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SHOULD MERGER ACCOUNTING BE RECONSIDERED?:
A DISCUSSION BASED ON THE CHINESE APPROACH TO ACCOUNTING FOR BUSINESS COMBINATIONS

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SHOULD MERGER ACCOUNTING BE RECONSIDERED? :
A DISCUSSION BASED ON THE CHINESE APPROACH
TO ACCOUNTING FOR BUSINESS COMBINATIONS

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Abstract

In 2006, the China Accounting Standards Committee (CASC) issued its Statement No. 20, which permits both the purchase and pooling of interests (or merger) method of accounting for business combinations. The decision of the CASC in Statement No. 20 stands in contrast to the decisions taken by the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) which both eliminated the pooling of interests method. As a result of the issuance of CASC 20, along with similar pronouncements by the Japanese standard setters and other standards setting bodies, the goal of harmonizing international accounting standards has been faced with a lack of convergence in the area of accounting for business combinations. In this paper we examine the reasons for this lack of convergence in order to develop a reconciled framework. In particular, the Chinese standards setters have sought to develop an approach to accounting for business combinations which distinguishes between instances where the combining entities are under “common control” or not under common control. Using a relatively narrow definition of common control, both the FASB and the IASB have excluded business combinations among entities under common control from the scope of their respective pronouncements. The purpose of this paper is to analyze the reasons for the distinctly different approach taken by the Chinese accounting standards setters by comparing the provisions of FASB 141, IFRS 3 and CASC 20. Our analysis will show that the technical differences between the standards are based on different understandings of the underlying economics of business combinations (Anthony, 1987), which leads in turn to different representations of the combination process. We believe that a forthright recognition of these differences may lead to a reconsideration of the pooling of interests and merger methods in a new comprehensive framework.

Key words: business combinations, mergers and acquisitions, purchase method, pooling of interests method, international accounting convergence

1. Introduction

Recently, the FASB and the IASB have been actively working towards international harmonization and convergence of financial accounting standards. However, in the area of accounting for business combinations, international convergence has not yet been fully achieved. The consensus position of the FASB and the IASB prior to 2007 with respect to accounting for business combinations was that all business combinations ought to be accounted for using the purchase method\(^1\). However, the choice of the purchase method and the related treatment of goodwill, have prompted a certain amount of resistance. Strong objections to the FASB-IASB approach to business combinations exist, even within the United States and Europe (including the United Kingdom), and on the part of various national standards setting bodies.

For example, the French accounting standards setters (CRC) rejected the non-amortization of acquisition goodwill in two decisions (No. 2005-9 and 2005-10), issued in November 2005; these decisions were applicable to enterprises that not required to follow international standards, including individual companies and non-listed corporate groups\(^2\). The Japanese accounting standards setters also manifested their dissatisfaction with the purchase method in several comment letters issued in 2001, 2003, and 2005. The Japanese standards setters allow the pooling of interest method in their national standards, and they require amortization of acquisition goodwill. The Chinese, Japanese and Korean standards setting bodies have joined their efforts in an initiative which contemplates the continued use of pooling under certain circumstances. The German Accounting Standards Committee (GASC) states its disagreement with

“… some fundamental principles laid out in the objective of ED IFRS3amend and [does] have major concerns about the main features of this draft. […] It seems that the ED is a further step on the way to introduce the full Fair Value model without having a proper discussion of the future accounting model in general. [The GASC does] understand that the FASB has agreed upon the full fair value model as the relevant future model. The IASB, however, has not (yet) and has delayed this discussion since 2001, nevertheless the IASB follows this route. [The GASC does] doubt whether the further expansion of the fair value model was truly demanded by the IASB’s constituents including investors and financial analysts and whether

\(^1\) The purchase method necessitates revaluation of the net assets of the acquired company to fair values and recognition of acquisition goodwill, which is not amortized, but tested annually for impairment.

\(^2\) See also the comment letter by the CNC, cf. IASB (2006: CL No. 146).
information usefulness is truly improved. [...] Additionally, [The GASC does] not appreciate delaying further the research on the following issues of the project “Business Combinations II”: the possible application for fresh start accounting and the accounting for business combinations involving entities under common control (IASB, 2006: CL No. 121, p. 1-2).

Furthermore, various respondents to exposure drafts issued by FASB and IASB have indicated their preference for a “net asset approach”, which is a variant of the pooling method. For example, American Community Bankers, a lobbying organization for credit unions, stated:

“ACB maintains the position that the use of acquisition accounting, as described in the ED, is inappropriate for mutual combinations and will result in arbitrary and costly revaluations, and financial statements that will not truly reflect the essence of the underlying combination transaction. We are not advocating the maintenance of pooling-of-interests, rather we believe that FASB should require [mutual savings banks] to use a net asset value approach, or [a] similar variation of acquisition accounting, using estimations of the fair market values of assets and liabilities assumed” (IASB, 2006: CL No. 96, p. 7).

Interestingly, both the FASB and the IASB have recently recognized these resistant voices, but in a somewhat puzzling and implicit manner. Certain revisions to previously existing standards (FASB 141r, IFRS 3r, IAS 27r) as well as a newly issued standard (FASB 160) appear to reintroduce pooling as an exception to the purchase method. The exception is found in the wording of several paragraphs in the revisions, and in some newly issued standards not directly related to business combinations, without seeking a reconsideration of the overall framework of accounting for business combinations. We believe that this approach based on scope exceptions adopted in the revised standards may lead to some confusion among preparers and users by effectively implying that “all horses are black, but some horses are white unicorns which are not horses”. This confusion actually occurs at the very basis of FAS 141, especially on “scope exceptions”. The former version of this standard stated:

“This statement states that the term business combination excludes transfers of net assets or exchanges of shares between entities under common control (FAS141, D11).”

Whilst it presently states:

“This statement does not apply to combinations between entities or businesses under common control (FAS141r, D8).”
In the former version, operations that are usually understood as a type of business combination are excluded by the definition and viewpoint adopted by the standard, whilst, in the revised version, a whole category of operations now called “business combinations” is again excluded from the scope of the standard that is explicitly devoted to the accounting of “business combinations”.

In order to respond to this impasse, this paper seeks to develop a reconsideration of the overall framework of accounting for business combinations based on a forthright discussion of the reintroduction of pooling as an allowable method of accounting for business combinations in certain cases. This discussion aims to take into consideration in a serious way the perspectives of the resistant parties, and it will especially draw upon the Chinese position. Business combinations constitute a critical issue in financial accounting regulation and practice, and the current treatment by scope exceptions based on multiplying the definitions of the underlying operations appears to be limited and hazardous. Instead, a more comprehensive framework ought to be developed to accommodate different kinds of combinations and appropriate methods of reference in a thoughtful way.

In particular, we argue that the positions of the national accounting standards setters which continue to allow the pooling of interests method may be based on different understandings of the underlying economics of business combinations as compared with the understandings contained in the FASB and IASB pronouncements. For example, the Accounting Standards Board of Japan (ASBJ) argued in its comment letter (2005, p. 5 and note 1):

“It seems that the IASB’s proposed approach views business combinations as transactions similar to financial investments. In our view, assets are classified into financial investments and non-financial (business) investments according to the purpose of the investment. Non-financial investments are investments aimed at obtaining results through operating the business, and financial investments are investments aimed at obtaining gains from changes in the market price. We view business combinations as a form of non-financial investment.”

In a similar manner, the Chinese accounting standards setting body (CASC) continues to allow the pooling of interests method when there is “common control” among the combining businesses, which is a significant
factor in the industrial reorganization that is currently taking place in China\(^3\).

The new comprehensive framework of accounting for business combinations ought to be capable of comprehending the different understandings in a coherent way.

Our methodology will consist in delineating the reasoning underlying the various standards using a common framework of analysis. We will analyze the reasons for the lack of international convergence by comparing the provisions of FASB 141, IFRS 3 and CASC 20. Since the FASB and IASB pronouncements are still being revised, we will pay special attention to the respective changes through 2006. The year 2006 was an important turning point in accounting for business combinations, and ultimately it may represent the greatest extent of divergence among the different perspectives.

This comparative methodology will allow an explication of the similarities and differences among the standards, and it will clarify the understandings of the underlying economics of business combination. Our comparative analysis will show that the technical differences among the standards are based on different understandings of the underlying economics, thus leading to different representations of the combination process (Anthony, 1987). We believe our analysis will lead to a better comprehension of the standards, enhance comparability among the standards, and facilitate the process of international accounting harmonization. We believe that a forthright recognition of the differences among the standards could lead to a reconsideration of the pooling of interests method in a more comprehensive framework based on a broader perspective.

The remainder of this paper is organized as follows. The next section discusses CASC 20 and the distinctly different understanding of business combinations adopted by the Chinese accounting regulatory bodies. The Chinese distinctive way is presented by analyzing both accounting regulation (the standard and its authoritative interpretation), and the reorganization of the TCL Group, one of China’s largest companies. The third section situates the Chinese position in a comparative analysis with the FASB and IASB pronouncements, taking 2006 as a year of reference, but also considering the revised pronouncements issued in 2007. The fourth section further refines this analysis by delving into the leading position of

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\(^3\) Using a restrictive definition of control, both the FASB and the IASB have excluded business combinations among entities under common control from the scope of their respective pronouncements.
the FASB on the matter. The fifth section will sum up the constructive critique of the current situation and presents a new comprehensive framework that might respond to the current impasse. In particular, it offers some recommendations for improving accounting for business combinations by summarizing the main arguments of the paper and situating the arguments within the ongoing process of accounting standards setting and accounting regulation.

2. Accounting for business combinations in China

2.1 Background

The rapid rate of economic growth in China has caused a significant amount of change in accounting regulation (see Biondi-Zhang 2007 for further details). This change has been affected by: (i) reorganizations among state enterprises, (ii) expansion of private business activities, and (iii) a more welcoming attitude towards foreign investment and international business relationships. Increasing economic development has led to greater exposure by Chinese enterprises to foreign accounting practices, and it has created a need for new accounting practices to account for new modes of economic activity (Scapens and Hao 1995; Blake and Gao 1995 eds.). Among the issues addressed by the recent accounting reforms are: accounting for consolidated entities, equity accounting, accounting for paid-in capital, fixed asset and depreciation accounting, intangible assets and goodwill, taxes and profit allocations. The case of business combinations is one of the more important issues, and it deserves special attention.

2.2 The Chinese Standard on Accounting for Business Combinations

CASC 20 was one of the new standards adopted by the accounting reform of 2006 (see Ernst & Young 2006 for an English summary; Chen, Sun, and Wang 2002). CASC 20 defines a business combination as “the bringing together of separate entities into one reporting entity”. Two methods are permitted depending on the degree of common control:

- For business combinations involving entities under common control, the pooling of interests method must be applied;
- For business combinations involving entities not under common control, the purchase method must be applied.

In the first instance, a business combination would be recorded using the book values of the combining companies and no goodwill would be recognized. In the second case, the business combination would be
accounted for based on the fair values of the net assets acquired, and goodwill would be recognized, subject to impairment tests, however the goodwill would not be amortized.

CASC 20 actually is a brief standard which provides no basis of conclusions for the approach chosen. In fact, since its establishment in October 1998, the China Accounting Standards Committee (“CASC”)4 has been dedicated to provide support on the development of Chinese accounting standards under the Ministry of Finance (“MOF”). The aim of the Committee is to provide advices and recommendations on setting and improving Chinese accounting standards. CASC finally is the advisory body for setting Chinese accounting standards that are legally established by the MOF. Following the CASC 20 (§5) and the interpretation of this standard offered by the Accounting Department of the MOF (AD MOF 2007, p. 292-293), a business combination under common control is defined as follows: “The combining enterprises are ultimately controlled by the same party or parties before and after the combination, and control is not transitory”. The AD MOF offered the following authoritative interpretive guidance together with this definition:

1. The party which can carry out the ultimate control over the combining enterprises before and after the combination is usually the mother company of an enterprise group;

2. The parties which can carry out the ultimate control over the combining enterprises before and after the combination are usually two, or more than two, legal persons or other organizations which demonstrate the same viewpoint or position when voting on the invested entities' productive and operational activities. In effecting the combination, these legal persons may intend to enlarge their voting shares in the invested enterprises, or strengthen the control status of certain investors over the invested enterprises, according to an existing agreement among investors;

3. The combining enterprises were controlled by the ultimate controller for more than one year before the date of combination, and the reporting entity after the combination will be controlled by the same ultimate controller for more than one year.

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Thus, according to CASC 20 and the authoritative interpretation offered by AD MOF, business combinations are considered to be reorganizations among ongoing economic entities, rather than capital market transactions. In particular, the presence or absence of “common control” is related to the structure of the continued relationship between the enterprise entities involved, and this criterion decides about the application of two different accounting methods, pooling (merger) of purchase (acquisition). This criterion especially distinguishes between combinations that are effected among related entities, and combinations that actually are the take-over of one entity on another unrelated entity.

According to Biondi and Zhang (2007), this Chinese perspective on business combinations may be explained in part by taking into account the massive industrial development that is taking place in China, and also on a “dynamic accounting” perspective which leading accounting theorists and Chinese regulatory authorities may wish to encourage (Aiken, Lu, and Ji 1995; Liu and Turley 1995; Liu and Eddie 1995; Xiao and Pan 1995). The following case illustrates the Chinese perspective.

2.3 The Reorganization of the TCL Group

In China, state-owned enterprises are often controlled by a specific governmental agency (xingzheng zhuguan bumen), colloquially known as the ‘mother company’ (mu gongsi). “Each state-owned entity typically owes a subsidiary’s duty of loyalty to a number of administrative units” (Ruskola 2000). The mother company may list its most profitable subsidiaries on the stock exchange, while continuing to be the controlling shareholder. Other less profitable subsidiaries may continue to be fully owned by the mother company. In 2004, this kind of state-owned or state-controlled enterprises accounted for 42.4% of the value-added by industry and 35.2% of the gross industrial output, while the private sector accounted for only 15.1% and 16.5%, respectively, and foreign owned enterprises (including those with ownership from Hong Kong, Macao and Taiwan) accounted for 27.8 and 31.4%.³ The following case study illustrates the application of CASC 20.

In 2003, TCL Group (“Parent”) and TCL Communication Equipment Co. (“Subsidiary”) entered into an agreement whereby the state-owned Parent merged with its publicly traded Subsidiary. The Subsidiary was the first component of TCL Group to be listed on Shenzhen Stock Exchange in 1993. Huizhou Investments, a government owned, limited-liability company, located in the city of Huizhou, Guangdong Province (southern China), was the majority shareholder of TCL Group. Huizou Investments was in turn controlled by the city of Huizhou, where TCL group is
Huizhou Investments is a government agency created to foster the economic development of Guandong province. In 2003, TCL Group owned 106,656,000 non-circulating shares of TCL Communication Equipment Co., which represented 56.7% of the shareholders’ equity of the Subsidiary. The other shares of the Subsidiary were traded on the Shenzhen stock exchange. On 30 September 2003, TCL Group (the Parent) announced that it was going to combine with its Subsidiary through an exchange of shares. After the combination, the joint entity was listed on the Shenzhen Stock Exchange. The 81,452,800 circulating shares of the Subsidiary were exchanged for 404,395,944 shares of the Parent at an exchange price of 21.15 RMB, an exchange ratio of 4.965. The combination was completed on 7 January 2004 and the TCL Group was listed on 30 January 2004.

Pursuant to FASB 141 prior to the recent proposed revision, the reorganization of the TCL Group would have been accounted for as “an acquisition of a minority interest” (FAS141, A6 (a)); consequently the purchase method would have been required to be used (FAS 141, §14). Pursuant to IFRS 3 before the recent revision, the purchase method would also have been used, because pooling was not permitted by IFRS 3.

In contrast, following CASC 20, the pooling of interests method was used to account for the TCL Group reorganization, since the combination occurs under common control between two related enterprises. The press release issued to describe the transaction included the following reasons why the pooling method was used. Firstly, all or most of the shares of the combining entities were exchanged. Second, the shareholders of the combining entities became the shareholders of the combined entity. Third, the shareholders of the combining entities collectively assumed all of the risks of the combined entity. Fourth, there were no resources flowing from the combining entities to other parties. Fifth, according to the projected exchange ratio, the equity owned by the controlling party (Huizhou Investments) did not change before and after the combination. For these reasons, the pooling of interests method was considered to produce a better representation of the underlying economics of the combination process.

Is the Chinese way to accounting for this business combination at least understandable? Let us explore further the potential impact on the economic representation provided by accounting numbers.

In the annual report for 2003 (see Table 1), the consolidated net income of TCL Group was reported to be 570.57 million RMB, which included 145.18 million RMB of the net income of TCL Communication Equipment
Co. (the Subsidiary) from January to June. The shareholders’ equity was 2,263.38 million RMB, so the return on equity (ROE) was 25.21% (see Table 1). If TCL Group had applied the purchase method, these performance ratios would have been reduced. At the date of the combination, the book value per share of TCL Communication Equipment Co. was 3.07 RMB, while the exchange price was 21.15 RMB. Thus, the ‘computed goodwill’ would have been 1,473 million RMB based on combining only the circulating shares without recognizing any control premium. This goodwill would have added 1,473 million RMB to the shareholders’ equity. If the purchase method had been used, the net income of the Subsidiary before the combination date would not be recognized in the consolidated income statement, and the goodwill produced by the combination would not be amortized. As a result, the net income of TCL Group would be reduced by 145.18 million RMB, from 570.57 million RMB to 425.39 million RMB, while the shareholders’ equity would be increased from 2,263.38 million RMB to 3,736.38 million RMB. Therefore, the return on equity (ROE) would be reduced from 25.21% to 11.39%.

Furthermore, the solvency ratio would have decreased significantly (from 4.51 to 2.73) as a result of an increase in shareholders’ equity, even though the liabilities of the Group would not change as a result of the combination. In fact, we are unable to account for the re-measurement of liabilities of the target to their fair values, as required by purchase accounting. This re-measurement may lead to reinforce the decrease of the solvency ratio of the enterprise group.

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5 The record date for recognition of the business combination was 30 June 2003, even though the combination was effected several months later.

6 The calculation of the ‘computed goodwill’ is as follows: (21.15-3.07) × 81452800 = 1,472.67 million RMB. Because of the limited disclosure of data, the fair values of TCL Communication Equipment Co. cannot be utilized; this is why the ‘computed goodwill’ is used here instead of the actual goodwill.

7 The above calculation of the ‘computed goodwill’ takes into account only the circulating part of the shares. If the TCL Group (the parent) did not hold the original 56.7% shares of TCL Communication Equipment Co (the Subsidiary), and if all the shares of TCL Communication Equipment Co. were combined at the same exchange ratio, the ‘computed goodwill’ would be of 3,401 million RMB. In that case, the net income of TCL Group in 2003 would be still 425.39 million RMB, but the equity would be raised from 2,263.38 million RMB to 5,664.38 million RMB; thus, the return on net assets would be reduced from 25.21% to 7.51%.
Finally, if the purchase method had been applied to the TCL Group reorganization there would have been a significant negative impact on the consolidated financial statements. The managers might not have proceeded with the combination, notwithstanding the important industrial and productive reasons for undertaking the combination. In addition, the negative effect on the performance ratios might have modified the initial public offering (IPO) price of TCL Group shares, and this may have affected the share price, whilst the overall effect on debt exposure and service might blur the information on and representation of the underlying transaction. In the actual recording of the transaction, goodwill was not recognized. Therefore, the performance ratios reflected in the consolidated financial statements did not deviate substantially from those of prior years. Arguably this accounting approach produced a more proper representation the underlying economics of the combination process.

This Chinese understanding might be seen as an alternative type of capitalism or as a representation of an economic transaction which is more appropriate to the Chinese context (Jackson and Miyajima 2007; Biondi and Zhang 2007). As the case study of the TLC Group reorganization suggests, business combinations in China often occur among related entities (Huang et al. 2004; Pan 2002). This implies that the details of the business combination are determined by the same controlling parties, and ownership control does not actually change hands, even though material aspects of the overall enterprise and related minority interests may be affected by that operation. Some Chinese business combinations factually are not takeovers, but mergers instead, which, in turn, are congruent with the accounting representation provided by the pooling of interest approach. In this context, the use of pooling is sound not only from an accounting standpoint, it also
reduces transaction costs. Furthermore, in a setting where the capital markets are often less than perfect (or absent) and “fair values” may not be reliable, the pooling of interests method appears to be the most appropriate measurement approach of accounting for business combinations. It is important to remember that many Chinese corporations are not listed in capital markets, and, even in the case of listed corporations, a large portion of the shares is not circulating. As of January 2007, of the total issued shares, the negotiable part was only 38.1% (based on the CSRC monthly report, http://www.csrc.gov.cn/).

Anyway, the Chinese understanding of the underlying economics of business combinations is different from the understanding contained in the FASB and IASB pronouncements through 2006. Interestingly, pursuant to the revisions of FASB 141, IFRS 3 and the new FASB 160, issued in 2007, the TCL combination would have been treated as an “equity transaction” and not as an acquisition. Therefore, the pooling method, which was eliminated by previous standards, seems to have been re-introduced, at least in some respects. In particular, the “equity transaction” method does not account for goodwill and does exclude any impact on the income statement. This reintroduction involves an implicit distinction between combinations where a change of control takes place, and combinations where there is no change of control. This distinction does not correspond exactly to the Chinese perspective and criterion, as the following section shall disentangle.

3. Comparative Analysis

This section provides a comparative analysis of the key provisions of FASB 141, IFRS 3, and CASC 20. The key provisions of the pronouncements are summarized in Table 2. The provisions are divided into the following categories: (i) definition of a business combination; (ii) exclusions from the scope of the standard; (iii) key concept for its application; (iv) treatment for acquisition goodwill; (v) valuation of identifiable assets, liabilities and contingent liabilities; and (vi) the accounting method of reference.

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8 In 2005, the number of listed companies on the Shanghai and Shenzhen Stock Exchanges was 1,381 (834 and 547, respectively), while the number of large and medium-sized industrial enterprises (excluding construction and financial intermediation sectors) was 29,774.

9 Holderness (2007) provides a relevant critique of dispersed shareholding in the US share market.
Table 2
A Comparison of FASB 141, IFRS 3 and CASC 20

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<thead>
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<th>FASB 141 (before 2007)</th>
<th>IFRS 3 (Before 2007)</th>
<th>CASC 20</th>
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<td>(i) Definition</td>
<td>A business combination</td>
<td>A business combination</td>
<td>A business combination</td>
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<td>business</td>
<td>occurs when an entity</td>
<td>involves the</td>
<td>involves the bringing</td>
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<td>combination</td>
<td>acquires net assets</td>
<td>bringing together</td>
<td>together of separate</td>
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<td>constituting a business</td>
<td>of separate</td>
<td>entities or businesses</td>
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<td>enterprise or acquires</td>
<td>entities or</td>
<td>into one reporting</td>
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<td>equity interests in one</td>
<td>businesses into</td>
<td>entity.</td>
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<td>or more other entities and</td>
<td>one reporting</td>
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<td>obtains control over</td>
<td>entity.</td>
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<td>that entity or entities</td>
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<td>(ii) Scope</td>
<td>♦ Not-for-profit</td>
<td>♦ Joint ventures</td>
<td>♦ Long-term equity</td>
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<td>exclusions</td>
<td>organizations</td>
<td>♦ Entities under</td>
<td>investments</td>
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<td>♦ Mutual enterprises</td>
<td>common control</td>
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<td>♦ Joint ventures</td>
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<td>♦ Entities under common</td>
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<td>control</td>
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<td>without obtaining</td>
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<td>other than acquisition</td>
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<td>ownership interests</td>
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<td>(iii) Perspective</td>
<td>Acquirer</td>
<td>Acquirer</td>
<td>Controlling party or</td>
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<td>from which the</td>
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<td>parties</td>
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<td>method is applied</td>
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<td>(iv) Treatment</td>
<td>Recognized as an asset,</td>
<td>Recognized as an</td>
<td>Entities under</td>
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<td>of goodwill</td>
<td>but not amortized.</td>
<td>asset, but not</td>
<td>common control: not</td>
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<td>Tested for impairment.</td>
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<td>Tested for impairment.</td>
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<td>(v) Valuation of</td>
<td>Fair value</td>
<td>Fair value</td>
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<td>common control:</td>
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<td>Fair value.</td>
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<td>(vi) Accounting</td>
<td>Purchase</td>
<td>Purchase</td>
<td>Entities under</td>
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<td>method of reference</td>
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<td>common control:</td>
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<td>Pooling.</td>
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<td>Entities not under</td>
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<td>common control:</td>
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<td>Purchase.</td>
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With respect to the definition of a business combination (point i), the FASB stated that the necessary pre-condition for the recognition of a business combination was a change of ownership control:

A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (FAS 141r, 3 (e))

This statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree) [omissis] (FAS 141r, p. i)

Control has the meaning of controlling financial interest in paragraph 2 of Accounting Research Bulletin No 51, Consolidated Financial Statements, as amended. (FAS 141r, 3 (b))

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one entity company, directly or indirectly, of more than 50 per cent of the outstanding voting shares of another entity company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned entity subsidiary shall not be consolidated if control does not rest with the majority owner (for instance, if the entity subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent’s ability to control the entity subsidiary). (FAS 160, Appendix A – “ARB 51, as amended by this statement”, §2).

As the previous quotations prove, according to the FASB, a business combination implies obtaining control, which is based on a “controlling financial interest” that, in turn, is mainly based on the “ownership of a majority voting rights”. In contrast, the IASB developed a broader definition of a business combination which did not specifically mention a change of ownership control (IFRS3, BC6-BC9, BC 12). However, both IFRS 3 (§19) – now included, with adjustments, in IAS 27r (§13), the latter being the main reference for identifying the acquirer under IFRS 3 (§7) - insist on the majority of potential and actual voting rights as main guideline.10

10 The analysis of the whole section (IAS 27r, §12 to §17) does not change this conclusion.
Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is [note: See also SIC-12 Consolidation—Special Purpose Entities]:

(a) power over more than half of the voting rights by virtue of an agreement with other investors;

(b) power to govern the financial and operating policies of the entity under a statute or an agreement;

(c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or

(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

(IAA 27r, §13).

All the powers listed above are formal in nature: powers under (a) and (b) are legal; the power under (b) is contractual, and the power under (c) is institutional. Some substantial powers based on economic, financial, commercial, or organizational factors (formerly mentioned by IFRS3, 20) are now relegated in the application guidance (IFRS 3r, B14-B18). However, following the factors mentioned by the application guidance, an overwhelming problem of clear distinction between business combinations that are acquisitions and combinations that are not factually occurs.

The difference in the definitions of “control” has been maintained in the new releases by FASB and IASB. While FASB 141r mentions the words “controlling financial interest”, the revised IFRS 3r defines control as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities” (Appendix A). Nevertheless, both the FASB and the IASB excluded combinations among entities under common control from the scope of their pronouncements (point ii). In FASB 141r, this exclusion is continued, but it is based on a relatively narrow definition of “common control” (FASB 141r, par.D1-D18; FAS 141, D11-D13). Neither an explicit understanding nor a thoughtful definition of common control is provided. The exclusion is based on a spare list of examples of combinations that are scoped out as exceptions. Most examples did address cases of formal changes in the legal relation between parent and
subsidiaries, but the standard failed to consider cases where the underlying economics is impacted, either combinations between related entities and/or effected within corporate groups, whatever outstanding minority interests do change or not. In fact, during the revision of FAS 141, the previous FAS 141 (§14, D13) that applied the purchase method to “the acquisition of all or a part of the noncontrolling equity interest in a subsidiary” has merely disappeared, but the underlying issue is left in a vacuum indeed.

IFRS 3 shared this exclusion of combinations under common control, but the revision (IFRS 3r) does not mention the issue; it postpones discussion on this matter to a further project that is scheduled on mid-2008. No clear-cut definition of common control is provided by these standards.

With respect to point’s iii, iv, v and vi, the FASB and IASB pronouncements are essentially the same. The pronouncements consider business combinations to be acquisitions, i.e. purchase transactions in which the consideration paid is based on arm’s length bargaining between unrelated entities: essentially, a (efficient) market exchange. This leads to goodwill being viewed as a permanent intangible asset that is recognized, but not amortized, but tested thereafter for impairment. An overall continuity is claimed through the different revisions of the respective standards, as the FASB explicitly states:

This Statement replaces FASB Statement No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. (FAS 141r, summary, i-ii).

In fact, both the FASB and the IASB allude to the existence of types of business combinations different from acquisitions, such as those where there is no consideration given, no change of control, a combination between a parent and subsidiary, or combinations among entities under common control. However, in an apparent desire to concentrate on a single method (i.e. the “purchase method”), these types of combinations were not included in the FASB and IASB pronouncements. In fact, the common wisdom about the purpose of new approach fostered by the FASB and IASB was and still is their joint desire to eliminate the pooling method, and then to extend the application of the purchase method as far as possible, by considering it as synonymous of the underlying economics of the business combination:

The Boards concluded that having more than one method could be justified only if the alternative method (or methods) could be
demonstrated to produce information that is more decision useful and if unambiguous and nonarbitrary boundaries could be established that unequivocally distinguish when one method is to be applied instead of another. The Boards also concluded that most business combinations are acquisitions and, for the reasons discussed in paragraphs B24–B28, that the acquisition method is the appropriate method for those business combinations (FAS 141r, B23).

However, the difficulty with the selection a single method is that it appears to imply that purchase accounting should be used for “virtually” all types of business combinations, even for those in which the purchase method and its underlying economics may not to be appropriate. In the recent revisions issued by the FASB and IASB (FASB 141r, IFRS 3r, and FAS 160) there is a possibility of accounting for some combinations as “equity transactions”. In IFRS 3r, the pronouncement goes further by permitting recognition of the “proportionate share of the acquiree’s identifiable net assets”. Consequently, the efforts of the FASB and IASB to allow only one method of accounting for business combinations appears to have been somewhat compromised by allowing variations of the pooling method in certain circumstances. For example, pursuant to the new FASB 160, released together the revised FASB 141r, a combination between a parent and a subsidiary - such as in the TCL case- would be treated as an equity transaction, i.e., as “investments by owners and distributions to owners acting in their capacity as owners” (par 33). FASB 160 (p. ii-iii) justifies this change as follows:

Before this Statement was issued, decreases in a parent’s ownership interest in a subsidiary could be accounted for in one of two ways: as equity transactions or as transactions with gain or loss recognition in the income statement. A parent’s acquisition of noncontrolling ownership interests in a subsidiary was previously accounted for by the purchase method. This Statement simplifies accounting standards by establishing a single method of accounting for these economically similar transactions. Eliminating the requirement to apply purchase accounting to a parent’s acquisition of noncontrolling ownership interests in a subsidiary also reduces the parent’s costs because it eliminates the need to value the assets and liabilities of the subsidiary on the date that each additional interest is acquired.

In the same spirit, pursuant to IFRS 3r, the acquiring company can measure the noncontrolling interest in the acquiree either at fair value or at its proportionate share of the acquiree’s identifiable net assets (paragraph 19). The pooling method therefore seems to have been reintroduced, at least
to a certain extent. This reintroduction actually appears to imply a key criterion that discriminates among acquisitions where control is acquired and other acquisitions where there is no change of control, but the criterion is not addressed explicitly, and the main change of orientation is scarcely noticed.

In our opinion, the new approach may be confusing. The scope exception to purchase accounting may be deficient from an informational perspective, because it does not show the changes in the different classes of assets and liabilities and the overall impact on the financial position and economic performance of the related entities, consolidated or not. Furthermore, the focus on change of control in terms of financial interests creates problems with stepwise acquisitions, minority control and forms of control without ownership. More generally speaking, introducing exceptions to accounting pronouncements may offer a temporary solution, but this does not lead to international accounting harmonization, especially in such significant and sensitive matters as business combinations. The preferable solution would be to reconcile different positions in a more comprehensive framework for guidance and interpretation. The following sections will try to open the way to the development of this framework.

4. The Rationale for FASB 141

While both the purchase and pooling of interests methods were permitted for many years under US Generally Accepted Accounting Principles (GAAP), the pooling method was eliminated in 2001 by FASB 141. The merger method, which was similar in many respects to pooling, was permitted by the International Accounting Standards Committee (IASC), but following the issuance of FASB 141, the IASB eliminated the merger method in 2004. In issuing these pronouncements, the FASB and the IASB adopted a quite similar approach to accounting for business combinations. The FASB and IASB pronouncements resulted from numerous meetings between the two standards setting bodies and various joint recommendations issued by a working group representing accounting standards setters from Australia, Canada, New Zealand, the United Kingdom, the IASB, and the FASB (commonly known as the G4+1; see G4+1, 1998). The role of the

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11 The Group met approximately four times a year from April 1993 to January 2001 in order to analyze and discuss financial reporting issues. In January 2001, the Group agreed to disband, because of the start of activities by the newly restructured International Accounting Standards Board. See http://www.acsbcanada.org/index.cfm/ci_id/4345/la_id/1.htm (December 17, 2006). On the important influence of G4+1 on international accounting convergence, see Street (2005).
FASB was central to achieving a consensus in this area of financial accounting.\footnote{As stated by the G4+1 (1998, vii): “The principal author is L. Todd Johnson, senior project manager on the research and technical activities staff of the US Financial Accounting Standards Board. A significant contribution was made by Kimberley R. Petrone, FASB project manager. Other FASB staff members as well as staff members of the other G4+1 organizations also assisted in the preparation of this Position Paper.”}

FASB 141 was issued as the successor to Accounting Principles Board (APB) Opinion No. 16, \textit{Business Combinations}. APB 16 had been issued during the merger boom of the mid 1960s in order to prevent certain “abuses” associated with the restrictions imposed to the pooling method (CAP 1944; CAP 1953; Wyatt 1963; Rayburn and Powers 1991). Pursuant to APB 16, business combinations were required to be accounted for using either the purchase or the pooling method. The pooling method was mandatory if 12 criteria were simultaneously met; otherwise, the purchase method had to be used.\footnote{Among the criteria, the most important were: (1) that there had to be an exchange of common shares for common shares (no cash or other consideration) for at least 90\% of the shares of the combined company, and (2) that the transaction had to be completed in one step.} FAS 141 (summary, p. 5-6) provided the following reasons for eliminating the pooling method:

1. \textit{Underlying economics}: Because the 12 criteria of APB 16 did not clearly distinguish between different types of business combinations, similar types of combinations (from an economic perspective) could be accounted for in different ways, thus resulting in different financial statement results;

2. \textit{Comparability}: Financial analysts and other users of financial statements had difficulty comparing the performance of combining entities because different methods of accounting were permitted;

3. \textit{Better information on intangibles}: Users of financial statements have a need for better information about intangible assets because intangibles represent an increasingly significant proportion of the assets acquired in business combinations. While the purchase method recognizes all intangible assets acquired (either separately or as acquisition goodwill), the pooling method does not recognize acquisition goodwill;

4. \textit{Unlevel playing field}: Company managements argued that the differences between the pooling and purchase methods adversely affected competition in the markets for mergers and acquisitions.
The provisions of FASB 141 constituted a distinctly different approach to accounting for business combinations as compared with APB 16. The choice of a single method was based on the belief that “virtually all business combinations are acquisitions” (FAS 141, summary at pp. 5, 7; B19), and therefore, all business combinations ought to be accounted for in accordance with the “values exchanged”. The FAS 141 (p. 6-7) argued that the use of the purchase method would improve financial reporting because financial statements would better reflect the underlying economics of the business combination. In particular (ibid.):

1. **Underlying economics**: Application of Statement No. 141 produces financial statements that reflect the full investment made in the acquired entity. This is because the purchase method records a business combination based on the values exchanged, thus users are provided with information about the total purchase price paid, allowing a more meaningful evaluation of the subsequent performance of that investment;

2. **Comparability**: Because all business combinations must be accounted for in the same way, the purchase method improves the comparability of financial information. Users can evaluate reported financial results on a comparable basis because the assets acquired and the liabilities assumed are recognized and measured in the same way regardless of the type of consideration exchanged;

3. **Better information on intangibles**: The specific criteria for recognition of identifiable intangible assets and acquisition goodwill and the expanded disclosure requirements provide more information about the assets acquired and liabilities assumed. This additional information provides users with a better understanding of the resources acquired and improves their ability to assess future profitability and cash flows;

4. **Unlevel playing field**: Requiring one method of accounting reduces the costs of accounting for business combinations, in particular the costs incurred by entities in positioning themselves to meet the 12 criteria for use of pooling under APB 16.

Statement No. 141 was based on the following understanding of the underlying economics of business combinations:

a) “Virtually all business combinations are acquisitions”; therefore, it is necessary to identify an acquiring company and an acquired
company. The focus is on accounting for the change in ownership that is takes place in the acquired company;

b) All business combinations involve a clearly identifiable price;

c) The purchase price is the best evidence of the values exchanged;

d) If the purchase price exceeds the fair values of the net assets acquired, goodwill must be recognized as a permanent asset of the combined company.

e) Acquisition goodwill is not amortized; instead it is tested periodically for impairment.

f) Goodwill is recognized regardless of the extent of ownership acquired; however, a change of ownership control is a pre-condition to the recognition of a business combination;

g) Goodwill is measured by subtracting the fair values of the net assets of the acquired company from the purchase price;

h) For accounting measurement purposes, it is assumed that the operations of the acquired company are discontinued; carryover of retained earnings of the acquired company is not permitted, and the acquired company’s earnings during the period preceding the date of the combination are not recognized.

The business combination is then assumed to be a market exchange at a certain market price that is fixed at the coincidence of values exchanged and purchased. In adopting Statement No. 141, the FASB articulated therefore the following arguments:

“"The Board noted that in a business combination, the fair value of the asset acquired – the acquired entity – is established through a bargained exchange transaction” (B163).

“Substantially all business combinations are exchange transactions in which each party receives and sacrifices commensurate value” (B187).

14 Either the assets already recognised by the acquiree and the other assets that the acquiree was unable or prohibited to recognize; in addition, if assets are acquired in groups, the cost of the group must be allocated to the single assets (FAS 141, par 7).
“Like other exchange transactions, acquisitions are measured on the basis of the fair values exchanged. In exchange transactions, the fair values of the net assets acquired and the consideration paid are assumed to be equal, absent evidence to the contrary” (FASB 141, paragraph 5).

“Exchange transactions in which the consideration is cash are measured by the amount of cash paid. However, if the consideration given is not in the form of cash, measurement is based on the fair value of the consideration given” (FASB 141, paragraph 6)

It is evident from these arguments that the FASB understood the underlying economics of a business combination as being exemplified by a (efficient) capital market transaction in which the primary consideration paid is cash, the owners of the acquired company are liquidated, the activities of the acquired company are discontinued, and the assets of the acquired company are combined with those of the acquiring company. The purchase method effectively assumes a discontinuity in both (i) the ownership interests and (ii) the activities of the acquired company, as evidenced by the accounting procedure of revaluing the net assets of the acquired company to their fair values and measuring goodwill as the difference between the purchase price and the sum of the fair values of the net assets acquired. The discontinuity of ownership interests (point i) justifies the recourse to fair value valuation of the target, since the acquirer becomes the new owner and needs a fresh start of the target. The discontinuity of the business (point ii) justifies the recourse to a piecemeal liquidation approach, because the single elements of the business are acquired, not the business as a whole. Absent the discontinuity of the business, the target might be valued as a unique financial investment and thus accounting for as a single value to the owner, the acquisition goodwill being still obtained by difference with the purchase price. This discontinuity is explicitly mentioned in paragraph B29 of FAS 141 and repeated by E37 of the revised FAS 141r:

“Under the purchase method, one of the combining entities is viewed as surviving the transaction and is considered to be the acquiring entity. The other combining entities that do not survive the combination as independent entities are considered to be the acquired entities.”

“The acquisition method is based on the premise that in an acquisition, the acquired entity (Company B) ceases to exist and only the acquiring entity (Company A) survives.”
The FASB’s pronouncements were therefore based on a particular understanding of the underlying economics of a business combination, an understanding focused on properly representing a capital market transaction where the acquisition price represents the best measure of the values exchanged. The key features of the FASB’s understanding are summarized in Table 3 (Purchase Column).

Table 3
Comparative Analysis of the Understandings of the Economics of Purchase versus Pooling

| (i) The underlying economic substance of a business combination | Purchase | Pooling |
|___________________________________________________________|-----------|---------|
| A business combination is a purchase of a target company by an acquiring company in a capital market transaction. |
| A business combination is a merger of previously distinct enterprises into a jointly managed enterprise. |

<table>
<thead>
<tr>
<th>(ii) Key logic underlying the application of the method</th>
<th>Purchase</th>
<th>Pooling</th>
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<tbody>
<tr>
<td>Discontinuity in the activities of the acquired company.</td>
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<tr>
<td>Continuity in the activities of the combining enterprises.</td>
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<th>(iii) Key notion for the application of the method</th>
<th>Purchase</th>
<th>Pooling</th>
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<tr>
<td>Acquisition</td>
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<tr>
<td>Merger</td>
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<tr>
<th>(iv) Treatment of goodwill</th>
<th>Purchase</th>
<th>Pooling</th>
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<tbody>
<tr>
<td>Recognized as a permanent asset. Not amortized but tested for impairment.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Not recognized. Any acquisition differential is adjusted against shareholders’ equity.</td>
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<th>(v) Valuation of assets, liabilities and contingent liabilities</th>
<th>Purchase</th>
<th>Pooling</th>
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<tr>
<td>Fair value (market basis).</td>
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<tr>
<td>Book value (historical cost basis).</td>
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<tr>
<th>(vi) Perspective of reference</th>
<th>Purchase</th>
<th>Pooling</th>
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<tbody>
<tr>
<td>Valuation based on a market exchange at a specific point in time.</td>
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<td></td>
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<tr>
<td>Representation of the activities of two or more continuous business enterprises joined together.</td>
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Source: Biondi (2007)

However, this understanding does not address virtually all types of business combinations, and, worst, fails to develop a comprehensive approach capable of addressing the whole accounting for the economics of business combinations in a coherent and understandable way. As the column two of the Table 3 testifies, the eliminated pooling approach actually
suggests a different family of business combinations. This suggestion may open the way to a broader perspective on the matter.

5. Discussion and Critique

This section takes the arguments of the resistant parties seriously. The Chinese approach to accounting for business combinations will separated from the special context of Chinese industrial development, and utilized instead as a comparative basis for a constructive critique of the FASB and IASB joint approach.

With respect to the underlying economics of business combinations, the problem was and still is primarily related to the representation of a business combination as a capital market transaction among unrelated parties at fair market prices. Relying on this perspective, the FASB and IASB reached the conclusion that “virtually all business combinations are acquisitions” where ownership control of one of the combining entities changes hands. However, as the new releases testify, it is sometimes difficult to determine whether a change of ownership control has actually taken place, for two main reasons. First, ownership control is a matter of degree and factual control may be obtained with less than the majority of legal voting rights. More generally speaking, ownership control may not be the best criterion for discriminating different types of business combinations. In particular, a number of business practices exist to obtain control without a change of ownership, as IFRS 3 (§11 and §12) and FASB 141 r (49) recognize, and as the seminal work of Berle and Means (1932) insightfully suggested (Biondi et al. 2007 eds.). Furthermore, “a business combination may be structured in a variety of ways for legal, taxation or other reasons” (IFRS 3, §5), even apart from an acquisition of ownership control. Consequently, a choice of accounting methods based on the criterion of a change of ownership control may be contradicted by actual business practices.

The Chinese position presents an alternate framework, based on the notion of “common control” rather than a “change of ownership control”. Common control is here a matter of continued relationship among involved entities. Pursuant to the Chinese perspective, the underlying economics of many business combinations reflect a continuity of business activities. This continuity may involve a change in strategies, organizational structures, shareholding interests, or management, but its primary purpose is the enhancement of the ongoing activities of the combining entities. Many business combinations - in China and elsewhere - are reorganizations among related entities, rather than capital market transactions. “Common control” may in fact be the main case rather than the exception, because continuity of
the underlying financial and operating activities is expected to occur. Control is therefore a matter of continued “coordination” rather than a change of “ownership control”.

When issuing Statement No. 20, the CASC and the MOF did not focus on the representation of a business combination as a capital market transaction. Rather its focus was on the reorganization of the combining economic entities. This perspective is consistent with the entity theory of accounting. While both the FASB and the IASB start with the entity theory, they quickly move to an acquirer’s perspective (i.e. proprietorship theory), which views a business combination as a takeover of a target company through an acquisition of ownership control of the target’s shareholders’ equity (FASB 1999; IFRS 3, BC50-BC53; G4+1 1998: 6, 11-12).15 This proprietorship perspective is exemplified by paragraph 39 of FASB 141:

“The net assets of one entity are transferred to another, which issues its shares in exchange, and that transaction should be accounted for on the same basis that would be used to record an investment by owners in the form of cash—that is, on a fair value basis. From the perspective of the acquired entity’s shareholders, that transaction is an exchange transaction, a sale on their part and a purchase on the part of the surviving entity” (emphasis added).

A proprietorship perspective reflects the viewpoint of the shareholders of the acquiring company who would like to have more information about the values of the accounting elements of the target entity, including previously unrecognized goodwill. However, in order for this information to be relevant and reliable, the fair values of the net assets of the target company, as well as the total consideration paid, must be “fair,” (i.e., the whole process must take place in complete and efficient markets). This viewpoint reflects (hostile) takeovers in active financial markets where a controlling part of the shareholders’ equity is acquired by one entity which is independent from the target entity. However, as the FASB (1999) has recognized, this viewpoint may be misleading when: (i) a significant premium is paid for the acquired firm above its pre-acquisition market value, (ii) a significant amount of goodwill is recognized, or (iii) the method of payment consists of the acquirer’s shares. In particular, this viewpoint scarcely fits the combination of entities which are under common control.16

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15 According to the new release, including a not fair value measurement at least in some cases, the IASB’s position on the matter is perhaps more prudent, but it is not yet fully disclosed or applicable, so any conclusion is provisional.

16 The measurement problems with the fair value approach are categorically stressed by dissenting comments from national standards setters and various constituents.
Furthermore, it should be noted that the shareholders of the acquiring entity do not actually acquire the net assets or the shares of the target entity. The underlying economics of a business combination does not involve an “acquisition” but rather a “combination” of previously separate entities. A business combination is therefore a matter of operational continuity rather than a change of ownership interests. Operational continuity involves a coordination of operations and activities among entities. If the combining entities are related, and if they share their business activities in some way, then the pooling of interests approach may be more appropriate. Consequently, the CASC and the MOF took a distinctly different view of the underlying economics of business combinations, one which was based on an entity perspective. In a quite similar way, the Japanese accounting regulatory body quoted in the introduction appears to draw upon the economic distinction between the markets and the business firm, and then make an accounting representational distinction between business investments and financial investments. When applied to business combinations, this distinction would imply that combinations made for business reasons (seeking for integration and coordination between involved entities) may be understood as mergers and accounted for by a pooling approach, whilst combinations made for financial reasons (seeking for acquiring disbanded net assets or a financial rent) will understood as purchases and accounted for by an acquisition approach.

In this way, the position taken by advocates of pooling, including the special viewpoint adopted by Chinese regulatory bodies (CASC and MOF), may be generalized in order to reach a more comprehensive understanding of the accounting and economics of business combinations. In an economic system characterized by competing business entities, a business combination is probably best understood as reorganization between entities whose governing parties want to combine their activities in order to pursue them in an enhanced way. This economic substance does not correspond with the purchase method. Many business combinations occur in a relational economic context, and those combinations are not based on arm’s length bargaining in a competitive marketplace. When combinations occur among related entities, or in the absence of efficient capital market transactions, the values exchanged do not reflect the underlying economics of the combination process. In such cases the use of the purchase method leads to recognition of internally generated goodwill (FASC 2004: 60) and the capitalization of uncertain future benefits, as well as a failure to match the
amortization of recorded goodwill against future revenues.\footnote{17} According to Busse von Colbe (2004: 212), the recognition of the discounted present value of uncertain future benefits may lead to unrealized profits being distributed as dividends. In addition, this accounting recognition can lead to a confused tax basis. In a combination among related economic entities, it is highly unlikely that the recognized goodwill or the “fair values” of the net assets of the combined entity will fairly represent the values implied by the underlying economics. If the pooling of interests method were used instead, the net assets of the combining entities would be accounted for using book values, and the problem of unfair “fair values” would be avoided.

It is important to remember here that, according to Jackson and Miyajima (2007), in 1991-2005, only a small minority of the business combinations in leading economies concerned publicly listed target companies (7,8\% in Germany, 14,9\% in USA, 9,5\% in UK, 23,3\% in Japan, 14,4\% in France), and this proportion was decreasing, whilst one half were private companies (including in the USA and UK) and one third were subsidiaries (including in USA and UK). According to these statistics, based on the Thomson Deals database, at least one third of the combinations are intra-group reorganizations, whilst one half occurs in a private setting where the representational focus on an (efficient) capital market transaction scarcely applies.

In addition, the alleged relevance for capital market intermediation of the new approach fostered by the FASB and IASB was questioned by several empirical studies. From the informational viewpoint, these studies have concluded that the lack of recognition of acquisition goodwill does not necessarily affect value relevance in capital markets. Hopkins et al. (2000) present evidence suggesting that analysts assign a lower post-acquisition value to a purchase combination in which the parent company records and amortizes an acquisition premium (i.e. goodwill), compared with either a purchase combination in which the parent expenses the entire premium as in-process research and development, or a pooling-of-interest combination. Furthermore, Mintchik (2006) has attempted to disentangle the impact on earnings forecast errors by eliminating pooling from accounting for goodwill and other disclosures. She provides evidence that pooling does not create additional problems to accurate forecasting, while at the same time the improved disclosure is beneficial. The pooling approach may therefore be preferred, even by capital market participants.\footnote{18}

\footnote{17} The latter point is emphasized by the minority dissenting opinions of Geoffrey Whittington and Tatsumi Yamada to IFRS 3 (IFRS 3, DO1-DO16).

\footnote{18} Pursuant to efficient market theory, market prices are the best representation of value, and accounting must follow them. However, the accounting information received by the
The arguments advanced by the FASB and IASB in favor of a single method of accounting for business combinations appear to be questionable when considered in light of this comprehensive perspective. The FASB’s four arguments mentioned above (underlying economics, comparability, better information on intangibles, unlevel playing field) were largely based on an assumed independence of the accounting method from the type of consideration used in undertaking the combination, and on the assumption that all business combinations are acquisitions. More generally speaking, both the FASB and IASB argue for purchase accounting because of its presumed value relevance for capital market participants because the consideration paid is the best measure of the value of the net assets and the goodwill acquired measured at the acquisition date.

Regarding the underlying economics argument (i.e. that all business combinations are acquisitions), the FASB essentially ignored the existence of mergers and focused exclusively on acquisitions, even though both mergers and acquisitions exist in actual economic settings. Many respondents to the FASB and IASB exposure drafts argued that mergers should be accounted for differently from acquisitions because of the differences in the underlying economics (FASB 141, B36). According to Ramanna (2007; table 4 at p. 49), a majority of firms commenting on the FASB 141 exposure draft wanted to maintain the pooling method. Paragraph B41 of FASB 141 argued that all business combinations are effectively acquisitions by stating that shares could be issued for cash and then the cash could be used to effect the combination, with the end result being the same as if shares had been used to effect the combination. However, when cash is used, the acquiring company provides the cash, and the former shareholders of the target company are liquidated. When a combination is effected through an exchange of shares, the acquiring company does not provide cash, and the former shareholders of the target become shareholders of the combined entity. Consequently, the two types of transactions are not the same either in their underlying economics or their results.

With respect to the discontinuity that is effectively assumed when using the purchase method, the FASB itself recognized that there is continuity in a merger (B40). In addition, the Board recognized that “all business combinations entail some bringing together of commercial strategies” capital markets is based on the earnings of the firm generated mainly in the past (Biondi 2005). This information plays an important role by providing a common knowledge base available for subjective valuation and decision-making (Sunder 2001). This is a particular type of information that complements and does not follow the information provided by the price system (Biondi 2003).
These observations contradict the discontinuity assumption of the purchase method. Furthermore, the elimination of the pooling method may not be sound from an empirical perspective because it is possible to identify business combinations that are not acquisitions, but mergers instead.

Regarding the comparability argument, if the existence of different kinds of business combinations remains an open question, comparability becomes effectively a claim for accounting uniformity, which is not necessarily justifiable if there are different kinds of business combinations in actual practice. When certain features of a transaction distinguish between transactions, then it is appropriate to account them in different ways.

Regarding the unlevel playing field, a choice among methods may be preferred if the intentions of management with respect to the underlying transactions are different. By choosing among alternatives, managers send signals to investors and analysts, thus providing useful information about strategies and policies adopted. In addition, pooling is less expensive to implement when compared with the costly appraisals that are required by the purchase method.

Last but not least, with respect to the better information about intangibles argument, if a business combination is effected through an exchange of equity interests or without any consideration at all, it is questionable whether anything of economic substance has occurred which would lead to the generation of goodwill. The most persuasive prior argument in favor of the pooling of interest method was that reflected a transaction in which there was only a change in the legal structure of shareholding interests which was not economically relevant from an accounting perspective.

In sum, the FASB admits that “accounting information cannot avoid affecting behavior, nor should it” (FAS 141, B72). However, if business combinations are felt to be too complex to be properly accounted for through an international convergence of accounting standards, accounting regulation might just as well be reduced to providing general guidance and permitting managerial choice regarding the specific accounting methods operation by operation. Therefore, the presumption that “virtually all business combinations are acquisitions” ought to be removed with the emphasis being instead on the need to consider the individual circumstances of each combination in determining whether it represents a merger or an acquisition. If the existence of different types of business combinations is nowadays conceded by all the participants in the accounting arena, accounting regulation, especially if based on principles, may easily accept

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19 As a matter of fact, the uniformity argument could just as easily be advanced in favor of the pooling method.
to leave preparers choose, and concentrate then on careful guidance that shall avoid opportunistic switch among methods through time. In addition, this freedom of choice between methods may offer relevant signals about the managerial intents to capital market participants and shareholders.  

In conclusion, the current state of resistance and confusion in the transnational accounting for business combinations requires abandoning the adjustments at the margin through scope exceptions, in order to seek instead for a comprehensive framework capable of encompassing difficulties and addressing preparers and users in a thoughtful and understandable way.

6. Suggestions for improving accounting for business combinations

Two main problems in the current approach adopted by the FASB and IASB need to be reconsidered: the existence of combinations that are mergers, and the measurement issues involved by the purchase approach. These problems relate to the overall position of the standard on business combinations in the accounting conceptual framework, as stressed by the German regulatory body as quoted in the introduction.

Both FASB 141 (BC29, BC57-B62) and IFRS3r (BC41–BC43) argue that there is congruence between the purchase method and the historical cost accounting model. This argument is based on an analogy between a business combination and the purchase of a single asset:

“The purchase method produces results that are comparable with those of entities that grow by acquiring similar assets in a number of smaller purchases that are not business combinations. The Board agreed with those who stated that the purchase method is consistent with how other asset acquisitions are accounted for” (FAS 141, B48).

The analogy is driven by the image of a transfer of ownership control where the right to exercise control is paid for in a lump sum. The acquired entity is therefore considered to be an acquired asset in its entirety. However, from an accounting measurement perspective, the net assets of the acquired entity are combined on a piecemeal basis. Consequently, the primary rhetorical image underlying the purchase method is at odds with the concept of the firm as an economic entity and a going concern. Continuity in the operations of the entity is a necessary condition for a going concern. Continuity of operations is also a useful criterion for distinguishing between a merger (continuity) and an acquisition (lack of continuity). When a

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20 If the risk of opportunistic behaviours and misleading representations are feared to be too high as the result of such accounting flexibility, then it may be more prudent to allow only one method; but in that case it seems that the pooling of interests method deserves greater consideration.
business combination takes place among entities under common control, continuity of operations is evident because the enterprises are related components of the same economic entity. When combinations occur among economically independent entities, the continuity of operations depends largely on management’s strategic intentions as in, for example, the desire to enhance the continuity of a brand; however, continuity in many cases is the desired strategic objective.

The economic entity assumption and the going concern principle are central concepts in virtually every country and regulatory context (Hoarau 2006, 43). These principles provide the basis for historical cost accounting. Historical cost accounting does not however purport to provide a current valuation for the firm; instead it reflects the income generating processes of the firm over time. The purchase method is therefore not consistent with the historical cost accounting principle (contrary to FASB 141, B58), especially when there is continuity in the operations of the combining entities. Moreover, when the complexities of the underlying economics of a business combination are accounted for using the purchase method, the reported values are subjective estimates. There is a disregard of the continuity in the activities of the combined enterprises and the generation of joint incomes through time. This casts doubt upon the relevance of fair values either for assessing managerial accountability or for purposes of share valuation (contrary to FASB 141, B44).

In sum, the rationale for eliminating the pooling of interests method appears to be questionable. While the FASB concluded that “virtually all business combinations are acquisitions”, this conclusion effectively ignored the existence of mergers, even though at least one third of business combinations in leading economies actually are mergers. In fact, business combinations are complex and significant events in the current economic organization and dynamics of business firms. This complexity should lead to a search for the distinctive features of business combinations that distinguish between different types of transactions. It factually appears that this recognition has led both the FASB and IASB to revise their previous positions and to release new standards that adopt a more cautious approach. However, the implicit notion of “change in ownership control” that they have adopted to distinguish between types of combinations actually fails to address the underlying issues properly. In addition, the “net assets approach” that is retained is opaque and less informative that the pooling approach.

The elimination of pooling was based on a proprietorship perspective, which considers the underlying combination to be an exchange of

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21 See for example, FASB 141, paragraph B53.
ownership interests between the owners of the combining entities (see FASB 141, B39). This accounting representation has merit when the combination is effected exclusively through an exchange of shares, and it may be understood to be a mere change in legal form. But, when a significant change in ownership interests is involved (see FAS 141, B40), something of economic substance has occurred, especially when a significant premium is paid in the exchange ratio. In order to recognize this economic event, the purchase method came to be defined as the best solution to the problem of accounting for business combinations. This decision was motivated by a capital market perspective which conflates the consideration paid with a change in ownership control.

However, from the Chinese perspective, which focuses on the combination of ongoing business entities, the main point to be considered is the distinction between shareholders’ equity and entity equity (Biondi 2007). If a distinction is made between shareholders’ equity and entity equity, the “mere change in legal form” argument no longer holds, and the continuity in the operations becomes the cornerstone of the pooling approach. From this perspective, the traditional non-recognition of acquisition goodwill allows for the maximum consistency in accounting reports (and related measures of performance). At the same time, this continuity of operations perspective may actually constitute a coherent basis for recognizing goodwill.\(^{22}\) The pooling method is able to distinguish entity equity from shareholder equity, and thus to recognize the difference between the consideration paid and the net book value of the acquired firm as a variant of “acquisition goodwill” which does not require estimating fair values. The acquired company’s shareholders essentially receive a form of consideration directly from the entity for ratifying the merger, especially when the business combination takes place among entities not under common control. By making a distinction between shareholders’ equity and entity equity, the pooling approach could charge or credit the acquisition differential to entity equity. This approach would account for the implicit financial resources management is paying for by effecting the merger.\(^{23}\)

\(^{22}\) Many respondents agreed that, if goodwill is also capitalised, it should be amortised, to make management responsible of the investment of entity resources that might be utilised otherwise, or distributed to stakeholders.

\(^{23}\) The consideration paid to bring the previously separate entities together comprises either an issuance of equity instruments (shares-driven consideration), or a transfer of cash or cash equivalents (cash-driven consideration), or a mix thereof. The cash-driven consideration may be effected by increasing debt (debt-driven combination). From the entity viewpoint, the overall consideration should be recognized as an outflow from the entity towards the relevant parties (usually, the shareholders), and the management should be held accountable for this transfer as a charge or an investment.
In sum, a new comprehensive approach to accounting for business combinations may be characterized by the following line of reasoning, which may lead to harmonize and enhance both the Chinese approach and the FASB and IASB’s joint approach. The first step would be to distinguish clearly between combinations among related or unrelated entities. The status of the relationship between the entities should not be limited to ownership control (or other criteria based on legal form and structure), but rather it should include influence and other economic indicators of group dependence. Focus in there on common control, economic integration, administrative interdependence, financial interdependence, commercial interdependence, employee interdependence, and common public persona (Strasser and Blumberg 2008). In the case of related entities, some variants of pooling ought to be preferred. In case of unrelated entities, the second step would be to check for continuity in the operations of the combining entities. Continuity may make pooling preferable, while a discontinuity of one of the combining entities may lead to purchase accounting. In addition, pooling ought to integrate the distinction between shareholders’ equity and entity’s equity, which may recognize the net economic consideration involved by the combination (goodwill) even in case of pooling. The question of how to measure goodwill under pooling would remain open.

More generally speaking, the standard on business combination should be considered together with the overall approach to accounting for enterprise groups. The suggested notions of relatedness and continuity should then correspond with the criteria adopted for related party disclosures, investments in associates (long-term equity investments), and consolidated statements.

7. Conclusion

The accounting treatment of a business combination as a purchase transaction requires the identification of an acquiring entity, the identification of an acquired entity, and the measurement of an acquisition price. While this seems to be a straightforward exercise, the satisfaction of these three requirements underestimates the complexities associated with the synergistic transformation taking place in a business combination through time. The measurement of the acquisition price requires an excessive reliance on the consideration paid as the proper measure of value, and it forces an unreliable estimation of fair values as the basis for future accountability in a way that may be detrimental to the firm (Ramanna and Watts 2007). The exceptions introduced by recent releases do not change this conclusion. The fair value approach is generally reinforced in the new
releases. The inclusion of minority interests in shareholders’ equity continues the “change of ownership” concept adopted by the FASB and partially by the IASB. As a result, it is practically impossible to distinguish fair value from book value. Moreover, transactions between shareholders and the acquiring company – such as exchanges of non controlling interests - are considered to be transactions among shareholders that will be accounted for as “equity transactions”. The latter method presents a problem because it is a variant of pooling; and if the transaction has a cost for the entity (i.e., involves a payment to minority shareholders from entity resources), the payment will not be recognized or accounted for.

More generally speaking, the elimination of the pooling method appears to have been based on a particular understanding of the underlying economics of business combinations. The Chinese accounting standards setting body sought to develop a distinctly different understanding of business combinations, one which reflects the likelihood that there will be reorganizations among ongoing entities under common control and that these types of combinations should be accounted for using the pooling of interest method. In any case, a new comprehensive framework for accounting for business combinations seems to be needed to overcome the current state of resistance and confusion in the transnational accounting for business combinations. The notions of relatedness between and continuity in the combining entities ought to be central to the development of this new framework, which should be considered in the context of accounting for enterprise groups that dominate the economic and financial scene.
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