THE REVISION OF THE ACCOUNTING RULES FOR BUSINESS COMBINATIONS: A CASE STUDY OF THE EFFECTIVENESS OF THE FINANCIAL ACCOUNTING STANDARDS SETTING PROCESS

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INTRODUCTION

In the United States scheme of securities regulation, the Securities and Exchange Commission ("SEC") is vested with the responsibility of setting standards for financial reporting by public corporations.[1] Since 1938, the SEC has delegated the responsibility for setting accounting standards to private-sector entities; currently, the Financial Accounting Standards Board ("FASB")[2] is charged with such authority.[3] In 2001, the FASB undertook to alter the rules of accounting pertaining to business combinations and associated goodwill, an alteration that may have notable impact on the income statements and balance sheets of many corporations. Influential in the process of evaluating revisions to accounting standards rules were arguments relating to the economic consequences of the FASB's initial proposal to eliminate the pooling of interests method and to require the use of the purchase method, as it then existed. One prevalent argument against the FASB proposal was that by eliminating the pooling of interests, the level of merger activity in the economy would be reduced.

This article argues that the accounting rules for business combinations have not discouraged aggregate merger activity and employs an empirical test to evaluate claims to the contrary. The significance of this contention is not limited to the specific accounting convention adopted by the FASB. Rather,

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1. *See* Securities Exchange Act of 1934 § 10A, 15 U.S.C. § 78j (2000).
2. *See infra* notes 7, 12-14 and accompanying text.
3. *See infra* notes 5-7 and accompanying text.

this argument is relevant to the larger question of whether the FASB can competently assess the negative impact such accounting standards may have on the economy.

Part I explains the structure and authority of the FASB and describes the 2001 change in the accounting rules for business combinations and associated goodwill. This section also describes the significance of the accounting rule change as it relates to various fundamental elements of accounting reporting. Part II describes the methodology utilized and results of an empirical test employed to review the level of aggregate merger activity in the U.S. in the context of the elimination of pooling, variations in the business cycle and the stock market. Part III argues that the formal process for setting accounting standards is critically flawed in that interest groups can effectively advance their goals by making economic consequence arguments beyond the FASB's capacity to evaluate.

I.
BACKGROUND

A. *Accounting Standards Regime*

1. *Structure*

Under the Securities Act of 1933 and the Securities Exchange Act of 1934, respectively, publicly traded corporations are required to file registration statements and periodic reports with the SEC.[4] The SEC possesses statutory power to define the accounting standards to which the information contained in these filings must conform. As one federal court has observed, registrants are "required to observe the rules and regulations promulgated by the SEC which govern the form and content of financial statements."[5]

Since being charged with this authority, the SEC has delegated the function of accounting rulemaking to private-sector

4. Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1007-08 (1984) (describing an SEC plan to partially integrate disclosure requirements under the two acts).

5. Arthur Andersen & Co. v. SEC, No. 76 C 2832, 1976 WL 826, at *1 (N.D. Ill., 1976).

entities.[6] The SEC first voted to defer to the accounting profession in 1938 in a process whereby:[7]

> [T]hree of the five commissioners voted . . . to rely on the public accounting profession to lead in developing standards in the private sector while the SEC retained an oversight function and final authority. This set the stage for a long-running drama of self-regulation that still is being played out. The fact that the private sector was granted the privilege of developing standards - a privilege that it valued highly then and still does - by a narrow 3-2 Commission vote took on a keen irony more than a half a century later.[8]

The current private sector accounting standards body with authority over for-profit businesses is the FASB, which was created in 1973.[9] The FASB succeeded the Accounting Principles Board ("APB") of the American Institute of Certified Public Accountants ("AICPA"), which itself succeeded the AICPA's Committee on Accounting Principles.[10] The FASB was viewed as an improvement to the previous organizations because its members served full time (after severing all ties with their former employers) and the organization was independent from the AICPA.[11]

The FASB has seven members, elected and funded by the trustees of the Financial Accounting Foundation ("FAF").[12] The FAF structure also includes a consultative body known as the Financial Accounting Standards Advisory Council ("FASAC").[13] The FASB affords what Tucker describes as "ex-

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6. *See id.* at *3 ("Although the [SEC] has and has had the power to promulgate its own accounting standards, it has elected historically in deference to and in cooperation with the accounting profession not to do so.").

7. Tracy N. Tucker, *It Really Is Just Trying to Help: The History of FASB and its Role in Modern Accounting Practices*, 28 N.C. J. INT'L L. & COM. REG. 1023, 1024 (2002).

8. ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 7 (1994).

9. Tucker, *supra* note 7, at 1026-27.

10. *Id.* at 1025.

11. *See id.*

12. *Id.* at 1026-27. The trustees, unlike the members of FASB are not required to serve full-time or to sever their outside financial connections. *See* VAN RIPER, *supra* note 8, at 15-16.

13. Tucker, *supra* note 7, at 1026.

tensive 'due process' . . . modeled on the Federal Administrative Procedure Act."[14]

The rules adopted by the FASB obtain legal significance from SEC Accounting Statement Release ("ASR") 150, which declares that "principles, standards, and practices promulgated by the FASB in its statements and interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."[15] The Release must be read in the context of ASR 4, issued in 1938, which states: "In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1934 are prepared for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate . . ."[16] Financial statements not prepared in conformance with the rules set by the FASB are considered to violate SEC rules. The SEC's delegation of a significant rulemaking power, with which it is statutorily endowed, to the private sector has been succinctly summarized by one chairman of the FASB.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission. The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For over 60 years the SEC has looked to the private sector for leadership in establishing and improving those standards. Therefore, the FASB may be viewed as an independent private-sector alternative to government regulation.[17]

2. *Goals*

In evaluating the success of this arrangement, it is first necessary to consider the goals of accounting standard setting.

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14. *Id.* at 1027.

15. Accounting Series Release No. 150, 3 SEC Docket (CCH) 275 275 (Dec 20,1973).

16. Accounting Series Release No. 4, 11 Fed. Sec. L. Rep. (CCH) 72,005 (April 25,1938).

17. *Financial Accounting Standards: Hearing Before the Subcomm. on Fin. and Hazardous Materials of the Comm. on Commerce,* 106th Cong. 2 (2000), *available at* www.fasb.org/news/Tstmny54.pdf [hereinafter Testimony of Edmund L. Jenkins] (Testimony of Edmund L. Jenkins, chairman, Financial Accounting Standards Board).

One such goal noted by the Supreme Court pertains to the importance of financial disclosure in the capital markets. As the Court has stated:

> By certifying the public reports that collectively depict a corporation's financial status, the auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to [the] investing public.[18]

Underscoring this point, a federal trial court has stated, "[t]he underlying rationale of ASR 150 is that full and meaningful disclosure of corporate financial information is more likely if financial statements are prepared using consistent and uniform accounting rules."[19] Taken together, these statements suggest that the goal of the accounting standard setting function is to create consistent, uniform rules that allow for efficient capital allocation by market mechanisms in order to maximize social wealth.[20]

This position is consistent with the FASB's own articulation of its purpose. The organization's mission statement begins: "The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of information."[21] Although users of financial information constitute just one of three constituencies noted in the FASB's mission statement,

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18. United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

19. Arthur Andersen & Co. v. Sec. & Exch. Comm'n, No. 76C-2832, 1978 WL 1073, *2 (N.D. Ill. Mar. 1978).

20. This of course assumes that capital markets perform their allocative role efficiently when presented with sufficient information. This assumption was recently articulated by a former member of the FASB: "Capital markets allocate economic resources in this country in an extremely efficient manner. But they can continue to do so only if participants in those markets have available to them credible, reliable and neutral financial information that faithfully portrays the economic effects of transactions." John M. Foster, *The FASB and the Capital Markets*, http://www.fasb.org/articles&reports/a&r_2003.shtml (last visited May, 2006).

21. Financial Accounting Standards Board, *Facts About FASB*, http://www.fasb.org/facts (last visited May, 2006).

the characterization of the benefit to these groups as "guidance and education" supports the claim that the FASB's mission is consistent with the SEC's motive for delegating rulemaking authority. The FASB expressly states that:

> Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.[22]

The mission statement further lists a series of acts that the FASB has undertaken to accomplish this mission, including: "Improv[ing] the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency."[23]

The FASB's mission statement confirms that the purpose of accounting rulemaking is to aid suppliers of capital in comparing investment opportunities. To appreciate the significance of this view it might be helpful to consider a contrary position - that the purpose of financial reporting is merely to compare one company's current performance against its past performance. Under such a position, it would not be necessary to adopt a uniform set of accounting principles. As long as each company were to formulate and disclose its own accounting rules, and faithfully adhere to them, suppliers of capital would need no additional information to evaluate investments.[24]

The adoption of financial accounting standards may serve the further goal of encouraging socially desirable results. Such a goal might be relevant, for example, to the accounting treatment given to energy exploration to encourage national en-

22. *Id.*

23. *Id.*

24. *See* VAN RIPER, *supra* note 8, at 16 (contrasting the "stewardship" approach to financial reporting to the modern view of providing "the new breed of investor" with "information that would be more useful in picking and choosing the most promising among many investment opportunities").

ergy independence,[25] or in designing accounting rules to prop up a failing sector of the financial services industry.[26] The furtherance of such goals has been omitted from the FASB mission statement and, in many cases, would be inconsistent with the goal of comparability and consistency.[27] Moreover, this goal would be conceptually inconsistent with the avowed purpose of the FASB in that it assumes that either: (1) it is normatively acceptable to withhold information from the suppliers of capital, adopting a paternalistic, or centralized, conception of who possesses the competence to make capital allocation decisions[28] or (2) investment decisions can be influenced by altering not the substance of the information but how it is presented to suppliers of capital. Both of these assumptions are at odds with the idea that the markets are semi-strong form efficient[29] and that efficient allocation of capital is the goal of financial disclosure.

The defenders of the FASB, and its mission statement, argue that it is not appropriate for a private sector body to pursue political goals. From this perspective, regardless of the desirability of encouraging socially beneficial investment, such encouragement might be better achieved through fiscal policy rather than manipulation of the information available in financial markets. Van Riper, arguing against the adoption of social policy by the FASB, notes the FASB's institutional lack of competence to make decisions based on social and economic consequences:

> Primary emphasis on economic and social consequences of standards, of course, demands that the process be in the political arena. And that arena calls for a wholly different set of skills than are now at

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25. *See id.* at 55-70 (canvassing the debate over the adoption of a FASB statement on accounting for unsuccessful exploration efforts).

26. *See id.* at 179-82 (arguing that the "savings and loan debacle of the 1980s" is the "reductio ad absurdum of the economic and social consequences argument").

27. Disparate treatment for a favored or disfavored sector of the economy would undermine these goals.

28. This is either because the markets do not act efficiently or because efficiency should not be the goal of capital allocation.

29. In which "prices reflect not only past prices but all other published information." RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 329 (5th ed. 1996).

> work in standard setting. It calls for decision making by panels of politicians or political appointees rather than panels of professional specialists.[30]

Despite the formal disavowal by the FASB of the idea that the social and economic consequences (if any) of accounting rules should be considered, arguments of this nature are routinely made when new standards are proposed.[31] The recent debate over accounting for business combinations was no exception. The FASB's attempt to create a uniform method of accounting for such transactions met sharp resistance from those who argued that such a change would produce real (and negative) economic consequences.

B. *FASB Statements 141 and 142*

In 2001, the FASB issued Statements 141 and 142, culminating decades of debate over accounting for business combinations. Prior to their issuance, many commentators feared that the FASB was on the verge of passing accounting standards that would impede the growth and competitiveness of American business. However, ultimately, the FASB adopted a solution that smacked of political compromise.[32]

In December 1998, the FASB issued a position paper, developed with other standard setting bodies, on the issue of accounting for business combinations, posing a general "Invitation to Comment" on its recommendation that only the purchase method be allowed.[33] Subsequently, in September 1999, the FASB issued an exposure draft proposing to eliminate the pooling method and reduce the permitted period for the amortization of goodwill to twenty years.[34] After extensive criticism, in February 2001, the FASB released a new exposure draft that proposed to eliminate pooling but not to amortize goodwill; rather, goodwill "would be reduced only if it was

30. VAN RIPER, *supra* note 8, at 178.

31. *See supra* notes 25-26.

32. *See* Teresa M. Cortese-Danile & Sylwia Gornik-Tomaszewski, *Setting New Standards for Business Combinations and Intangible Assets*, 23 REV. BUS. 10, 14 (2002) ("The influence of the political process on private sector accounting standard setting was clear in this case.").

33. *Id.* at 11.

34. *Id.* at 11-12.

found to be impaired."[35] On June 29, 2001, the FASB unanimously adopted Statements 141 and 142.[36]

The contemporary debate over how to account for these transactions has its roots in APB Opinion 16, which was issued by the FASB's predecessor organization in 1970.[37] It allowed two methods of accounting for business combinations: the pooling of interests method and the purchase method.[38] The former was available only for "business combinations effected by an exchange of stock and not to those involving primarily cash, or other assets, or liabilities."[39] The APB noted that the difference between the two methods essentially related to the nature of the transaction:

> Those who endorse the pooling of interests method believe that an exchange of stock to effect a business combination is in substance a transaction between the combining stockholder groups and does not involve the corporate entities. The transaction therefore neither requires nor justifies establishing a new basis of accountability for the assets of the combined corporation. Those who endorse the purchase method believe that the transaction is an issue of stock by a corporation for consideration received from those who become stockholders by the transaction. The consideration received is established between independent parties, and the acquiring corporation accounts for the additional assets at their bargained – that is, current – values.[40]

35. *Id.* at 12.

36. *Id.*

37. *APB Opinion No. 16: Business Combinations* 130 JOURNAL OF ACCOUNTANCY 69 (Oct. 1970); *APB Opinion No. 17: Intangible Assets,* 130 JOURNAL OF ACCOUNTANCY 85 (Oct. 1970).

38. *See* APB Opinion No. 16, *supra* note 37, at 74 ("[T]he Board concludes that some business transactions should be accounted for by the purchase method and other combinations should be accounted for by the pooling of interests method.").

39. *Id.* at 71. In addition to restricting its applicability to instances of stock consideration, Op. 16 imposed a long list of requirements to use pooling, which included completion of the transaction within one year and a restriction on recapitalizations in relation to a transaction. *Id.* at ¶ 47.

40. *Id.* at 75.

Functionally, the difference between the two methods available under APB Opinion 16 related to the difference between the consideration given to the shareholders of the acquired corporation and the book value of their shares before the transaction. Under the pooling method, this difference did not appear in the financial statements.[41] Under the purchase method, the difference was recognized as goodwill - an asset.[42] This asset had to be amortized over a period not to exceed forty years. Net income was reduced by the amount of the annual amortization every year. Ultimately, the entire difference between book value and the consideration would be an expense.

APB Opinion 16 was controversial as soon as it was written. In fact, several members of the board dissented and disagreed with the view of business transactions under the pooling method. In addition, one dissent did not support the idea that accounting standards should attempt to shape or accommodate behavior: "Some say that to eliminate pooling will impede mergers. Mergers were prevalent before pooling, and will continue after. Accounting does not exist to aid or discourage mergers, but to account for them fairly."[43] The dissenters concluded their argument by emphasizing that Opinion 16 failed to produce uniformity in financial accounting:

> Elimination of pooling will remove the confusion that comes from the coexistence of pooling and purchase accounting. Above all, the elimination of pooling would remove an aberration in historical-cost accounting that permits an acquisition to be accounted for on the basis of the seller's cost rather than the buyer's cost of the assets obtained in a bargained exchange.[44]

One sign of dissatisfaction with APB Opinion 16 and its companion APB Opinion 17 (accounting for goodwill) is that a project to revise them was on the FASB's agenda as early as

41. Of course, the issuance of new shares by the acquirer would be fully disclosed, and anyone who cared to consider the dilutive effects on the economic interests of existing shareholders was free to do so.

42. *APB Opinion No. 17 supra* note 37, at 85.

43. *APB Opinion No. 16 supra* note 37, at 84 (dissenting opinion).

44. *Id.*

November, 1973.[45] However, after the publication of a discussion memorandum in 1976, no further action was taken for more than two decades.[46] In September 1999, the FASB finally issued an exposure draft proposing to abolish pooling and reduce the allowed amortization period for goodwill from forty years to twenty years.[47]

The chairman of the FASB, Edmund L. Jenkins, laid out the case for elimination of the pooling of interests method when he testified before Congress on the subject.[48] He argued that requiring the purchase method would provide more information to investors (the premium over book value paid) and make financial statements consistent (between different firms and for individual firms that had accounted for different transactions differently).[49] He also argued that the purchase method would promote consistency with international accounting standards: "Part of the Board's mission includes promoting international comparability of financial reporting, and accounting for business combinations is one of the most significant areas of difference in accounting standards. In most parts of the world, the pooling method is either prohibited or used only on an exception basis."[50]

The FASB proposal to eliminate the pooling of interests method was heavily criticized on the grounds that it would pre-

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45. VAN RIPER, *supra* note 8, at 20.

46. *Id.*

47. Robert Tie, *Special Report: The Battle Over Pooling of Interests; Accounting Standards for Mergers and Acquisitions*, 5 J. ACCOUNTANCY 14 (1999).

48. Testimony of Edmund L. Jenkins, *supra* note 17.

49. *Id.*

50. *Id*, at *15. However, critics noted that the elimination of pooling would not perfectly harmonize U.S. GAAP with international accounting for business combinations. *See, e.g.*, Tie, *supra* note 47, at 14 (quoting a Merrill Lynch study stating that "the changes that FASB proposes would still fall short of creating a uniform global standard"). For an overview of European accounting methods for business combinations, *See* Fédération des Experts Comptables Européens, FEE Survey on Business Combinations (Mar. 2002). Note, however, that the world is moving away from pooling; Europe may be following the United States rather than the other way around. In 2002, the International Accounting Standards Board (IASB) announced business combination rules, which mirror those currently in effect in the United States. These rules become mandatory for all public companies in the European Union in 2005. Lucy Smy, *Accountancy Plan Irks UK*, FIN. TIMES, Dec. 4, 2002, at 9.

vent desirable transactions. For example, a Merrill Lynch study alarmingly declared:

> [T]he purchase accounting method itself would prove an obstacle to a merger that both parties are eager to consummate. As a result, the wave of consolidations that has enhanced productivity, encouraged innovation, and stimulated dynamism in the U.S. economy may notably decline.[51]

This argument is premised on the assumption that the stock market punishes companies that employ the purchase method (or that the managers of public companies believe this to be the case). This belief was exemplified by a Lehman Brothers analyst: "Companies that use purchase accounting see their stock price hammered."[52] Presumably, the expected reduction in stock price is a product of the enormous impact that accounting for some business combinations, under the purchase method as opposed to the pooling method under APB Opinions 16 and 17, could have had on the reported earnings of the corporations that engaged in them.[53]

There was a further concern that the elimination of pooling would harm the sectors of the economy that fueled economic growth during the 1990s. Merrill Lynch emphasized the importance of growth in industries typified by corporate entities with low ratios of book value to market value: "[A]ccording to the U.S. Department of Commerce, three knowledge-intensive industries - financial services, information technology and pharmaceuticals - accounted for nearly 30% of

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51. Tie, *supra* note 47, at 14.

52. *Draining the Pool*, THE ECONOMIST, Sept. 11, 1999.

53. In 2003, Alcatel, a French company with American Depository Receipts (ADRs) listed in the United States, reported a loss for 2002 of 4.7 billion euros under French accounting rules, which allowed it to treat two large acquisitions as poolings. When the results were converted to U.S. GAAP for the benefit of the ADR holders, the reported loss widened to 11.5 billion Euros. *Alcatel SA: French Telecom Posts Loss for 2002 of $12.52 Billion*, WALL ST. J., Apr. 3, 2003, at B2. *See also* G4+1 POSITION PAPER: RECOMMENDATIONS FOR ACHIEVING CONVERGENCE ON THE METHODS OF ACCOUNTING FOR BUSINESS COMBINATIONS, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE para. 27 (1998) [hereinafter G4+1] ("The different accounting methods produce differences in accounting outcomes that are quite pronounced in most instances. Because of that, considerable controversies surround the methods to be used to account for business combinations.").

America's GDP (gross domestic product) in 1998."[54] The implication was that the purchase method would produce especially high goodwill - with its associated amortization -for these sectors thereby reducing the willingness of managers to grow the enterprise under their control via business combinations.[55]

Interestingly, even the chairman of the FASB appeared to give some credence to the argument that the availability of pooling had real economic consequences. He testified before Congress that "the ability - or inability - to use the pooling method often affects whether a company enters into a business combination and also affects the prices they negotiate for those transactions."[56] He added:

> Many companies that cannot use the pooling method believe that companies that can use it often are willing to pay higher prices for targets than they would if they had to use the purchase method because they do not have to account for the full cost of the resulting investment.[57]

He also read from a letter from the Financial Institutions Accounting Committee of the Financial Managers Society citing a study that indicated that AT&T paid between $50 million and $500 million to achieve pooling of interests accounting for its acquisition of NCR.[58] Chairman Jenkins concluded by observing that to the extent to which the capital markets failed

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54. Tie, *supra* note 47, at 14.

55. *See* G4+1, *supra* note 53, at para. 61 ("The pressure to use the pooling method is quite strong, with many executives and investment bankers asserting that many deals simply would not get done unless they could be accounted for by the pooling method.").

56. Testimony of Edmund L. Jenkins, *supra* note 17.

57. *Id.*

58. *Id.* at *23-24 (citing T. Lys & L. Vincent, *An Analysis of Value Destruction in AT&T's Acquisition of NCR*, 29 J. FIN. ECON. 353 (1995)). While the AT&T/NCR deal is anecdotal, it is oft-cited as evidence that pooling encouraged uneconomical behavior, and the postscript is worth considering. As the title of Lys and Vincent's article suggests, the efficacy of AT&T as an acquirer is highly questionable. Subsequent events that culminated in the disposition of its cable assets demonstrate that the company appears to have destroyed enormous amounts of shareholder value through acquisitions and to have paid the price for it in the capital markets. *See* Nikhil Deogun & Deborah Solomon, *Cold Call: Comcast Bid Gives AT&T Breakup Plan an Unexpected Push*, WALL ST. J., July 10, 2001, at A1. This suggests that the capital markets will ultimately punish companies that pay for pooling.

to look through the earnings per share distortions of pooling, it resulted in an inefficient allocation of capital that justified eliminating the method.[59]

Other reasons besides the basic capital markets inefficiency hypothesis (or the related hypothesis about managers' belief in that inefficiency) have been offered for why corporations would pay more for pooling. One reason is that the pay of some executives is tied to accounting earnings.[60] Another is that it is cost-effective for money managers - and, via their influence, the markets - to factor a certain amount of accounting manipulation into their assessment of investment opportunities, punishing those enterprises that do not engage in earnings manipulation, including pooling of interests.[61]

The opponents of the proposed elimination of pooling were able to organize political support. Senators Charles E. Schumer (D-NY) and Richard C. Shelby (R-AL) called for Senate hearings.[62] Two congressional hearings were eventually held on the question.[63] Thirteen members of the House of Representatives sponsored H.R. 5365 - "A bill to impose a temporary moratorium on the elimination of the existing 'pooling of interests' method of accounting for business mergers and acquisitions . . . "[64]

The counterarguments were outlined in the dissent to APB Opinion 16.[65] The first is that accounting changes do not result in changes to economic behavior in general or to the desire of businesses to expand through mergers and acquisitions. The second counterargument is that even if they do re-

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59. Testimony of Edmund L. Jenkins, *supra* note 17, at *25.

60. *See, e.g.*, *Draining the Pool*, THE ECONOMIST, Sept. 11, 1999 ("[P]erhaps the real objection to purchase accounting is one that is rarely discussed: executive compensation. Increasingly, American managers are paid on the basis of earnings growth. By depressing corporate earnings, the new FASB recommendation could depress bosses' earnings too."). For empirical support of this proposition, *see* David Aboody et al., *Purchase Versus Pooling in Stock-for-Stock Acquisitions: Why Do Firms Care?* 29 J. ACCT. & ECON. 261, 262 (Sept. 2000). However, where incentive compensation is in the form of stock-options, this argument would collapse back into the capital markets inefficiency hypothesis.

61. *See* Claire A. Hill, 22 DEL. J. CORP. L. 141, 161-63, 180 (1997).

62. Tie, *supra* note 47, at 14.

63. Cortese-Danile & Gornik-Tomaszewski, *supra* note 32, at 12.

64. 146 CONG. REC. H8735 (October 3, 2000).

65. *See supra* text accompanying note 29.

sult in changes, it should not concern the accounting standard makers so long as the standard they choose is the one that achieves optimal "decision usefulness" for the users of financial information.[66]

The first of these arguments was articulated by a former chairman of the FASB: "If the economics are there, ultimately the transaction will get done . . . We typically get 'the sky is falling' arguments - that this will be the end of Western civilization or certainly the finish of capital markets and so forth. Obviously that never happens . . . "[67] This view was shared by Microsoft's senior director of financial reporting and planning who stated that a major acquisition would have gone forward even if pooling of interests were not an available method: "We don't want accounting to drive this stuff any more than it has to. Analysts and readers of financial statements will understand these premium amortizations are not necessarily a part of ongoing operations."[68]

The second argument was present in Jenkins's congressional testimony. In acknowledging that accounting conventions may impact behavior in significant ways, Jenkins argued that the FASB's responsibility was to reduce incentives for uneconomic behavior. This argument exposes a tension in the FASB's normative framework: the policy behind establishing uniform accounting standards assumes that they do matter.[69]

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66. For a discussion of the analytical framework appropriate for the selection of an accounting standard with respect to methods of accounting for business combinations which the FASB was involved in writing, see G4+1, *supra* note 53, at para. 76 ("In assessing the relative decision usefulness of the information produced by the various methods, the Group focused primarily on the qualitative characteristics of relevance, reliability, and comparability. The Group also considered related cost-benefit issues.").

67. Tie, *supra* note 47, at 14.

68. *Id.*

69. Arguably, this could be limited to a recognition of the desirability of uniformity of accounting conventions across companies. However, if this were the case, the choice of accounting conventions would be utterly arbitrary - any uniform set of rules would do, and much time and ink would be saved from the debate over the optimal rules. There would be no need for technical expertise or an independent rulemaking body with an elaborate "due process" system.

The FASB's proponents argue that this tension is resolved by the pursuit of "neutral" rules.[70]

The impasse over reform of APB Opinion 16 and Opinion 17 was resolved when the FASB issued a new exposure draft in February 2001 that changed the proposed accounting for the excess of consideration over book value.[71] The new proposal was adopted by a unanimous FASB vote in June of that year.[72] Under FASB Statement 141, all business combinations initiated after June 30, 2001 are to be accounted for under the purchase method.[73] However, the force of the effect on earnings is strongly mitigated by Statement 142, which represented a significant change from the FASB's earlier proposal to reduce the permitted period of goodwill amortization: "Goodwill shall not be amortized."[74] Instead, goodwill shall be periodically tested for "impairment."[75] GAAP now recognizes that goodwill can have an indefinite economic life, placing it in the same category as raw land.

However, in a further twist, the entire difference between pre-merger book value and the consideration does not necessarily become goodwill. Rather:

> [A]n entity shall allocate the fair value of a reporting unit to all of the assets and liabilities of that unit (including any unrecognized intangible assets) . . . The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill.[76]

Before goodwill is debited, all identifiable assets - including intangible ones - must be written up to fair market value. These assets would then be depreciated (or amortized, in the case of intangible assets) over their useful lives.[77]

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70. *See* Foster, *supra* note 20 (stressing "[t]he importance of preserving the FASB's independence to achieve neutral accounting standards").

71. *See* Cortese-Danile & Gornik-Tomaszewski, *supra* note 32, at 12 (describing the new exposure draft).

72. *Id.*

73. BUS. COMBINATIONS, STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 141 paras 13, 59a. (Fin. Accounting Standards Bd. 2001).

74. GOODWILL & OTHER INTANGIBLE ASSETS, STATEMENT OF FIN. ACCOUNTING NO. 142, para 18 (Fin Accounting Standards Bd. 2001).

75. *Id.*

76. *Id.* at para. 21.

77. *See id.* at paras 11-17.

Roughly speaking, the new rules on accounting for business combinations meant that transactions that would have been accounted for under the purchase method as available under the old rules would result in higher accounting earnings than in the past. Transactions that would have qualified for the pooling of interests method would be expected to result in lower reported earnings than in the past. Both of these generalizations assume that some - but not all - of the difference between the consideration and book value in a given transaction is classified as goodwill.[78] In a world in which accounting conventions affect levels of merger activity, these two effects might be expected to balance out.

Arguably, Statements 141 and 142 fail in two ways to achieve the uniformity that the FASB claimed was one of the reasons for introducing those statements. The first sense in which uniformity is not achieved is in the accounting for assets acquired through corporate acquisition as opposed to the accounting for other assets held by acquirers. Assets so acquired will be marked up to current fair market value from historical cost, while other assets held by an acquirer will not. The G4+1 Group recognized the inconsistency of such a step with normal accounting principles:

> Establishing a new measurement basis is controversial in some jurisdictions because reporting entities generally do not comprehensively revalue or remeasure their assets and liabilities on a regular basis. Although some assets and liabilities . . . are often remeasured, most others are not. Some fixed assets are remeasured in certain jurisdictions, but the rest are rarely, if ever, remeasured.[79]

This problem is most acute when the write-up is of newly recognized assets or assets (e.g. intellectual property) whose capitalized historical cost is a fraction of its economic value:

> Recognizing and measuring additional assets or liabilities is perhaps even more controversial because

78. Also, with respect to transactions that would have been accounted for under the purchase method as it was formerly known, this generalization ignores the possible effects of disparate depreciation schedules for goodwill under APB Op. 17 and the other assets which are written up to fair market value under FASB Statement 142.

79. G4+1, *supra* note 53, at para. 29.

> the assets that are recognized are usually identifiable intangibles that have been internally generated. Since the costs of generating them are usually written off to expense rather than recognized as an asset, recognizing those intangibles as assets in conjunction with a business combination is seen by some as an anomaly.[80]

This leads to the second sense in which the new rules lack uniformity – application across different industries. The new rules will apply radically differently to the financial statements of companies in different industries who engage in mergers. Two industries, in particular, made widespread use of the pooling method: commercial banking and prepackaged software.[81] Commercial banks deal in a commodity that does not lend itself to undervaluation at historical cost - money.[82] While banks may own some real estate or other tangible assets, they do not commonly develop intangible assets. Therefore, most of the excess of consideration to book value in banking mergers can be expected to be assigned to goodwill. In a sense, this means that banking acquisitions can receive the perceived benefits of pooling without meeting the dozen requirements for pooling treatment when it was available.[83] The reverse is true for prepackaged software where an acquirer

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80. *Id.* at para. 30.

81. A query of SDC data, for all acquisitions with an announced deal value greater than $25 million announced by U.S. acquirers from January 1, 1998 to December 31, 2000 that were accounted for as poolings, produced 810 results. Transactions in which the target's industry sector was classified as "Commercial Banks, Bank Holding Companies" accounted for 211 of those 810 results, or 26%; transactions in which the target's industry sector was "Prepackaged Software" accounted for 93 results, or 11%. Where the acquisition was not purely horizontal, the relevance of these numbers is contingent on the idea that the importance of the accounting treatment is a factor of the nature of the target's assets.

82. *See* Andrew Bary, *The Waiting Game: Unable to Find Bargains, Warren Buffet Is Making a Pitch for Patience*, BARRON'S 20 (Oct. 27 2003), ("Looking at the banking industry, Berkshire says it's 'amazing' that so many companies continue to earn returns on tangible equity of 20% or more, given that they all deal in a commodity - money.").

83. For a narrative of the banking industry's ferocious lobbying efforts against current value accounting, see VAN RIPER, *supra* note 8, at 39-43; *see also id.* at 135-44 (describing Citicorp CEO John Reed's efforts on behalf of the Business Roundtable to limit the FASB's ability to make accounting rules).

may be paying entirely for the target's intellectual property. Therefore, an investor, comparing the financial statements of companies in these two industries that have grown through acquisitions, would not be looking at highly comparable data.

The question of how the new rules would affect the M&A industry was the subject of much discussion. There remained the possibility that the elimination of pooling would reduce the willingness of acquirers to pursue deals, particularly in industries whose main assets consist of intellectual property. On the other hand, some dealmakers argued that the new rules allowed for greater flexibility, which would in turn spur creativity and a higher level of merger activity. A partner in M&A services at Deloitte & Touche said, "A lot of transactions that couldn't get done because of restrictions under the pooling rules can now get done because the buyer gains more flexibility."[84] Still another possibility would be that an accounting convention that mainly changed the presentation of information would not affect economic behavior.[85] One variation on this argument would be that the disclosure of additional information - the current value of identifiable assets - should not be expected to reduce mergers that make economic sense. To the extent that mergers are efficient transactions, they would not be impacted.

It is apparent that in the years following the elimination of pooling, merger activity in the United States declined dramatically from the levels of the late 1990s.[86] It is also clear that the levels of business activity and stock market valuations - two variables that are known to affect the level of merger activity[87] - were reduced over the same period. This raises the question

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84. Martin Sikora, *M&A Dealmakers Applaud the Elimination of Pooling: Less Restrictive Rules Free Heavy Acquirers to be More Nimble, Flexible, and Competitive*, MERGERS & ACQUISITIONS J. 1, 12 (July 1, 2001).

85. *See supra* notes 65-66 and accompanying text.

86. *See* Judy Radler Cohen, *No More High Times? M&A's Record $3.5 Trillion Likely Won't be Repeated This Year*, INVESTMENT DEALERS DIG. (Jan. 15, 2001) (predicting downturn in M&A activity in 2001); Juliana Ratner & Peter Thal Larsen, *Survey - International Mergers & Acquisitions*, FIN. TIMES, Sept. 13, 2001 (quoting Jack Levy, global chairman of M&A at Goldman Sachs: "From a global perspective, the M&A market continues to be slow."); Fay Hansen, *Global Mergers and Acquisitions Sputter*, 6 BUS. CREDIT 60 (June 1 2003) (quantifying reduction of merger activity from 2000 to 2003).

87. *See* Sean Becketti, *Corporate Mergers and the Business Cycle*, 71 ECON. REV.: FED. RESERVE BANK OF KAN. CITY 13 (1986); John A. Polonchek &

of whether the decline has been caused by the accounting rules or changes in economic conditions and the cost of capital.

II. EMPIRICAL STUDY

A. *Methodology*

1. *Statistical Methodology*

This study used regression analysis to test the hypothesis that the elimination of pooling of interests has affected the aggregate level of merger activity in the United States by looking at the number and volume of merger transactions announced from the first quarter of 1990 to the fourth quarter of 2004. The technique was to compare the statistical relationship of the level of merger activity with: (1) the availability of pooling; (2) the economic cycle; and (3) the stock market value. The goal was not to develop a comprehensive model capable of accounting for merger activity over a very long period.[88] Rather, it was to test the hypothesis that the decline in merger activity was attributable to the elimination of pooling rather than a downturn in the business cycle and an increase in the cost of capital for publicly held companies - two variables with which merger activity has a well-established connection.[89] Moreover, limiting the regression to three variables allows for a better focus on the explanatory contribution of each.[90] The study analyzed four sets of data: (1) aggregate dollar volume of merger activity for the United States; (2) dollar volume of those transactions with a value under \$100,000,000; (3) dollar volume of those transactions with a value over \$100,000,000; and (4) number of deals announced.

Marie E. Sushka, *The Impact of Financial and Economic Conditions on Aggregate Merger Activity*, 8 MANAGERIAL AND DECISION ECON. 113 (1987).

88. For an example of such a study *see, e.g.*, Polonchek & Sushka, *supra* note 87, at 116 (using eleven variables to derive an equation that predicts 82% of the variation in merger activity over the period 1956-1978).

89. *See id.*; Becketti, *supra* note 87.

90. *See* N.M DOWNIE & ROBERT W. HEATH, BASIC STATISTICAL METHODS 88-89 (5th ed. Harper & Row Publishers 1983) (1959) ("After the addition of a fourth or fifth variable, the increase in the efficiency of the prediction equation declines rapidly, and after that only slight gains in predictive ability occur.").

B. *Data*

The first step was to consider the aggregate level of merger activity for the United States alone. This was based on the number of announced transactions with a disclosed transaction value of over $25 million in which the acquirers were all publicly owned U.S. corporations.[91] The best-fit regression line was derived using the all-industry capacity utilization rate, the S&P 500 price index and the availability of pooling.[92]

The aggregate utilization rate was used as a proxy for the business cycle. Assuming that (1) corporations tend to invest in growth when the business cycle is in an expansionary phase and when their existing capacity is strained, and (2) that businesses often view the decision to grow through merger as an alternative to direct investment in assets, the correlation between capacity utilization and merger activity should be positive.

The S&P 500 was selected for the study because it is a broad-based and widely accepted index of the price level of U.S. equities.[93] The value at the beginning of each quarter was used to avoid any feedback effect of merger activity on equity valuations. It is an adequate source of information about the cost of capital because inflation over the period in question was quite low by historical standards.

There are two possibilities for the effect of the stock market on the level of merger activity in a given period. First, several factors suggest that the level of the S&P 500 should be

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91. The study was limited to public corporations on the assumption that their behavior would be more susceptible to accounting conventions than private corporations which are not subject to reporting requirements. $25 million was selected as a critical mass at which decisions to merge would be important investment decisions for acquirers. Polonchek & Sushka used mergers of firms with assets over $10 million. Polonchek & Sushka, *supra* note 87, at 116. *The Bureau of Labor Statistics' Inflation Calculator* at http://www.bls.gov/cpi/home.htm converts $1 in 1978 dollars to $2.50 in 1998 dollars. Multiplying $10 million by this factor yields $25 million.

92. Linear regression analysis derives an equation that predicts a given variable based on one or more other variables. The best-fit line, or its equation, is the one that minimizes the sum of the squares of the differences between each actual and predicted value. *See* DOWNIE & HEATH, *supra* note 90, at 75-89.

93. *See* Polonchek & Sushka, *supra* note 87, at 114 ("[M]erger research has focused on the level of a broad index of stock prices, typically the S&P 500.").

positively correlated with the level of merger activity. An increase in the price level of the stock market implies a decrease in the cost of capital; at the margin, more investment projects would acquire positive net present values.[94] This also raises the value of the currency used for many acquisitions - corporate stock - thereby increasing the buying power of public corporations. Finally, as a pro-cyclical economic indicator, the stock market may contain information about the overall economic climate that is independent of the cost of capital.[95]

Second, one important factor suggests that the value of the S&P 500 should be negatively correlated with the level of merger activity: a decline in the equity markets indicates that corporate assets have become cheaper.[96] As managers of acquirers perceive investment in expansion to be more affordable, they can be expected to pursue more expansion opportunities. These two possible effects are not mutually exclusive. Both could be operating simultaneously, and either might be stronger over a given period in a given market. But, the S&P 500 should be expected to have an effect.

The third input variable in the multiple regression[97] was the availability of pooling. If the elimination of the pooling method has seriously affected merger activity, the t-statistic[98]

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94. *See id.* ("High stock prices reduce the firm's estimate of its cost of capital, raising the net present value of the future economic benefits available from a merger . . .").

95. *See id.* (citing E.F. Fama, *Stock Returns, Real Activity, Inflation and Money*, 7 AM. ECON. REV. 545 (1981) & R. Geske & R. Roll, *The Fiscal and Monetary Linkage Between Stock Prices and Inflation*, 38 J. FIN. 1 (1983) for the proposition that "current stock returns are statistically significant predictors of the future rate of change in economic activity and corporate earnings").

96. *See id.* ("[A] low level of [the ratio of the market value of equities to the replacement value of the real capital stock] implies that firms can acquire additional productive capacity more cheaply by buying an existing firm rather than purchasing the relevant capital goods directly and constructing the capacity itself . . .").

97. Defined as a regression analysis to predict an output variable with more than one input variable. *See* DOWNIE & HEATH, *supra* note 90, at 88-89.

98. T-statistic defined as a measure of the statistical significance of a relationship. A t-statistic with an absolute value of two means that the results did not occur by chance with a 95% probability, which is generally considered to be statistically significant. *See* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 196-97 (2d ed. 1995); JOHN E. HUNTER & FRANK L. SCHMIDT, METHODS OF META-ANALYSIS: CORRECTING ERROR AND BIAS IN RESEARCH FINDINGS 354 (1990).

for the availability of pooling should be statistically significant after the inclusion of the first two variables control for the business cycle and other factors discussed above. The former accounting regime, under which pooling was available, is represented by a 1 value, and the current regime is represented by a 0. The coefficient for the availability of pooling should be positive under the variant of the hypothesis that holds that its elimination has affected merger activity by reducing the number of transactions that are announced, and negative under the variant that holds that its elimination has facilitated additional transactions. Alternatively, if the fact that the purchase method under the new rules does not require mandatory amortization of goodwill has increased merger activity, the coefficient would be negative.

Each additional regression analysis was run with the same input values as those for the total dollar volume data. The discussion of the expected correlation of each input variable with the relevant sample of announced mergers would not change for any of the subsequent steps of this study.

The second set of data analyzed was the number of deals announced. The purpose of this analysis was to look for indications as to whether the change in accounting rules affected different size transactions differently. Since the analysis (discussed below) suggested that smaller transactions were affected differently than large transactions, the study proceeded to analyze the dollar volume of differently sized deals. The next set of data analyzed was the subset of deals with a transaction value under $100,000,000. The final data set was those deals with a transaction value over $100,000,000.

C. *Results*

Table 1 is a key to the variables used in the formulas derived from regression analyses in this section.[99] For all formulas, t-statistics are in parenthesis below the variable. For the dollar volume analyses, standard deviations, coefficients and y-intercepts are expressed in billions of dollars.

99. Standard error of estimate "is the standard deviation of the errors of prediction and provides an indication of their variability about the regression line in the population in which predictions are being made." DOWNIE & HEATH, *supra* note 90, at 84. The errors of prediction are the differences in actual and predicted values. *Id.* at 83.

TABLE 1

MergerV	=	Dollar Value of Mergers Announced per Quarter for the Relevant Data Set
MergerN	=	Number of Mergers Announced per Quarter for the Relevant Data Set
S&P=		Level of the S&P 500 Price Index
Capacity	=	Industrial Capacity Utilization Rate
Pool	=	Availability of the pooling of interests method (value = 1 before Q3 2001, 0 thereafter)
SE	=	Standard Error of Estimate
R^2	=	Coefficient of Determination

1. *Total Dollar Volume Analysis*

The regression analysis of the total dollar volume data yielded the equation in table 2. The relationships with both capacity utilization and the S&P are both statistically significant.

TABLE 2

MergerV	=	12.996 Capacity +	0.294 S&P +	33.294 Pool +	-1183.534
		(2.39)	(11.97)	(0.86)	(-2.87)
		SE = 65.23		R^2 = .74	

The correlation with capacity utilization is positive, as expected. It appears that the stock market level had a positively correlated relationship with the level of general merger activity in the United States over the test period. Overall, the above equation accounts for 74% of the variation in the data. The correlation between the accounting change and the total dollar volume of merger activity, while positive, is not statistically significant. This suggests that the decline in merger activity following the new merger accounting regime is coincidental with, rather than the result of, the rule change.

2. *Deal Volume Analysis*

The regression analysis of the deal volume data yielded the equation in table 3. As in the total dollar volume analysis, the relationships between the deal volume and both capacity utilization and the level of the stock market are both positive and statistically significant. However, the correlation with the availability of pooling was negative and, while not statistically significant at the 95% level, strong enough to warrant further analysis. The difference between both the sign and the statistical significance of the correlation with the accounting rule change suggested that the rule change may have had an effect on smaller deals – specifically, it may have caused more – not less – such deals to be initiated. Therefore, I ran the same regression analysis for the dollar volume of the subsets of deals with transaction values under $100,000,000 and over $100,000,000.

TABLE 3

MergerN	=	31.797 Capacity +	0.288 S&P +	-69.816 Pool +	-2488.069
		(6.27)	(12.59)	(-1.92)	(-6.46)
		SE = 60.82		R^2 = .80	

3. *Under $100,000,000 Transaction Value Dollar Volume Analysis*

The regression analysis of the dollar volume data for deals with a transaction value under $100,000,000 yielded the equation in Table 4. Again, the relationships with both industrial capacity utilization and the price level of the stock market are positive and statistically significant. The correlation with the availability of pooling is negative, as in Table 3, but here, it is statistically significant. This is evidence that the change in accounting rules actually encouraged mergers with a transaction value under $100,000,000.

TABLE 4

MergerV	=	0.936 Capacity +	0.006 S&P +	-2.526 Pool +	-71.722
		(5.77)	(8.86)	(-2.18)	(-5.82)
		SE = 1.95		R^2 = .69	

The apparent reason for this result relates to the new purchase method. Since it is now possible to achieve non-amortization of goodwill without satisfying the prior, onerous requirements of pooling of interests treatment, the transaction costs associated with deals that achieve this accounting result are lower. Since there is a typical inverse relationship between deal size and transaction costs as a percentage of transaction value, these transaction costs could be expected to be a higher percentage of the value of smaller deals. Therefore, for potential acquirers who care about the accounting treatment of goodwill, these transaction costs would have prevented some smaller acquisitions. With the new accounting regime, smaller acquisitions have become more feasible.

4. *Over $100,000,000 Transaction Value Dollar Volume Analysis*

The regression analysis of the dollar volume data for deals with a transaction value over $100,000,000 yielded the equation in Table 5. Again, the correlation for both the stock market level and industrial capacity utilization was positive and statistically significant. The correlation with the availability of pooling was positive and not statistically significant. This is consistent with the hypothesis advanced above to explain the results in the preceding section – that the change in merger accounting rules led to increased merger activity with deals at the smaller end of the spectrum.

TABLE 5

MergerV	=	12.090 Capacity +	0.287 S&P +	35.627 Pool +	-1,114.051
		(2.24)	(11.83)	(0.92)	(-2.72)
		SE = 64.60		R^2 = .73	

III.
CONCLUSION

In attempting to reform the accounting standards for business combinations, the FASB put forward a proposal based on what its members and staff believed to be optimal accounting rules. After receiving complaints that the proposed rules would harm the American economy, the FASB changed its proposal to make it amenable to its initial critics. This suggests that the FASB at least took the warnings seriously enough to err on the side of caution. The members of the FASB were either convinced by the claims or were not confident in their own expectations of the impact of changes to accounting standards on merger activity.

The empirical study presented in this article provides evidence that FASB Statements 141 and 142 have not had a significant impact on US aggregate merger activity. This is a surprising result given the large amount of anecdotal evidence that suggests that a significant number of managers of public corporations attach a large, positive value to accounting for acquisitions in a manner that does not result in the amortization of goodwill. This result suggests that the new method for accounting for goodwill under the now-mandatory purchase method treatment allows these managers to achieve their desired results. Under Statement 142, goodwill is no longer amortized.[100]

Moreover, for smaller deals that are a relatively minor fraction of the merger activity, as measured by dollar volume, the new accounting regime appears to have had the effect of encouraging transactions. This suggests that the opponents of the FASB's initial proposal obtained an improvement compared with the prior situation. The new regime reduces the costs of transactions that result in non-amortization of goodwill. Achieving this accounting result - rather than any metaphysical accuracy of pooling treatment - was the concern of those who initially supported pooling. Therefore, the FASB appears to be highly susceptible to lobbying efforts by sufficiently motivated sections of the business community.

This suggests that the accounting standards setting regime is failing to accomplish its goals. While the FASB was able to achieve uniformity in merger accounting, it did so at the price of neutrality. The imperative to create neutral rules of financial disclosure that facilitate the efficient allocation of capital does not appear to be the only driving force in the process of standard setting. Rather, the process appears to be susceptible to interest groups who seek to shape accounting rules by issuing dire warnings about their economic consequences.

Rather than facilitating objectivity in shaping financial accounting rules, the current system appears to facilitate successful lobbying. The much vaunted independence of the FASB seems to mean little more than independence from government control. As a private body, the FASB lacks the expertise and authority to make decisions that may have real economic consequences for the United States.[101] However, the rule making process appears to require these competencies in addi-

100. While it is true that Statement 142 does call for periodic tests of impairment, presumably managers are optimistic about the acquisitions they pursue and rarely initiate transactions that they expect to result in later impairment.

101. *See supra* note 30 and accompanying text.

tion to accounting expertise. This situation calls for increased government involvement.[102] While such involvement could take several forms, it is clear that the SEC has the mandate to ensure that the accounting standards governing financial disclosure by public corporations are made with the foremost goal of facilitating efficient capital allocation. Economic consequences lobbying is the Achilles' heel of the accounting standards setting process. It is possible to lobby successfully against an accounting standard without making a showing that the opposed standard fails to fulfill the avowed goals of the accounting standards setting process. Until the SEC eliminates this defect from the process it will have failed to fulfill its responsibility.

102. A separate body of public sector rules designed for private companies would have the added benefit of separating the rules for private and public companies. Consider FASB Statement 150, which requires the disclosure of certain liabilities on the balance sheet. It appears to be a response to the Enron scandal. However, it also may have a secondary effect on private corporations whose lending agreements with financial institutions include covenants that impose restrictions on allowed liabilities as measured by GAAP. If the FASB rule change puts the corporation in violation of the covenant, the FASB has essentially endowed the lending institution - a sophisticated party - with an unbargained for option to terminate the lending agreement. For a general discussion of this problem, *see* VAN RIPER, *supra* note 8, at 93-94.