in the world. Before the FASB radically changes these accounting rules to a model that will certainly stifle technology development, impede capital formation, and slow job creation in this country, the FASB should make sure that the new proposed method is without question the absolute correct answer.

In reality, the FASB's proposed standard does not improve financial reporting, it merely changes it. Worse yet, the proposed changes require companies to use a purchase model that does not work for companies in the new economy, where most of the acquisition value cannot be attributed to hard assets, forcing companies

to report an arbitrary net income number that is irrelevant and misleading.

We believe that, first, the FASB should retain the pooling of interests method of accounting. The pooling method of accounting continues to have broad support, as evidenced by two-thirds of the respondents to the current FASB exposure draft, and all of the Big 5 accounting firms disagreed with the FASB's plan to eliminate pooling accounting.

Second, revise the purchase method to correct its deficiencies, such as charge purchased goodwill directly to shareholders' equity, or amortize it through comprehensive income, or reduce goodwill only when it has actually declined in value, or the impairment method; and then limit the allocation of purchase price only to those intangibles that can be objectively and reliably valued; and third, engage a task force which would include evaluation experts to develop adequate guidance on how to identify, value and account for intangible assets for new economy companies.

I agree with Mr. Jenkins in his statement with respect to the Garten Commission. It was not commissioned to address this point. As a member of that commission, I can verify that. What that means, though, I think, is that someone needs to address this issue, because it is not being addressed today. I think that is the FASB's job. I think they should do that before they issue their pronouncement.

Thank you very much.

[The prepared statement of Dennis D. Powell follows:]

PREPARED STATEMENT OF DENNIS D. POWELL, VICE PRESIDENT, CORPORATE CONTROLLER, CISCO SYSTEMS, INC.

INTRODUCTION

My name is Dennis Powell. I am Vice President and Corporate Controller for Cisco Systems, Inc.

Cisco is the worldwide leader in networking with revenues currently approximating $17 billion per year. We are a multinational corporation with more than 28,000 employees in 200 offices and 55 countries. In the U.S., we have significant operations in California, Texas, Massachusetts and North Carolina.

BACKGROUND

The two methods of accounting—"Purchase" and "Pooling of Interests"—have been generally accepted in practice since 1945. In 1970, the Accounting Principles Board studied and discussed the pros and cons of the two accounting methods, and issued APB16 "Business Combinations", which reaffirmed the validity of both the purchase and pooling of interests methods.

This viewpoint was again reaffirmed in 1994 by a task force commissioned by the American Institute of Certified Public Accountants to study the usefulness of financial reporting. This report, entitled "Improving Business Reporting—A Customer Focus" concluded, after three years of study, that, "A project to do away with either method would be very controversial, require a significant amount of FASB time and resources, and in the end is not likely to improve significantly the usefulness of financial statements."

The arguments for and against the pooling and the purchase methods of accounting haven't changed over the past 30 years—we are still debating the same issues.

However, the problems of the purchase method are still with us, and the implications today are much more severe than they were in 1970. In 1970, most of an acquisition price was allocated to tangible, hard assets. Today, for knowledge-based technology companies, most of the acquisition price is allocated to intangible assets—and very little allocated to hard assets. For example, since 1993, Cisco has acquired over 50 companies amounting to $19 billion. Of these acquisitions, only $900 million, or 5%, is attributed to hard assets—$18 billion or 95% would be left to allo-

cate to intangible assets or goodwill. So the limitations of the purchase method have become more problematic. And yet the new FASB proposal would force all acquisitions to be accounted for under the purchase method, without having solved its defects.

GOODWILL AMORTIZATION

The most significant defect of the purchase method is the accounting for goodwill once it is recorded as an asset on the balance sheet. The FASB proposal requires that goodwill be treated as a wasting asset, and be amortized ratably over 20 years. This model incorrectly assumes that goodwill declines in value over time, which artificially reduces net income and misrepresents economic reality. In reality, the value of goodwill is dependent upon the success of the merger, and is not a function of time.

For example, we studied four technology mergers that occurred in 1996 and 1997, which were reported as poolings. We then recast the poolings as if they were purchases, and restated the financial statements for periods after the acquisition to show the impact of goodwill amortization. The results of all four companies in the study are summarized on Attachment B. The purchase accounting model significantly reduced actual earnings by an average of 48% because of the amortization of goodwill. This would suggest that goodwill has declined in value. However, over this same time period, goodwill has actually increased from the date of the merger by an average of 43%.

Based on the above study, it is clear that in successful mergers, the presumption that goodwill is a wasting asset is not valid. Goodwill increases in successful acquisitions and declines rapidly in unsuccessful acquisitions. Goodwill does not decline ratably over twenty years—the FASB model simply does not report true economic performance.

INTANGIBLES

Regarding valuation of other intangible assets, the FASB proposal obligates companies to identify and value all intangible assets, without giving adequate guidance on how these assets should be separately identified and valued. There are no standards in the valuation community to provide any consistency or reliability around the valuation of these intangibles.

At risk is a loss of credibility in financial reporting. FASB must provide more guidance and tools around how their requirements should be implemented.

COMPARABILITY

The FASB has stated that elimination of pooling solves a comparability issue between purchase transactions and pooling transactions. But elimination of pooling simply trades one comparability issue with a set of new comparability problems. First, mandating the purchase method creates significant comparability issues between companies who grow from internal organic development and those who grow through acquisition.

For example, a company that generates significant goodwill from its internal operations will report no goodwill value while the company that acquires goodwill through a merger will report the "value" of the goodwill at the time of the acquisition. So, while both companies may have the same value of goodwill, only the company who obtained the goodwill through a merger will report any amount on its balance sheet.

Secondly, elimination of pooling prevents comparability within the same company—in comparing operations before the acquisition, which do not include the activities of the acquired company, to operations after the acquisition, which do include the activities of the acquired company. Eliminating pooling does not solve the comparability issue.

I believe the comparability issue would be more effectively addressed by correcting the inherent problems of the purchase method than by eliminating pooling accounting as an option.

DEFENSE OF POOLING ACCOUNTING

The FASB argues that the pooling method provides investors with less information—and less relevant information—than provided by the purchase method, because the pooling method ignores the values exchanged whereas the purchase method records these values on the face of the balance sheet. I disagree that the pooling method provides less information. At the time of a merger, the numbers of shares exchanged and related share values are known, so the value of the transaction is

known. Furthermore, the pooling method of accounting reports a more conservative balance sheet, reports results of operations more accurately and presents investors and creditors with more relevant information to assess subsequent performance of the combined entities than the purchase method. Using Attachment C as an illustration, if Companies A and B would combine, the pooling method would record a combined equity of $0. However, the purchase method would create an inflated equity of $4,000, giving the impression that these two anemic companies had been made well by simply combining.

Furthermore, because the purchase method incorrectly assumes that the goodwill recorded on the balance sheet declines over 20 years, the combined company's operations are artificially reduced from its actual performance under purchase accounting. The pooling method more faithfully reports true economic performance as illustrated in Attachment C.

Finally, application of the purchase method would mislead the reader of the financial statements of the combined financial statements into believing that the revenues had increased 100%, from $2,500 in Year 1 to $5,000 in Year 2. However, the pooling method would correctly reflect the true view that sales had been flat between the two years, because this method requires that previously reported financials be restated to report the combined operations as if they had always been together; in this case both Years 1 and 2 would reflect sales of $5,000.

In summary, the pooling method reports a more conservative balance sheet, more accurate income, a better comparison of operations and a truer picture of sales trends.

SUMMARY

In conclusion, the U.S. accounting rules for Business Combinations, which includes both the pooling and purchase methods, has for the past 50 years, generated and supported the strongest capital markets in the world. Before the FASB radically changes these accounting rules to a model that will certainly stifle technology development, impede capital formation and slow job creation in this country, the FASB should make sure the proposed new method is without question, the absolute, correct solution. In reality, the FASB's proposed standard does not improve the accounting—it merely changes it. Worse yet, the proposed changes require companies to use a purchase model that does not work for companies in the New Economy, where most of the acquisition value cannot be attributed to hard assets, forcing companies to report an arbitrary, artificial net income number that is irrelevant and misleading.

We believe the FASB should:

(1) Retain the pooling of interests method of accounting. The pooling method of accounting continues to have broad-based support. Two-thirds of the respondents to the current FASB exposure draft and all of the Big 5 accounting firms disagreed with the FASB's plan to eliminate pooling accounting.

(2) Revise the purchase method to correct its deficiencies, such as:

  (a) Charge purchased goodwill directly to shareholders' equity, or amortize it through comprehensive income, or reduce goodwill only when it has actually declined in value; and

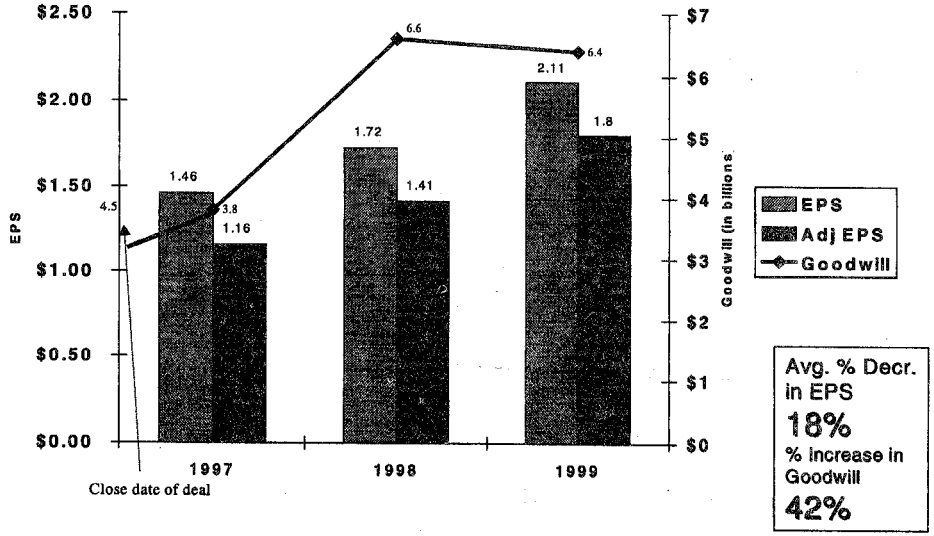
  (b) Limit the allocation of purchase price to only those intangibles that can be objectively and reliably valued;

(1) Engage a task force, which would include valuation experts, to develop adequate guidance on how to identify, value and account for intangible assets for New Economy companies.

Attachment A

COMPUTER SCIENCES/CONTINUUM

20 Year Amortization



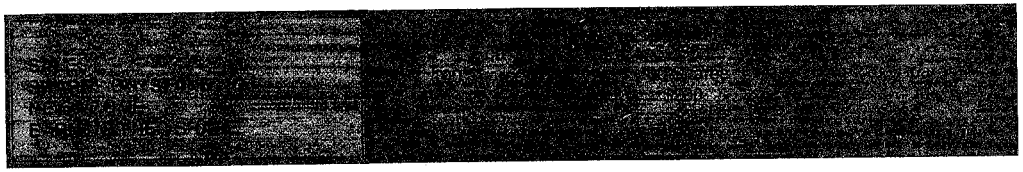
Attachment B

SUCCESSFUL ACQUISITIONS

		AVERAGE INCREASE GOODWILL ↑
Rational/PureAtria	84%	59%
KLA/Tencor	45%	58%

Attachment C

COMPARISON OF PURCHASE VERSUS POOLING METHOD



ASSUMPTIONS

1. Fair market value of both Company A and Company B are $4,000 each (100 shares @ $40/share = $4,000)
2. Net book value of both companies is $0.
3. Company A shareholders exchange 100 shares of Company A stock for 100% of Company B stock with Company B shareholders at beginning of fiscal year.
4. Merger occurs after Year 1. Sales and net income of both companies are the same in Year 2 as in Year 1 before purchase accounting entries.

DISCUSSION

A. EPS of Combined Company using pooling accounting is the same $2/share:
   1. Consistent with merger of the two shareholder groups, one would expect that income would remain at the combined level of $2.
   2. Reflects economic reality of combined interests of the two shareholder groups--adds the income of Company B and the additional shares outstanding.

B. EPS of Combined Company using purchase accounting is $1/share:
   1. Calculated as:

combined net income	$400
less goodwill amortization ($4,000/20)	(200)
	200
÷ shares outstanding	200
	$ 1/share

   2. Goodwill charge required by purchase accounting fictitiously reduces net income because it wrongly assumes goodwill is declining in value.

C. Beginning balance sheet of Combined Company--net book value:
   1. Pooling method = $0 (original historical cost)
   2. Purchase method = $4,000 (less conservative balance sheet)

D. Value of transaction is known--100 shares @ $40/share = $4,000

Mr. OXLEY. Thank you.
Mr. Bible?

STATEMENT OF PETER R. BIBLE

Mr. BIBLE. It is a pleasure to be with you here today, especially a fellow Buckeye, Mr. Chairman. In the land of Wolverines and Spartans, it is kind of lonely up there.

To put my comments in context, Mr. Chairman, I think it is important to understand that the General Motors Corporation is a participant in both the new and the old economy. Some of our new ventures, eGM, Trade Exchange, Hughes Electronics, are among some of the darlings on Wall Street as the high-tech industry. Those businesses have been built on purchase accounting acquisitions.

Presently there is an exchange offer for $9 billion for GM-1 and 2 shareholders to exchange their one and two-thirds shares for shares of Hughes. I am not sure how their growth through non-pooling transactions has impeded their value.

Now to my written testimony.

The act of bringing together two or more independent businesses to function as one business is known by many names on Wall Street and in the media. For purposes of my testimony here today, I will use the term "business combinations" to refer to that act.

A business combination can be and often is a very significant financial and cultural event in the life of a business. That financial significance is the very heart of the topic of your hearings, and that is the combined income statement of the businesses subsequent to the business combination.

Why the income statement, you ask? The answer is, that is where investors and other users of financial statements look to see if the business combination was accretive, a good thing, or dilutive, a bad thing, to net income and earnings per share, two of the key determinants for stock price for many businesses.

Why is this the very heart of the topic of your hearings, you ask? The answer is, under purchase accounting, the difference between the amount paid for a business and the historical net book value of that business's net assets or equity find its way to the income statement over time as expenses. This dilutes net income and earnings per share of the combined businesses.

Under the pooling method, however, that difference between the amount paid for a business and the historical net book value of that business is never recognized in the financial statements of the combined businesses; thus, the game. Therefore, at worst, net income of the combined businesses is equal before and after the business combination. Accordingly, a business combination on an economic basis could be and often is dilutive, but that dilution is never reflected in the income statement of the businesses.

The contrarion to this view would tell you that investors and analysts are not ignorant, and they can see through the differences between purchase and pooling of interests accounting. This may be true, but in today's world of "you're as good as your last quarterly results," memories fade fast.

The Accounting Principles Board in their Opinion 16 recognizes that there are business combinations that represent a uniting of

shareholders' interests, or what is referred to in today's world as a merger of equals, that would be best accounted for by combining the historical financial statements of the combined businesses.

To define this type of business combination, the Accounting Principles Board put in place 12 tests to be passed. Since its issuance in August 1970, Wall Street and others have been gainfully employed navigating around the 12 tests in AB16.

This has given rise to countless interpretations of the pooling of interests rules by the Accounting Principles Board, the Financial Accounting Standards Board, the Emerging Issues Task Force, and the Securities and Exchange Commission.

Do mergers of equals really exist? Sure, just like Michael Jordan and Jack Nicklaus exist, but they are rare, and to define them is close to impossible.

I mentioned earlier in my testimony the cultural significance of business combinations. Perhaps that is why the term "merger of equals" is often used in the press to describe an acquisition. I would be shocked if you do not hear today that the Financial Accounting Standards Board's Proposed Statement on Business Combinations will bring a plague on high-tech and startup businesses. You should ask those testifiers on what basis the stock of a high-tech or startup business trades: net income or revenue?

Not being in the proposed standard affects the recognition of revenue. If your concern is there, talk to the SEC on their staff accounting bulletin 101.

Historically, many acquisitions have been accounted for using the pooling of interests method because of the use of stock as the currency. It is often the case that, for tax reasons, stock is a more efficient currency than cash.

In closing, as you will see in my written testimony, there are several provisions of the proposed standard that I do not agree with. However, I do support the elimination of the pooling of interests method.

Thank you very much.

[The prepared statement of Peter R. Bible follows:]

PREPARED STATEMENT OF PETER R. BIBLE, CHIEF ACCOUNTING OFFICER, GENERAL MOTORS CORPORATION

The act of bringing together two or more independent businesses to function as one business is known by many names on Wall Street and in the media. For purposes of my testimony here today, I will use the term "business combinations" to refer to that act. A business combination can be, and often is, a very significant financial and cultural event in the life of a business. That financial significance is at the very heart of the topic of your hearings, and that is the combined income statement of the businesses subsequent to the business combination. Why the income statement you ask? The answer is: that is where investors and other users of the financial statements look to see if the business combination was accretive (a good thing) or dilutive (a bad thing) to net income and earnings per share, which are two of the key determinants of stock price for many businesses. Why is this at the very heart of the topic of your hearings, you ask? The answer is: under purchase accounting, the difference between the amount paid for a business and the historical net book value of that business' net assets or equity finds its way to the income statement over time as expenses. This dilutes the net income and earnings per share of the combined businesses.

Under the pooling of interests method, however, that difference between the amount paid for a business and the historical net book value of that business is never recognized in the financial statements of the combined businesses. Therefore, at worst, net income of the combined businesses is equal before and after the busi-

ness combination. Accordingly, a business combination on an economic basis could be, and often is, dilutive, but that dilution is never reflected in the income statement. The contrarion to this view would tell you that investors and analysts are not ignorant and can see through the differences between purchase and pooling of interest accounting. This may be true but, in today's world of "you're as good as your last quarterly results," memories fade fast. The Accounting Principles Board in their Opinion No. 16 recognized that there are business combinations that represent a uniting of shareholders interest, or what is referred to in today's world as a merger of equals, that would best be accounted for by combining the historical financial statements of the combined businesses. To define this type of business combination, the Accounting Principles Board put in place twelve tests to be passed. Since its issuance in August 1970, Wall Street and others have been gainfully employed navigating around the twelve tests in Opinion No. 16.

This has given rise to countless interpretations of the pooling of interests rules by the Accounting Principles Board, the Financial Accounting Standards Board, the Emerging Issues Task Force, and the Securities and Exchange Commission. Do mergers of equals exist? Sure they do, just like Michael Jordan and Jack Nicklaus exist, but they are rare and to define them is close to impossible. I mentioned earlier in my testimony the cultural significance of business combinations. Perhaps that is why the term "merger of equals" is used so often in the press to describe an acquisition. I would be shocked if you did not hear today that the Financial Accounting Standards Board's Proposed Statement on Business Combinations will bring a plague on high-tech and start-up businesses. You should ask those testifiers on what basis the stock of a high-tech or start-up business trades: net income or revenue? The topic of your hearing has no affect on revenue. Historically, many acquisitions have been accounted for using the pooling of interest method because of the use of stock as the currency. It is often the case that, for tax reasons, stock is a more efficient currency than cash.

In closing, as you will see in my written testimony, there are several provisions of the Proposed Standard that I do not agree with. However, I do support the elimination of the pooling of interests method.

General Motors

December 14, 1999

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference No. 201-A: Proposed Statement of Financial Accounting Standards - Business Combinations and Intangible Assets

Dear Tim:

General Motors appreciates this opportunity to respond to the FASB's Proposed Statement of Financial Accounting Standards ("proposed Statement"), "Business Combinations and Intangible Assets."

Our comments on the questions raised in the proposed Statement are summarized below.

Scope

Issue No. 1: This proposed Statement would not apply to combinations of not-for-profit enterprises. The Board has decided to address issues specific to those combinations in a separate subproject to be conducted as part of the overall business combinations project. The Board tentatively plans to begin discussing those issues in the second half of 1999. Are there any specific issues the Board should consider when it discusses combinations of not-for-profit enterprises?

Paragraph 91 discusses the basis for the Board's conclusions on this issue.

Response No. 1: We agree that this project should not address not-for-profit enterprises.

Issue No. 2: Paragraphs 10-12 of this proposed Statement would modify the definition of a business combination in Opinion 16 in two ways. First, a change would be made to the Opinion 16 definition to reflect the Board's conclusion that all business combinations are acquisitions that should be accounted for using the purchase method and its consequent decision that the pooling-of-interests method should not be used to account for any business combination. Second, a change would be made to clarify that an exchange of a business for a business is a business combination. Otherwise, it is the Board's intent that this proposed Statement would apply to the same transactions covered by Opinion 16. Based on the proposed definition of a business combination, are there other transactions that appear to be included in or excluded from the scope of this proposed Statement that were or were not similarly covered by Opinion 16? If so, how should the definition be clarified to accommodate those transactions?

Paragraphs 92-94 discuss the basis for the Board's conclusions on this issue.

Response No. 2: We agree with the Board's decision that the pooling-of-interests method should not be used to account for any business combination. We also agree with the Board's definition of a business combination. Our response, however, is conditioned on the fact that "new basis" issues will be discussed in a later phase of the business combinations project.

Method of Accounting for Business Combinations

Issue No. 3: This proposed Statement would eliminate use of the pooling-of-interests method to account for business combinations and require the purchase method to be used to account for all business combinations. Do you agree with the Board's conclusion that all business combinations are acquisitions? If not, why not?

Paragraphs 143-153 discuss the basis for the Board's conclusions on this issue.

Response No. 3: We agree with the Board's conclusion that all business combinations are acquisitions.

Issue No. 4: Application of the purchase method would require that an acquiring enterprise be identified in all business combinations. This proposed Statement would modify the provisions in Opinion 16 for determining the acquiring enterprise. In addition to factors relating to voting rights, this proposed Statement would require consideration of the composition of the board of directors and the senior management of the combined enterprise (paragraphs 15-17). Do you believe those factors are sufficient for determining the acquiring enterprise in all business combinations? If not, what additional factors or guidance should be included?

Paragraphs 160-168 discuss the basis for the Board's conclusions on this issue.

Response No. 4: We agree with the Board's conclusions on this issue and have nothing to add at this time.

Issue No. 5: This proposed Statement would change the accounting for the excess fair value of acquired net assets over cost (*negative goodwill* or *excess*). Opinion 16 requires that the excess be allocated on a pro rata basis to the noncurrent assets acquired. This proposed Statement would require the excess to be allocated on a pro rata basis first to intangible assets for which there is no observable market and, second, if an excess still remains, to acquired depreciable nonfinancial assets and to any other acquired intangible assets. If all the assets to which the excess would be allocated are written down to zero and an excess still remains, that amount would be recognized as an extraordinary gain. Under Opinion 16, that remaining excess would be deferred and amortized.

The Board initially decided that *all* negative goodwill should be recognized as an extraordinary gain. Is the approach required by this proposed Statement (paragraphs 23 and 24) preferable to the approach in Opinion 16 and to recognizing an extraordinary gain for the entire amount of negative goodwill? If not, which approach is preferable and why?

Paragraphs 289-297 discuss the basis for the Board's conclusions on this issue.

Response No. 5: We refer the Board to the last sentence of paragraph 294 of the proposed Statement. For a U.S. accounting standard to be based, in part, on the anticipation of inappropriate, if not perhaps unlawful, conduct of a preparer of financial statements is troubling. We encourage the Board to reconsider the negative goodwill section of the proposed Statement. We see no theoretical grounds for accounting for goodwill differently based on whether it is positive or negative.

Accounting for Goodwill

Issue No. 6: This proposed Statement would require that the excess of the cost of the acquisition over the fair value of acquired net assets (*goodwill*) be recognized as an asset.

This proposed Statement would require that goodwill be amortized over its useful economic life; however, the amortization period may not exceed 20 years.

a. Does goodwill meet the assets definition and the criteria for recognition as an asset in FASB Concepts Statements No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, and No. 6, *Elements of Financial Statements*? If not, why not?
b. Should goodwill be amortized in a manner similar to most other assets? If not, why not?
c. Is the 20-year maximum amortization period appropriate?

Paragraphs 169-243 discuss the basis for the Board's conclusions on this issue.

Response No. 6: We agree with the Board's conclusions regarding Issues 6a and 6b. We do not agree, however, with the conclusion on issue 6c and believe that the Board has the opportunity to improve the U.S. accounting model in this area.

Most, if not all, businesses are bought and sold based upon an anticipation of net cash flow generation for a period of time. A portion of that period of time is often comprehended by a terminal or residual value. The value of those future net cash flows is a highly subjective matter that can be influenced by several factors including the risk and rewards inherent in the business to be acquired and in owning that business. This process also involves probability assessments as to the occurrence or non-occurrence of future events. To arrive at purchase price, a discount factor is applied to the adjusted future cash flows. That discount factor will vary from acquirer to acquirer and acquisition to acquisition based upon the acquirer's internal management matrices and investment objectives.

Accordingly, rarely does the purchase price have any direct relationship to the simple sum of the fair value of the net assets of the acquired business at the date of acquisition. Prices paid often reflect perceived value of key personnel and expertise, the potential for unquantified as well as quantified future success through synergy, the value of eliminating one or more competitor channels, and a host of other business factors unrelated to the fair values of individual assets. Moreover, the goodwill or excess of the purchase price over the fair value of those net assets is determined by the acquirer based upon its own assessment of value as described above. Accordingly, prescribing uniform rules for the allocation of purchase price to acquired identifiable and unidentifiable intangibles and, as a practical matter, set amortization lives, we believe will cause clearly unlike transactions to be accounted for as though they were alike.

Therefore, we support an approach that aggregates the excess of purchase price over the fair value of the tangible net assets of the acquired business. This excess would be comprised of identifiable intangible assets (as described further in our response to Issue 8 below), and remaining goodwill. We would not place any artificial and arbitrary time period limits on amortization of intangible value acquired in a business combination, but instead utilize a "burden of proof" approach for identifying the appropriate life and time period for each identifiable intangible. The remaining goodwill would then be amortized over the period used in valuing the business not to exceed the current APB Opinion No. 17 requirement of 40 years.

We believe this approach is preferable to the Board's approach in that it further recognizes the uniqueness of each acquisition and recognizes that the future net cash flows from intangibles cannot be separated from the future net cash flows of the acquired business. For example, working capital, fixed assets and debt of an acquired business can be turned over without significantly affecting the future net cash flow of that business. The patent or brand, however, that limits other's use to the core product of the acquired business cannot be turned over without significantly affecting that business' future net cash flow.

Issue No. 7: The Board considered several approaches that would have permitted some or all goodwill to be capitalized and not amortized. However, the Board found that none of those approaches were operational because of the subjectivity involved in identifying and measuring the discernible elements of goodwill, particularly those with indefinite lives, and the inability to adequately review goodwill for impairment (no identifiable direct cash flows).

a. Is there a way to overcome the subjectivity involved in identifying and measuring discernible elements of goodwill and thereby to make the discernible-elements approach described in paragraphs 230 and 231 operational?
b. Is there a robust and operational way to review goodwill for impairment such that more reliance could be placed on an approach that includes not amortizing some or all goodwill? If so, please describe it.

Paragraphs 229-235 discuss the basis for the Board's conclusions on this issue.

Response No. 7: Please refer to our Response No. 6. We believe the results of this project's field test proved the discernible-elements approach to be inoperable.

Accounting for Identifiable Intangible Assets

Issue No. 8: This proposed Statement would require acquired identifiable intangible assets that can be reliably measured to be recorded separately from goodwill in the financial statements of the acquiring enterprise at their fair value (paragraph 19). That requirement is based on the assumption that intangible assets acquired in a business combination can be measured separately from goodwill with a sufficient degree of reliability to meet the asset recognition criteria. Based on information provided by valuation experts, the Board reached a conclusion that various intangible assets can be reliably measured.

a. Is that conclusion appropriate or inappropriate? Why?
b. Are some classes or types of intangible assets more reliably measurable than others are? If so, please describe them.
c. Can paragraphs 18, 198, 21 and 37 be modified to better achieve the Board's objective of separately recognizing more intangible assets than are currently recognized under Opinion 17?
d. Are the examples of identifiable intangible assets that might be acquired in a business combination listed in Appendix A appropriate? Are there other examples that should be included?

Paragraphs 253-272 discuss the basis for the Board's conclusions on this issue.

Response No. 8: Please refer to our Response No. 6. We support the requirement to identify all acquired intangible assets that can be reliably measured for recognition in the financial statements. However, we are concerned that the recognition criteria for determining what is "reliably measurable" has a significant operational difficulty. Therefore, we suggest that the Board further refine the criteria for recognition of intangibles in a business combination to include only those intangibles which are traded in a secondary market and those intangibles which would be recognized under other existing accounting standards. As discussed in Response No. 6, we would utilize a "burden of proof" approach for identifying the appropriate life and time period for each identified intangible.

We strongly believe in the paradigm that in a business combination, an enterprise acquires future net cash flows rather than net assets. In that view, it is not possible or relevant to separate the future net cash flow from an in use identifiable intangible asset from the future net cash flow of the acquired business. Accordingly, we do not believe that intangible assets acquired in a business combination should be presented separately from goodwill.

Issue No. 9: Opinion 17 imposed a 40-year maximum amortization period for all intangible assets. If certain criteria are met, this proposed Statement would require an intangible asset (other than goodwill) to be amortized over a period longer than 20 years and in some circumstances to not be amortized at all.

a. Are the criteria in paragraphs 37 and 40 for overcoming the 20-year useful life presumption appropriate? If not, how should they be modified and why?
b. Are the criteria in paragraph 41 for nonamortization appropriate? If not, how should they be modified and why?
c. Are the examples in paragraph 77 illustrating the amortization period for certain identifiable intangible assets helpful? If not, how could they be improved?

Paragraphs 273-288 discuss the basis for the Board's conclusions on this issue.

Response No. 9: Please refer to our Responses Nos. 6, 7 and 9. We do not believe, as sustained by the results of this project's field test, that the discernible-elements approach is operable. Further, under the cash flow paradigm, we believe that the value of an intangible should not be separately measured from the value of a business.

Impairment

Issue No. 10: This proposed Statement would require that all goodwill be reviewed for impairment in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and included examples of events and circumstances that would require goodwill to be tested for recoverability (in addition to those in paragraph 5 of Statement 121).

a. Are those examples (paragraph 47) appropriate? If not, which of the examples should be modified and how?

   Paragraph 26 of this proposed Statement would require goodwill to be tested for recoverability no later than two years after the acquisition date if more than one of the four factors listed in that paragraph was present at the acquisition date.

b. Are those factors appropriate? If not, which of the factors should be modified and how?
c. Is two years the appropriate time frame during which that recoverability test should be performed? If not, what should that time frame be and why?
d. Is the Statement 121 approach described in paragraphs 46-48 an operational way to review goodwill for impairment? If not, why not?

Paragraphs 298-316 discuss the basis for the Board's conclusions on this issue.

Response No. 10: We agree with the Board's conclusions on this issue if the acquired company is to be managed as a separate entity by the acquiring enterprise; however, if the acquired business is to be combined with the existing operations of the acquiring enterprise such that the original identity of the goodwill is obscured, we question the operability of the existing standard in these circumstances.

Presentation in the Income Statement

Issue No. 11: This proposed Statement would require that goodwill charges (amortization expense and impairment losses) be presented in the income statement as a separate line item on a net-of-tax basis. The goodwill charges would be followed by other line items that do not constitute "continuing operations" such as discontinued operations and extraordinary items. This proposed Statement would also require that enterprises present a subtotal on the income statement *before* the goodwill charges. However, that required subtotal would *include*amortization expenses related to other intangible assets acquired in a business combination as well as the effects of the step-up in basis of the other net assets acquired.

In addition, this proposed Statement would permit enterprises to present per-share amounts on the face of the income statement for the subtotal before the goodwill charges and for the goodwill charges.

a. Would those income statement presentation provisions (paragraphs 52-58) result in more useful financial information? If not, what presentation would be preferable?
b. Would the unique treatment of goodwill charges in the income statement serve as a disincentive to separately recognizing identifiable intangible assets that are not afforded the same treatment?

Paragraphs 325-348 discuss the basis for the Board's conclusions on this issue.

Response No. 11: We agree with the Board's conclusions on this issue except that we would include amortization expenses related to other intangibles acquired in a business combination, whether or not measured separately.

Disclosure Requirements

Issue No. 12: This proposed Statement would eliminate the Opinion 16 requirement to disclose information about the results of operations on a pro forma basis. Instead, paragraph 27(e) of this proposed Statement would require that the notes to the financial statements of the acquiring enterprise include a condensed balance sheet of the acquired enterprise disclosing both the book values as reflected in the acquired enterprise's financial records and the comparable fair values assigned at the date of acquisition.

a. Is information about the book values and fair values of the net assets acquired useful? If so, why; if not, why not?
b. Should disclosure of pro forma results of operations continue to be required? If so, why?

Paragraphs 351-354 discuss the basis for the Board's conclusions on this issue.

Response No. 12: While we would limit the disclosure to book values and fair values of tangible net assets acquired, we agree with the Board's conclusions on this issue and would support the continuation of the pro forma results of operations. We believe that both of these disclosures are beneficial to the analyst community and other users of financial statements.

Effective Date and Transition

Issue No. 13: The Board decided that goodwill being accounted for in accordance with ARB No. 43, Chapter 5, "Intangible Assets," would be written off as the cumulative effect of a change in accounting principle when the final Statement is initially applied. However, for practical reasons, the Board decided to "grandfather" the manner in which previously recognized goodwill is being accounted for under Opinion 17 and the manner in which other previously recognized intangible assets are being accounted for under ARB 42, Chapter 5 or Opinion 17.

Should this proposed Statement require retroactive application of its amortization provisions to previously recognized goodwill and other intangible assets? If so, why: if not, why not?

Paragraphs 372-284 discuss the basis for the Board's conclusions on this issue.

Response No. 13: We are not sure how to interpret paragraph 65 since it incorporates paragraph 64, which requires ARB No. 43, paragraph 5, goodwill to be written off, yet, at the same time, grandfathers intangibles and goodwill recognized under that standard. In any event, we believe that all previous accounting for goodwill should not be disturbed. This is consistent with the transition provision governing Part 1 of the proposed Statement.

Issue No. 14: The provisions in the proposed Statement related to reviewing goodwill for impairment (including allocating goodwill to individual asset groups), presentation in the financial statements (including presenting goodwill charges on a net-of-tax basis), and disclosures (specifically, information and intangible assets by class) would be applicable to goodwill and other intangible assets acquired in transactions initiated on or before the date the final Statement is issued as well as those initiated afterward. The Board decided that restatement or reclassification would not be required for intangible assets acquired in transactions initiated on or before issuance of the final Statement if it was not practicable to do so because records may not be available.

Which of those provisions might not be practicable to apply to previously recognized goodwill and intangible assets and why?

Paragraphs 385-394 discuss the basis for the Board's conclusions on this issue.

Response No. 14: We agree with the Board's conclusion on this issue and do not presently see any impracticalities associated with this issue.

We appreciate the opportunity to respond to the FASB's proposed Statement and would be pleased to discuss our comments further at your convenience.

Sincerely,

Peter R. Bible

Peter R. Bible
Chief Accounting Officer

Mr. OXLEY. Thank you, Mr. Bible.

Mr. Hoffman.

STATEMENT OF GENE HOFFMAN, JR.

Mr. HOFFMAN. Mr. Chairman, thank you very much for holding the hearing. Thank you very much for inviting me and giving me the opportunity to speak. I will submit my written testimony for the record, and speak quickly, hopefully remaining in my time here, on some of the various topics that are brought up.

First of all, let me tell you what EMusic is and where I came from and what I do. We have a unique perspective on intangibility, as we are one of the few companies that actually sells no physical goods whatsoever. We actually sell downloadable music in the form of bits over the Internet for 99 cents a song or $8.99 an album.

We also own or operate, or I should say operate, RollingStone.com, to which we sell advertising and sponsorship revenues and drive downloadable music sales from the Internet at that magazine's Web site.

Because of this, we are uniquely impacted by intangible accounting. Unlike Cisco, which is probably one of the tech leaders, frankly, we do not even ship a box. When we make or made approximately $2.8 million in gross profits last quarter, all of that was directly delivered over the Internet; no physical goods; no pick, pack and ship; no warehouses. We are always in stock.

It is interesting when we look at these issues, because what we are really concerned with overall is the handling of intangible accounting. I think my associate from Cisco said it well. My concern is that the purchase method accounting has yet to really well understand those issues that are fully intangible.

One of the issues I would like to point out specifically is—and before I go too deep in this, I want to say that again, I have a different and unique perspective. I am the son of an accountant, hard-

ly an accountant myself, and the youngest NASDAQ CEO, so I look at this, again, from a very different perspective than many companies in the space.

There seems to be a prevalence of a concern that this is just a technology company situation. I want to challenge any company to admit that they are not a technology company. Every single company is a technology company. Even my associate here from General Motors admits to the fact that GM is a technology company, a very good and successful technology company. Even the auto division strives with Armstrong and other programs to become more of a service and an intangible asset-based business.

So these are issues for any company that looks at strong growth and the ability to monetize, the ability to be weighed against their intangible assets.

I want to make an interesting point and bring the tangible assets a little bit more home to the everyday American. Twenty years ago a song was written by Don McLean called American Pie. Well, that song as an asset. It faded from memory, so in some ways, yes, it absolutely decreased in value, but with no expenditure by the original songwriter, a small artist we all have heard of once in a while called Madonna decided to rerelease that song. That intangible asset, the ownership of the copyright in American Pie, has tremendously increased in value without any expenditure of asset, any expenditure of cash, any expenditure of promotion by the original copyright owner. That is an important aspect, now, very specific to my industry, but telling in the same way that this happens in software companies and others.

Brand names and other pieces, part of which—for example, our own public disclosures are heavily laden with the write-down of goodwill for the acquisition of Tunes.com, RollingStone, the EMusic name, the music rights themselves are heavily laden with.

One other important point I want to make, we have heard from various people who have had quite a bit more accounting experience than I do, but anyone who does a pooling acquisition absolutely shows a cost. When AOL acquired NetScape, there was a dilutionary cost. It was a direct impact to earnings per share.

This brings me to what I think is the most important issue facing us. I personally do not really concern myself with whether or not pooling will really be an available and acceptable accounting method in the future. What concerns me is is it truly transparent to not have it.

Let me make my point here. Currently when the average mother and father, a 40-year-old, tries to evaluate my company and other companies in technology space, and I will use the company Excitehome, which actually did a purchase method acquisition of Excite, there are now two different disclosures that are looked at. There are cash basis pro forma and earnings per share.

For the not-as-sophisticated investor who does not have access to sell and buy side analysts and equities analysts and all the other levels of information that your mutual funds and pension funds have, it is very difficult to understand the difference between pro forma and actual EPS.

Most people are used to AT&T in the classic sense, where EPS was the No. 1 way they judged a company. Growth in EPS, actual

EPS, was how they looked at companies. The elimination of pooling means a direct double charge in some senses to EPS, both dilutionary and then the write-down of the goodwill, the acquisition itself. That is the issue. The issue really is not how we account for it, it is are we providing the level of disclosure and the level of transparency to the individual investor.

I am not concerned about California Teachers Pension Fund. I am quite sure that with the type of assets they bring to bear, they will be able to easily evaluate my firm and other firms quite like me to figure out whether or not we are actually performing and whether or not that merger was actually a good, positive, accretive merger, or simply a bad mistake and something that should never have happened before.

What I am concerned with is the person who today bought 1,000 shares at the opening of the market because they thought that what we were doing was the right thing, and they looked at our EPS and were concerned, how could they lose this much cash, because your average individual investor does not know the difference between losing cash and losing goodwill, frankly.

That really is the summation of my concerns. As long as we look at this issue in a careful and slow manner, because this is a very important change, we are talking about changing 40-some plus years of generally accepted accounting principles, as long as we first tackle the issue that has arisen around intangible assets—and again, I put my company to the table here and say that very few companies that ever come before you have no tangible assets, period. Even Cisco has inventory, chips and boxes and various pieces that they are going to sell. I can show you a hard drive. That is my inventory. Is it the value of the hard drive itself, or is it the 8 percent of the U.S. music market that is represented by the files included in that which, in the offline world, generated $1.2 billion?

That is an interesting question. As long as we address that question first and then tackle how we do business combinations, I am comfortable.

But as an entrepreneur, I am not comfortable if there is a significant disincentive for a smaller, but larger than my firm, company to have a disincentive because of the EPS impact that a buying company like mine would have to acquiring my company. That is a disservice to my shareholders, as much as it would be a positive service to say this is a write-down in my income statement.

Thank you.

[The prepared statement of Gene Hoffman, Jr. follows:]

PREPARED STATEMENT OF GENE HOFFMAN, JR., FOUNDER, PRESIDENT, AND CEO, EMUSIC.COM, INC.

Introduction.

It is a pleasure to take part in this morning's hearing on FASB and the important issue of purchase and pooling accounting. My remarks today will focus on public policy and not accounting technicalities. I am not a CPA. I am an entrepreneur. First, let me take a few moments to tell you about EMusic. Since it was founded in January 1998, EMusic has established itself at the forefront of how new music will be discovered, delivered and enjoyed in the next decade. In addition to having the Internet's largest catalog of downloadable MP3 music available for purchase, EMusic operates one of the Web's most popular families of music-oriented Web sites—including RollingStone.com, EMusic.com, DownBeatJazz.com, and IUMA. The

company is based in Redwood City, California, with regional offices in Chicago, Los Angeles, New York and Nashville.

EMusic.com is the Web's leading site for sampling and purchasing music in the MP3 format, which has become the standard in the digital distribution of music. Through direct relationships with leading artists and exclusive licensing agreements with over 650 independent record labels, EMusic.com offers music fans an expanding collection of more than 100,000 tracks for purchase—individual tracks for 99 cents each or entire downloadable albums for $8.99. EMusic.com features top artists in all popular musical genres, such as Alternative (Bush, Kid Rock, They Might Be Giants, Frank Black), Punk (Blink-182, The Offspring, Pennywise), Jazz (Duke Ellington, Dizzy Gillespie, Louis Armstrong, Concord Records), Blues (John Lee Hooker, B.B. King, Buddy Guy), Hip Hop (Kool Keith, The Coup), Country (Willie Nelson, Merle Haggard, Patsy Cline), Rock (Phish, Goo Goo Dolls, David Crosby), World (Nusrat Fateh Ali Kahn, Lee "Scratch" Perry) and Vintage Pop (Liza Minnelli, Eartha Kitt, Judy Garland).

To give you an idea of how fast the downloadable music industry is growing, the company has now sold over 1 million songs in the popular MP3 format since its launch. This total includes single-track sales as well as tracks included as part of albums and special collections. In addition, EMusic.com's catalog has grown to offer more than 100,000 high-quality MP3s for sale from over 650 independent labels.

I am the youngest CEO in NASDAQ. I am twenty-four years old. I am one of those freaks of nature in the high tech world—but in a very good sense. I am very proud of the fact that I have taken ideas and created companies with my friends and with many new people that I have been fortunate to meet along my journey. EMusic is my third company. My first, PrivNet, I created while in college. I sold it to PGP, Inc., and went to work for PGP. PGP was sold in 1997 to Network Associates. While at EMusic I have bought four companies. Creating companies, jobs, economic wealth—all depend on sound accounting principles supported by well thought out public policy. EMusic is a young company that has grown by acquisition. So far EMusic has done purchase transactions because we are not poolable. But I will come back to that point shortly.

It is important to understand that EMusic represents significant intangible assets. Many companies in the New Economy do not nor will not have any physical assets. Their value is either between the ears of their employees or on the hard drives of their computers and networks. EMusic digitally delivers music to consumers. Our only physical asset is a farm of computer servers; but frankly, I prefer to outsource that to a vendor who really knows that business better than I do and can do it for me more cheaply than I can on my own. So far my earnings are not too significant; they are increasing however. I am in a loss basis. I can tell you that my intangible losses are much more significant than my cash base losses because I do write down a lot of intangibles.

Purchase vs. Pooling

I don't think good public policy here should make this an either or discussion. There are problems with both purchase and pooling accounting. At the high level the overall process has flaws. FASB needs to fix purchase accounting first before it can go after pooling. There is a large problem in the high tech community: the growing disparity between book value and market value. FASB has yet to effectively engage the high tech community on this issue. I have testified to FASB on this issue and invite them here today before this Committee to meet with me at my offices in Silicon Valley to continue the conversation after this hearing is over. We really need a better method for measuring intangibles. As more economic wealth moves into intangibles, the accounting methods and their supporting public policy have to keep up. By not fixing purchase accounting and by eliminating pooling accounting FASB only makes matters worse for the New Economy. Moreover, there will be no improvement in the flow of information about companies out to the markets and investors. As we all know the past few years have enabled more Americans to directly invest in the stock market and individual companies. Many Americans do so via the Internet; many have stock from their employers; many have their retirements and investments in stocks and mutual funds. Transparency and the flow of information are critical to the success of democracy; the same is true in an increasingly democratic, egalitarian and participatory stock market.

The Entrepreneur's Dilemma: An Example.

As an entrepreneur I have two options to perform a transaction. I can utilize purchase accounting method and I have to take an EPS impact in the future, or I can do pooling, which obviously has positive benefits for myself as a high tech company and an intangible asset company. Those companies who have built their intangible

assets from ground zero don't have that hit against their earnings, frankly, because those intangible assets have never been valued. But when I buy a company that has valued its intellectual property assets (i.e., its intangible assets), that value is against my doing business. Simply put, the valuation process is not black and white. A company can see the value of its assets increase without doing anything. For example, an artist such as Madonna can perform an old song and increase its value even though the song is owned by a company unrelated to Madonna and her record label. The problem is that valuation is confusing, and if it is confusing to companies in the business who know or should know as much as there is to know about valuing intangibles, then where does this leave the individual investor and institutional investors? One of my biggest concerns here is how intangible assets are valued because I am not sure that the public really knows what stated assets are really worth or are not worth. Institutional investors may be able to get down into the details and ascertain from their own perspective what value may be but the average Josephine is not likely to decipher what is and what is not included in a company's pro forma presentation of earnings before they make their personal investment. Notwithstanding the great amount of information available to individual investors via the Internet the average individual investor simply does not have access to the analysts that companies and institutions do.

This touches upon an even larger public policy issue. And this issue underscores why it is so important for the Congress to increase its scrutiny of FASB and how it changes the accounting rules. This larger public policy issue is a matter of who gets the information, in what form and when. Individuals may not get all the information at all, in a useable form, or at the last moment after others have seen it and made their move in the market. This is an increasing market inefficiency given the expanding amount of capital flowing into the market from individuals and the growth of margin debt.

Conclusion.

When so much of the value of the American economy is tied up in intangibles, in intellectual property, how the pieces of intellectual property are perceived is really the driver of value and not the methodology of some accounting practice or rule. If the market is being driven more by perception than by the principles and rules that government, industry and professionals have set out, then effective governance no longer works and the anarchy of the market has taken over. This is not fair to individuals and is not reflective of our nation's democratic values. Intellectual property is an extremely important part of our nation's export economy. Jack Valenti of the Motion Picture Association of America (MPAA) and others have testified to Congress that movies and other content products have contributed to America's economic bottom line. Whether it is Hollywood in southern California or Silicon Valley in northern California, ideas and intellectual property are drivers of our nation's economic growth and international economic influence. Valuation of intangibles like intellectual property must be grounded on sound public policy and democratic values.

In closing, I want to leave a clear impression with you. The current process is flawed and FASB needs to fix purchase accounting first before they should do anything with regard to pooling or other rules. The big problem for high tech companies is the fact that current purchase rules do not provide investors with better or more useful information. The high tech community has been engaged on this issue through organizations such as TechNet but to date the feed back from FASB has been less than satisfactory. While I am not in favor of any new governmental role here or in any new body charged with setting accounting standards, we do need to work together in a new way to develop a better method for measuring intangibles such as intellectual property. FASB's proposal to require all companies to use purchase accounting will only make these issues worse and will not improve the flow of information to investors, especially the individual. I am pleased that Congress is exercising its proper oversight over the FASB process on this important economic issue and look forward to working with the Congress in the future on this issue.

Mr. OXLEY. Thank you, Mr. Hoffman.

Mr. Lewis?

STATEMENT OF WILLIAM FREDERICK LEWIS

Mr. LEWIS. Mr. Chairman and members of the committee, my name is Bill Lewis. I come to you today as president and chief executive officer of Prospect Technologies, an advanced computer technology and international Web-based firm providing numerous com-

puter solutions to governments, associations, and commercial firms. I also appear today as a member of the United States Chamber of Commerce Small Business Council.

Mr. Chairman, I appreciate this opportunity to comment on the FASB's proposal, and I commend you for holding these hearings. I also ask that my full written testimony be included in the record.

Mr. OXLEY. Without objection, all statements will be made part of the record.

Mr. LEWIS. Thank you, sir.

When firms combine, there are two long-standing accounting methods for combining financial statements, the pooling method and the purchase method. Historically each has worked reasonably well and has given firms the opportunity to accurately reflect to their shareholders their balance sheet and income statements.

I believe that FASB's proposal to eliminate the pooling method is unjustified. Remember, again, with the pooling method the balance sheets of each partner in the merger is simply added together. Furthermore, its adoption may have a dramatic negative impact on our economy.

I strongly disagree with FASB's assertion that all of business combinations should be accounted for as purchases rather than mergers. This fact ignores the reality that business combinations may vary substantially as to the traits of the combining entities and aspects of the combining transactions. Clearly many of today's combinations do not meet FASB's assertion that one firm necessarily gains control over the other.

Furthermore, forced use of purchase accounting, with its creation and amortization of goodwill, can result in misleading financial statements. Often the benefit, the very synergy of combining two companies, continues and grows over time, rather than depreciating.

I can speak extensively to this point as 2 years ago Prospect Technologies merged with a computer hardware manufacturing service support firm. Once this marriage, marriage of our two firms, occurred, Prospect Technologies, now formed from two firms, was able to enter into markets which heretofore it was impossible for either company to enter and penetrate by themselves.

To arbitrarily force the financial statements to reflect a write-off of goodwill, an item which can significantly distort an Internet or .com, if you will, firm, distorts financial information, giving misleading indications of the combined firms' profitability. It understates the firm's bottom line, which in turn would hamper a firm's ability to attract outside capital, go public, or, in more simple terms, grow and make jobs.

With this ruling, as CEO of Prospect Technologies, I would look very carefully at merging with another firm to expand our growth, form new jobs, and help fuel the American economy.

One FASB rationale for eliminating pooling is to reduce the SEC's staff time devoted to mergers and acquisitions using this method. Another is to harmonize or force convergence of our accounting standards with international conventions.

Staffing constraints should not force the rejection of a useful and workable accounting approach, nor should the international "stand-

ards" for which universal consensus is lacking be a motivating or driving force on this.

Mr. Chairman, it is my opinion that over the past several years United States technology and information-based firms have been the preponderance of buyers of firms. It appears that the world looks to us in terms of getting accurate or reasonable pictures in terms of what the accurate portrayal of a financial statement is, not vice versa.

I am not asking Congress today to adopt accounting standards or even to establish an official oversight board over Mr. Jenkins and his fine work that he has done at FASB, but rather to encourage FASB to rethink this rush to judgment. There are no egregious market failures driving this proposal for change. However, as pointed out by many on this panel, including my colleague Mr. Hoffman, there are legitimate concerns over the proper accounting for intangibles or goodwill especially prevalent in the high-tech Internet, the .com companies.

To ameliorate this situation, various groups and commissions have been delegated to examine this issue. I believe you will find under way studies currently done by the Brookings Institute and another one done by a graduate school of business. Clearly, as the owner of a high-tech Internet company creating jobs and fueling this economy, I ask you not to take action until these study groups have come back—these study groups I mentioned before have come back and helped us understand the nature of this problem by shedding light on the wide disparity that has been pointed out by Mr. Powell in his testimony here as well as in the Senate between what the market value of the firms are and what the book value is.

As a small business owner, I believe we have time to wait and evaluate. Prudence dictates that this is the action we should so take.

Mr. Chairman, thank you very much for having me here today.

[The prepared statement of William Frederick Lewis follows:]

PREPARED STATEMENT OF WM. FREDERICK LEWIS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PROSPECT TECHNOLOGIES, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. Chairman and members of the committee, I am Bill Lewis, President and Chief Executive Officer of Prospect Technologies a small business headquartered in the District of Columbia. Our firm employs 23 individuals dedicated to providing information solutions for corporations and government agencies both here in the United States and internationally. Our business includes computer hardware manufacturing, computer software, and Internet and Web based solutions. I also come before you as a member of the U.S. Chamber of Commerce's Small Business Council.

Working with organizations like the U.S. Coast Guard, the Federal Maritime Commission, the Department of Defense, Princeton University, Enterprise Rent-a-Car, the Government of the District of Columbia and McGraw Hill, we provide solutions that help to dramatically improve business processes through the use of technology and the Internet. Our work has received a great deal of recognition including winning Vice President Gore's Golden Hammer Award for streamlining government, cutting through red-tape, and improving the quality of customer satisfaction that is delivered by the Federal Government. This year we have been nominated again for this prestigious award by the Federal Maritime Commission for automating all of the FMC's service contracts and amendments filings via the Internet and the Web.

Mr. Chairman, we appreciate the opportunity to testify on the issue of accounting for business combinations, in particular the question of whether the pooling-of-interests method of accounting should be eliminated. We commend you for holding these hearings.

We oppose the decision of FASB to prohibit the use of the "pooling-of-interest method of accounting" for all business combinations and to force the use of the "purchase method" with the subsequent amortization of goodwill over, at most, a twenty-year period. Not only will changes in this longstanding practice and the adoption of new standards not further the goals of providing more accurate, transparent and reliable financial statements, but they also may well have a substantial negative impact both on the economy's and my company's ability to grow.

Prospect Technologies

I am the CEO of a thriving private company, Prospect Technologies, and I am looking for opportunities to expand my business. Two years ago I merged with PC's & Systems, Inc., a computer hardware manufacturing and services company. The transaction was reported using the pooling-of-interests of both companies and combination of our two historical balance sheets. However, in spite of Prospect Technologies recording this on its balance sheet as a simple sum of the assets of the two firms, the result of the merger created a synergy that allowed us to bid and win contracts that would not have been possible by either of the two previous companies individually.

Due to the positive results that the recent merger has had on the growth of my business, I am looking to combine with other businesses in the near future, especially with other Internet firms—"dot com" related businesses—whose assets may be largely made up of "goodwill." If I am required to use the purchase method of accounting, with its adverse effects on reported earnings, I may have second thoughts. If the combination results in a company that is required to amortize a large amount of goodwill, then the emerging enterprise will have a diminished capacity to access capital. For a growing company that reinvests most of its cash flow into its future revenue, even the smallest variance in its apparent profitability could have a major impact in capital formation. Moreover, if in the future, I were to decide to "go public," artificial reductions of net income due to the use of purchase accounting could make such an offering less appealing.

Pooling-of-interests vs. Purchase Accounting

When firms combine, there are two alternative methods for computing and reporting for financial statement purposes the combined entity: the pooling-of-interest method and the purchase accounting method. Each combination is evaluated according to a 12-factor test. Those combinations that meet all 12 factors *must* use the pooling-of-interest method, whereas those failing any of the 12 factors *must* use the purchase accounting method.

Under the pooling method, the balance sheets of each partner in the merger are simply added together. The new entity reports the combined historical book value. Under purchase accounting, one firm must be designated the acquirer and the other the acquiree. The acquired firm's identifiable assets are valued at current fair market value, and the difference between the fair market value of those assets and the purchase price is recorded as an intangible asset—goodwill. The financial statement of the combined entity is reported as the combination of the acquiring firm's historical book value and the acquired firm's fair market value plus the goodwill. Thereafter, over the years, the goodwill must be "written-off" or charged against reported income. As a result, under purchase accounting, there is a subsequent drag on reported earnings. The magnitude of this drag will depend upon the proportion of intangible assets in the acquired firm and the length of the amortization period—currently 40 years, but shortened to 20 under FASB's proposal.

The pooling-of-interest method of accounting is a generally-accepted method that has been in use for a long time. It is not, as some recent press accounts have alluded, an artificially advantageous method designed to bolster financial statements so that its proponents can boost stock prices or attract outside financing. If all of the 12 requisites are present to permit its use, pooling-of-interests requires the combining companies to add the historical book values of assets, liabilities and shareholder equity, and presents them on integrated financial statements. If one or more factors are not met, then use of purchase accounting is required. In fact, because of its restrictive nature, this pooling method can have a potential downside. For instance, if a company that recently engaged in a pooling-of-interest transaction found its stock price artificially depressed and good business sense indicated a repurchase of its shares on the market, it would be *prohibited* from making that repurchase.

Use of the purchase method of accounting is not without its problems, too. The calculation and reporting of intangible assets and goodwill is dependent upon subjective and speculative "measurement." The accounting profession continues to grapple with how to properly value intangible assets and goodwill, and, as of yet, there are no clear-cut solutions.

Technical Issues

FASB's decision to eliminate the pooling-of-interest method and to shorten the allowable amortization period of goodwill to 20 years is based on two assertions: first, that all business combinations are equivalent to a purchase where one firm acquires another and gains control; and second, that all goodwill and other intangible assets degenerate over time. We disagree on both counts.

Clearly, many of today's combinations do not meet FASB's assertion that one firm gains control. For example, when the new entity has a combined board of directors, management and staff, no clear-cut control is established. In such cases, the exposure draft states that one firm will be designated the acquirer based on the "evidence available" without stating what that evidence is or how it should be weighted in the decision process. We do not believe that disallowing a longstanding accounting method that addresses such an ambiguity without prejudice against either partner, and substituting a methodology that may ultimately rely on an arbitrary decision, is an improvement. When a market activity does not fit an accounting model, arbitrarily forcing it rarely achieves the desired result.

We also disagree with FASB's assertion that purchase accounting, with its creation and amortization of goodwill, will result in more accurate or more reliable financial statements. While some intangible assets are definable, measurable, and have discernable lives, many do not. For example, the same exclusive shopping mall part of a nationally-recognized web site would have a very different value then one as part of a simple family Web site created by any one of you or your children. Its value—and concomitant "goodwill"—would be determined by "on what Web site it was located."

Furthermore, it is hard to see how the purchase accounting convention—which lumps intangible assets that are unidentifiable or identifiable but not measurable into an amorphous category called goodwill that is immediately assumed to depreciate in value—provides more accuracy. The excess of the purchase price over the fair market value of the identifiable assets, *i.e.*, the goodwill, is the result of a complex interaction. In past times, it was interpreted as the premium paid for the value of the "ongoing" concern—the brand name and the customer and community relationships. While these factors are still part of goodwill today, intangible assets in the new economy are much broader and more pervasive. Education, management style, and entrepreneurial spirit can easily represent the bulk of assets in today's information technology-driven firms. Whereas, goodwill in the old economy may have been a depreciating asset, goodwill in the new economy may not be. The synergies achieved by modern combinations create intangible assets that are designed to appreciate in value. That is why the free market values them so highly. Plus, I have seen this first hand when I merged my firm Prospect Technologies with another firm two years ago.

While purchase accounting may have been useful for acquisitions of firms with a large percentage of physical assets, it is inadequate for combinations of firms composed primarily of intangible assets, especially when those intangible assets are largely unidentifiable, immeasurable and of indeterminate lives. It is hard to see how combining the historical book values of an arbitrarily designated acquiring firm with the estimated market value of an arbitrarily designated acquired firm and some dubious measure of goodwill yields a more reliable financial statement than a combination of book values, especially if the combined entity engages in successive combinations. Moreover, resorting to the approach of forcing a "write-off" of an intangible asset merely because accountants cannot understand or quantify it, is unacceptable.

A better course of action might be to examine the issues surrounding the accounting of intangible assets and goodwill, and to develop suitable methods for addressing this problem before prohibiting a longstanding and well-understood accounting method. We urge FASB to adopt this more cautious approach.

General Policy Considerations

In addition to the previously discussed technical objections, we believe that the proposed action by FASB has broad economic ramifications as well. We understand that FASB should, indeed must, be concerned primarily with the "relevance" and "reliability" of financial information, and not the economic consequences. However, the Exposure Draft states two reasons for undertaking this project, neither of which are relevance and reliability concerns. One concern was the increasing amount of staff time at both the SEC and FASB being devoted to mergers and acquisitions using the pooling-of-interest method. The other concern was a desire to achieve international convergence of accounting standards given the increase in international capital flows. We believe proposals to change accounting standards under-

taken for staffing and/or international policy considerations ought to also include domestic economic considerations in the evaluation process.

The fact that SEC staff are being asked to devote more time to business combinations using the pooling method is as much an indication of the increased importance of the high technology sector in today's new economy, as it is an indication of excessive use of what some might call a "loophole." Today's high technology firms are composed primarily of intangible assets. They are in many cases relatively cash poor and, as such, are not in a position to buy other firms. They do, however, wish to create synergistic value through business combinations, and the financial markets have voted their approval. While we share FASB's belief that accounting standards must remain credible and reliable, the current method is well established and widely understood and, in our view, clearly meets that standard. Staffing constraints should not be sufficient cause for changing a useful and workable approach.

We find FASB's other rationale equally non-compelling. There is no plan currently in place to achieve convergence of accounting standards for business combinations. Some countries allow the pooling method, some do not, and others allow it in fairly restrictive circumstances. If we want to adjust our standards on the basis of achieving convergence of international policy, then we should have assurances from the other countries of a similar commitment in advance, and the decision process to adopt such changes should include domestic economic consequences.

The technology and financial services sectors have played a crucial role in our current position as a world leader. One reason for the success of these sectors has been their ability to grow. We do not believe that this opportunity for economic growth should be curtailed because of staffing constraints or the desire to adjust our standards to conform to our international competitors, especially when there is no consensus abroad. We should not change our standards without more compelling reasons.

Prospect Technologies and the U.S. Chamber of Commerce urge FASB to reconsider its position and withdraw its exposure draft on this issue until the issues surrounding the proper accounting of intangibles has been vetted and all concerned parties have had the opportunity to digest the findings. The issues at stake are of great concern to our members and to all who want to encourage the continued economic growth we are currently enjoying.

In conclusion, I would like to add that we are not asking Congress to adopt accounting standards or to establish an official oversight role, but rather to encourage FASB to rethink this rush to judgment. While having its faults, the current accounting framework has worked well. There are no egregious or exigent market failures driving this proposal for change. There are legitimate concerns over the proper accounting for intangibles and various groups and commissions have been delegated to examine this issue.

Clearly, let us not take action until these groups help us by shedding light on this growing problem. As a small business owner, I believe we have time to wait and evaluate. Prudence dictates that we do so. Thank you.

Mr. OXLEY. Thank you, Mr. Lewis.

Thanks to all of our panel.

The Chair recognizes himself for 5 minutes for questions.

Now I know why I avoided an accounting class, which is literally right across the street from my fraternity house. But I am reminded of our good friend, Dick Armey, the Majority Leader, who was introduced recently and said that he was an economist. His mother wanted him to be an accountant, and he didn't have the personality.

Anyway, this has actually been an interesting debate. Let me begin with just a general question to our panelists, and I will go the other way this time and end with Mr. Jenkins.

This is a general question. How would the elimination of pooling accounting make financial statements more or less accurate for investors and creditors under those circumstances? Mr. Lewis?

Mr. LEWIS. As I understand it, one of the issues, and I will just point to one right off the bat, is the amortization of the goodwill issue.

We have heard today and we understand that merging and synergy is one of the reasons why companies come together and merge. That is considered to be a depreciable asset.

I can tell you from personal experience when I did a merger, or a marriage as I rather call it, it was not for a depreciable asset, it was for increased asset. Yet, by FASB rules, I would have to take that as a depreciation expense against my balance sheet, not over 40 years, but over now 20 years. That could significantly reduce my—artificially significantly reduce my income statement to my stakeholders and stockholders in my firm. That is one of the issues right off the bat.

Mr. OXLEY. So that was less accurate.

Mr. LEWIS. Yes.

Mr. HOFFMAN. To answer that directly, less accurate.

One other consideration that factors into the consideration, generally when we are talking about intangible assets, the only really fair way to value this is based on the market. That value is based on comparables.

An interesting presentation I have seen by others, I will try to briefly describe the concept, if you have three companies, one of which decides to do two complimentary technologies, both in-house and build them from scratch, then one company does part of that technology, and the third does the other part. Two and three merge. Comparability is lost, especially on an EPS basis and a balance sheet basis, even though, frankly, the actual success of the business is about the same. So basically, now, you are forced to look only pro forma, which is a different number than what is reported publicly in the SEC filings.

So basically now you are relying on, frankly, Wall Street sell side analysts and the PR machines of these individual companies to state what the reality of their competitiveness is on a comparable basis. That is a concern because sophisticated investors have no real issue being able to ascertain the difference there. The unsophisticated investor, which, frankly, I think is the SEC's larger mandate, is the one who has a difficult time seeing the difference.

Mr. OXLEY. Thank you.

Mr. Bible?

Mr. BIBLE . Mr. Chairman, I can make it more accurate. There is an accounting fiction out there. That is, equity has no cost to it. The reality is cash and stock of a company both represent the currency.

The accounting fiction is if I use stock, I don't have to account for the economics of that transaction, and the example the gentleman brought up over here is a perfect example.

Mr. OXLEY. Thank you.

Mr. Powell?

Mr. POWELL. Mr. Chairman, I think that elimination of pooling would make the financial statements less accurate. The reason is that it forces companies to go through a pooling method that is not equipped to deal with intangible assets, which represents 90 to 95 percent of the purchase price of acquisitions today. It assumes that they depreciate over time, and, in fact, that is not the case. As I mentioned in my case, if a good acquisition, it increases, it does not decrease. Therefore, the earnings per share number that would be

reflected in purchase transactions would be inaccurately reflected in the financial statements.

Investors would make bad decisions as result of that, and companies would make decisions about whether they should make that investment based on whether they could afford the hit to their earnings that was a fictitious hit.

Mr. OXLEY. Mr. Jenkins?

Mr. JENKINS. Clearly, I believe they would be more accurate and comparable, Mr. Chairman, because all companies would account for acquisitions in the same manner. All companies would account for acquisitions based on the value of the currency that they use, whether it is stock or cash or a combination of the two.

If I could quote really from a study made by an investor, Credit Suisse First Boston, with respect to bank acquisitions that were accounted for as pooling of interests, Credit Suisse First Boston recalculated each bank's cash return on tangible equity as if it had used the purchase method of accounting rather than the pooling method of accounting.

Bank One, for example, in its acquisition of First Chicago, the 1998 return on equity went from 27 to 12 percent. At First Union it fell from 35 percent to 11.8 percent. BankAmerica's return fell from 29 percent to about 10.8 percent.

The premium paid for these acquisitions ranged from 18 percent to 43 percent over the market value of those acquisitions at the time. Without reflecting the acquisition price paid, investors lose track of how much of their wealth, how much of their dilution was involved in these acquisitions, and they never can find it out again.

Mr. OXLEY. Your statement is that those were bad acquisitions?

Mr. JENKINS. No, not at all. They may not have been bad acquisitions, but their subsequent performance with respect to those acquisitions, their rate of return, rather than reflecting 27 percent, really should have reflected 12 percent. The 12 percent return may have been an appropriate and a profitable return. It may have been a very good acquisition.

I am certainly not saying, for example, the example that we use mostly around here, the AOL-NetScape acquisition was a bad acquisition. All I am suggesting is that the investors needed to have the information with respect to the excess of the purchase price over the underlying value, underlying amounts that were, in fact, recorded under pooling accounting.

Mr. OXLEY. Aren't you in essence looking in your rear-view mirror at this?

Mr. JENKINS. All investors need to evaluate subsequent performance against the investment made.

Mr. OXLEY. I thought that is what markets were all about, that people made those decisions in the marketplace based on their broker's advice, based on the particular company that was advising them.

Mr. JENKINS. The markets do, in fact, make those decisions, but they make them on information, on transparent information. They cannot make it if they have no information.

Financial statements, financial presentations have been widely acknowledged as being perhaps the single most important area of

information in assessing and keeping strong our capital markets and providing a level playing field between investors and sellers.

Mr. OXLEY. Our time has expired.

I recognize the gentleman from Michigan, the ranking member of the full committee, Mr. Dingell.

Mr. DINGELL. Thank you, Mr. Chairman.

Gentlemen, is there anybody down there at the committee table who would take issue with the fact that the purpose of accounting is to get the truth so that the government regulatory process and investors and the market may function efficiently and correctly according to the law? You all agree with that?

Let us take the gentleman, the second from your left, if you please. I would like you to focus your attention, if you please, on this question.

Two firms merge. They have the choice of using pooling, or they have the purchase accounting for the acquisition. Are the results going to be exactly the same in terms of their reports and the accounting on that particular acquisition?

Mr. HOFFMAN. The reports as reported——

Mr. DINGELL. The answer is, there will be a difference between the two methods of accounting; will there not?

Mr. HOFFMAN. There will be a difference in what is reported, yes.

Mr. DINGELL. Let's take a look. One is going to say one thing under one method, the other—the other method will give you a different result. The two results are different. Which will be the true result?

Mr. HOFFMAN. The problem is that that is not something that is easy to say. I don't necessarily say one result is better than the other. What my biggest concern——

Mr. DINGELL. You have two statements, one of which says one thing, one of which says another. Neither of them agree with the other. You have two different results. Only one of two differing results may be true. Which of the two results will be true?

Mr. HOFFMAN. That is an awful assumption that one is actually accurate at all.

Mr. DINGELL. I am making the rather generous assumption that one is correct and one is not. It may well be that both are incorrect.

Mr. HOFFMAN. I think that is partially what the concern is here, sir.

Mr. DINGELL. We now, Mr. Bible, have ourselves in a situation where we have—Mr. Bible, would you give us the answer, your view on that?

Mr. BIBLE. On the question you rose with Mr. Hoffman?

Mr. DINGELL. You have two statements coming in with different results. One may be true. If it is, the other is not. Which is true, using the——

Mr. HOFFMAN. What I am trying to say, I would tell you that is too hard to answer in all cases. The reality is that the balance in different kinds of transactions is rather complex.

Mr. DINGELL. Mr. Bible, what is your comment?

Mr. BIBLE. The statement that reflects purchase accounting would be the most accurate. Whether you use cash or stock to do the acquisitions should not make a difference.

Mr. DINGELL. The gentleman on the end?

Mr. LEWIS. Mr. Dingell, you, like several in the room, are not a CPA but do have a legal education.

Mr. DINGELL. I also know how to find truth.

Mr. LEWIS. That is what we are all trying to do, sir. One of the things my attorney says to me is, it all depends. I believe that is what we are saying today.

Mr. DINGELL. I am like Harry Truman. I am still looking for a one-handed economist, because I know I am going to get the truth.

Mr. POWELL. Could I answer that question, Congressman?

Mr. DINGELL. Quickly, Mr. Powell.

Mr. POWELL. I want to back up and say, first of all, you don't have a choice as to which method of accounting you use. There are rules which determine whether you have to use pooling or——

Mr. DINGELL. I am not quarrelling with that. Which am I going to believe? My problem in a nutshell here is a very difficult one. I don't mean to be discourteous to any of you, but there is a vote on the floor, and our time is limited.

We have two different results. Let us say that a major U.S. high-tech company buys another high-tech company. The investors out there are going to see that if the high-tech acquired uses purchase or uses the other system, they are going to have two different results.

So then the result—the result of that acquisition is acquired by a third high-tech company. The question is, who is going to believe and how will they believe the resulting accounting? You have now got accounting which can be different, depending on the kind of accounting system used and the assumptions made. How is an investor going to understand what the facts might be, and how is the market going to properly evaluate the result of that succession of three or rather two acquisitions?

Mr. HOFFMAN. Mr. Dingell, the answer is, the truth is, what is the cash situation? The reality is that most of these companies that we are talking about, as they get more and more layered, and various goodwill charges, and have amortization situations, we start talking about other things.

The question is, are you continuing to generate more cash? Are you continuing to grow your ability to generate cash without spending significant assets?

Mr. DINGELL. Some, however, you would note, are, in the language of what I learned back in law school, committing daily acts of bankruptcy by preferring one creditor over another, making payments when they are incapable of addressing all of their debts.

I am no advocate of any particular view, but you gentlemen are here before us as a learned panel to advise us as to what the system of accounting should be. I don't have any views on this, but I don't think that we are here in a position where you are able to tell us that the accounting system that you are suggesting or not suggesting is going to arrive at the kind of truth that we need to have a workable, transparent, intelligent marketplace.

The problem that you confront is you are going to get differing results, results which may or may not be believable. But remember, I remind you, the accounting system is to produce truthful results so that the company's management can understand what the hell is going on in the company.

The Japanese did not do it, and as a result they have had a continuing period of depression there that has gone on for about 10 years. Other countries have the same situation where, quite frankly, their accounting system lies most diligently to all and sundry.

All I am trying to do is to have you tell me what is an accounting system which would tell us the truth, which will enable us to do business? You are here as a strong proponent of one system. I am asking you to tell me, if you please, what is that one system that is going to give me the truth?

Mr. OXLEY. The Chairman would inform the members that we have about 3 minutes left on the vote.

Mr. DINGELL. I apologize, Mr. Chairman.

Can Mr. Jenkins just give us a quick answer, and we will hear what he has to say?

Mr. OXLEY. Briefly, please.

Mr. JENKINS. I believe there is one method that gives you the truth.

Mr. DINGELL. What is that?

Mr. JENKINS. That is the purchase method of accounting, I believe, not the pooling of interests method of accounting, for the reasons that I explained in response to Chairman Oxley's question, that we need to reflect in the financial statements for the benefit of investors, the consumers of that information, the price paid for an acquisition, whether that price be denominated in the currency called common stock or denominated in cash. That gives the truth.

Mr. OXLEY. The gentleman's time has expired.

The Chair notes there is a vote on the floor. There may be another one subsequent. The Chair would have the subcommittee in recess until 1 o'clock to give everybody the opportunity to get something to eat for lunch, and then we will return at 1.

[Whereupon at 12:07 p.m., the hearing recessed to reconvene at 1 p.m., the same day.]

Mr. OXLEY. The subcommittee will reconvene.

Staff informed me a couple of our guests have to leave by 2:15, is that correct?

Mr. HOFFMAN. Yes.

Mr. OXLEY. We will do our best. We understand if you have to parachute out of here.

I recognize now the gentleman from Iowa, Dr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman.

I thank our guests for being patient. This is the way it is when we have votes. We go back and forth. We have to interrupt these hearings.

Mr. Jenkins, in one of the addenda to your testimony, you have quotes from various people in support of the change. I notice that Warren Buffet is quoted, and he said, "In essence, there are some areas that I disagree with this proposed change, but in general I firmly believe that this nongovernmental organization ought to be the one doing this."

First of all, what were Mr. Buffet's objections?

Mr. JENKINS. Let me paraphrase what I believe he said.

First of all, I believe he said that we should have one method of accounting for business combinations, and it should be the purchase method. Where he has some objections then deals with the

area of accounting for goodwill, and goodwill that arises in a purchase business combination.

Whereas our current proposal requires that goodwill be amortized over a period of not longer 20 years, Mr. Buffet would suggest that it not be amortized at all but, rather, tested for impairment. If the goodwill is concluded to have lost some or all of its value, then a write-down should take place at that point in time.

The difference that Mr. Buffet has with our current proposal is completely focused on the question of amortization of goodwill.

Mr. GANSKE. Is there merit in his argument? Is there is that something you are looking at in terms of changing?

Mr. JENKINS. It is something we are looking at. There are a variety of ways that you could address the goodwill question, and certainly I believe at this point in this project, in these redeliberations, and based in particular on what we have heard here and in our own hearings that we held, that the focal point of the issue is on goodwill and how it should be treated once it is recognized under a purchase business combination.

We have already allocated the majority of the time that we expect to spend redeliberating this issue on that very question. The issue of not amortizing goodwill at all but testing it only for impairment is an approach that we will consider carefully.

There are a variety of other approaches, too. One might say not limit it to 20 years but leave it to the judgment of management and the auditors. That is an approach. Another approach is to recognize it but write it off immediately someplace or another.

There are 4 or 5 different approaches. We are going to be carefully considering all of those and balancing them against the proposal that we made initially in our exposure draft. But we have reached no final conclusions. We really have not begun our redeliberations in this what I believe is the key focal point of this discussion at this point in time.

Mr. GANSKE. Okay.

Let me see if we can get agreement on this panel. Does anyone on this panel think that Congress should get involved in writing the regulation of this? You can just say yes or no going right down the aisle.

Do you want Congress to—the political process to start really getting involved?

Mr. LEWIS. No.

Mr. HOFFMAN. We are glad Congress is showing a leadership position in addressing the issue. I don't think there is any real need for specific addressment of that issue.

Mr. BIBLE. No.

Mr. POWELL. I don't believe that Congress should be promulgating accounting principles. However, I do believe that there is a place for congressional oversight, and that is when it comes to when this is going to have significant implications on the Nation's economy. FASB's role is not to do that. It is a stated role not to do that. There has to be a forum someplace that someone is looking at that.

Mr. GANSKE. I am not arguing against a forum. I am asking specifically, do we go to the floor of the House with a bill? I don't know

how much politically aware you are of the situation, but, boy, some bizarre things can happen on the floor.

Mr. POWELL. We are not in favor of accounting being legislated on an issue-by-issue basis.

Mr. GANSKE. I assume, Mr. Jenkins, you feel the same way?

Mr. JENKINS. I agree.

Mr. GANSKE. My final question would be this, then. Let us go back to the actual case as described by Mr. Jenkins that is reported in the New York Times where the quote is, "Pooling accounting is ridiculous because it allows corporations to pretend that they paid much less for an acquisition than they did. Let's say company A buys company B for $100 million in stock, and then a few years later sells company B for $50 million. In reality, that was a disastrous acquisition for company A, but thanks to the magic of pooling, company A would have shown the original acquisition as costing not the $100 million that it paid but a number that could be far lower, say $20 million, reflecting the book value of company B. Presto, company A reports a profit of $30 million when it actually lost $50 million."

I would just like to go down the row here. To me as an individual investor wanting to really know how much a company owes or has spent on an acquisition, I just want to know, doesn't this specific case strike members of this panel as something of concern?

Maybe we could start on this end. Isn't there some valid concern about this type of accounting?

Mr. HOFFMAN. I am going to go ahead and step ahead, if you don't mind. There are a couple pieces of data that are missing to make a real judgment here.

One is, what were the relative valuations of the company at the time the transaction was done? Did the market fairly value that? The issue is the capital stock of the corporation. Because when two companies come together you are talking about a set of shareholders and another set of shareholders, and the relative ownership of the entire company is diluted based on the shares relegated to that acquisition.

Mr. GANSKE. I understand that, but I am an investor out there looking at the balance sheets.

Mr. POWELL. Congressman, could I answer that question?

Mr. GANSKE. Okay.

Mr. POWELL. First of all, I think it is an interesting theory, but, in reality, it rarely happens often.

I have had this question posed to me before. I had one of the major banking firms, international banking firms, review this to find examples of where this had happened, and they could not locate examples where this had occurred. I think that is the first point that I would like to make.

Mr. GANSKE. But how do you respond to Mr. Jenkins, who gave several examples of a recalculation by Swiss Credit, for instance, on bank acquisitions, where there was a difference?

Mr. POWELL. I think that the issue that Mr. Norris is reporting is a different issue, which is you sold off assets and reported a gain, when in fact you sold them for less than what you paid for them. I think—so I would like to speak to the Norris issue, if I could.

If you think about the fact that—let's suppose in the example that I used, a company A, company B, you have twice as much stock outstanding. If you are going to sell the company that you expected to generate twice as much income, what happens the day that you sell that is you have lost your revenue stream and profit stream, and your income, in the example that I give, is going to go from $2 a share to $1 a share.

I don't know many management people that are going to be around once that happens. To view that in some sort of positive way is wrong. It is going to be viewed very negatively, and it will have an impact on that management team.

The other thing is that if you look at one-line types of transactions, as we see in in-process research and development or restructuring charges, analysts have a tendency to discount those and not give credit to those reductions.

The same thing happens on one-time gains. Management is not going to look at that gain and give a credit to the management team for the fact that that one-time gain occurred. They are going to look more to what is the impact on the earning stream.

The last thing that I would say is if FASB thinks that this is an issue that is subject to abuse, let us deal with the abuse but not throw the baby out with the bath water. I think that is the same position that the committee on corporate reporting of the FDI suggested in their FASB testimony, if there are abuses, let us fix them, but not throw out the entire methodology.

Mr. OXLEY. The gentleman's time has expired.

Mr. GANSKE. Maybe Mr. Bible can answer that.

Mr. BIBLE. All I would say is that you all have your constituents. Our constituents are shareholders. If I give you a tool to make it look like you are doing better than you actually are, would that be fair?

Mr. OXLEY. It happens all the time.

Mr. BIBLE. We are trying to get rid of it in the accounting world.

Mr. POWELL. I would turn that around to say, should we be penalized for a negative transaction that in reality does not reflect the economics of what the transaction is?

Mr. OXLEY. Thank you.

The Chair recognizes the vice chairman of the subcommittee, the gentleman from Louisiana.

Mr. TAUZIN. I thank the Chair.

Mr. Jenkins, I chair the Subcommittee on Telecommunications. My interest in these high-tech companies and what they are doing for the economy stems from that work.

Let me first ask you about our relationship, Congress, to your agency. I am very pleased to hear you today indicate that concerns expressed by Members of Congress about the work of FASB, making sure that you account for those concerns, is in fact a relevant relationship, because I hope it clarifies the open letter that FASB sent out.

It seemed to indicate that we had no business engaging in any legislative activity, that that might threaten the independence of FASB. Your quote is, "Explicit or implicit threats of increased legislative activity create a real risk of continued viability of private sector standards setting."

Do you really believe that? Do you believe we don't have a role here in oversight, in recommendations and in letters like our chairman has sent to you, urging that you go slow and examine some of the concerns that have been raised by the other side or concerns about the purchase method of accounting?

Mr. JENKINS. Congressman Tauzin, I stated in my testimony, not only here but earlier in my testimony before the Senate Committee on Banking and Financial Services, that we support and understand and accept the oversight responsibility of Congress. I have no problems with that.

Mr. TAUZIN. I should hope so.

Mr. JENKINS. Just as a matter of clarification, please, the letter that you are reading from is not a letter from the FASB, it is a letter from the trustees of the Foundation. My understanding, having talked with the trustees about that letter, is perhaps it is inartfully worded.

Mr. TAUZIN. That is not your view?

Mr. JENKINS. I'm sorry.

Mr. TAUZIN. That letter does not reflect your view?

Mr. JENKINS. No, it does not reflect my view.

Mr. TAUZIN. Let me ask you, with reference to another letter, however, that you did send to Members of the Senate who wrote to you concerned about problems in the purchase accounting method and addressed recommendations to you, I think the tone of their letter was, before you go around repealing pooling that you had better doggoned fix up the purchase accounting. If you have two systems, neither one of which are working good, you don't want to throw one out and accept another equally bad. Fix that up first.

I thought that was a pretty good letter. I thought the chairman's letter to you was excellent, particularly when he pointed out that intangibles do not necessarily depreciate, often they appreciate. If you set some arbitrary depreciation schedule on intangibles in this new economy that you will, in fact, be encouraging false and inaccurate information to the public, when the truth is that intangibles in this new economy may be an increasing and appreciating asset that investors ought to know about and ought to have real information about.

But you wrote to the Senators in effect saying that, look, we haven't made any final decision about this; we are going to consider everything. But the only thing you did in your letter was to cite examples of complaints about the pooling method.

As I read your letter, it seems to me you have made some preliminary judgments that you plan to abandon it and go to purchase accounting, with no necessary attention paid to the flaws in that system. It seems you are saying we are not interested in your recommendations. We insist that the pooling method is no good. Here are the reasons why. And, by the way, a whole range of the Board's constituents have told us that and you have not paid attention to them yet because you did not allow them to testify at some Committee on Banking and Financial Services, Housing, and Urban Affairs. That is the gist of your letter.

Is that the way you respond to congressional concerns that the purchase accounting method has serious flaws in it that ought to be adjusted for this new economy?

Mr. JENKINS. I think it is evident that we do intend and have addressed concerns with respect to purchase accounting. We will reconsider all of those decisions in our redeliberations.

With specific respect to intangibles, in our proposal we did change—we did propose to change the current requirement for intangibles, which is in place and has been in place since 1970, that required them all to be amortized over some common period. We did change that to permit flexibility on the part of management in determining the lives over which intangibles should be amortized.

Mr. TAUZIN. The point is, what happens when they are appreciating in value? What happens when 80 percent of the company is all about knowledge, it is all about eyeballs, about the potential of this company attracting customers to products that are advertised that surround a package of information, and all of that is appreciating as more and more people come to that site, that e-com business, and use those services and view those advertisements and buy those products?

Are you saying that the company has no choice but to write-down that intangible asset over some arbitrary, fixed period? Is that not false information?

I notice the ranking minority member, Mr. Dingell, talking about the search for the truth. But is that not the opposite of the truth?

Mr. JENKINS. I think the first thing we have to do is get the intangibles recognized in the first place. Recognizing intangibles in the first place does not come about through the use of the pooling of interests method.

The second point is to your point. Some intangibles are going to increase, some intangibles perhaps are going to decrease. We don't always know. But under our system of accounting, that has been true for a long time. Some of our—some trademarks of old line companies increase in value and some decrease, but we generally don't recognize them.

Mr. TAUZIN. Mr. Jenkins, I just want to say one thing, and then ask you a final question.

The first is that of all the things I have seen that can severely impact the extraordinary growth of this new economy, what you do here may have more impact than what we do in policy up here. How you handle this issue and how carefully you handle it and how well you handle it may well determine whether or not this new economy continues to grow, whether we inflate or whether we deflate it.

We are deeply concerned about that. We have tried to express that to you. I want to second the comments of the chairman of our committee in his letter to you. I think it is an excellent letter of concern that I hope you folks have taken seriously.

In his letter he makes a request of you. He requests that FASB commence a comprehensive study of the accounting treatment of intangibles, and he further requests that you wait until those results of the separate studies being conducted by the SEC and hopefully by yourselves on this issue might be concluded where we can all get a good handle, a good look at it.

What is your response to his request?

Mr. JENKINS. I responded in part in my testimony when I made the point that the one study is not really relevant to dealing with

intangibles. Mr. Powell, who was a member of that group, concurred in that.

We are beginning in our own process to consider intangibles. We will be giving careful thought as we go forward as to whether or not it is or is not appropriate at the end of the day for us to go forward with this standard without coming to a final conclusion on accounting for all intangibles.

We do intend—with respect to the intangible that is most significant by a long ways in respect to purchase business combinations, goodwill, we do intend to carefully consider all of the various alternatives that I described for the Congressman from Iowa in open meetings before we reach a final conclusion. We will listen carefully to what we have heard in these meetings.

Mr. TAUZIN. Can I inform the chairman as a result of our conversation today that your answer to him is yes?

Mr. JENKINS. The answer is not necessarily yes, because I cannot guarantee you that we will solve all of the problems of intangibles before we go forward.

Mr. TAUZIN. He simply asked that you let all these studies happen, that we have a chance to look at all these studies and get a chance to analyze the different outcomes of these studies before you move. Can I inform him at least that that is a likely outcome here?

Mr. JENKINS. We will consider those studies as we go forward. The outcome——

Mr. TAUZIN. You are going forward as the studies are being done?

Mr. JENKINS. The timing of those studies is out of our control.

Mr. TAUZIN. So the answer to the chairman is, you may move even before the results of the studies are in?

Mr. JENKINS. I do not even understand or know what the nature of those studies are, with all due respect. I can't commit myself or my board to the outcome of studies about which I do not know their approach or anything.

Mr. TAUZIN. Mr. Jenkins, with the indulgence of the chairman, let me just say, sir, that you are inviting legislative action when you give an answer like that. When the chairman of our committee—and you have heard the expression, I think, of many members of the legislature that we consider this of such a serious note that we have asked you to make sure that these studies are in before you make this momentous change in the way these accounting rules—these generally accepted rules are applied to this new economy—I think you have heard enough of us telling you that over and over again that when you tell us that you might not wait for the results of the studies, you might plow ahead with some preconceived notions even, that just invites legislative action.

Mr. JENKINS. We don't have any preconceived notions. We will consider all of the evidence. We will consider very carefully and take very seriously your admonitions to us and what we have heard today from everyone on this subcommittee, and we will do our very best to make sure that we consider all of the evidence before we make any decision and the applications of our decision.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from California, Mr. Cox.

Mr. COX. Thank you, Mr. Chairman.

I would like to thank each of the members of our panel, some of whom I had a chance to say thank you to during the break, for your presence here and your willingness to indulge the Congress' interest in this.

I think that the topic that Chairman Tauzin has gotten us into here is worth pursuing in two respects.

First, I think, as I mentioned in an aside to Mr. Jenkins, that the real issue here is the accounting treatment of intangibles. There has been a lot of change in our economy over the last many years, and the relative role played by what we loosely call goodwill M&A is significantly larger now than ever before.

The second issue that Chairman Tauzin raised that I think is worth pursuing is what the Congress ought to do in this circumstance. I think my colleague, Mr. Ganske, certainly crystallized, at least with you, this panel, about whether Congress should write a law and describe the proper accounting treatment for intangibles in all cases or the proper accounting treatment for business combinations, managers, acquisitions, and so on.

I would not be inclined to do that myself. Although I think the best answer to your question, Greg, as to whether it would be a good idea for Congress to write the accounting standards is, is the congressional proposal as bad as FASB's? If it is not, then it would be superior, at least in that instance.

But I think your question really goes to the precedent we would be setting and the kind of system we would inherit if we willy nilly got into the business of writing accounting standards.

What Congress might do, with greater restraint and wisdom, however, is force a delay, a moratorium until the information is in. I did that with Internet taxes, and my legislation which I wrote with Senator Wyden is going to be on the floor next week.

Again, we already have a moratorium in place as a result of legislation I passed a couple of years ago, and the Internet Tax Freedom Act moratorium as a result of what was just reported out of the Committee on the Judiciary will now be extended a further 5 years, assuming that we are successful on the floor of the House and on the floor of the Senate, as we were today on the Committee on the Judiciary, where I think the vote was 29 to 8.

It would not be irresponsible, although it would be quite a change from the way normally we do business, I think, for Congress to require FASB to look at the information. And if the information is not in before you make your rule, I think it raises serious questions.

If you don't know what the studies are about, that scares me right there, because that is where we ought to be focused.

The bread and butter accounting, as we all learn in business school or wherever we first learn accounting, is based on a paradigm in which book value is the only thing you can really sink your teeth into. We recognize book value doesn't represent real value, but it is a real number. We know where it comes from, so we put a lot of our heart and soul into that back value figure.

In that paradigm, goodwill is the fudge factor. But what happens is that the fudge factor, which is something we never really could get our arms around, has sort of taken over the universe, in much

the same way that the Arab mathematicians flirted with the idea of irrational numbers when they first tried to solve cubic equations.

Remember, Omar Khyam, for example, figured out how to solve cubic equations but looked at this multiple of the square root of minus one as a false root. They didn't know what to do with it. They screwed around with it for a long time. These days, not only are we comfortable with the square root of negative 1, but you cannot manage an electric circuit without it.

I think we need to get a little more comfortable with goodwill, with intangibles, because that is the 21st century. That is really this hearing ought to be focused on. It is what it really ought to be about.

If I were to ask you the same unfair question that Chairman Dingell or former Chairman Dingell, Ranking Member Dingell, asked a moment ago when he said what is the truth, purchase or pooling, in an arbitrary transaction, the facts of which none of us is informed, and if I were to ask you what is the depreciable life of goodwill, Mr. Jenkins, what is the answer to that?

Mr. JENKINS. I would acknowledge that the amortization of goodwill as a single number is arbitrary, but that doesn't mean that it is necessarily wrong. It is an estimate of life. We have had goodwill being amortized for a long time over varying lives.

While there is an outside limit, there is certainly not a prohibition against using anything shorter than that. And, in fact, in the many, many acquisitions in the high technology area, for example, that have not been accounted for as purchase transactions, they utilize goodwill life that is significantly shorter than 20 years, or 40 years, for the most part.

I think you are correct, that the focal point of this issue is on goodwill. I acknowledge that. I expect that we will be spending very much of our time over the next many months as we work on this issue trying to resolve the goodwill question.

I described several alternatives a few minutes ago that we intend to reexplore. Many of those concerns and our attention to this come out of this hearing and out of previous hearings and listening carefully to our constituents.

So I agree with you. The focus is on goodwill. I think we will address it. We have a group that has asked if they can make a presentation to us on a methodology for dealing with goodwill. I do not know what it is, but we certainly have agreed to do that. We will be having a public meeting of our board at the end of this month where that will be displayed for us, and we will carefully consider it.

I agree with you. That is the focus and where we need to spend our efforts as we proceed to explore this issue.

Mr. GANSKE. Will the gentleman yield?

Mr. COX. Sure.

Mr. GANSKE. I am trying to get my hands around this goodwill concept. Let me see if I can put it into a specific example.

In Des Moines, we had a company called Pioneer which was bought by DuPont at a premium above what the stock was selling for. So that difference, is that what you would call goodwill?

Mr. JENKINS. No, not necessarily.

Mr. GANSKE. Okay. Because I wonder whether it is part of it.

Mr. JENKINS. It could be part of it.

Mr. GANSKE. That was premised on the management for Pioneer, which was well respected, sticking with the new, larger company for a period of time. It did not work out that way. Management left rather quick.

I am just wondering whether in fact there aren't some intangibles that are always going to be intangible, and how well you think you can actually get your hands around that component of so-called goodwill.

Do you have a comment on that?

Mr. JENKINS. Yes, I do. I think that is a good example of an intangible that probably cannot be specifically valued but does get subsumed into goodwill. It is a portion of goodwill.

One could also conclude that if the entire difference between the market value and the purchase price was due to this management and then they left, that at that point you ought to write off that portion of goodwill, because it is no longer there.

That might be what we would say is one of the approaches I suggested to you, that we recognize goodwill, we recognize this need for superior management to stick around, but we don't amortize it. But if they leave, you write it off.

Mr. GANSKE. That is where I see that Dr. Lewis and Mr. Hoffman and everyone else on the panel—you are all very bright, but let's say that Mr. Hoffman's company gets scarfed up by a bigger guy. I would want Mr. Hoffman to stick with my company, my bigger company. The premium that I would pay for that would include him. But if he left, I think I would be—I wouldn't have gotten the value.

Mr. COX. Let me add to your question another example we might think about. Let's say that the Tribune Company and Times Mirror combined. How much, Mr. Jenkins, did that cost?

Mr. JENKINS. I don't remember the number.

Mr. COX. No, I mean what is the cost of that combination?

Mr. JENKINS. I think the cost is the consideration that the Tribune Company paid for the Times Mirror.

Mr. COX. Does it matter if they used outstanding shares or newly issued shares?

Mr. JENKINS. It doesn't matter if they used outstanding or newly issued, or if they use cash or shares.

Mr. COX. So your sense—I use that because the Times Mirror and Tribune Company are roughly comparable in size, and there are some bragging rights going on about who got whom in the deal. And if you are from Chicago, there is no question. If you are from California, there is some question there.

But at least to read the newspapers, which seem to be carrying fair and full accounts of all of this, they are really going to combine the operations. That is really what is happening in economic reality. What is the cost of that? What is the economic cost of that combination?

Mr. JENKINS. I still believe that in that case, and I have not examined it in detail, that you can determine which company acquired the other company.

Mr. COX. What if that is not really what happened?

Let us back off of that example, if you think that there is a flaw in my analogy.

Let's take a situation in which, having done M&A work for a decade, I can tell you happens fairly frequently, and you know this better than I because you have done this for more of your life, if you have two partners in a business transaction and they get together—and they really get together, one did not swallow the other—they get together, they—somebody used the term "marriage" earlier, community property, let us say that is the economic reality. What is the cost?

Mr. JENKINS. I just think in that case I think the best answer is to say that you have a new entity. You have put two companies together. You have created a brand new entity.

Mr. COX. How much in economic terms—to put on your economist's hat, in economic terms how much did that cost?

Mr. JENKINS. I would say that you would recognize the value of the assets of both parties that have contributed to that transaction, the fair value of the assets.

Mr. COX. That is a different question. That is a question of how you write up the assets on the balance sheet.

My question is, what is the economic cost? Think of this as sort of a physics question. You have some molecules. They bump into each other. What is the energy expended? It is that sort of question. In economists' terms, what is the costs?

Mr. JENKINS. Again, I think it is the fair value of the assets that they each contribute.

Mr. COX. The assets are still there. The assets did not go away. They are still there.

Mr. JENKINS. I understand, and you are recognizing all of those assets from both parties at the fair value when they are contributed.

Mr. COX. You are making a different and valuable point, which is that this might be a good opportunity to recognize the current market value of those assets and not run them at the old book value. If you come up with a better way than purchase or pooling, probably that is one of the things you will want to take a look at.

Mr. JENKINS. Yes, we are.

Mr. COX. I am asking a different question. I am asking whether or not there is a real economic cost to the combination. Rather than trying to beat my answer out of you, let me give you my answer to that, which is that the cost of the combination is probably the extra lawyer fees that you paid to file with the SEC and your Hart-Scott-Rodino fees and your extra accounting fees to do whatever is necessary, and, you know, if it is a big combination, that is a trivial amount.

In fact, there is no business asset lost or consumed in the transaction. All the cash of the one company and all the cash of the other company is still there. In fact, they probably got a new joint bank account and you can see all the money still there. You can keep your eyeballs on it.

So that a bias in the accounting system that absolutely requires in that case that somebody be the acquirer and somebody be the acquiree and that there be a cost of the transaction and that it be a significant amount and measured in terms of the full value of the

assets of one of them, that it seems to me to be strange to use a paradigm that is not always the right one.

To use another one of those ancient analogies, it is like that Procrustean bed where Procrustes stretched all of his victims to fit. Sometimes it does not work. Purchase accounting is designed with some paradigms in mind, and it is absolutely perfect for some business combinations, but in other cases it is not.

Mr. Bible has been desperate to get a word in edgewise I think, with the chairman's indulgence.

Mr. OXLEY. We will make this the last word edgewise.

Mr. BIBLE. I would add, Mr. Chairman, it depends on what economic school you believe in. But the bringing together of both, there was a decision made. That is, I can achieve the most value for my interest by combining with you, Mr. Chairman, in a joint venture, rather than selling to a third party. I think that is the economic reality that Ed is speaking of.

Mr. POWELL. Could I make one comment? In reality, this is two groups of shareholders coming together and combining their interest. No one acquired anyone else.

The reflection of that is that if I own 10 percent of that company before, I will now own 5 percent of that company. The cost is in the dilution of me as a shareholder. But in terms of one company acquiring another, Congressman Cox is exactly right. There was no cash exchanged. No company gave up assets to purchase this. There was simply a combining of those two companies, and that is what pooling is all about.

Mr. BIBLE. No, they made a decision to give up cash to a third party sale to join with the Congressman in a merger.

Mr. COX. I want to point out that some people think accounting is boring, but this, you can see, it is just loaded with interest.

Mr. OXLEY. This is put on your helmets.

I recognize the ranking member for a unanimous consent request.

Mr. TOWNS. Thank you, Mr. Chairman.

I ask unanimous consent that I place in the record Congressman Crowley's statement and also questions to be answered in writing to Mr. Jenkins.

Mr. OXLEY. Without objection.

[The prepared statement and questions of Hon. Joseph Crowley follow:]

PREPARED STATEMENT OF HON. JOSEPH CROWLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you Mr. Chairman for holding this critical hearing and for allowing me to be here today.

I have a serious concern about the impact of the Financial Accounting Standards Board's (FASB) proposal, in its Exposure Draft on Business Combinations and Intangible Assets, to eliminate the pooling of interest's method of accounting. I am very concerned that this will have a negative impact on the American economy, particularly on the fast-growing companies driving our increasingly knowledge-based economy-what people are calling the new economy.

Financial experts have said that the proposal will have the greatest impact on the financial services, information technology, and pharmaceuticals sectors, areas of our economy that, according the to Commerce Department, accounted for nearly 30 percent of America's GDP in 1998. Information technology alone was responsible for over 28 percent of U.S. real economic growth in 1997. Those percentages represent

a large number of jobs, both in those industries directly, and in collateral and support industries.

I understand that FASB has received nearly 200 comment letters on its Exposure Draft. In its own summary of the comment file, FASB noted that more than three quarters of the letters addressed the proposal to eliminate pooling. Of those, the banking and high-tech sectors strongly disagreed, and the rest were "split." This does not sound like the kind of endorsement of a proposal that compels immediate action. Rather, with such disagreement on the value of the proposal, I would suggest the wiser route is to reconsider and address some of the concerns raised.

It is also my understanding that the responses, in fact, were 3 to 1 in favor of retaining at least some form of pooling, or for not eliminating pooling until significant other issues related to the purchase method, the only remaining method, were resolved. And these responses include the Big 5 accounting firms. In light of such significant opposition and the very real concern about the impact of the proposal on our economy, what is the rush?

The pooling method of accounting has been around for many decades. I know of no clamor, and no crisis, which demands immediate action on the issue. In fact, only six years ago, Mr. Jenkins, in a comprehensive AICPA study on business reporting that he headed before he became FASB chairman, found that "the existence of the two accounting methods is not a significant impediment to users' analysis of financial statements. A project to do away with either method would be very controversial, require a significant amount of FASB time and resources, and in the end is not likely to improve significantly the usefulness of financial statements." Why then the rush to act?

It may well be that something needs to be done regarding pooling of interests accounting. I am not an accounting expert. But I am concerned when so many experts in their field express the kinds of concerns I have been hearing. In fact, I understand that eleven Members of the Senate Banking Committee, a bipartisan majority, have written a letter to the FASB suggesting that it defer its decision on pooling until the concerns and issues relating to the purchase method have been resolved. I have also joined Congressman Cal Dooley and a number of my colleagues in sending our own letters on this topic.

FASB has stated the importance it places on international harmonization of accounting standards as justification for this proposal. I would only point out that the home countries of many of U.S. companies' strongest competitors permit pooling. Britain, Germany and Japan all permit some form of pooling. Our economy is the strongest in the world, based in part on the ability of companies to innovate and reach productivity through mergers. Do we really want to throw this new hurdle in front of U.S. companies?

I would hope that FASB is taking these concerns seriously. I certainly do. I urge FASB to take some more time to consider the very serious concerns raised over this issue.

Mr. Chairman, once again, thank you for calling this important hearing. I look forward to working with you and my colleagues on this important issue.

CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
May 4, 2000

The Honorable MICHAEL G. OXLEY
Chairman
Subcommittee on Finance and Hazardous Materials,
Committee on Commerce
2125 Rayburn HOB
Washington, D.C. 20515

DEAR MR. CHAIRMAN: I would appreciate your assistance in including the following questions for Mr. Edmund L. Jenkins, Chairman of the Financial Accounting Standards Board, in the record for today's Commerce Subcommittee Hearing on the Financial Accounting Standards Board's proposal to eliminate the "pooling of interests" accounting method. I would also like to thank you for your leadership on this issue and for calling this important hearing.

1) Many knowledgeable people have said that FASB's decision to eliminate pooling could have a damaging impact on economic growth. In a recent white paper, Merrill Lynch concluded that the change could result in a notable decline in the consolidations that have enhanced productivity, encouraged innovation, and stimulated dynamism in the U.S. economy. And, a Goldman Sachs study specifically says that FASB's changes could have a dramatic impact on certain indus-

tries, including information technology and medical devices. Why is FASB willing to take the chance that they are right?

2) You have received a number of thoughtful alternative proposals to the elimination of pooling. You have a great deal of concern about the valuation of intangibles. What is the rush to eliminate pooling rather than looking first at the valuation questions? If the problem with studying the issues is that it will take some time, why not do it right the first time rather than in a piecemeal fashion, especially when the consequences of "getting it wrong" could be so severe?

3) A review of the comment letters sent to FASB shows that two-thirds of all of those who sent comment letters and all of the Big 5 accounting firms advocated either retaining at least some form of pooling or not eliminating pooling until significant other issues were resolved. Why is FASB determined to abolish pooling in light of this significant opposition to its decision?

4) Your Exposure Draft specifically states that international harmonization is one of the reasons for your decision to eliminate pooling. Let's assume for a minute that that is a valid goal. Given the fact that countries like the U.K., France, Japan and Germany permit pooling, at least in some form, how could eliminating pooling here increase international harmonization? Assuming that various foreign and international accounting rules are moving away from allowing pooling accounting, why should the U.S. be following a trend in Europe or elsewhere rather than encouraging the adoption of U.S. rules?

Once again, thank you for your assistance in this important matter. I look forward to working with you, the Committee and our colleagues who support the burgeoning high-tech economy.

Sincerely,

JOSEPH CROWLEY
Member of Congress

cc: The Honorable Edolphus Towns, Ranking Member

Mr. OXLEY. Should anyone else wish to submit written questions, that would be acceptable, as well.

The Chair would ask unanimous consent that extraneous materials, including a study called "Valuing the New Economy," a white paper, be made part of the record.

Without objection, so ordered.

Gentlemen, thank you very much for your appearance today. Mr. Cox is correct. We have put a new twist on an old profession, and that is always exciting. Thank you for your participation.

The subcommittee stands adjourned.

[Whereupon, at 2:04 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

FINANCIAL ACCOUNTING STANDARDS BOARD
NORWALK, CONNECTICUT
May 23, 2000

Mr. ROBERT E. SIMISON
Legislative Clerk
Committee on Commerce
United States House of Representatives
Washington, DC 20515

DEAR MR. SIMISON: The following is our response to the questions raised by Congressman Joseph Crowley in his May 4, 2000 letter to Chairman Michael G. Oxley in connection with the May 4, 2000 hearing of the Finance and Hazardous Material Subcommittee of the Committee on Commerce ("Subcommittee Hearing"):

Question 1 Congressman Crowley writes: "Many knowledgeable people have said that FASB's decision to eliminate pooling could have a damaging impact on economic growth. In a recent white paper, Merrill Lynch concluded that the change could result in a notable decline in the consolidations that have enhanced productivity, encouraged innovation, and simulated dynamism in the U.S. economy. And, a Goldman Sachs study specifically says that FASB's changes could have a dramatic impact on certain industries, including information technology and medical services. Why is FASB willing to take the chance that they are right?"

Response: The Financial Accounting Standards Board ("FASB" or "Board") has issued an FASB Exposure Draft, *Business Combinations and Intangible Assets* ("Exposure Draft"), for public comment that has proposed to eliminate the pooling-of-in-

terests method ("pooling method"). The Board will hold as many public meetings as necessary to carefully evaluate all of the feedback received in response to the Exposure Draft and to decide what modifications or clarifications, if any, to the Exposure Draft are appropriate. The Board will not make *any* final decisions about the Exposure Draft, including whether or not to retain the pooling method, or consider whether to issue a final standard, until it has completed its full due process and is satisfied that all substantive issues raised by all parties have been carefully considered.

The Board has *proposed* to eliminate the pooling method because the Board believes that the elimination of the pooling method will benefit consumers—investors, creditors, and other users of financial statements—as well as companies that prepare those reports, by providing more information, and more relevant information, about all business combinations.

The Exposure Draft's provisions also will benefit consumers by improving the comparability of financial reporting, thereby making it possible to more easily contrast companies that participate in business combinations.

Many consumers have expressed support for elimination of the pooling method. As one example, a letter from the Financial Accounting Policy Committee of the Association for Investment Management and Research, the leading organization of investment professionals in the United States with over 40,000 members, states:

> The FAPC is unequivocal in its support of the FASB's proposal that there be only one method of accounting for business combinations in the United States. We also agree that the purchase method is the one that reflects properly the economics of all business combinations, and that pooling-of-interests should be eliminated . . .
>
> The pooling method fails to revalue the assets and liabilities of the acquired enterprise at fair value and the excess, commonly called "goodwill," is not recorded. Hence, pooling does not faithfully represent the values of the assets and liabilities exchanged, nor does it reveal the actual premium paid by the acquirer in the transaction. Users of financial statements are thus impeded in their attempts to understand the underlying economics of the business combination.

In addition, Moody's Investors Services, the leading global rating agency, stated:

> Moody's supports the objectives of accounting standards setters to improve the harmonization of accounting standards globally, and welcomes the FASB's proposal to eliminate the pooling of interests method. We believe that a single accounting method can improve analytic efficiency, especially in cases where a single transaction or essentially identical transactions would produce dramatically different accounting results, and thus enhance the ability of cross border capital market participants to compare, easily and accurately, alternative investments.

Many companies that prepare financial reports also agree. Those companies that have written letters to the FASB supporting the elimination of the pooling method include IBM Corporation, Eaton Corporation, American Electronic Power, General Motors, Caterpillar, Inc., IMC Global, Cigna Corporation, and PPG Industries, Inc., to name a few. The IBM Corporation letter stated:

> IBM agrees with the FASB that all business combinations are acquisitions and, thus, we support the FASB's proposal to eliminate the pooling-of-interests method of accounting for a business combination. We believe that financial statement users are ill-served by the existence of two methods to account for the same economic transaction. We agree with the FASB that using the purchase method to account for all business combinations will increase the comparability of financial statements and will reflect the true economics of the transaction, that is, an arm's length investment that should be accounted for at the fair value of the assets and liabilities that are acquired.

The Exposure Draft's provisions will also benefit companies that prepare financial statements and the auditors of those statements by providing a single method of accounting for all business combinations. Having one method of accounting for all business combinations will reduce certain costs to companies and auditors that are currently related to the existence of the pooling method.

For example, the availability of the pooling method often puts companies and their auditors under pressure to employ that method because it typically produces higher reported earnings and rates of return subsequent to a business combination than the purchase method. Moreover, because the pooling method is applied retroactively, the comparative earnings reported for periods preceding the combination are also higher than under the purchase method—even before the companies were, in fact, combined.

As a result of those pressures, companies often must bear significant costs, both monetary and nonmonetary, in seeking to use the pooling method. In positioning

themselves to try to meet the 12 qualifying criteria for applying that method, companies may refrain from engaging in appropriate economic actions that they might otherwise undertake, such as asset dispositions or share reacquisitions. They also may incur substantial fees from auditors and consultants in seeking to meet those criteria. The efforts to meet those criteria also may lead to conflicts between companies, auditors, and regulators with respect to judgments about whether the criteria have been met, thereby adding uncertainties and their attendant costs to the process and raising questions about the operationality of those criteria.

A report published by the Silicon Valley office of McKinsey & Company, an international consulting firm, stated:

> The fear that purchase accounting, by lowering reported earnings, will destroy shareholder value is a myth. In fact the opposite is true. Efforts to qualify for such treatment actually destroy value. FASB's proposal to eliminate pooling accounting is a blessing in disguise. Why? Because the transition to purchase accounting will require corporations to adopt more robust deal evaluation processes and enhance their shareholder communications.

Similarly, a letter to the FASB from the Financial Institutions Accounting Committee of the Financial Managers Society, a group of financial professionals working in executive level positions in the thrift and banking industries, stated:

> Formal research supports the proposition that reporting firms consume substantial resources in structuring transactions solely to achieve a favorable financial reporting outcome. Lys and Vincent (1995) report that AT&T paid at least $50 million (and possibly as much as $500 million) to achieve pooling-of-interests accounting for its acquisition of NCR . . . A single method of accounting for business combinations would redirect these corporate resources into more productive areas.

In addition, having one method of accounting for business combinations benefits companies by leveling the playing field for competition among companies in the business combinations market. The ability—or inability—to use the pooling method often affects whether a company enters into a business combination and also affects the price it negotiates for that transaction. Companies that cannot use the pooling method because they cannot meet the criteria required for its use (for example, criteria that prohibit certain share acquisitions) often conclude that they cannot compete for targets with those that can meet the criteria.

Many companies that cannot use the pooling method believe that companies that can use it often are willing to pay higher prices for targets than they would if they had to use the purchase method because they do not have to account for the full cost of the resulting investment. Thus, by using the pooling method, they can understate the income statement charges (primarily related to goodwill and other intangible assets).

In a letter to the FASB, KeyCorp explained:

> Since most publicly-traded companies are gauged by EPS performance, there is a strong incentive to use the "earnings-friendly" pooling method. The desire to avoid the earnings consequences of the purchase method has almost certainly resulted in uneconomic behavior. It is well understood in the investment banking community that a company is willing to "pay" more for a target if the pooling method is available for the resulting transaction. Clearly, there is a view that the pooling method results in a type of accounting arbitrage . . .

Even though using the pooling method rather than the purchase method might result in being able to report higher per-share earnings following the combination, the fundamental economics are not different because the actual cash flows generated following the combination will be the same regardless of which method is used. As a result, the added earnings reported under the pooling method reflect artificial accounting differences rather than real economic differences.

To the extent that the markets respond to artificial differences, they direct capital to companies whose financial reporting benefits from those differences and they direct capital away from companies whose financial reporting does not benefit. As a result, markets allocate capital inefficiently rather than efficiently. While inefficient allocation of capital may benefit some companies and even some industries, it imposes added costs on many others, depriving them of capital that they need and capital they could employ more productively. The outcome is detrimental to those companies—but, more important, to the capital markets as a whole.

Finally, two further clarifications. First, Question 1 states that the "Goldman Sachs study specifically says that FASB's changes could have a dramatic impact on certain industries, including information technology . . ." Unfortunately, the statement is not accurate. The May 29, 1999 Goldman Sachs survey by Gabrielle Napolitano, CFA, and Abby Joseph Cohen, CFA, to which the question refers, states that the FASB's pre-Exposure Draft preliminary decisions on accounting for busi-

ness combinations may adversely affect some industries including the "healthcare information technology" industry. The survey does not conclude that the Board's decisions may adversely affect the entire information technology industry as implied in Question 1. More significant, the overall conclusion of the Goldman Sachs survey was that the Board's preliminary decisions, including the elimination of the pooling method, would "*not* have a material adverse effect on future business combinations."

Second, Question 1 refers to conclusions of a Merrill Lynch "white paper" on the impact of the Board's proposed decision to eliminate the pooling method. For purposes of the Subcommittee Hearing record, it should be noted that in a March 3, 1999 Merrill Lynch "In-depth Report" on regional banks, Sandra J. Flannigan, CFA, first vice president, Global Securities Research & Economics Group, Global Fundamental Equity Research Department, concluded:

> In our opinion . . . the economics of a "purchase" and "pooling" are the same. We, therefore, don't think elimination of pooling-of-interests accounting will halt consolidation. Indeed, ultimately, required usage of purchase accounting could generate more transactions given greater comparability from an international accounting standpoint and fewer earnings reporting/share buyback constraint issues.

Question 2 Congressman Crowley writes: "You have received a number of thoughtful alternative proposals to the elimination of pooling. You have a great deal of concern about the evaluation of intangibles. What is the rush to eliminate pooling rather than looking first at the valuation questions? If the problem with studying the issues is that it will take some time, why not do it right the first time rather than in a piecemeal fashion, especially when the consequences of 'getting it wrong' could be so severe?"

Response: Since first adding the project on business combinations to its agenda in 1996, the Board has held over 40 public meetings, issued 2 preliminary documents and the Exposure Draft for public comment, and carefully analyzed and is still in the process of discussing at public meetings over 400 comment letters received from a broad range of companies, investors, and other constituents. We have hardly rushed to complete this project, as Question 2 suggests. As stated in response to Question 1 above, the Board will hold as many public meetings as necessary to carefully evaluate all of the feedback received in response to the Exposure Draft and to decide what modifications or clarifications, if any, to the Exposure Draft are appropriate. The Board will not make *any* final decisions about the Exposure Draft, including whether or not to retain the pooling method, or consider whether to issue a final standard, until it has completed its full due process and is satisfied that all substantive issues raised by all parties have been carefully considered.

With respect to the issue of the "valuation of intangibles," feedback received in response to the Exposure Draft reveals that some constituent concerns, including, possibly, the concerns raised in Question 2, result from having misread or misunderstood the Exposure Draft's provisions regarding intangibles. To clarify, those provisions *do not* require the separate valuation of *any* intangible assets, such as many forms of knowledge-based intangible assets so often associated with technology companies, that cannot be separately identified and reliably measured. Under current accounting standards and the Exposure Draft, *only* purchased intangible assets that can be identified and reliably measured, like many trademarks and customer lists, are required to be separately valued, reported, and amortized over their useful economic lives.

Question 3 Congressman Crowley writes: "A review of the comment letters sent to FASB shows that two-thirds of all of those who sent comment letters and all of the Big 5 accounting firms advocated either retaining at least some form of pooling or not eliminating pooling until significant other issues were resolved. Why is FASB determined to abolish pooling in light of this significant opposition to its decision?"

Response: Many of those commentators that wanted to retain pooling wanted it retained in only very limited circumstances. Those circumstances were (1) where there was a true merger of equals (a very rare occurrence) and (2) where companies under common control were combined (a pooling-method-type result would be required under both current accounting and the Board's proposal).

The Board is addressing and will resolve all of the "significant other issues" raised in the comment letters about the proposed accounting for goodwill and purchased intangibles before it redeliberates whether the pooling method should be retained.

The FASB's Rules of Procedure provide for an open and thorough due process that includes analysis and public discussion of the relevant information and persuasive arguments contained in the comment letters, and other feedback, received in response to an FASB proposal. The Board's mandate is to establish and improve standards of financial accounting and reporting that result in credible, transparent,

and comparable financial information for the efficient functioning of the US capital markets.

As former US Securities and Exchange ("SEC") Chairman Richard C. Breeden stated in testimony before Congress almost a decade ago:

> The purpose of accounting standards is to assure that financial information is presented in a way that enables decision-makers to make informed judgments. To the extent that accounting standards are subverted to achieve objectives unrelated to fair and accurate presentation, they fail in their purpose.

The US capital markets are the deepest, most liquid, and most efficient markets in the world. The unparalleled success and competitive advantage of the US capital markets are due, in no small part, to the high-quality and continually improving US financial accounting and reporting standards. As Federal Reserve System Chairman Alan Greenspan stated in a June 4, 1998 letter to SEC Chairman Arthur Levitt:

> Transparent accounting plays an important role in maintaining the vibrancy of our financial markets . . . An integral part of this process involves the Financial Accounting Standards Board (FASB) working directly with its constituents to develop appropriate accounting standards that reflect the needs of the marketplace.

As stated in response to Question 1 above, the Board will hold as many public meetings as necessary to carefully evaluate all of the feedback received in response to the Exposure Draft and to decide what modifications or clarifications, if any, to the Exposure Draft are appropriate. The Board will not make any final decisions about the Exposure Draft, including whether or not to retain the pooling method, or consider whether to issue a final standard, until it has completed its full due process and is satisfied that all substantive issues raised by all parties have been carefully considered.

Question 4 Congressman Crowley writes: "Your Exposure Draft specifically states that international harmonization is one of the reasons for your decision to eliminate pooling. Let's assume for a minute that that is a valid goal. Given the fact that countries like the U.K., France, Japan and Germany permit pooling, at least in some form, how could eliminating pooling here increase international harmonization? Assuming that various foreign and international accounting rules are moving away from allowing pooling accounting, why should the U.S. be following a trend in Europe or elsewhere rather than encouraging the adoption of U.S. rules?"

Response: Because of the rapidly accelerating movement of capital flows globally, the Board believes there is a need for financial reporting to be comparable internationally. In response to that need, part of the Board's mission includes promoting international comparability of financial reporting, and accounting for business combinations is one of the more significant areas of difference in accounting standards.

For example, in most parts of the world, the pooling method is either prohibited or used only on a rare exception basis. A recently issued exposure draft from the Canadian Accounting Standards Board would prohibit use of the pooling method, the International Accounting Standards Committee has established a Steering Committee on accounting for business combinations that will consider whether the pooling method should be prohibited, and in the United Kingdom, the technical director of the Accounting Standards Board has stated:

> If the US bans pooling, the International Accounting Standards Committee (IASC) will come under pressure to ban it and then the UK will have to ask itself whether it wants to be the only country that allows it.

The part of the Board's mission that includes promoting international comparability is secondary to the Board's central mission of establishing standards that result in credible, transparent, and comparable financial information for the efficient functioning of the US capital markets. The Board, and many of its constituents, believes that the proposed elimination of the pooling method is consistent with the both the Board's central mission *and* the Board's secondary mission.

I hope that my effort to provide thorough answers to the questions posed by Congressman Crowley has been helpful. I would be pleased to meet with the Congressman in person to further discuss any of his concerns.

Sincerely,

EDMUND JENKINS
Chairman

BIOTECHNOLOGY INDUSTRY ORGANIZATION
WASHINGTON, D.C.
May 4, 2000

BRIAN MCCULLOUGH
House Committee on Commerce
316 FHOB
Washington, DC 20515

DEAR BRIAN: Per my conversation with Jim Conzelman, enclosed for the Finance and Hazardous Materials Subcommittee's hearing record are six copies of the testimony BIO presented at the Financial Accounting Standards Board's ("FASB") hearing on February 11, 2000 in New York City.

The biotechnology industry is totally opposed to the FASB proposal to repeal the "pooling" method of accounting. In our industry, more so than in any other industry, appropriate business combinations are often the only source of capital for struggling companies. The use of the pooling method of accounting facilitates these arrangements. If pooling is repealed, there will be a dramatic downturn in combinations in our industry. This will result in many companies simply going out of business.

Thank you for including our testimony in the Committee hearing record. Please feel free to call if you wish to discuss this matter in greater detail.

Sincerely,

PHILIP J. UFHOLZ
BIO Tax/Finance Counsel

PREPARED STATEMENT OF RICHARD POPS BEFORE THE FINANCIAL ACCOUNTING STANDARDS BOARD ON EXPOSURE DRAFT

BUSINESS COMBINATIONS AND INTANGIBLE ASSETS

Grand Hyatt Hotel, New York, New York

FEBRUARY 11, 2000

Good afternoon, my name is Richard Pops. I am the Chief Executive Officer of Alkermes, Inc., a biotechnology research and development company located in Cambridge, Massachusetts. I wish to thank you for allowing me the opportunity to testify today on behalf of the Biotechnology Industry Organization (BIO), the national trade association that represents over 850 biotechnology companies worldwide.

My testimony will focus on the Financial Accounting Standards Board's (hereafter, "the Board") proposal that would repeal the "pooling" method of accounting which allows companies that merge to record their assets in the ongoing entity by simply combining their assets and liabilities. This testimony will supplement my comments that were submitted to the Board on December 3, 1999.

If pooling is eliminated, all mergers will be treated as purchases of one company by another. The result of this mandatory application of "purchase accounting" will be that biotechnology companies will be required to recognize and value at the time of the transaction a variety of intangible assets, including goodwill. This asset would have to be amortized, according to Generally Accepted Accounting Principles (GAAP), over the course of twenty years. This has at least two important implications for biotechnology companies. Both relate to the critical issue facing entrepreneurs seeking to build and grow successful biotechnology companies: the ability to raise large sums of capital over a period of several years prior to first profitability.

First, elimination of pooling accounting means a potential delay in profitability for businesses that merge to build critical mass. Biotechnology companies are unique in that they typically operate for years (average approximately 14.5 years by BIO's estimate) in a loss position. Raising enough money to survive is incredibly challenging. The pooling method of accounting allows a profitable or potentially profitable biotech company to acquire a non-profitable company without incurring an adverse charge to its earnings. In most cases, a merger or acquisition is the only viable option for the loss company. The alternative, due to a lack of cash flow and resultant inability to continue vital research and development efforts, is frequently financial failure. This is generally not the case in other high technology industries where profitable companies acquire or merge with other profitable companies in order to create synergy and improve efficiency. With biotech companies, it is a case of survival. For investors supporting these companies, the timing of profitability is a critical consideration in their investment decision. A delay in profitability due to noncash amortization charges can add years to the time that a biotechnology company

operates at a loss. This extends the time that its securities are unattractive to many investors and, therefore, increases the already difficult task of fundraising.

Second, it means that, once profitable, biotechnology companies that merged to build critical mass may report significantly depressed earnings per share over the course of many financial reporting periods. This has the potential to severely damage the company's overall value. This has a profound effect much earlier in the company's life as investors make the investment decision prior to profitability. If the eventual valuation of the company is lower once it is profitable, the present value of its equity is lower today. This affects the company's ability to raise capital.

It is important to recognize that for biotechnology companies, tangible book value is low in comparison to total company value. Biotechnology mergers often occur between companies of similar size, and result in large amortization charges in purchase accounting. The effect of the elimination of pooling accounting is magnified for small biotechnology companies, where the non-cash amortization charges can dwarf total profitability of the combined business in the early quarters of profitability.

Biotechnology companies are part of a new generation of companies that presents a financial profile profoundly different from traditional "bricks and mortar" enterprises. The issue of pooling should be addressed in the context of a larger examination of how GAAP can best handle the financial disclosure for these types of companies. For the same reason that the Board recently decided to defer consideration of new rules governing in process research and development, because the issue was too closely intertwined with the treatment of research and development costs generally, the Board should defer consideration of the pooling issue.

Repeal of the pooling method will reduce the likelihood that some desirable combinations will occur. This would be an unfortunate outcome for the biotechnology industry, where mergers of complementary technologies are often necessary to enable the development of innovative new drugs and diagnostic products for the benefit of patients and families around the world.

The problems of comparability, relevance, reliability, and neutrality that the Board says drives its proposed change are recreated in purchase accounting by the need to confront the many problems inherent in the treatment of intangible assets, in general, and goodwill in particular. With so much of the value of biotechnology companies lying in these intangibles, the financial presentation under the mandated use of purchase accounting will be significantly more problematic than under pooling.

One of the foundations of financial accounting is comparability across time as well as between companies. Users of financial statements should be able to look across periods and evaluate a company's performance over time, to see and be able to evaluate trends and significant new developments in its financial situation. The strength of accounting for business acquisitions by pooling is that it allows for just such a comparison. The merger of two entities by their owners, the shareholders, is undertaken with the expectation that the new, combined entity will allow for greater value to be generated going forward. By preserving the historical values of assets carried on the books of the predecessor companies, such a comparison can be made easily. The assets, income flow, and other financial elements of the two companies are simply combined and not altered, and so any change in the future, good or bad, is readily apparent.

Purchase accounting departs from this model of combination and thus undermines the users of financial statements' ability to compare performance over time easily. Under purchase accounting, the historical valuation of assets of one of the predecessor companies is preserved, while the assets of the other company are revalued according to the fair market value at the time of the business combination. Thus, going forward there is an amalgam of valuation of assets, some at historical cost and some at this new, fair market valuation.

The Board's proposed rule does not adequately take into account the true worth of a biotechnology company's intangible assets and would slow their growth, which is more important than detailed accounting. Investors do not care about accountants' estimates of a company's various hard-to-measure intangible assets. What they really want to know is, does this merger contribute to the bottom line.

I do not pretend that there are any easy answers to the problem of dealing with intangible assets and their role in biotechnology companies. The rapid changes in the biotechnology industry have created new situations where traditional accounting principles no longer can be relied upon to provide accurate, transparent, public disclosure. The worth of biotechnology companies is increasingly related to intangible assets that traditional accounting fails to measure. It is a difficult problem, and I applaud the Board for continuing to grapple with it. However, in the face of this recognized difficulty, the elimination of pooling alone means not that problems with

accounting reliability, comparability and neutrality will be eliminated, but instead will be exacerbated.

The magnitude of this proposed rule change requires a careful weighing of the possible costs of change against the conviction that the public will enjoy significant benefits.

The risk of adverse impact to the biotechnology industry due to the elimination of pooling is significant enough to require an equally significant showing of the benefits to be realized. In fact, none of the benefits claimed on behalf of the proposed rule change meet such a standard either separately or collectively.

NATIONAL ASSOCIATION OF MANUFACTURERS
May 3, 2000

The Honorable MICHAEL OXLEY
Chairman, Subcommittee on Finance and Hazardous Materials
House Commerce Committee
2233 Rayburn House Office Building
Washington, DC 20515

DEAR MR. CHAIRMAN: I am writing on behalf of the National Association of Manufacturers (NAM) regarding the subcommittee hearing on business combinations scheduled for Thursday, May 4. The NAM—"18 million people who make things in America"—is the nation's largest and oldest multi-industry trade association. The NAM represents 14,000 members (including 10,000 small and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states. As many of our members are current or frequent participants in mergers and acquisitions (M&As), we have a vested interest in this issue and have, in fact, testified before the Financial Accounting Standards Board (FASB) and the Senate Banking Committee in February and March of this year, respectively.

While the NAM fully supports the independence of the FASB and strongly believes that setting of accounting standards should be left to the private sector, we are also very concerned about some of the changes the FASB has suggested in its proposal on Business Combinations and Intangible Assets. Most notably, the FASB has proposed to eliminate the pooling-of-interests method of accounting and to halve the maximum amortization period for goodwill (currently 40 years, would be 20 years under the proposal). The NAM opposes both of these changes for the reasons set forth in our enclosed statement for the record.

Our primary purpose for writing to you today is to clarify the scope of those who would be harmed by these proposals, should the project move forward unmodified. In much of what has been written and said about this issue, it has been characterized as a "high tech" issue. (The NAM insists that modern manufacturing and "high tech" are increasingly synonymous but, for the sake of this discussion, will accept the distinction.) And the FASB has correctly asserted that accounting rules should be equally applicable to all sectors of the economy and not favor one sector over another. However, while it is certainly true that much of the incredible growth of the high tech sector has been achieved through mergers relying on pooling, pooling has also played, and continues to play, a very significant role for more traditional manufacturers. It is important to note that the NAM's very active involvement in this issue is not due solely—or even most significantly—to the interests of our many high tech members. We are consistently hearing, primarily from more traditional manufacturers, that this merger or that merger would not have occurred had it not been for the applicability of pooling. This is not to say that all mergers are inherently good, but that is up to the market to decide—not the FASB.

The FASB has made it quite clear that it is not its mission to take into account economic consequences when promulgating new accounting standards. But there is no "abuse" being addressed in this case that would require drastic or expedited action, and the potential risks far outweigh the potential benefits. Consequently, we are heartened that this subcommittee has seen fit to fill the gap by considering the potential economic consequences of the FASB's Business Combinations and Intangible Assets proposal. Please feel free to call me or the NAM's director of corporate finance and tax, Kimberly Pinter (202-637-3071) if you have further questions.

Sincerely,

MICHAEL E. BAROODY, *Senior Vice President*
Policy, Communications and Public Affairs,
National Association of Manufacturers

Enclosure

PREPARED STATEMENT OF KIMBERLY J. PINTER, DIRECTOR, CORPORATE FINANCE AND TAX, NATIONAL ASSOCIATION OF MANUFACTURERS ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

I. INTRODUCTION

The National Association of Manufacturers (NAM) appreciates this opportunity to present its views on the Financial Accounting Standards Board's (FASB) Business Combinations and Intangible Assets proposal. The NAM is the nation's largest and oldest multi-industry trade association, representing 14,000 members in every industrial sector and in all 50 states. A significant number of our members are frequent or current participants in merger and acquisition (M&A) activity and have a vested interest in the outcome of this project.

II. POOLING

The centerpiece of this project is the proposed disallowance of the pooling-of-interests method of accounting. The NAM finds this proposal objectionable based on a number of different factors.

First of all, the NAM disagrees with the FASB's underlying premise that all business combinations are substantively the same. My personal observation as a non-accountant is that it seems very odd that the term "M&A" would be standard jargon if "M's" and "A's" were really exactly the same thing.

Substantively, a transaction in which a shareholder remains a shareholder fundamentally differs from one in which the shareholder cashes out. The pooling method respects this continuity. The criteria for using the pooling method are already quite strict and reflect the primary factors of such continuity. The FASB contends that by eliminating pooling they will be aiding comparability of financial statements—making like things look alike. It is the NAM's position that not all transactions are alike, and that while like things should look alike, dissimilar things should look different.

Additionally, there are substantive problems with the purchase method that should be addressed, particularly before the elimination of pooling, should its elimination ultimately be determined to be an appropriate goal. These problems center around the valuation of intangibles.

The NAM's first concern in this area is the proposed halving of the maximum allowable period over which to amortize goodwill charges. The FASB has taken the position that goodwill is a diminishing asset. The NAM disagrees with this premise. In the case of a successful merger, goodwill should actually increase. Goodwill results because the value of a company is greater than the sum of its parts. Following from that, every merger participant is hopeful that a successful merger will yield more than the sum of its parts.

Furthermore, even if we were to accept the idea of goodwill as a wasting asset, it has been conceded that goodwill cannot be reliably measured nor its actual useful life determined. Therefore, the arbitrary limit of 40 years was set some time ago. Companies and markets have acclimated to this standard. Now, with no more accurate or useful way to account for goodwill, the FASB is proposing to replace one arbitrary limit with another—in a way that would significantly and adversely affect our members' financial statements.

The problems inherent in the valuation of goodwill are not unique to goodwill. Technological advance has fueled a whole host of new intangibles, many of which are equally difficult to characterize and value. They are, if you will, a by-product of the "new economy." But let me explain for a moment what I mean by the "new economy." It is not a place or a specific industry segment. It is a pervasive concept affecting all industries to varying degrees. The NAM has done several reports, in fact, on "Technology on the Factory Floor." Traditional manufacturers are huge consumers and producers of technology, whether it's to improve methods of cutting steel using laser-like streams of super-cooled chemicals; to locate oil, gas, or other natural resources; to automate an assembly line; or even to provide all of their employees with home computers. Such a dramatic evolution in the way our companies do business seems to warrant at least an examination of whether traditional accounting principles are still accurate and appropriate.

I have personally discussed the proposed elimination of pooling with many of our member companies, and I have been truly surprised by the number of times I have heard that this merger or that merger would not have happened had it not been for the applicability of pooling. And I have heard these comments across the board from all kinds of manufacturers. Even those that don't use pooling are very concerned about its possible unavailability for future transactions.

Manufacturing is the largest contributor to economic growth, and the recent surge in M&A activity has coincided with a surge in productivity growth. By mentioning these facts, I don't mean to suggest that pooling should be retained because it somehow "encourages" business combinations; rather, it appears that the existence of only the purchase method to account for a diverse array of transactions would *discourage* such activity—and that result could well have a negative effect on the economy.

III. PROCESS

Finally, the NAM is concerned that the FASB is not hearing from all parties who may be critical of the project. Too often we have found that companies are very reluctant to too visibly criticize the merits of a FASB proposal due to concern that such activity might invite increased SEC scrutiny. Regardless of whether such concerns are founded, as they say, perception is reality, and it does have a chilling effect on full participation in the process. That said, the NAM appreciates the FASB's extensive efforts to thoroughly evaluate these issues with significant outside input and participation, and we do fully support the FASB's independence and private-sector setting of accounting standards.

AMERICAN BUSINESS CONFERENCE
May 3, 2000

The Honorable MICHAEL G. OXLEY
United States House of Representatives
Washington, DC 20510

DEAR CONGRESSMAN OXLEY: I write in regard to the upcoming hearings in the Subcommittee on Finance and Hazardous Materials on the efforts of the Financial Accounting Standards Board (FASB) to change substantially accounting rules for business combinations.

The American Business Conference (ABC), a coalition of CEOs of fast-growing, midsize companies, is very concerned about FASB's proposal. We hope that the Subcommittee's hearing will illuminate the many important issues put into play by the FASB initiative—issues we regard as far from settled. As background, I have enclosed with this letter a memorandum I wrote on FASB's business combinations project. I hope it may prove of use to you and your colleagues.

In the view of ABC members, the single greatest service your hearing can perform is to underscore the comprehensive nature of FASB's business combinations project. The project is not, as some have suggested, merely an effort to eliminate pooling-of-interests with a few extra details thrown in. FASB's project seeks to change *all* business combinations—accounting—the pooling-of-interests method, used in about 5 percent of merger and acquisition deals, and the purchase method, used in the vast majority of merger and acquisition transactions.

Because the FASB business combinations project is a comprehensive agenda for change, it carries critical implications for every business enterprise in the country, regardless of industry and regardless of which method of accounting—pooling or purchase—they have used in the past or may plan to employ in the future. Interest in and concern about various aspects of FASB's proposal accordingly can be found in all segments of the American business community, among accounting firms, and among investors.

This is the essential point for understanding the controversy swirling around FASB's project. *The fact is, as a reading of comment letters to the FASB demonstrates, there is no meaningful consensus in the private sector in support of the business combinations project.*

For example, defenders of FASB's plan to abolish pooling-of-interests accounting point to the Association for Investment Management and Research (AIMR), for support of their position. And it is certainly true that AIMR, the leading association of investment professionals, on balance advocates the elimination of pooling. However, the AIMR "disagrees strongly" with another crucial aspect of FASB's proposal, namely the display under the purchase method of goodwill amortization charges net of tax and after operating earnings.[1] (The enclosed memorandum discusses the latter issue in greater detail.)

A review of the positions of the major accounting firms also displays misgivings about the FASB proposal. PricewaterhouseCoopers, as an instance, disagrees with

[1] Letter of the Association for Investment Management and Research, to Mr. Timothy Lucas, Director of Research and Technical Activities, Financial Accounting Standards Board, December 7, 1999 (Letter of Comment No.: 56A).

FASB's position regarding the elimination of pooling and with some of the Board's proposed changes to purchase accounting, including the display of goodwill amortization. For its part, KPMG does not support the total elimination of pooling or the separate treatment of goodwill amortization from other intangible assets under purchase accounting.[2]

The comment letters to the FASB from corporations constitute a litany of dissent. Thus Ford Motor Company, *although it does not use the pooling-of-interests method,* is nonetheless "not in favor of its elimination." As for FASB's proposed reform of purchase accounting, Ford does not agree with the Board on goodwill recoverability, disclosure requirements for acquisitions, the new twenty-year period for goodwill amortization, or the separate line-item disclosure of goodwill amortization. Ford's dissent is more or less typical of the response of other corporations, big and small, "old" economy and "new" economy.[3]

Although the Board's rulemaking process. is not complete, FASB members thus far have shown little inclination to rethink their proposal. In spite of the considerable criticism that the Exposure Draft has attracted, the Board seems determined to move forward on the elimination of pooling accounting and the alteration of purchase accounting. Undoubtedly the Board will have to "tweak" aspects of its proposal, but it seems unlikely that those marginal changes will speak to the broader objections of the private sector.

If I am correct about the Board's attitude, the result will be unfortunate. It will be unfortunate first because FASB will force on the business, accounting, and investment communities a "reform" of business combinations accounting that I believe is deeply flawed and that will almost surely have to be revisited, sooner rather than later.

It will be unfortunate, too, because a decision by the Board to press ahead with a rule that has met with so much resistance during the comment period threatens the Board's long-term capacity to exert leadership on a host of other cutting-edge accounting issues. The Board very well may have its way in this matter, but at what price? ABC strongly supports the FASB and respects the Board's independence. We believe, however, that FASB's ability to maintain that independence is directly proportionate to its constituents' faith in the Board's capacity to respond to constructive criticism. Fairly or not, many of our colleagues in the business community harbor serious doubts on this point.

We at ABC believe that a responsible, intellectually tenable compromise is possible in regard to business combinations accounting. We also believe the FASB process itself is sufficiently flexible to allow for that compromise to happen, *provided that all the interested parties are willing to take the time to do the job correctly.* I do not pretend to know the exact lineaments of a workable compromise but I suspect it would, as a first step, entail a satisfactory, mutually agreeable recasting of purchase accounting, particularly as it pertains to intangible assets including goodwill.

In closing, let me state a view that I suspect you share: Congress ideally ought not to have a legislative role in the setting of accounting standards. What Congress can do, and indeed, what I hope it will do through the Finance. Subcommittee's hearing, is to exert its traditional oversight function in such a way as to inform citizens of the issues at stake while encouraging intelligent compromise within the private standard-setting process. To that end, ABC stands ready to assist you and your colleagues on the Subcommittee.

Sincerely,

BARRY K. ROGSTAD
President

cc: The Honorable Edolphus Towns

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[2] Letter of PricewaterhouseCoopers LLP to Mr. Timothy Lucas, Director of Research and Technical Activities, Financial Accounting Standards Board, December 7, 1999, (Letter of Comment No: 1A) and Letter of KPMG to Timothy Lucas, December 7, 1999, (Letter of Comment No: 35A). Most of the other accounting firms submitting comment letters to FASB cite similar problems in the exposure draft. These misgivings are mirrored in letters from leading investment banks, commercial banks, and money management firms.

[3] Letter of Ford Motor Company to Timothy Lucas, Director of Research and Technical Activities, Financial Accounting Standards Board, December 3, 1999 (Letter of Comment No.: 92).

Merrill Lynch

VALUING THE NEW ECONOMY

How New Accounting Standards
Will Inhibit Economically Sound Mergers
and Hinder the Efficiency and Innovation
of U.S. Business

A White Paper presented by
The Merrill Lynch Forum

June 1999

Valuing the New Economy

from the Merrill Lynch Forum

Earlier this year, an independent organization of accountants made a decision that could have far-reaching consequences for the American economy — particularly for fast-growing companies driving our growing knowledge-based economy.

In April, the Financial Accounting Standards Board, known by its acronym FASB, announced its intention to change the accounting method used in many U.S. mergers and acquisitions. Though well-intentioned, this major shift in the basic accounting rules used by businesses would eliminate a firmly established mode of accounting used by countless U.S. firms of all sizes that have made a strategic decision to join together. Many business combinations would suddenly face a new and higher hurdle. The accounting method itself would prove an obstacle to a merger that both parties are eager to consummate. As a result, the wave of consolidations that has enhanced productivity, encouraged innovation, and stimulated dynamism in the U.S. economy may notably decline.

The fact is, what might appear to be an arcane accounting matter could prove to be a public-policy decision of serious and far-reaching economic consequences.

This White Paper attempts to give some context to the proposed change in accounting principles. In doing so, it will address critical questions surrounding this proposed change in accounting rules, including:

- Will the FASB decision harmonize U.S. accounting standards or will it reverse long-standing rules that are well-suited to complement the unique qualities of the U.S. economy?

- Will the FASB decision create a level playing field for all U.S. companies or will it prove disadvantageous to the businesses that form the core of our knowledge economy?

- Will the FASB decision enhance the opportunities for promising companies to realize value through a sale, or does it indirectly discourage potential buyers from seeking mergers with companies whose greatest value is in their human capital?

- Will the FASB decision create a clear, global standard in accounting rules (a laudable goal) or will it put U.S. firms at a disadvantage compared to their international competitors?

As the answers to these questions will demonstrate, the FASB decision needs careful scrutiny and reconsideration before the ruling becomes final at the end of next year. The U.S. economy is driven by many different types of enterprises. In our view, it

would be a serious mistake to force all of these companies to subscribe to a single accounting treatment for their mergers and acquisitions. The *option* of using either pooling or purchase accounting should be preserved.

The Issue: Pooling vs. Purchasing Accounting

Although little-known outside the financial world, FASB is the officially recognized private sector body that determines the rules for all financial accounting and reporting, including the preparation of financial statements. Every public company regulated by the Securities and Exchange Commission is affected by FASB rulings.

On April 21, 1999, FASB announced that it would eliminate "pooling-of-interests" as a method of accounting for business combinations and require all merger transactions to employ the "purchase method." The effective date of the new rule is expected to be late next year when the Board is scheduled to issue its final rule. FASB's stated purpose is to bring the U.S. into closer alignment with practices around the world and, more specifically, to end the use of two different accounting methods.

At first glance, these seem like noble goals. But the impact of the change that FASB now advocates is considerable. Eliminating the option of using pooling-of-interests accounting altogether and in all circumstances will have a profound effect on companies involved in merger transactions, especially when one looks at the effect different accounting methods have on publicly released financial statements.

When a company is involved in a merger, it goes without saying that it wants its financial statements to be accurate and informative. But the precise method by which a company is able to present accurate and informative financial statements has been in dispute for some time in the U.S., where both the pooling and purchase methods have long been recognized. Although this has largely been a debate among accountants, the question takes on particular importance when it comes to assessing the value of intangible assets such as a company's reputation, its intellectual assets, customer base, or brand name. An acquiring company typically is willing to pay a premium for those intangible assets, and in financial accounting, that premium is referred to as "goodwill." The treatment of goodwill is critical in assessing the value of companies following a merger.

In truth, the concept of goodwill is a product of the limitations of modern accounting. No accounting system has been invented that can accurately measure the precise value of human and intellectual capital. Yet in many businesses, human and intellectual capital are the most important elements in assessing a company's true worth. This is the heart of the current dispute over accounting methods.

Pooling-of-interests accounting combines the existing assets, liabilities and net worth of two companies, treating their financial histories as if they had always been one company. The shareholders of each company are viewed as merely combining their interests, rather than having one company "purchase" another. Under this method of accounting, the new combined company is treated as a continuation of its predecessors since shareholders of both companies have united their interests. The premium paid for the intangible goods — the goodwill — is never recorded because pooling simply brings together the existing assets and liabilities of two companies. Goodwill, therefore, does not need to be amortized over any period of time in this type of accounting.

Under the purchase method, on the other hand, one company is clearly acquiring the other. The acquiring company must recognize the value of the goodwill (the new intangible assets it has purchased) and write off or amortize this asset over a prolonged period. Under existing rules, the amortization can be as long as 40 years. This method implies that the asset of goodwill erodes or depletes over time. In successful acquisitions, of course, the asset and equity base grows stronger, not weaker over time. Nevertheless, the current purchase accounting rules require the goodwill cost to be amortized, decreasing the amount of earnings a company reports each year. For large, multi-national companies with great resources, this diminution of their earnings can be significant, but their income statements can often absorb the earnings shock created by purchase accounting and the associated amortization of goodwill. But, in certain businesses that have a high level of intangible assets, such as financial services, technology, and pharmaceuticals, the decline in earnings caused by a switch to purchase accounting will not be ignored in the marketplace.

In 1998, 55% of the dollar volume of U.S. mergers employed the pooling method. Many of these mergers — and the efficiencies they produce — would not have occurred had companies been forced to comply with the new accounting standard now being contemplated.

For new and small companies in these sectors, the hurdle of purchase accounting is even higher. These growing companies will find that the requirement to amortize goodwill can greatly distort the long-term cost of a strategic consolidation, making it a less appealing option to potential partners. It could even cause the acquiring company to report operating losses due to the goodwill amortization.

Although the purchase method of accounting has a longer history, the pooling method is hardly a new idea. Pooling of interests has been formally recognized in the U.S. since the mid-1940s. Its use expanded considerably through the 1950s and 1960s when it was also adopted in Britain and Europe. Despite its growing use, pooling of interests is not used indiscriminately. In the U.S., every merger must meet certain criteria to qualify to use the pooling method, and the SEC strictly monitors its use and is frequently called upon by the companies themselves who

want to "pre-qualify" for pooling-of-interests accounting. Generally, only mergers that rely on equity shares rather than cash, assets, or debt can use the pooling method. All other mergers must comply with the purchase method of accounting.

Accounting and the New Economy

To most business leaders, these distinctions between pooling and purchase accounting merely represent two different perspectives within the accounting profession. But more recently, the treatment of intangible assets in corporate mergers — the core difference between these two sets of accounting principles — has emerged as a critical business issue. Today, the American economy is increasingly driven by companies whose primary asset is human capital, not physical capital. What recognition human and intellectual capital should receive in financial accounting is the heart of the current controversy.

According to the Commerce Department, three knowledge-intensive industries — financial services, information technology, and pharmaceuticals — accounted for nearly 30 percent of America's GDP in 1998. In 1997, information technology alone was responsible for 28.3 percent of real economic growth in the U.S. For businesses in technology, pharmaceuticals, financial services, and other research- and reputation-driven industries, the pooling method has become an integral — one might say, indispensable — part of the economic landscape.

Companies in industries like these, whose value is derived largely from intangible assets, are most likely to suffer under the new FASB guidelines. In these idea-driven businesses, the greatest value is not in physical plant and equipment, but in research capability, trademarks, patents, and other knowledge-based assets. In fact, the most valuable assets in these companies — the knowledge of the employees or the brand — is not accounted for on a balance sheet at all.

Because these intangible assets are so extraordinarily valuable relative to the overall enterprise, goodwill often accounts for a very large amount of the market value in any merger transaction involving these companies. If acquiring companies were forced to comply with the purchase method and amortize the cost of this premium over many years, their future reported earnings would diminish considerably. In some cases, they would be forced to report negative earnings, even as the company grows and thrives. Even though such pessimistic earning statements may be ignored by financial analysts — who will recognize strong operating results despite lackluster reported "earnings" — a company forced to use the purchase method of accounting could find itself suddenly perceived to be less powerful and have trouble

Mergers and the U.S. Economy

Mergers and acquisitions are a vital part of the American economy. They are a key component in the drive for efficiency, innovation, and creative partnerships that characterize the New Economy. The combination of deregulation, expanding global markets, technology, and lower trading barriers has increasingly made consolidation a necessary competitive strategy. As Table 1 shows, the number and value of mergers is far greater in the U.S. than elsewhere.

Table 1: Mergers and Acquisitions in 1998

	Number of Mergers	Total Value
U.S.	11,400	$1.62 trillion
Europe	5,485	$510 billion
Asia	2,001	$60 billion

Source: Mergerstat.com; Securitiesdata.com

attracting investment capital. This result is not a function of the economics of the merger, but purely the effect of using one method of accounting rules over another. Purchase accounting would distort the earnings power of the combined company and mislead the individual investor.

How Accounting Rules Can Distort Earnings

To understand the impact of eliminating the option of pooling, consider two recent high-profile mergers, both of which were qualified to use the pooling-of-interests accounting method: AOL and Netscape, and Travelers and Citicorp. Because these acquisitions are still new, the amount of data about post-merger earnings is limited. Nevertheless, they are emblematic of recent combinations in which a great deal of the purchase price is determined by intangible assets: knowledge, reputation, expertise, brand name, and so on.

To see how each of these mergers might have fared had the companies been forced to use the purchase method, imagine that the consolidations had occurred three years earlier, and we applied the amortization of goodwill of the recent mergers to the last three years of earnings reports. In each case the charts below rely purely on publicly available information and very broad assumptions. They are not in any way an attempt to provide a comprehensive analysis of these mergers, but rather are illustrations of the impact goodwill might have on earnings.

The second and third columns of Table 2 (below) show the purchase price and the equity of the acquired company. The fourth column assumes, for the purpose of this illustration, that the goodwill premium is 70% of the difference between the price and the equity. (In practice, the computation of goodwill is far more complex.) In the fifth column, goodwill has been arbitrarily amortized over ten years. This is a conservative estimate and in practice goodwill may be amortized over a much longer period of time. (FASB is in the midst of issuing new rules on the permissible goodwill amortization period.)

As is clear from this chart, these are mergers in which goodwill plays a significant role. The assumed goodwill is more than 35% of the Citibank/Travelers deal and almost 70% of the AOL/Netscape consolidation.

Table 2: Estimated Amortization Costs for Recent Mergers

(in millions)

Merger	Estimated Purchase Price	Target's Equity Per Closing Balance Sheet	Estimated Goodwill	Annual Amortization* (Over 10 Years)
AOL/Netscape	10,000	173	6,880	688
Citicorp/Travelers	36,000	17,769	12,760	1,276

** New rules to be issued by FASB are expected to establish a maximum 20-year amortization period for goodwill.*

With these rough estimates, we can now compare the impact of pooling accounting (in which goodwill is not recorded on the balance sheet) to the purchase method (in which the goodwill must be amortized over time). As mentioned above, Table 3 is based on the imaginary premise that these mergers were consummated three years ago. Using publicly available information about the companies' actual earnings, the chart shows how the new combinations would have performed under both a pooling and purchase scenario.

Table 3: Pooling vs. Purchase: Hypothetical Earnings of a Combined Company*

Merger/Year	Combined Earnings (Pooling Method)	Goodwill Amortization	Net Income/(Loss) (Purchase Method)
AOL/Netscape			
1996	35	688	(653)
1997	(485)	688	(1,173)
1998	(71)	688	(759)
Citicorp/Travelers			
1996	6,739	1,276	5,463
1997	6,705	1,276	5,429
1998	5,807	1,276	4, 531

** This illustration does not consider the tax deductibility of goodwill, which varies according to jurisdiction.*

As the figures above illustrate, goodwill amortization depresses reported net income. By doing so, it unavoidably creates a new obstacle for companies that want to join together. And while clearly the impact is felt by both large and small companies, it is obvious that growing companies whose purchase price is heavily based on goodwill will feel the sting of purchase accounting even more strongly. Had AOL and Netscape been forced to rely on the purchase method rather than pooling method, their 1998 loss (in the rough estimation provided here) would have

increased more than ten-fold. Even a financial institution as large as the new Citigroup would have great difficulty accepting a nearly $1.3 billion decrease in earnings due solely to a new requirement that it use purchase accounting in its transactions. The effect of the FASB decision, in other words, could be to make the accounting method itself a considerable obstacle to a strategically sound combination.

Penalizing Start-Up Businesses

This is unwelcome news for smaller companies with few physical assets but a great capacity for innovation. They bear the greatest burden under the purchase method because, as illustrated above, the high cost of amortizing goodwill drags down the earnings of any acquiring company. But a penalty is also paid by companies seeking to be acquired. Because the purchase method depresses earnings, companies with a high goodwill premium built into their price would suddenly become less attractive to potential buyers. From the perspective of real economics, the accounting treatment does not change the fundamentals of the deal. From the critical perspective of market perception, however, these changes can leave a strong negative impression in the marketplace. Making efficient mergers with typical "new economy" companies becomes all the more difficult.

It is not an overstatement to suggest that by indirectly discouraging mergers of knowledge-based companies, the new FASB rules might have a chilling effect on the flow of venture capital to promising new sectors. As Professor Richard Puntillo of the University of San Francisco pointed out in a letter to FASB opposing the revocation of the pooling method, venture firms have basically two strategies for recouping their investments: a sale or merger of the firm or an initial public offering. Limiting the availability of the first strategy would decrease the liquidity of venture-backed firms — a move that would, in Professor Puntillo's words, "jeopardize … the high investment returns necessary to attract institutional investors' capital — the principal source of investment capital fueling America's venture capital industry."

The FASB decision is unwelcome news for smaller companies with few physical assets but a great capacity for innovation.

The FASB decision, should it become effective, would also create a new, two-tier playing field in American business. Those companies that were fortunate enough to have completed their mergers while pooling-of-interests accounting was still an option could continue to rely on that method. They would have an advantage that could not be enjoyed by future companies wishing to pursue a similar acquisition or sale.

More broadly, the FASB ruling ignores the overall importance of mergers to the U.S. economy. In most cases, mergers have helped improve research capacity, lower overall costs, increase geographic reach and reduce prices for customers. While it is

certainly true that many mergers fail to meet expectations, it is impossible to deny that mergers have been instrumental in maintaining a vigorous market for corporate control that has kept managers focused on protecting and enhancing shareholder value. And in an era increasingly reliant on intellectual assets, mergers have been not only an important strategy for rapid growth, but also a tactic for acquiring talented employees and arraying them in a single enterprise.

FASB's "Solution" Still Fails to Harmonize World Standards

Part of the rationale that FASB gives for its intention to change the accounting principles used in U.S. mergers and acquisitions is that American standards must be harmonized with the rest of the world. In theory, that makes sense. However, the changes that FASB proposes would still fall short of creating a uniform global standard.

In Germany, for example, companies involved in a merger can write off the cost of goodwill against equity immediately in a share transaction. Under the proposed FASB rules, American companies would not have that option and would be forced to amortize their goodwill cost over a period not to exceed 20 years.

The Incalculable Value of Knowledge: The new FASB rule would diminish the value of the greatest asset held by firms operating in the new knowledge economy — assets based on intellectual capital, not physical capital. Consider: the market value of Microsoft is approximately $380 billion — almost as much as the combined GDPs of Sweden, Finland, and Norway, even though the company only employs 27,000 people.

Similarly, in the United Kingdom, companies involved in a merger of equals — that is, similar companies in businesses of roughly the same size — are permitted to use the pooling-of-interests methods. Additionally, under the purchase method in the U.K., there are cases, though few, in which a company is permitted to treat goodwill as if it had an indefinite life span and, therefore, need never write off the cost against future earnings. Again, U.S. firms under the pending FASB rules would be denied this option.

The problem is that FASB is trying to alter U.S. accounting rules at a time when the International Accounting Standards Committee and other non-U.S. jurisdictions have yet to reach a consensus on accounting principles involving all aspects of business consolidations. If the U.S. were to move ahead unilaterally, there will be many circumstances in which American firms find themselves at a distinct disadvantage to their European counterparts merely because of the more restrictive accounting policies FASB now advocates.

Changing the Rules in the Middle of the Game

The U.S. economy prospers through a dynamic process called, in economist Joseph Schumpeter's famous phrase, "creative destruction." New firms are constantly created; existing firms merge to form more efficient companies; ineffective firms give way to more innovative competitors. The possibility of being acquired in a friendly takeover creates opportunities for greater productivity

and rewards small firms that put a premium on innovation. The threat of being acquired in a hostile takeover keeps management from growing complacent and forces companies to remain competitive.

Creating a new, more difficult test for these business consolidations — as the new FASB rules would do — would undermine the dynamism of the U.S. economy, creating a static environment more reminiscent of the slow-growing 1970s than the rapidly moving 1990s. It would also unfairly reward firms that have already merged under the current rules and penalize growing companies that had hoped to either expand or realize value through an acquisition or merger.

The Special Impact on Financial Services

Financial experts have long recognized that the Glass-Steagall Act of 1933 and subsequent banking regulations have given America obsolete financial service laws that limit competition, restrict consumer choice, and hamper America's ability to thrive in the global economy. With Japan in the midst of its own financial reforms, the U.S. will soon be the only industrialized nation that still imposes arbitrary barriers between commercial banking and investment banking.

This financial regulatory regime effectively prevents securities companies from purchasing banks. As a result, in recent years, American securities firms have become prime targets for foreign acquisitions. Bankers Trust (which had previously purchased Alex Brown, the oldest U.S. securities firm) was purchased by Deutsche Bank last year. Oppenheimer and Company is owned by the Canadian Imperial Bank of Commerce. Dillon Reed, the reputed Wall Street securities firm, was purchased by SBC Warburg, the Swiss investment house.

After twenty years of failed attempts, the U.S. Congress now seems poised to modernize financial service regulations. Over the past year, broad, bipartisan support has emerged for reform legislation that would end the Glass-Steagall restrictions and allow U.S. securities firms to merge and compete on an equal basis with both U.S. and non-U.S. banks.

This reform is desperately needed. At a time when the rest of the world's banks and financial service institutions have gone through a period of consolidation and efficiency, the U.S. still has approximately 8,000 banks. The passage of financial service reform legislation would trigger a process that would allow the U.S. financial industry to mature and create efficiencies through business combinations that are long overdue.

Yet a sudden prohibition against the pooling method of accounting might derail this consolidation process — effectively replacing the old regulatory hurdle with a new accounting hurdle. Securities firms and other financial service institutions that typically qualify for pooling of interests would, under the new rule, have no choice but to calculate mergers under the purchase method. Goodwill from a purchase transaction has a severe negative impact on a U.S. bank's capital. Small and midsize institutions seeking to consolidate would clearly be disadvantaged relative to their larger brethren — who frequently are non-U.S. institutions.

Refining a System that Works

By any conventional measure, the American economy today is healthy, robust, and dynamic. During a time of extraordinary economic transition — driven by globalization, deregulation, and unprecedented scientific and technical innovation — mergers have been one route American firms have chosen to adapt to changing economic conditions and meet challenges from European and Asian competitors. In the knowledge economy especially, most mergers reflect the need to constantly seek new sources of efficiency and synergy — a competitive necessity and a sound course for realizing shareholder value.

Indeed, it has been the very success of American business over the last few years — and especially the service and technology industries — that makes the FASB decision so puzzling. Although last year the number of mergers using the pooling method slightly exceeded the number relying on purchase accounting, that statistic in itself suggests nothing fundamentally ur sound about the merger market. Nor does the fact that other countries rely largely on the purchase accounting method have much meaning. The pooling method of accounting simply reflects the needs of a diverse U.S. economy that has relied on business combinations for efficiency, productivity and creativity.

The proposed accounting rules would undermine the dynamism of the U.S. economy.

In conclusion, the pooling method of accounting has been an integral part of American finance for over 25 years. A sudden decision to prohibit all uses of pooling in all circumstances would inevitably have a significant impact on business consolidations. That should not be the purpose of accounting rules. The current system neither promotes nor discourages a specific type of merger. Under the careful scrutiny of the SEC, our system today gives public companies a fair and reasonable choice of accounting methods that differentiate between mergers (pooling) and acquisitions (purchase). In an economy as diverse as ours, and in a world in which the very nature of "business assets" is changing so dramatically, that choice still makes good sense.

America's Powerhouse Knowledge Economy

- Information technology represented 8.2% of the U.S. economy in 1998 up from 6.1% in 1990 and 18.5% of the S&P 500® Index.
- The information technology industry employs over 7 million people in the U.S.
- In 1997, information technology contributed to 28.3% of Real Economic Growth.
- The financial service industry accounts for approximately 19% of GDP.
- Service industries accounted for 55% of GDP in 1998 and 80.3% of total employment.
- The service industries created 100% of increased employment in the past decade as goods employment actually fell.

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