AN ANALYSIS OF THE ACQUISITION AND PURCHASE METHODS

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ABSTRACT

Business Combinations occur when an entity obtains control over another entity. While the main goal of business combinations is to increase profitability, acquiring entities may utilize different strategies to obtain the goal, including through vertical integration, growth in size and negotiation power, risk diversification, and many others.

The history of regulation regarding accounting for business combinations began in 1970 with APB Opinion No. 16, which allowed both the purchase method and the pooling of interests method. Although popular due to its many perceived advantages, the use of the pooling of interests method contributed to inconsistency and a lack of comparability between company financial statements. In 2001, FASB issued SFAS 141, which allowed only the use of the purchase method in which the fair value of net assets recorded was based on cost allocations. In an effort to infuse full fair values into business acquisition accounting, FASB issued SFAS 141(R) and 160 in 2008. SFAS 141(R), which prescribed the exclusive use of the acquisition method, provided greater transparency and a greater understanding of financial statements for users. In addition, the acquisition method improved the representational faithfulness and completeness of financial statements.

We perform a detailed comparison of ten key attributes of the purchase and acquisition methods of accounting for business combinations. The key attributes include the treatment of business combination costs, bargain purchase gains, contingent consideration, other contingencies, and in-process research and development costs. We provide simple numeric illustrations to show how the use of the two methods varies. In addition, we describe the differences in goodwill measurement, step acquisition treatment, supplemental disclosures, the measurement period and noncontrolling/minority interest calculation. Also, an example of a company's post-acquisition financial statement notes using the purchase method is provided.

Based on our research and discussion of some of the pros and cons of the two methods, we conclude that the acquisition method of accounting for business combinations is superior to the purchase method. The use of the acquisition method provides more complete, relevant, and understandable information for financial statement users. Additionally, the application of the fair-value principle represents a convergence with the principles-based accounting prescribed by IFRS. It is believed that the adoption of the acquisition method of accounting for business combinations is just the first of many changes in an effort to bring GAAP in line with IRFS; and we believe that it is a step in the right direction.