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Accounting for Complex Financial Structures

According to a Bureau of National Affairs report, complexity in accounting principles and practices is one of the top challenges of accounting professionals and businesses. The knowledge economy and global marketplace have spawned larger, more diverse, and more complex organizations. Accounting standards and practices have increased in complexity in proportion to the organizations for which they are written. The Financial Accounting Standards Board (FASB) in the United States is the organization that is primarily responsible for writing accounting standards for both public and private companies in the United States. The FASB maintains Generally Accepted Accounting Principles (GAAP) for use by public and private businesses to prepare their financial statements. FASB has been criticized by various stakeholders for adding to the complexity of accounting standards in the United States. The FASB has been working on an internal codification project that will reorganize GAAP into a much more user-friendly and accessible format. The FASB is also working with other American boards and entities to reduce redundancy in the writing and interpretation of accounting principles. The FASB and the Securities and Exchange Commission (SEC) teamed up in 2007 to address the issue of complexity in accounting and financial reporting and are addressing major issues that have been raised by stakeholders in the public and private sectors. International Financial Reporting Standards (IFRS's) are being converged with U.S. GAAP standards to eliminate the need for two different sets of accounting standards in the United States. The topics covered in this article highlight some of the challenges that complex accounting practices are posing to public and private businesses in the United States. This article also highlights a number of steps that are being taken to reduce complexity in accounting for complex organizations.

OVERVIEW

The topic of complexity as related to accounting is like the chicken-or-the-egg scenario. Is complexity related to accounting as the result of the complexity of today's organizational structure, or have the rules just become more complicated in an effort to account for complex organizations? The answer to this question lies somewhere in the middle. Certainly the nature of American corporations has changed rapidly and radically over the years, and accounting rules have struggled to keep up. The following comments were made in 2006 by then SEC commissioner Cynthia Glassman.

> "The economy continues to evolve at a rapid pace, while reporting standards and mechanisms are in a "catch-up" mode. "Advances in technology, including the emergence of the Internet, faster and more ubiquitous communication and other technological developments, have changed the way companies do business, as well as changing the types of financial arrangements and instruments that businesses utilize. As the business world has become more complex, so have financial reports and accounting standards" (Glassman, 2006).

The comments by Commissioner Glassman indicate that accounting rules are being written in response to the changing nature of American and global business.

According to the Bureau of National Affairs' (BNA) *Accounting Policy & Practice Series(tm)*, "The advisory board members—high level corporate accountants from Corning, Microsoft, and Eli Lilly and Co., as well leading academics and advisors —named complexity as a key topic when asked to name top [accounting] issues for 2007" ("Surviving Complexity," 2007). This article focuses on the complexity of today's accounting standards and how organizations

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are responding to the myriad of changes that affect their financial and accounting practices.

The following comments underscore just how big the issue of complexity is for those who must interpret accounting rules in today's economy. The comments were delivered to the FASB and the SEC by a committee from Financial Executives International (FEI).

- Every effort should be made to work with stakeholders "to end the proliferation of detailed rules"; the general consensus from FEI and its subcommittee, the Committee on Corporate Reporting (CCR), is that accountants are struggling to understand and keep up with the deluge of new accounting standards.
- "Over the past ten years, the Board (FASB) has issued a significant number of standards that are among the most complex we have ever encountered. These standards have caused significant difficulties in practice due to one or more of the following: Scopes that are broad and hard to comprehend; complex accounting principles that require extensive supplemental interpretive guidance; and measurement principles that presume a level of valuation capabilities that do not exist uniformly across the preparer community" (Difabio, 2007).

Globalization, the rise of multinational corporations, compliance, government oversight, and mergers and acquisitions have greatly impacted accounting practices at public companies. "Accountants, investment bankers, and clients are structuring financial instruments around the provisions of highly technical, complex accounting pronouncements. The game is based on whether the security falls either inside or outside of the established principle. The predictable recipe resulting from this cookbook is what one observes in Enron, WorldCom, Adelphia, and so on" (McCarthy, 2004).

Currently, regulatory and financial reporting is much more demanding for public companies than for private companies—as are the stakeholders who have the most invested in sound accounting practices and accurate reporting of company financials. Common stakeholders for public and private companies include employees, customers, partners, and boards of directors. Private companies' biggest stakeholders are company owners and banks and institutions that finance the company's growth. Public companies' stakeholders include executive managers, investors, and creditors.

Private Companies

Private companies, while not subject to the same government oversight as public companies, are faced with increasingly complex accounting rules as well. GAAP for public companies are increasingly diverging from the GAAP standards for private companies.

In reference to the proliferation of complex accounting principles, one critic points out that the FASB is rewriting accounting standards to support publicly traded companies, which constitute the minority of businesses in the United States.

> "To whom is FASB pandering when it promulgates these principles? The answer is the international accounting firms, their multinational public clients, and the relative few financial analysts and investment bankers that say they need this kind of information.

> Understand this phenomenon for what it is. The historical record of economic activity in the United States is being replaced with a system tailored to these specific constituencies" (McCarthy, 2004).

Privately held companies still comprise the vast majority of businesses in the United States, and many are convinced the FASB is rewriting accounting standards to support the minority of businesses (public companies).

To fully understand how and why accounting standards are changing so rapidly, one must also look at the changing nature of American business as it moves steadily to a knowledge-based economy. Many of the standard industrial-age accounting practices do not accurately address the changing nature of American and international business. In today's knowledge economy, businesses have fewer tangible, "hard" assets on their balance sheets. More typically, today's corporation derives much of its value from intangible assets such as customer relationships, intellectual property, brand recognition, and other knowledge-based activities.

The sheer number and breadth of current accounting standards contributes to the difficulty and complexity for public and private companies to stay on top of current accounting procedures. "The proliferation of codified accounting principles has, in large part, led to the distress that the profession currently is experiencing. Codified principles issued by the Accounting Principles Board (APB), then by FASB, have led to a 'cookbook' approach to financial reporting" (McCarthy, 2004).

Few investors and other stakeholders would disagree that corporations have become complex entities. Many corporations (U.S.-based and others) have operations in many different countries. Operations continue around the clock in different time zones, and many corporations rely on far-flung but highly integrated supply chains. Investment capital is readily available along with a more diverse set of creditors and investors. The vast changes that globalization and the "flattening" of the world have initiated are reflected in the financial and accounting standards that have attempted to keep pace with these changes.

This article investigates the current topic of reducing financial reporting complexity that is being studied by the SEC, FASB, and the U.S. Treasury Department. Topics include

- SEC efforts to study practices that will reduce complexity in the creation and application of accounting principles.
- increasing numbers of financial restatements.
- what information investors and owners really want on financial statements.

This article concludes with a look at the move toward the adoption of IFRS's, the future role of the FASB, and some of the implications affecting private companies.

APPLICATIONS

The FASB is the specified private-sector organization that determines financial reporting and accounting standards.

Financial statements should be

- credible
- concise
- transparent
- understandable
- responsive to a changing economic environment
- useful to public and others for decision making
- promote, whenever possible, convergence with existing standards

This article investigates different viewpoints regarding just how well stakeholders from public and private companies think the FASB is adhering to its stated core mission and directives.

Public Companies—GAAP

Private companies are largely exempt from many of the prescribed accounting and compliance standards that affect public companies. As accounting standards are revised, many would say with an emphasis on public companies, GAAP standards for public and private companies diverge to a greater extent.

Complexity has become part of the business landscape in the United States when it comes to accounting practices. Officials at the Public Companies Accounting Oversight Board (PCAOB) "acknowledged that, as a result of the enactment of the

Sarbanes-Oxley Act, auditing standards for public companies now differ substantially from those of nonpublic companies. The differences are factual and no longer arguable" (McCarthy, 2004).

Private companies greatly outnumber public companies in the United States. Critics of the FASB contend that the board has largely ignored private companies, as many of the recent standards are slanted toward publicly traded companies. "Private companies have a significant impact on our economy, and the attention given to this sector by our standard setters has been largely nonexistent compared to that given to public companies, which represent only a fraction of the 22 million businesses in the United States" (Kranacher, 2006). As FASB accounting standards and GAAP are written for different constituencies—public and private companies—the volume and complexity of standards increase. Private companies are not subject to the same regulatory reporting and financial transparency as public companies, and as such may be erroneously regarded as having a lower bar for financial reporting and for applying GAAP.

"The intention is not for private-company GAAP to be less significant or less prestigious than public-company GAAP. It would be different, that is all. Auditing standards for public companies are not considered superior to those required for nonpublic companies. Neither should private-company accounting principles be considered less significant than those promulgated for multinational companies" (McCarthy, 2004). The future of the FASB is in question— particularly in regard to its role as a standard setter for public companies. As IFRS standards take the place of GAAP standards for public companies, it has been suggested that the FASB may refocus its attention on setting standards for private companies. It remains to be seen if maintaining GAAP alongside IFRS standards will help to reduce accounting complexity for private companies.

Creation of the SEC & Treasury Board Oversight Committees

Early in 2007, it seemed that Congress was finally ready to address the topic of complexity in accounting. This time, the FEI sounded the warning that complexity in accounting standards is likely compromising American market competitiveness. While concerns about increasing complexity in accounting standards had been a topic for some years, in 2005 the FEI filed comment letters with the FASB expressing concerns about FASB statement 141 (Business Combinations). The FEI stated that the "cumulative consequences of these statements leave accountants struggling to understand what to do." According to the FEI (a perennial watchdog of the FASB), the complexity of FASB statements was increasing company reliance on outside subject matter experts to apply requirements. Fast forward to 2007 and the FEI once again voiced concerns about reducing complexity, while concurrently the FASB was working to finalize standards on business combinations and release new or revised statements such as FIN 48 and statement 133 (DiFabio, 2007). In June of 2007, "Washington responded to the crisis by forming a commission to study the problem" (DiFabio, 2007). The SEC chair at the time, Chris Cox, with support from the FASB and the PCAOB, announced the establishment of SEC's Advisory Committee on Improvements to Financial Reporting (CIFR).

"Cox said the SEC-sponsored group will focus on reducing complexity in U.S. financial reporting, while an effort promoted by U.S. Treasury Secretary Henry Paulson will examine the business of U.S. accounting, now dominated by the Big Four accounting firms. Still, Cox didn't rule out potential overlap between the two studies and said the SEC will coordinate closely with Treasury Department officials on the committee's work" (SEC Unveils Effort To Attack U.S. Accounting Complexity, 2007).

The goals outlined by the SEC-sponsored group included the following goals and objectives addressed in 2007-2008 ("Surviving Complexity," Top 2007):

- creating less complex accounting rules and clear direction for companies applying them
- determining better ways to communicate financial results to sophisticated and ordinary investors
- reducing irrelevant financial reporting
- moving toward convergence with international standards
- pushing toward fair value reporting for financial instruments
- continuing the FASB codification project

While the FASB chair did not dispute that accounting standards are overly complex, he was quick to point out the mission of the FASB in creating current standards. Accounting standards are written to meet business needs through accurate application and creation of financial reports (Glassman, 2006).

- Standards allow companies to present their business and financial conditions based on current knowledge and expectations for the future.
- Standards provide accurate reports of companies' operating results and cash flows.
- Financial statements reflect economic and business reality and help investors formulate investment decisions.
- Statements decrease the probability of distorted business reality and cause capital to be deployed suboptimally.
- Standards allow companies to provide investors with accurate information about the value of investing in a given company.
- Standards provide customers and suppliers with accurate data to make important business decisions.
- Standards inform lenders about the true risk associated with loans.
- Standards provide employees with an accurate picture of employer's financials.

Financial complexity can be as devastating to corporate reputation and confidence as fraud (Glassman, 2006).

Codification

The FASB has its eyes on a convergence of American accounting standards with international standards, but first the United States needs to reign and codify its own disperse accounting regulations. According to Glassman, "Accounting standards and literature flow from a vast array of standard setters, regulators and other sources. The financial reporting landscape is littered with pronouncements from the FASB, the AICPA, the EITF, the APB, the SEC and the PCAOB. We have pronouncements, rules, regulations, guides, bulletins, audit standards, interpretations and practice aids in the form of SOPs, FAQs, SABs, Q&As and FSPs" (Glassman, 2006).

Estimates put the number of separate pronouncements that apply to U.S. GAAP at more than 2,000. According to Glassman, the SEC, like many government agencies, has a "bureaucratic tendency to create ever thicker rule books." The standard setters simply add another layer of complexity with each pronouncement until "the original regulatory goal becomes obscured amid thousands of words of detailed dictates. Some SEC rules, intended to guide market participants in daily decisions, have become a kind of Latin liturgy, comprehensible only to those of us who have devoted our professional lives to abstract regulatory nuances" (Glassman, 2006).

Before the United States can even hope to converge U.S. GAAP and other accounting principles with international standards, a huge amount of work needs to be done with the U.S. codification project. "Codification has been cited as a top issue in 2007 and will serve to move toward the development of a uniform set of accounting standards. The standards will be more objective-oriented and principles-based. The codification project will integrate accounting guidance from the FASB, AICPA, EITF, and SEC into a single, consistently written source" (Iannaconi & Schinas, 2007).

Robert Pozen also took a stab at the myriad of standards that are inundating companies and their financial preparers. The SEC group blames the complexity buildup on the wealth and length of accounting standards from the FASB in the past several years, and on the mounting interpretations of those rules coming from regulators and the accounting firms. "We have too much GAAP running around," Pozen said during the CIFR's first meeting. "We need to figure out what is and isn't GAAP and grab hold of it" (Johnson, 2007).

Financial Restatements

One big concern around complexity in financial and accounting reporting is the increase in financial restatements by companies. A restatement refers to the revision of a company's earlier financial statements. Restatements can result from clerical error, fraud, or misinterpretation of accounting standards. The increasing number of restatements has been seen by the SEC committee as an indication that the financial reporting system is overly complex (SEC Unveils Effort To Attack U.S. Accounting Complexity, 2007).

Robert Pozen, then chair of the CIFR, stated "We need clearer accounting standards." He also suggested that firms are finding it difficult to comply with accounting rules and added that costly and confusing financial restatements could be improved if American accounting rules "were simpler to understand and apply" (SEC Unveils Effort to Attack U.S. Accounting Complexity, 2007).

Value of Financial Statements

Complexity in accounting standards has led to complexity in financial reporting as well. In general, financial statements are not only difficult to prepare, but are also difficult for many holders to understand. The use of press releases by corporate management is thought to be an indication that many users do not want or need the complex level of information that is provided on many financial statements (Iannaconi& Schinas, 2007). The Governmental Accounting Standards Board (GASB) has committed to using plain language in its communications with constituents (Governmental Accounting Standards Board, 2013).

Comments provided by constituents to the FASB are being taken seriously. The end result of all the complexity associated with creating accurate and usable financial statements is having the opposite effect for many end-users. According to Glassman, "Commentators have suggested that our current prescriptive accounting rules have contributed to a lack of transparency in financial reporting, where boilerplate conceals what is really going on" (Glassman, 2006).

Glassman added, "Reducing accounting complexity and migrating to a more principles-based accounting system would encourage more accurate and complete financial disclosure. Therefore, standard setters and regulators should consider how accounting standards and disclosure rules can be re-designed to elicit information that is complete, clear and concise, and thus, more useful to investors" (Glassman, 2006).

The SEC's CIFR group also examines what type of financial information investors and other stakeholders need and want going forward. The CIFR is aware that companies may be more interested in key performance indicators (KPI) and forward-looking information rather than complex financial statements. According to the CIFR, "Financial performance summaries, compressed into a few pages, might be helpful for individual investors, provided firms include links to supplemental details that are useful to analysts and sophisticated investors" (SEC Unveils Effort to Attack U.S. Accounting Complexity, 2007). This information may be more useful than much of the current information that is provided on financial statements (Iannaconi & Schinas, 2007). The CIFR helps make financial statements more useful and relevant to end-users.

CONCLUSION

In the third quarter of 2007, the SEC issued a statement that proposed eliminating the requirement of international companies to reconcile its IRFR-prepared financial statements with GAAP. Some question if U.S.-domiciled businesses (multinationals) should have a similar choice. Critics of this move state that the SEC is pushing too fast for the adoption of IFRS standards. These are related questions:

- What is the future of GAAP?
- How will this move affect the ongoing convergence of GAAP and IFRS standards?
- What will be the role of the FASB going forward if GAAP is eliminated?

There is certainly a suggestion that the FASB will still lose its standing as the official standard setter for the accounting rules that govern American-based public companies. There have been suggestions that the FASB could serve as the new standard setter for private companies and nonprofits in the United States. The FASB could also take on a role in educating companies about the new IFRS standards or serve in an advisory capacity to the board (Is FASB fading away? 2007).

This proposal is a clear signal that there is an international movement to adopt one strong global accounting standard. The major accounting firms have voiced favor for the SEC proposal and concede not only the inevitability of IFRS adoption, but also a speedier time line for adoption. There are numerous concerns about any course of action; some fear that allowing for a dual set of standards (GAAP and IFRS) will slow down the convergence to a global standard. Others feel that the SEC is being hasty in its proposal, as many feel that IFRS standards are not yet ready.

Terms & Concepts

Accounting complexity: Refers to the proliferation of American accounting principles, which have become increasingly bureaucratic, complex, and prolific. In 2007 the SEC established an independent committee to investigate how to address the debilitating issue of accounting complexity for American corporations.

Bureau of National Affairs (BNA): The largest independent information and analysis publisher for tax, law, business, and government professionals.

Business combination: A transaction or other event where one entity takes control of one or more businesses through acquisition. A business combination can occur in a number of situations but usually happens through the purchase of the net assets or equity interests of one or more businesses.

Codification Project: See FASB Codification Project.

Convergence with U.S. GAAP: In 2002 the IASB and the FASB agreed to coordinate their agendas to minimize differences between IFRS and U.S. GAAP (the Norwalk Agreement).

Financial Accounting Standards Board (FASB): The specified private sector organization responsible for determining financial reporting and accounting standards. The FASB is recognized by the SEC as the official setter of accounting standards.

FASB Codification Project: This project organized the thousands of articles in the U.S. GAAP based on accounting topic. All 90 or so topics are presented using a standardized structure (Federal Accounting Standards Board, 2012).

FEI (Financial Executives International): FEI has become the leading advocate for ensuring that corporate financial management voices get heard. Its 15,000 members hold numerous policymaking positions as chief financial officers, treasurers, and controllers. The FEI is a watchdog organization of the FASB.

Financial restatement: Refers to the revision of a company's earlier financial statements. The need for restating financial figures can result from fraudulent practices or the misrepresentation of financial or accounting standards through human error.

Generally Accepted Accounting Principles (GAAP): The standardized structure for financial accounting guidelines. Mainly used in the United States, it includes standards, conventions, and rules followed by accountants while recording and summarizing transactions and preparing financial statements.

Intangible assets: Nonmonetary assets that cannot be physically measured but that are created through time and effort. The two main types of intangibles are legal intangibles—such as trade secrets, copyrights, patents, trademarks, and goodwill—and competitive intangibles—such as knowledge activities, collaboration activities, leverage activities, and structural procedures.

International Financial Reporting Standards (IFRS): Standards and interpretations adopted by the International Accounting Standards Board (IASB).

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Essay by Carolyn Sprague, MLS

Accounting for Mergers and Acquisitions

This article explains the basic principles relating to accounting for mergers and acquisitions. The article provides an overview of mergers and acquisitions, with explanations of the most common types of mergers, merger procedures, and the means by which companies finance a merger or an acquisition. The two most common types of accounting methods for mergers and acquisitions are also described, including the pooling method, which was traditionally used but was phased out in 2001, and the purchase method. In addition, this article also describes the valuation procedures for accounting for mergers and acquisitions, including valuation methodologies using the purchase method, calculating the purchase price, and the required disclosures using the purchase method. Finally, various applications of accounting in business combination activities are described, such as tax considerations in a merger or an acquisition, pension liabilities, and the accretion or dilution of earnings following a merger or an acquisition.

OVERVIEW

Mergers and acquisitions are types of business combinations in which separate entities or operations of entities are merged into one reporting entity. Mergers occur when two or more corporations become one. In a typical merger, the assets and liabilities of one company are transferred to another, and the two companies no longer operate independently. Shareholders of the merging company become shareholders of the resulting company or are entitled to compensation for their shares. Mergers occur for many reasons such as improved market share or ownership of supply or distribution channels. Mergers can be either friendly or unfriendly. Friendly mergers develop with the management of the merging firms approving and supporting the combination. Hostile mergers are known as takeovers, because they are met with resistance and opposition from the merging firm.

An acquisition occurs when one company acquires, or takes control, of another company. This can occur when the acquiring company assumes total control of the target, or the company that has been identified for acquisition, or when the acquiring company purchases the majority of another company's stock or all of its assets. Although acquisitions can be unfriendly, as in a hostile takeover, in a purchase of assets, the acquiring company must still negotiate the asset acquisition with the management of the target. The following sections provide a more in-depth explanation of mergers and acquisitions, and the accounting techniques used in these business combinations.

Understanding Mergers and Acquisitions

Mergers and acquisitions are methods by which corporations legally unify ownership of assets formerly subject to separate controls. Mergers and acquisitions are regulated by federal and state laws that are aimed at monitoring the effects of the elimination of competition in an industry, which increases the potential for the dominant company to raise prices or reduce output. However, mergers and acquisitions often result in a number of social benefits. Mergers can bring better management and technical skills to smaller companies and can streamline production processes resulting in reduced costs, quality improvement, and product diversification. The following sections explain the types of mergers and acquisitions and the procedures and methods companies use to complete and finance the business combination.

Types of Mergers and Acquisitions

Three common forms of mergers are the result of the relationship between the merging parties.

- In a horizontal merger, a company acquires a competitor firm that produces and sells an identical or a similar product in the same geographic area.
- In a vertical merger, a company acquires a customer or supplier.
- Conglomerate mergers include a number of other types of business combinations, regardless of common geographic location or industry affiliation. Conglomerate mergers may arise when a company wants to expand for reasons not directly related to competition in the marketplace, such as when a furniture manufacturer buys an appliance manufacturer or when a sales agency in Ohio buys a sales agency in Florida.

Like mergers, acquisitions can take several forms. In a tender offer, the acquiring company makes a public offer to purchase a majority of shares from the target company's shareholders, thus bypassing the target company's management. In order to induce the shareholders to sell, or "tender," their shares, the acquiring company typically offers a purchase price higher than the market value of the shares, although the acquiring company may require that enough shares must be tendered in order for the acquiring company to gain control of the target company. If the tender offer is successful, the acquiring company may change the management and certain procedures of the target company or the acquiring company may use its newfound control to effect a merger of the two companies. For instance, in a cash-out merger, the target company is merged into the acquiring company, and the shareholders of the target company are given the right to receive cash for their shares.

Procedures for Mergers and Acquisitions

There is no single corporate law in the United States that governs business combinations. Instead, each individual state has its own domestic corporation law. However, companies involved in a merger or an acquisition must generally obtain the approval of the board of directors for certain significant corporate changes. In addition, the shareholders of a target company are typically required to give their approval for a merger or an acquisition.

The approval of the boards of directors of the companies has to include such information as the terms of the merger and the entities that will survive or be acquired in the transaction. Once the required approvals are obtained, a notice is filed by the surviving entity with the Secretary of State within the state where the entity has been formed. Statutes often provide that corporations formed in different states must follow the rules of the respective states for a merger to be effective.

In addition, companies involved in a merger or an acquisition may need to comply with federal securities laws, unless the transaction is exempt from registration under the Securities Act of 1933. For transactions that are not exempt, a registration with the Securities and Exchange Commission (SEC) is required if the transaction includes corporate modifications, reorganizations or transfers of control in a company.

Financing Mergers and Acquisitions

There are several different methods by which companies finance mergers and acquisitions.

- First, payment may be by cash from the acquiring company's reserves or from cash that has been borrowed from a bank or raised by an issue of bonds.
- Companies may also participate in a leveraged buyout, in which most of the debt is financed by selling off some of the target company's divisions or assets while the acquiring company pays only a small percentage of the total purchase price.
- Also, an acquisition can involve a combination of cash and debt, or a combination of cash and stock of the purchasing entity.
- Finally, there are Employee Stock Ownership Plans (ESOPs), which call for a firm to tender its own stock, paying for it by borrowing at a bank and then repaying the loan from the employee stock fund.

Ideally, mergers are implemented to facilitate synergism, whereby the value of the merged firm is greater than the sum of the two separate entities. However, mergers are not always this neat. The combined company after a merger can become too large, which can create management problems. Also, company founders or top performers who have aggressively pursued profits at an individual company may become disenchanted by heavy-handed managerial oversight from an acquiring company. Or, the combined operations of the merged companies may not operate as efficiently and effectively as a smaller, streamlined business.

Methods of Accounting for Mergers and Acquisitions

Mergers and acquisitions are reported and analyzed using unique accounting methods. Historically, there were two accepted methods of accounting for business combinations: the pooling method and the purchase method, sometimes referred to as the purchase acquisition method. However, the pooling method is no longer permitted for new business combinations initiated after June 30, 2001. Although the pooling method has been phased out, it is still an important accounting method to understand, as many business combinations used this accounting method until it was eliminated. The following sections will provide greater details about these two accounting methods.

Pooling Method

Under the *pooling method*, all assets and liabilities were recorded at existing book values while goodwill was not recorded. As a result, the values for the assets and liabilities listed in the accounting records and financial statements of each company involved in a merger or an acquisition were carried forward to the surviving company that remained or was created after the business combination. Under the pooling method, no new assets or liabilities were created by the business combination. Further, the income statement of the surviving company included all of the revenues and expenses of the fiscal year for each company. Ultimately, the operating results for both companies were combined for all periods prior to the closing date, and previously issued financial statements were restated as though the companies had always been combined.

The pooling method was not designed to be used whenever it would produce favorable accounting records. Instead, it was intended to be used only for mergers of two entities of approximately equal value. This method came under increasing scrutiny and disfavor because over time it created disparate financial outcomes in transactions that were otherwise relatively similar, and thus became a tool that could be misused for financial gain. For instance, if an acquiring company paid cash for an acquisition, the accounting records created using the pooling method could appear to reflect that the acquiring company had lower earnings and financial returns compared to companies that paid using debt or a cash and stock combination because an acquiring company paying cash could amortize the additional goodwill on its income statement. In addition, the pooling method was unique to the United States, and this raised concern among the global accounting community that the use of different accounting methods may produce unequal or biased financial statements. As a result, the pooling method was eliminated as an approved accounting method in July of 2001.

Purchase Method

The *purchase method* is now the preferred accounting method used for business combinations. Under the purchase method, the purchase price and costs of the acquisition are allocated to the identified assets that are acquired, whether tangible or intangible, and to any liabilities that are assumed based on the current fair market value of the assets and liabilities. If the purchase price exceeds the fair value of the purchased company's net assets, the excess is recorded as goodwill. Goodwill, or the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed, is almost always present because the purchase price of a target or its assets is almost always higher than the sum of the fair values of all of the assets being purchased. This is because a company is more than just the sum of its assets. It also has intangible qualities such as its reputation in the business community that add to its value beyond the market value of its assets. However, the purchase method does not allow the allocated purchase price for any asset to exceed its fair value. Thus, the excess is recorded as goodwill as a type of catchall category.

In addition, under the purchase method, earnings or losses of the purchased company are included in the acquiring company's financial statements beginning on the closing date of the acquisition. The total liabilities of the combined firms equal the sum of the two firms' individual liabilities. The equity of the acquiring firm is increased by the amount of the purchase price. Short-term or current liabilities have a current fair value equal to their book value. Long-term liabilities may have fair values different from current book value should the face amount of the interest rate not fluctuate with current market conditions.

Attitudes toward the purchase method are not altogether positive. The method was blamed by Gerard Cassidy, a director of equity research, for merger and acquisition activity in the banking industry slowing down considerably following the thrift and banking crises of the late 1980s and early 1990s (Anason, 2012).

Accounting Procedures for Mergers and Acquisitions

Under the purchase method of accounting for mergers and acquisitions, all assets acquired and liabilities assumed are recorded at their current fair market value. This process follows certain valuation procedures.

- First, the process of allocating valuation among the various assets purchased starts with the determination of tangible assets purchased, such as inventory, equipment, or furniture.
- Next, any identifiable intangible assets are classified and valued, such as trademarks, patents, or covenants not to compete.
- Finally, if appropriate, goodwill is recorded and expensed down to its fair value.

In addition to the valuation of a target's assets and liabilities, an appropriate purchase price for the target must also be calculated. This calculation involves determining the minimum and maximum price that an acquiring company should pay for the target. Once this range has been established, the negotiations between the acquiring company and the target get underway. Finally, when the transaction has been completed, certain information must be disclosed in the financial statements of the companies. The following sections will provide further explanation of these valuation procedures.

Valuation Using the Purchase Method

Under the purchase method of accounting, there are specific methodologies for valuing each major balance sheet category, and each of these categories must be assessed and valued in order to properly calculate the assets of the target company. For cash and accounts receivable, these items are reduced for bad debt and returns and are then valued at their values on the books of the target company prior to the acquisition. Marketable securities are valued at their realizable value after any transaction costs. Inventories are broken into finished goods and raw materials. Finished goods are valued at their liquidation value; raw materials inventories at their current replacement cost. Last-in, first-out inventory reserves maintained by the target before the acquisition are eliminated. Property, plant and equipment are valued at fair market value.

In addition, accounts payable and accrued expenses are valued at the levels at which they were recorded in the accounting records of target prior to the acquisition. Pension fund obligations are valued in relation to any excess or deficiency in the value of the fund relative to its obligations, and by calculating the present value of the projected benefit obligations given the present value of pension fund assets. Intangible assets are valued at their appraised values. All other liabilities are recorded at their net present value of future cash payments.

After this process of valuing all of the target's assets and liabilities, the target's net identifiable assets are calculated. This is done after both eliminating the target company's goodwill and valuing all assets and liabilities according to their fair value. Then, any difference between the target's identifiable assets and liabilities is calculated. This difference represents the target company's net identifiable assets. Further, a target's net identifiable assets provide an accurate approximation of the fair value of the target. Any excess of the purchase price paid above that fair value is considered transaction goodwill and recorded as such.

On July 1, 2013, the Financial Accounting Standards Board (FASB) issued two proposed Accounting Standards Updates on the subject of goodwill in private-company accounting. PCC Issue 13-01A, Accounting for Identifiable Intangible Assets in a Business Combination, would allow private companies relief from the requirement to separately recognize certain intangible assets that are acquired in business combinations. In other words, a private company would have the option not to recognize an intangible asset separate from goodwill, unless that asset arises from a non-cancelable contract or other legal right. PCC Issue 13-01B, Accounting for Goodwill Subsequent to a Business Combination, would allow private companies to amortize goodwill and use a simplified goodwill impairment model. Specifically, a company would amortize goodwill using the useful life of the primary asset acquired in the business combination for a timeframe of up to 10 years (Evans, 2013).

Calculating the Purchase Price

In addition to valuing all assets and liabilities, accounting for mergers and acquisitions requires that companies determine an appropriate purchase price for a target firm. In order to make this calculation, acquiring companies generally seek to establish both the minimum price and the maximum price that they might be willing to pay for the target company, and these figures help shape the ensuing negotiations. The minimum price is the actual price of the target company's stock, as quoted in the market, times the number of its shares outstanding. Because a target company's shareholders are unlikely to sell all or most of their shares for no more than they could obtain in the open market, the acquiring company generally has to offer to purchase shares at a premium in order to induce stockholders to part with their shares. However, an acquiring company must be mindful of the market activity that inevitably follows news of a possible merger or an acquisition. As shareholders and investors catch wind of a potential merger or an acquisition, the price of the target share's stock often rises, sometimes significantly.

While this process is important, in many merger cases, the price paid for target companies is higher than is justifiable under objective financial principles because of goodwill or relative bargaining positions of the two companies. If the target company is strong financially and unwilling to settle except for a high premium over the minimum price, its final acceptance will be closer to the maximum price. Thus, the minimum price that an acquiring company can pay for a target will likely be greater than the price of the market value of the number of shares the acquiring company wishes to purchase. However, once the minimum price for a target is determined, it represents the lowest value for the purchase price of the target and furnishes a starting point for negotiations for a merger or an acquisition.

The maximum price of a target company must take into account the total synergistic benefits that may result from the merger while still accounting for any investments an acquiring company must make in order for the merger or an acquisition to yield a profitable outcome. As in the calculations to determine the minimum price for a target company, establishing the maximum price is also an approximation, as some of the factors that must be calculated cannot be determined to any exact figures before the business combination occurs. However difficult they may be to calculate, the minimum and maximum price levels for a target company create bookmarks that represent an appropriate negotiating range for the final acquisition price of the target.

Required Disclosure Under the Purchase Method

Once a merger or an acquisition has occurred, certain financial information must be publicly disclosed in financial statements or their footnotes. For the period in which a purchase occurs, a schedule disclosing the fair values of assets purchased must be included in the financial statement footnotes. Additionally, other key information must also be included within the financial statement footnotes, including the name of the company acquired, the percentage of voting shares acquired and the reasons for the acquisition and the determination of goodwill. In addition, whether and to what extent any research and development costs were acquired and expensed during the period must be revealed. And finally, full disclosure must be given if any portion of the purchase price was not yet determined, along with the reason why such determination had not yet been finalized, and any subsequent allocations must also be disclosed.

During the acquisition period, there must also be footnote disclosure as to the results of operations as if the purchase was made as of the first day of the acquisition period, as well as the operating results for the immediately prior period if comparative financial statements are issued. Finally, footnote disclosure must include revenue, income before extraordinary items and cumulative effect of accounting changes, net income and earnings per share.

Factors Affecting the Purchase Price

Although an acquiring company may determine a minimum and maximum price for the book value of the target company, as described above, the purchase price of a target company can be affected by certain factors such as pre-acquisition contingencies or acquisition-related costs and fees. Pre-acquisition contingencies, in particular, can significantly alter not only a target's purchase price, but the level of interest an acquiring company maintains in pursuing the transaction through to closure. For instance, a contingent liability such as a possible or pending lawsuit could hinder the ability of the companies to complete a merger or an acquisition, and the expense and potential liability of the litigation or a final judgment could impact the financial position of the companies. These factors must be considered and factored into any purchase price calculations. In addition, professional fees associated with the merger or an acquisition process must be factored into the purchase price, including any legal, investment banking, accounting, appraisal and environmental costs. The following sections describe these factors, which can have a significant impact on the purchase price of a target firm, in greater detail.

Pre-acquisition Contingencies

A contingency is an economic event, usually negative, that may occur or is in the process of occurring and, therefore, has not yet been resolved. A pre-acquisition contingency is a contingency of the target that is in existence before the merger or an acquisition is completed. For instance, a pre-acquisition contingency could include pending or threatened litigation, obligations relating to product warranties or product defects and actual or possible assessments to be levied against a company. These assessments could include income tax examinations, assessments by environmental agencies or guarantees of certain debts owed by other affiliated or unaffiliated entities.

The techniques used in accounting for mergers and acquisitions are designed to enable acquiring companies to determine whether a pre-acquisition contingency should be included in the calculation of the purchase price. For instance, according to these accounting principles, if the fair value of the pre-acquisition contingency can be determined during the allocation or valuation period, the pre-acquisition contingency is included in the allocation of purchase price based on the fair value of the contingency. If the fair value of the contingency cannot be determined during the valuation period, the pre-acquisition contingency is included in the calculation of the purchase price only if, before the end of the valuation period, the acquiring company can obtain information to show that a contingent asset or liability existed or an existing asset might be impaired at the close of the merger or acquisition. Thus, in order for a pre-acquisition contingency to be included in the calculation of the purchase price of the target, even if the fair value of the contingency cannot be readily determined during the valuation period, the acquiring company must at least be able to point to one or more future events that will occur to either confirm the contingency or aid in estimating the amount of the contingent asset or liability. Contingencies that arise from the acquisition and that did not exist prior to the acquisition are the buyer's contingencies rather than pre-acquisition contingencies of the target company.

Acquisition-Related Expenses

Expenses, costs, and fees related to the search for and process of merging with or acquiring a target company can be significant, and thus can impact the price that an acquiring company can or will pay for a target firm. For instance, companies that desire to merge with or acquire a competitor, supplier, or some other company must spend the money necessary to search for the proper candidate. Since a merger or an acquisition is very difficult to undo, companies seeking to grow through this process must be very sure that the target company will be the right fit. Once a good target company is identified, the acquiring company must pay the necessary legal fees to ensure that an antitrust violation would not arise from the business combination. Also, the shareholders of the target company may object to the merger and raise legal challenges, which can add to the legal costs associated with the merger or an acquisition. Aside from the legal fees, many companies hire professionals such as investment bankers to facilitate the process of searching for and negotiating with a target company in order to complete a merger or an acquisition. Finally, even if a business combination is consummated with relatively few problems, the acquiring company will face significant administrative costs associated with completing and filing the necessary paperwork and registrations, issuing new shares and registering stock in the name of new stockholders and handling other matters that arise as the transaction is finalized.

APPLICATIONS

Tax Considerations

The gains from an acquisition may result in significant changes to the tax liabilities of companies involved in a merger or acquisition. These changes may stem from gains from enhanced revenues, cost reductions or a lower cost of obtaining operating capital. Increased revenues may come from stronger market power or more effective advertising, supply and distribution channels and product quality. However, a merger or an acquisition may also create tax losses, especially on the part of the target companies. Tax losses are not always a negative factor, though, since any tax losses of target firms may be used to offset the acquiring company's future income, within certain restrictions. For instance, although tax losses can be used to offset income for up to 15 years or until the tax loss is exhausted, only tax losses for the three years preceding the merger or an acquisition can be used to offset future income.

Tax advantages can also arise from an acquisition when a target firm carries an asset on its books with a basis, or the value of the asset that is subject to taxation, below its market value. If these assets could become more valuable if acquired by a corporation that could increase the tax basis of the assets following the acquisition, an acquiring company may depreciate the assets based on the higher market values of the assets after the acquisition, thereby enabling the company to gain additional depreciation tax benefits.

While companies engaged in a merger or an acquisition face the potential for tax gains or losses because of changes in asset ownership, they may also initiate a merger or an acquisition based solely on tax gain or loss considerations. For instance, loss carryforwards, which involve an accounting technique that applies the current year's net operating losses to future years' profits to reduce tax liability, can motivate a business combination in that a company that has earned significant profits may search for a target company facing tax losses, which can then be used to offset the earnings of the acquiring company. Also, firms that have accrued surplus funds may choose to acquire another firm based upon tax considerations. This is because distributing the money as a dividend or using it to repurchase shares will increase income taxes for shareholders, while shareholders pay no income tax when a company acquires another entity.

However, in factoring tax considerations into business combination transactions, companies must be careful to comply with tax laws and regulations. The tax regulations, which often require detailed recordkeeping and complex calculations, can affect the tax gains or losses that acquiring companies ultimately realize. Further, companies may not structure a merger solely for tax purposes. In addition, an acquiring company must continue to operate the pre-acquisition business of a target company in a net loss position for a period of time, and as a result the tax benefits obtained by the acquiring company may be reduced.

Regarding employment taxes in particular, while costs related to such taxes do not drive decisions relating to merger and acquisition transactions, pre-transaction planning, and post-transaction review of the available employment tax opportunities and reporting requirements can result in significant tax savings and help companies avoid penalty and interest assessments for late notifications and filings (Russo, 2011).

Finally, the tax implications of a merger or an acquisition may be felt long after the deal has been completed. If an acquiring company assumed significant levels of debt in the transaction, the interest payments on the debt are a tax-deductible expense while the dividend payments to stockholders for equity ownership are not. This is why some companies view the assumption of debt as a means of financing merger and acquisition transactions as more advantageous than any type of equity financing, such as through the sale of additional shares. However, although the use of financial leverage produces tax benefits, significant levels of debt also raise the possibility of future financial problems if the acquiring firm cannot make the required interest payments on the acquisition debt.

Pension Liability Considerations

When two companies merge, they will have to decide whether to terminate one of the firm's employee benefits plans or whether to incorporate one or both of the plans into another existing plan. In addition, accounting for mergers and acquisitions must take into account any assets or liabilities created by these plans. If the target company sponsors a single-employer defined-benefit pension plan or any other postretirement benefit plan, the acquiring company must recognize a liability or an asset for the unfunded or over-funded portion of the projected benefit obligation that exists on the acquisition date. Similarly, any accumulated postretirement benefit obligation ("APBO") for defined-benefit post-retirement benefit plans assets or liabilities must also be accounted for. If the plans are over-funded, then the acquiring company recognizes a long-term asset, thus reducing transaction goodwill, instead of a long-term liability, which would increase transaction goodwill.

Also, 401(k) plans are a common employee benefit and pose unique challenges to companies interested in a merger or an acquisition. For instance, employers and plan sponsors have certain fiduciary duties to beneficiaries in that they are responsible for overseeing the 401(k) plan. These duties may include selecting the best investment options for the plan or monitoring the plan's performance. If a company is interested in acquiring another company that has not met these fiduciary responsibilities, the acquiring company runs the risk of facing future litigation from participants who have experienced investment losses or other problems with their 401(k) plans. To avoid this, the acquiring firm may choose to have the target firm terminate its plan prior to the merger or an acquisition and resolve any ensuing litigation before proceeding with the business combination. However, terminating employee benefits plans raises several additional issues relating to proper distributions, and thus companies must carefully consider any potential problems stemming from terminating or altering employee benefits plans that could slow or halt the merger or an acquisition process.

Accretion and Dilution of Earnings

After the acquisition date, the projected earnings of both the acquiring company and the target company are reported on a combined basis. Accretions reflect the growth of an asset through an addition or expansion such as a merger or an acquisition. A dilution refers to a reduction in the earnings per share of a company's common stock. Thus, if the projected earnings of the acquiring company and the target company increase on a per-share basis, the transaction has facilitated the accretion, or increase, of earnings. If the projected earnings decrease on a per-share basis, the results are dilutive to earnings in that they reflect a decrease.

Determining the accretion or dilution of earnings from a business combination is a four-step process.

- First, the expected operation structure of the combined company is analyzed and the best approach for projecting the target company's operating results is determined.
- Second, based on the outcome of the first step, either the target company's results are combined with the acquiring company's results for the transaction period and then the combined operating results are projected forward, or the target company's operating results and the acquiring company's operating results are projected separately and then these results are combined and projected into each forecast period.

- The third step is accounting for the effects of the transaction on the earnings of the combined firm. This includes accounting for matters such as synergies stemming from the merger or acquisition, changes in corporate interest and dividends of the acquisition and target companies and amortization of certain other items included in the transaction.
- The final step is that the difference between the acquiring company's own per-share earnings results and the earnings results of the combined entity are analyzed. The results, whether positive or negative, are generally presented as a percentage of accretion or dilution of earnings. Determining the accretion or dilution of earnings as a function of a business combination can help accountants and investors make informed decisions about a particular merger or acquisition or in regard to the merits of a potential business combination.

CONCLUSION

Accounting for mergers and acquisitions under generally accepted accounting principles in the United States relies upon the purchase method. The purchase method records the target company's identifiable assets and liabilities at fair value, and the excess of the purchase price over the net identifiable assets is recorded as an asset called goodwill. Transaction goodwill is positive whenever the purchase price exceeds the fair value of the net identifiable assets. When considering a business combination, companies must consider what form of merger or acquisition best suits their needs. Mergers can take several forms, such as horizontal mergers, vertical mergers and conglomerate mergers. Each type of merger has different attributes and offers different benefits. Acquisitions can also take different forms in that they can be friendly, as in a tender offer, or unfriendly, such as a hostile takeover. When initiating and implementing a merger or an acquisition, companies must follow state laws as well as any relevant federal securities regulations. To finance a merger or an acquisition, companies may pay by cash or a combination of cash and stocks, or they may finance the deal through debt, as in a leveraged buyout. In order to determine the value of the target firm, each major balance sheet category of the target company must be assessed and valued. Then, the purchase price of the target company is calculated, and any pre-acquisition contingencies or acquisition-related expenses factored in. Certain information related to the transaction must also be disclosed in corporate financial statements. Finally, in accounting for mergers and acquisitions, various factors are important considerations, such as the tax gains or losses resulting from the transaction, pension liabilities and the accretion or dilution of earnings following a merger or an acquisition.

Terms & Concepts

Adjusted grossed-up basis: The amount for which the new target is deemed to have purchased all of its assets in the deemed asset sale.

Carryback: Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year.

Carryforward: Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year.

Contra accounts: Offsetting accounts that are normally presented on the face of the financial statements or in footnote disclosures, as in accumulated depreciating offsetting the property, plant, and equipment account.

EBITDA: Earnings before interest, taxes, depreciation and amortization. EBITDA is often used as a proxy for cash flows from operations.

Earnings per share (EPS): The amount of earnings attributable to each share of common stock. EPS is also used to refer to either earnings or loss per share.

Financial accounting standards board (FASB): The designated standards board in the United States for establishing financial accounting and reporting standards.

Generally accepted accounting principles (GAAP): The rules, standards, laws, and common practices that firms must adhere to when preparing financial statements for presentation to auditors or to outside users.

Goodwill: An account that can be found in the assets portion of a company's balance sheet that typically reflects the value of intangible assets such as a strong brand name, good customer relations, good employee relations, and any patents or proprietary technology. Also, in an acquisition, the amount paid for the company over book value usually accounts for the target firm's intangible assets.

Income statement: A financial statement that measures a company's financial performance over a specific accounting period.

Net identifiable assets: A firm's total assets minus its total liabilities minus recorded goodwill.

Net operating loss: The excess of the deductions allowed for by the Internal Revenue Code (IRC) over gross income.

Old target: The target for periods ending on or before the close of the target's acquisition date, or the target while it is still in the hands of the seller as part of the seller's consolidated selling group.

Realize: In accounting terminology, realize is a concept relating to *when* revenues should be recorded in the income statement.

Recognize: In accounting terminology, events or items are recognized by recording them in the financial accounting books, the tax books, or both.

Salvage value: The amount for which an asset can be sold or disposed of at the end of its useful depreciable life.

Target: A firm that has been targeted by another firm for a takeover.

Valuation: The process of determining the current worth of an asset or a company.

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Essay by Heather Newton, J.D.