

**American Accounting Association's Financial Accounting Standards Committee
Response to IASB Exposure Draft 3 "Business Combinations"**

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The Financial Accounting Standards Committee of the American Accounting Association ("the Committee") is charged with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the IASB (hereafter, the Board) Exposure Draft on Business Combinations (hereafter, the ED). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response is presented in five sections. First, in order to evaluate the ED we describe the Committee's perspective on the desired attributes of a general business combinations standard. In the second section, we evaluate the ED within the rubric of this preferred standard. The third section describes the Committee's general comments and recommendations on the proposals in the ED. The fourth section summarizes relevant academic accounting research findings that form the basis for the Committee's views. We note that much of this research does not directly investigate issues relating to the purchase method of accounting for business combinations. Given the lack of direct research on purchase method accounting, the Committee's opinion is based on inferences from related research, as well as the Committee's understanding of the IASB's Framework for the Presentation and Preparation of Financial Statements ("Framework"). The final section summarizes our position.

I. What should a high quality business combinations standard accomplish?

The committee favors standards that are conceptually-sound and based on economic principles. We support the IASB's claimed preference for principles-based standards. We maintain that a principles-based standard should exhibit the following characteristics:¹

(1) The economic substance, not the form, of a given transaction or event should guide its financial reporting. The IASB's "Framework for the Preparation and Presentation of Financial Statements" defines the elements of financial statements and provides recognition and measurement criteria to guide the reporting process. These principles should serve as the

¹ American Accounting Association (AAA) Financial Accounting Standards Committee. 2003. Evaluating Concepts-Based vs. Rules-Based Approaches to Standard Setting, *Accounting Horizons*. 17 (1): 73-89.

foundation for financial reporting that reflects the economic substance of the underlying transactions.

(2) The standard should include a description of the particular transaction or event that is the subject of the standard. This description should encompass the underlying economics of the transaction or event that is the subject of the standard in order to provide a common, explicit understanding of these economics.

(3) The standard should include a general discussion of the mapping between the economics of the transaction or event and the financial statements, using the Framework to guide classification and measurement issues associated with this mapping.

The business combinations standard should follow from the IASB's Framework for the Presentation and Preparation of Financial Statements. Covered transactions or events, identities of the parties to the transaction, and measurement rules should be consistent with the Framework. The standard should include a description of a business combination and its underlying economics. A standard should contain no detailed rules beyond the broad principles outlined in the standard. There should be no scope exceptions.

A principles-based standard will require the preparer to exercise judgment in determining whether a covered transaction, as defined, has occurred. In addition, the preparer may exercise judgment in identifying the parties to the transaction (in particular, the acquirer and acquiree), and in applying the measurement rules to the transaction. Because principles-based standards are likely to be interpreted differently even by well-intentioned managers, and because they afford unscrupulous ones the opportunity to abuse the reporting model, we view disclosure as key to making the standard useful to users of financial statements.

II. How does the ED compare to the preferred principles-based standard?

Our response to the ED is framed within the context of creating principles-based standards. However, because the current ED deviates in some ways from a principles-based standard, our response is best understood in light of the detailed guidance in the ED. We summarize its key features below:

- a) All business combinations within its scope must be accounted for by the purchase method.
- b) An acquirer must be identified for every business combination within its scope.
- c) The acquirer must recognize all identifiable assets, liabilities, and contingent liabilities of the acquiree at the date of acquisition, regardless of whether or not they were previously recognized on the acquiree's books. It specifically prohibits recognition of "acquisition liabilities" not previously recognized on the acquiree's books.
- d) It prohibits amortization of goodwill, and instead requires that goodwill be tested for impairment.
- e) It requires disclosure of the effects of business combinations occurring prior to, during, and subsequent to the reporting period.

- f) It requires disclosures to enable users to evaluate changes in goodwill during the reporting period.

A standard on business combinations should apply to all transactions fitting the definition of a business combination. The Exposure Draft defines a business combination as “the bringing together of separate entities or operations of entities into one reporting entity.” Excluded from the scope of the ED are “joint ventures” and “entities under common control.” Explicitly included within the scope of the ED are “true mergers,” in which a business combination occurs in which one entity does not obtain control of another.

We believe the absence of an economic definition of a business combination is a major weakness of the IASB standard. A business combination is defined as the creation of a reporting entity. We note that the definition does not require that an economic transaction or event take place and specifies that the financial reporting determines the definition of the transaction rather than the reverse.

Because the current definition does not entail any concept of ownership or control, absent scope exceptions, the ED applies to joint ventures, combinations of entities under common control, and “true mergers.” The ED might even be used to justify “new basis” reporting for the operations identified in the creation of a tracking stock. All seem to satisfy the definition of a business combination as presented in the ED.

However, we note that the IASB does not want the standard to be applied to joint ventures or entities under common control and creates scope exceptions, which we consider inconsistent with a principles-based standard. Furthermore, while the IASB exhibits some ambivalence about whether “true mergers” exist, guidance in the current ED says that the standard will be applied, perhaps temporarily, to true mergers. Meanwhile the IASB will deliberate about whether to exempt such transactions, if they exist. Assuming they exist, a third scope exception will be created. We would anticipate a fourth scope exception were an entity to apply the standard in the creation of a tracking stock.

The committee believes that the definition of business combination should suffice in determining which transactions are covered and which excluded. We recommend the ED incorporate a definition of a business combination defined in terms of its underlying economics.

Notwithstanding its definition of a business combination as the creation of a reporting entity, the ED seems to address transactions between two entities in which control over one of the entities changes hands. The ED states that all business combinations within its “scope” consist of an acquirer which obtains control over the operations of the acquiree. The ED does not rule out the possibility of a combination occurring in which one of the combining entities does not obtain control of the other combining entity or entities [BC 27], and suggests that a future standard may cover such transactions. For the time being, it includes such combinations within the scope of the ED. The identification of the controlling entity will be effected by sheer willpower: “an acquirer shall be identified for all business combinations within the scope of this IFRS” [17].

The Committee suggests that the ED can eliminate the need for scope exceptions by defining the covered transactions as those in which one entity obtains control over another. The change in control is a transaction with economic consequences that should be reflected in the financial statements. Joint ventures, combinations of entities under common control, “true mergers,” and tracking stocks would presumably fall outside the scope of the standard. Until the IASB specifically addresses the issue of transactions or events not resulting in a change in control, such transactions would be accounted for under current guidance.

Defining covered transactions as those in which one entity obtains control over another would eliminate a major inconsistency in the ED, which suggests that certain business combinations might not have a controlling party and yet requires that the controlling party be identified. The problem of identifying and accounting for “true mergers” would not be resolved by an ED covering transactions involving a change in control. However, the Board states that it is investigating whether “fresh start” accounting might be applied to such combinations. Given the skepticism of the IASB that such “true mergers” exist (“true mergers, assuming they exist, are likely to be relatively rare” [BC28]), the failure to resolve these accounting issues is a minor issue.

If a business combination represents a change in control, the ED will require the preparer to exercise judgment in determining whether control of an entity has been transferred. A principles-based standard should not incorporate bright line rules defining covered transactions. Entities engaging in transactions in which control did not change hands should be required to disclose the facts supporting that conclusion. The existence of rigid or detailed rules increase the complexity of the standard and provide firms with an opportunity to “play the system” by engineering transactions to obtain a desired reporting outcomes. Such opportunities do not appear desirable in high quality reporting standards.

III. Responses to Specific Questions Raised in the Exposure Draft

Q1: Scope

The ED proposes to exclude from the scope of the IFRS business combinations in which separate entities are brought together to form a joint venture, and business combinations involving entities under common control, and to include guidance on identifying entities under common control.

As we suggested above, the ED should define transactions within its scope on the basis of the underlying economics. If the ED were drafted to cover transactions between entities in which there was a change in control, joint ventures and business combinations involving entities under common control would not fall within the scope of the ED. Under a revised ED, no scope exceptions would be necessary.

Q2: Method of Accounting for Business Combinations

The ED proposes to eliminate the use of the pooling of interests method and require all business combinations within its scope to be accounted for by applying the purchase method. Assuming the covered transactions are redefined in terms of change in control, the Committee supports the IASB's decision to eliminate pooling of interests accounting. As we suggested above, we believe the ED should be applied to all transactions in which one entity acquires control of another. This description may apply to all business combinations except joint ventures, combinations of entities under common control, and "true mergers," if they exist.

In a response to the FASB,² the Committee noted that neither anecdotal evidence nor research support the view that certain business combinations conform to the description of a "true merger." Furthermore, research suggests that acquisition premiums have been largest in transactions accounted for as poolings. One interpretation of that finding is that both "purchase" and "pooling" combinations are economic transactions in which one entity pays to acquire control over another. Absent evidence that a business combination did not entail a change in control, the Committee believes that continued use of pooling of interests accounting would create further opportunities for the costs of acquisition to be ignored in the subsequent accounting.

Q3: Reverse Acquisitions

The ED proposes to modify the circumstances in which a business combination could be regarded as a reverse acquisition by clarifying that for all business combinations effected through an exchange of equity interests, the acquirer is the combining entity with the power to govern the financial and operating policies of the other entity (or entities) so as to obtain benefits from its (or their) activities. The ED also proposes additional guidance on the accounting for reverse acquisitions.

The Committee agrees with conclusions of the ED that the accounting should be dictated by the economic substance of the transaction rather than its form. If the legal subsidiary is the controlling entity, it should be treated as the acquirer for accounting purposes.

Q4: Identifying the acquirer when a new entity is formed to effect a business combination

The ED proposes that when a new entity is formed to issue equity instruments to effect a business combination, one of the combining entities that existed before the combination should be adjudged the acquirer on the evidence available. This prescription for identifying the acquirer in a business combination will be unnecessary if covered transactions include only those in which control changes hands.

² AAA Financial Accounting Standards Committee, 1999. Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence. *Accounting Horizons* 13 (3): 299-303.

Q5: Provisions for terminating or reducing the activities of the acquiree

The ED proposes that an acquirer should recognize a restructuring provision as part of allocating the cost of a business combination only when the acquiree has, at the acquisition date, an existing liability for restructuring recognized in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets. Furthermore, the ED does not allow future losses or other costs expected to be incurred as a result of the combination shall not be included as part of the cost of the combination.

The committee supports this position. It follows directly from the IASB Framework's definition of a liability, and is consistent with IAS 37. We note that there may be circumstances in which the restructuring liability post-acquisition will differ from that in the acquiree's books. For example, the acquiring firm may have a restructuring plan as part of the acquisition that runs counter to, or is distinct from, the plan contemplated by the acquiree. In such circumstances the committee recommends that adjustments to the liability should be made in the acquirer's books subsequent to the acquisition in accordance with IAS 37. More important, the Committee recommends that such post-acquisition adjustments be clearly disclosed and explained in the footnotes.

Q6: Contingent liabilities

The ED proposes that an acquirer should recognize separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination, provided their fair values can be measured reliably.

The Committee does not agree with the position of the ED. It is inconsistent with the IASB's measurement criteria for recognition of a liability. The Framework states that "a liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably." If the liability does not exist on the acquiree's books at the date of the acquisition, then management has judged it to be either not probable or not measurable. We see no basis for the assumption that a business combination will affect either of those judgments.

The ED is also inconsistent with IAS 37, which requires that provisions for contingent liabilities be recognized in the balance sheet when, and only when: an enterprise has a present obligation (legal or constructive) as a result of a past event; it is probable (i.e. more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation. Under IAS 37 a contingent liability will be recorded in the acquiree's book at the date of acquisition, if probable and reliably estimable.

The Board proposes to revisit the role of probability in the Framework as part of a future Concepts project. Until a revised Framework articulates different standards for the recognition of contingent liabilities, we do not believe contingent liabilities should be

recognized in the business combination unless they would be recognized in the acquirer's books absent the combination.

Differences of opinion regarding the probability and fair value of contingent liabilities may arise at the time of the acquisition, and/or the probability or fair value may change as a result of the acquisition. In such circumstances, we believe there is justification for substituting the acquirer's assessment of the value for the acquiree's assessment. Nevertheless, the ED should require disclosure to document why the probability and fair value of the contingent liability differs from those reflected in the acquiree's books.

Finally, the committee notes with concern that permitting contingent liabilities to be revalued at acquisition creates the opportunity for earnings management. Because increasing contingent liabilities results in an equivalent increase in goodwill, *ceteris paribus*, the acquirer faces no charge on the income statement in the future.³ However, any excess contingent liabilities recorded at the acquisition date could be subsequently reversed and flow into the income statement, consistent with paragraph 46 of the ED. This creates the opportunity to create cookie jar reserves through "over identification" of contingent liabilities at acquisition date.⁴ The potential for earnings management underscores the need for full disclosure of any adjustment at the time of, and subsequent to, the acquisition.

Q7: Measuring the identifiable assets acquired and liabilities and contingent liabilities assumed

The ED requires the acquiree's identifiable assets, liabilities and contingent liabilities recognized as part of allocating the cost to be measured initially by the acquirer at their fair values at the acquisition date. Therefore, any minority interest in the acquiree will be stated at the minority's proportion of the net fair values of those items. If the ED covers transactions in which there is a change in control, we believe that measuring all assets and liabilities at fair value would be consistent with the underlying economic transaction.

Q8: Goodwill

The ED proposes that goodwill acquired in a business combination be recognized as an asset and not amortized. Instead it should be accounted for after initial recognition at cost less any accumulated impairment losses.

³ A future charge on income can arise due to impairment of goodwill but it is unlikely to be related to contingent liabilities. In any event, potential earnings management in this case results from creating fictitious liabilities that are reversed in the future and hence, can not lead to future goodwill impairment.

⁴ It is pertinent to note that such potential for earnings management existed under the provisions for IAS 37 which allowed firms to reverse previous contingent liability provision as a profit in the income statement if an outflow of resources is no longer probable. However, unlike the case of acquisitions, a firm incurs the cost of having to recognize expense in the income statement when such liability is determined.

We agree that goodwill meets the conceptual definition of an asset. We also agree that the measurement problems associated with estimation of the fair value of net assets and of overpayment at the time of the acquisition are not so severe that the goodwill should not be reflected on the balance sheet.

We do not agree with the Board's prohibition of periodic goodwill amortization. The Board argues that amortization does not provide useful information when firms are prohibited from recognizing the internally generated goodwill that replaces the amortized goodwill. We note, however, that the board does not permit explicit recognition of internally generated goodwill. The combined effect of the board's rulings is that internally generated goodwill may be recognized for firms that have acquired subsidiaries, but not otherwise.

To resolve this inconsistency, the board would have to permit recognition of internally generated goodwill, or require systematic amortization of acquired goodwill. If the board believes that valuation of goodwill subsequent to acquisition is sufficiently reliable to perform impairment tests, then valuation methods should be sufficiently reliable to value internally generated goodwill. However, we do not believe the board has made a compelling case for the reliability of the valuation tests,⁵ and we do not support recognition of internally generated goodwill. Absent this recognition, we support systematic amortization of acquired goodwill.

Q9: Excess over the cost of a business combination of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

The ED proposes that when such an excess exists, the acquirer should:

- reassess the identification of the acquiree's identifiable assets, liabilities, and contingent liabilities and the measurement of the cost of the combination; and
- recognize immediately in profit or loss any excess remaining after that reassessment.

The ED suggests that such excess could potentially be due to errors in measuring the fair value (Para 56). The Committee takes the position that an excess of fair value over cost is evidence that the fair values of the acquired assets and liabilities have not been measured correctly. In most cases we believe the excess should be allocated to the fair value of the assets and liabilities acquired. The difference should be recorded in income only when the net assets cannot be written down further without violating another standard.

Q10: Completing the initial accounting for a business combination and subsequent adjustments to that accounting.

The ED proposes that:

⁵ AAA Financial Accounting Standards Committee. 2001. Equity Valuation Models and Measuring Goodwill Impairment. *Accounting Horizons* 15 (2): 161-170.

- if the initial accounting for a business combination can be determined only provisionally by the end of the reporting period in which the combination occurs because either the fair values to be assigned to the acquiree's identifiable assets, liabilities, or contingent liabilities or the cost of the combination can be determined only provisionally, the acquirer should account for the combination using those provisional values. Any adjustment to those values as a result of completing the initial accounting is to be recognized within twelve months of the acquisition date.
- With some exceptions carried forward as an interim measure from IAS 22, adjustments to the initial accounting for a business combination after that accounting is complete should be recognized only to correct an error.

The Committee recognizes that in some cases the cost of the business may be provisional at the date of the combination. In the event that the acquisition cost changes post-acquisition, we recommend that the offsetting entry be made to goodwill.

The Committee is less comfortable endorsing the ED's position regarding post-acquisition adjustments to the fair value of identifiable assets, liabilities, and contingent liabilities acquired. We believe these adjustments are often neither detected nor understood, even by reasonably sophisticated investors and analysts.

Prohibiting such adjustments may have unforeseen consequences, but we recommend that the IASB consider this alternative, particularly for adjustments that would increase goodwill. The acquiring company performed due diligence prior to the acquisition, and presumably estimated the fair values of the net assets. We believe one could reasonably argue that any subsequent reduction in the fair value of the identifiable net assets is evidence of overpayment for the acquired company, and should be recognized in income.

Assuming post-acquisition adjustments are not prohibited, it is nonetheless the committee's view any subsequent adjustments to the provisional numbers should be exceptional. Adjustments should be triggered only by the receipt of new factual information regarding the values of the net assets at the date of acquisition (for example, an audit of acquired pension assets). Adjustments made under these circumstances should be clearly disclosed. The acquiring firm should quantify the impact of the adjustment on the balance sheet and the income statement, for the current and subsequent periods.

Finally, the Committee believes that allowing the acquiring firm twelve months to finalize the purchase price allocation is excessive. It opens the possibility that events subsequent to the acquisition date will inappropriately influence the estimate of fair value as of the acquisition date. The Committee recommends that all adjustments should be accounted for by the end of the first full quarter after the acquisition.

IV. Related Research

Empirical accounting literature has a striking absence of research relating to the application of purchase method accounting. However, we note that the research that does exist supports the ED's decision to eliminate the creation of purchase liabilities. We also believe that related research supports the increased disclosure requirements of the ED. Research supports the recognition of goodwill as an asset, and one recent empirical test supports the ED's prohibition on the amortization of goodwill. However, the latter study covers only five years, and the results may not be robust to other time periods.

A. Purchase Method Procedures

Brown, Finn, and Hope (2000) find evidence that provision-taking in business combinations was associated with declining accounting and market-adjusted stock price performance over the three-year period following the fiscal year of the acquisition. Their results are consistent with the hypothesis that the high provisioners used the provisions to insulate accounting earnings from the effects of declining cash flows. The market belatedly reacted to these firms' declining fortunes when net income was no longer inflated by provision reversals. We believe this evidence supports the ED's decision to disallow the creation of liabilities in the purchase price allocation.

Moehrle (2002) presents evidence that firms opportunistically reverse restructuring reserves in order to meet certain earnings targets. Using a sample of 121 reversals recorded between 1990 and 1999, he finds that some firms record reversals to beat analysts' forecasts, to avoid reporting net losses, and to avoid earnings declines. While the evidence relates to restructuring provisions taken outside business combinations, the evidence may generalize to such provisions taken in a business combination.

Evidence in the literature suggests that restructuring charges create uncertainties for analysts, and that enhanced disclosure of the components of the charges helps resolve some of the uncertainties. Chaney, Hogan, and Jeter (1999) provide evidence that analyst forecast accuracy is impaired by restructurings. Lopez and Clement (2000) conclude that restructurings create uncertainty for analysts for at least two years subsequent to the announcement of the event. Lopez (1999) presents evidence suggesting that analysts benefit from enhanced disclosures in connection with restructuring charges. He finds that the components of the restructuring charge required by EITF 94-3 have incremental information over the aggregate charge in explaining analysts' earnings forecast revisions. Although these results do not bear directly on business combinations, they provide some tangential support for the disclosure requirements proposed in the ED.

Jennings, Robinson, Thompson, and Duvall (1996) report that market prices are consistent with the idea that investors view goodwill as an asset. Jennings, LeClere, and Thompson (2001) report that earnings before goodwill amortization are more informative than reported earnings (which include goodwill amortization) as a summary indicator of firm value. They report that earnings before goodwill amortization explains significantly more share prices than earnings after goodwill amortization and that when share valuations are based on

earnings alone, goodwill amortization simply adds noise to the measure. These results suggest that making the earnings impact of goodwill accounting more transparent would benefit investors and analysts. On its face, this paper supports the ED's proposal to eliminate goodwill amortization. We note, however, that the sample covered a relatively short window of time, and coincided with a historic bull market in U.S. equities. Thus its conclusions might not be robust to alternative time periods.

B. Purchase Method versus Pooling of Interests

Empirical research provides support for the ED's operational stance that "pooling" and "purchase" method transactions are economically similar events. Vincent (1997) compares investors' responses to firms' choice of pooling or purchase method accounting. She reports that investors appear to adjust firms' reported accounting numbers so that they value purchase and pooling firms on an equivalent basis. Although the results indicate that pooling firms enjoy some price advantage over purchase firms, the price difference is not associated with accounting differences.

Aboody, Kaznik, and Williams (2000) find that managers opportunistically choose between pooling and purchase method in response to their private economic incentives. The authors present evidence that the accounting choice is jointly determined by the premium paid over the book value of the acquired firm and the managers' economic benefits derived from accounting-based contracts. They report that when the business combination involves a large step-up to the target's net assets, CEOs with earnings-based compensation plans are more likely than others to incur the costs of qualifying for pooling and avoid the earnings 'penalty' associated with the purchase method. However, they find no association between stock-based compensation and the purchase-pooling choice, suggesting managers are not concerned about implications of large step-ups for firms' equity values.

Although Vincent's (1997) results suggest that markets eventually price firms similarly, Hopkins, Houston, and Peters (2000) present evidence indicating that potentially costly information processing problems among professional analysts exist when multiple methods exist to report economically equivalent events. Specifically, their results show that analysts assign a lower post-combination value to a purchase combination in which the parent company has recorded an acquisition premium compared to a purchase combination in which the parent expenses the entire premium as in-process research and development and compared to a pooling-of-interests combination. In addition, when the parent company records and amortizes an acquisition premium in a purchase-method business combination, analysts' stock-price judgments are significantly lower if the business combination occurred three years ago as compared to one year ago.

C. Joint Ventures

The literature has limited evidence supporting the ED's position that joint ventures differ in important economic ways from other business combinations, and should be excepted from the current standard. Hauswald and Hege (2002) present theoretical arguments suggesting that, for many joint ventures, it may be optimal for neither venture parent to acquire control

over the venture. They create a model showing that 50/50 joint ventures are optimal ownership structures when the parent firms have complementary resources and neither has a dominant position with regard to the joint venture in terms of industry or location. The resource complementarity eliminates moral hazard in parent contributions so that ownership provides sufficient incentives for optimal investments. However, majority ownership by one parent creates the opportunity for it to extract rents from the other owner, making a 50/50 stake the optimal structure under these circumstances. The authors report evidence consistent with their theoretical model. In particular, they find that 50/50 joint ventures are more common when the parent firms have complementary resources, and neither has a dominant position with respect to the joint venture. Majority ownership and control by one parent is more common when the only one of the parent firms shares the industry or country of origin with the joint venture.

V. Summary

The committee views the exposure draft as flawed, primarily due to its lack of an economic description of a business combination. We believe its scope exceptions could be eliminated if the ED defined transactions within its scope as economic, rather than reporting, events. In particular, we note that the ED seems to be written to cover transactions in which one firm acquires control over another, and we suggest that it be drafted to cover only such transactions. We also propose that the ED eliminate the inconsistency between the IASB Framework and the ED's guidance regarding recognition of contingent liabilities in a business combination at fair value. We endorse the ED's disclosure provisions, and believe these will aid investors and analysts in assessing the economic consequences of business combinations.

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