154 103

United States General Accounting Office

GAO

Briefing Report to the Honorable Richard T. Schulze, House of Representatives

December 1987

FOREIGN INVESTMENT

Country Differences in Accounting for Takeover Costs

134703

040903

GAO/NSIAD-88-56BR

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-197843

December 28, 1987

The Honorable Richard T. Schulze
Ranking Minority Member
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Schulze:

Your June 2, 1987, letter requested us to review the ability of foreign firms to gain competitive advantages over U.S. firms in bidding to acquire U.S. firms as a result of national differences in practices for accounting for acquisition costs. We also agreed with your office to provide data related to foreign direct investment in the United States.

You specifically asked us to review differences in national practices with respect to accounting for "goodwill"—that is, for the amount of payment made in excess of the fair value of the acquired company's actual assets. Therefore, we compared how selected countries account for goodwill. We found that (1) Canada and Japan use the same method as the United States does, requiring goodwill costs to be capitalized as an asset and amortized against future income, (2) the United Kingdom and West Germany allow firms to choose between capitalizing and amortizing goodwill or writing it off against shareholder equity, which avoids the dilution of future earnings, and (3) international accounting standards allow either type of accounting treatment.

In theory, because British and West German accounting methods allow firms to avoid declines in future earnings, these firms may be willing to outbid U.S. firms in acquiring other U.S. firms. In addition, Canadian, Japanese, and West German companies benefit from improved after-tax cash flow by being able to deduct costs of goodwill from taxable income. This is not permitted in the United States or the United Kingdom. Details on accounting for goodwill and its tax deductibility are contained in appendix I.

With regard to the amount of foreign direct investment and merger activity in the United States, there have been significant absolute increases during the 1980s. However, because U.S. domestic investment and merger activity have also grown dramatically, the relative proportion of foreign activity has remained fairly stable.

Reasons for the absolute increase in foreign direct investment in the United States include (1) the growing U.S. trade deficit, which has sharply increased foreign holdings of U.S. dollars, (2) a decline in the value of the dollar compared to certain European currencies and the Japanese yen, (3) the U.S. economy's stronger growth performance compared with almost all of the other major industrialized countries, and (4) the fear of U.S. protectionist measures. More detail on foreign direct investment is contained in appendix II.

In reviewing the accounting standards for Canada, Japan, the United Kingdom, the United States, and West Germany, as well as those established by the International Accounting Standards Committee of the International Federation of Accountants, we examined various articles, papers, and books related to the subject. We also contacted officials in several major U.S. accounting firms and the American Institute of Certified Public Accountants for information, as well as representatives from the U.S. company which brought this matter to your attention.

Our review focused on differences in accounting for goodwill as a source of possible disadvantage for U.S. firms vis-a-vis foreign firms in acquiring U.S. companies. We did not examine the major differences among countries in how tax systems treat investment and how banking systems finance acquisitions. Such differences also may result in unequal conditions for U.S. firms bidding against foreign firms.

As agreed with your office, we are distributing this briefing report to other congressional offices and to appropriate executive agencies and will also make it available to others upon request. If you have any questions, please contact me on (202) 275-4812.

Sincerely yours,

Allan I. Mendelowitz

Allan I. Mendelowitz
Senior Associate Director

Contents

Comparison of Selected Countries' Practices in Accounting for Goodwill

Over the past few years mergers and acquisitions[1] have been increasing in the American business world. Proponents of such combinations believe they are an efficient method of gaining needed assets or resources and improved market positions, realizing economies of scale, and improving efficiency. In making such acquisitions, companies often have to bid against other companies, with the target company going to the highest bidder.

Some American companies have complained that they suffer a disadvantage when bidding against a foreign company for purchase of a U.S. firm. The reasons given are several, but the one we were asked to examine stems from differences in how countries account for goodwill—that is, the amount of payment made in excess of the fair value of the acquired company's individual assets. This is commonly called "purchased goodwill" and is, in effect, a payment made to gain a potential for rising future earning capacity.

In the United States, the cost of goodwill is capitalized as an asset and amortized[2] against future income over a period not exceeding 40 years; by this method, future income is decreased by the amount of goodwill to be written off each year. Because earnings are an important measure of how well a business is performing and are watched closely by investors and creditors, management must weigh the impact of goodwill on future earnings when making their bids in order to have an acceptable rate of return for their investors.

Depending upon the accounting requirements in each particular country, foreign companies may be able to write off the cost of goodwill directly to shareholder equity or to capitalize it as an asset either with or without amortization against future income. Therefore, some foreign firms may have an advantage over U.S. companies at least when considering future earnings as a measurement of investment or credit potential. The result may be that foreign firms may be willing to outbid U.S. firms in acquiring other U.S. firms.

[1] Mergers combine participating companies into a single company, whose assets and liabilities are transferred to the company that survives. An acquisition differs from a merger in that the acquiring company receives only those assets being sold; the selling company remains in existence.

[2] Amortization involves the gradual extinguishing of an account by periodic payments. In this case, future income would be reduced by such periodic payments.

Methods of Accounting for Goodwill

Goodwill accounting has been debated for many years and continues to be a controversial issue. Various ways of viewing goodwill have led to the following possible accounting treatments.

1. Capitalization as an asset without amortization unless a reduction in value becomes apparent.

2. Capitalization as an asset with amortization as an operating expense over some period of time.

3. Deduction of the cost from stockholders' equity at the date of acquisition.

4. Maintenance of the cost as a separate, identifiable deduction within stockholders' equity until a reduction in value becomes apparent.

Each alternative has its proponents, and their supporting arguments are discussed below.

Asset Without Amortization

Under this accounting method, goodwill is set up as an asset on the balance sheet and remains there indefinitely. Supporters of this method believe that since an expenditure has been made for goodwill, the acquiring enterprise has received something which will be of continuing value. Therefore, like various other assets, it should be capitalized. They contend, however, that the value of goodwill is not consumed or used up in the production of earnings as are most other assets and therefore it should not be amortized. Goodwill is viewed as having an indefinite life, and any periods of amortization are criticized as requiring an estimate of life that is not measurable and is therefore arbitrary. Goodwill would be written off only if the decline in its value became reasonably evident. Such a decline would generally be difficult to establish and a write-off would seldom occur. As a result, the purchase of goodwill would not have a direct adverse effect on the earnings of future periods.

Proponents of this method also argue that if goodwill is not recognized as an asset, it would not be possible for an investor to use the financial statements to calculate a true rate of return on investment. They view the rate of return as a valuable measurement of managerial performance. If the goodwill is not included in the investment base, then the rate of return could be misleading. They also believe that goodwill amortization would distort the true rate of return of every period since return would be affected by an arbitrary cost in the absence of evidence that the value of the goodwill has declined.

Asset With Amortization

Proponents of this method also view goodwill as an asset because it has value to the continuing enterprise and a consideration has been given for that value. They believe, however, that goodwill is a cost incurred in expectation of future earnings and must be systematically amortized to income of future periods to most accurately match costs against revenues. Goodwill is seen as similar to other assets that are consumed or used up in the production of future income. The fact that it is difficult to estimate when the goodwill will finally be exhausted is not as important as the fact that it is eventually consumed. Goodwill must therefore be amortized to income over some period of time even if the period must be arbitrarily established. Supporters believe that non-amortization of goodwill overstates the earnings of the enterprise since future income statements would fail to include all costs incurred to generate that income.

The effect of this accounting method is a periodic decrease in the asset value of the goodwill and a corresponding reduction in earnings. The amount of decrease in each for any future period is determined by the estimated life of the goodwill.

Deduction From Stockholders' Equity at Acquisition

Supporters of this accounting method believe that goodwill is not an asset and should not be treated as one by the accounting process. They argue that goodwill is intrinsically different from all other assets by virtue of its nature and characteristics and therefore should be accorded special treatment. These differences in characteristics are often identified as follows.

- Goodwill is not an independent asset in and of its own right, but exists only by virtue of the business as a whole. It is not independently realizable.
- Goodwill is not a resource that is used and consumed in the production of earnings as are other resources. It is, instead, the result of earnings or the expectation of future earnings.
- The true value of an enterprise's goodwill at any point in time has no predictable relationship to the costs paid in its creation or paid on acquisition. The value of goodwill may fluctuate widely and quickly because many other factors affect the potential for future earnings.

- Goodwill is a value that favors the investor or owner of an enterprise. Its value is based on investor opinion which can and does change with time. If treated as an asset, its value is fixed as of one point in time based on one set of opinions. This value does not have a continuing significance to other investors and creditors at a later date.

Under this accounting treatment, goodwill is deducted or written off directly against retained earnings or capital surplus at acquisition. The proponents of this method view goodwill as a payment on behalf of the continuing stockholders in exchange for interest in expected future earnings of the acquired enterprise. In this regard, it is seen as a disbursement of resources which reduces the stockholders' equity in a company's resources and property rights by an equal amount. Some supporters would require disclosure of the amounts paid for goodwill in footnotes to the financial statements for some number of future periods.

Some who favor this method compare it to the treatment of treasury stock. An enterprise will acquire treasury stock to increase the expectation of earnings for the remaining shares outstanding. The purchase of treasury stock is treated as a reduction in stockholders' equity.

This method of accounting for goodwill has no direct effect on earnings in future periods.

Maintenance in Accounts as Separate Deduction From Stockholders' Equity

This method is like the previous one except that, instead of just writing off the cost to retained earnings or capital surplus upon acquisition, the cost is shown as a separate line (contra account) in the financial statements, which in effect reduces the stockholders' equity amount. Supporters of this method believe that the goodwill should be highlighted in the financial statements and see this method as a way to direct the users of the financial statements to the explanations and disclosures in the footnotes. The reasons given in support of this accounting treatment are essentially the same as those given for direct write-off to shareholders' equity. This method has no direct effect on future earnings.

Goodwill Accounting in the United States

History

The accounting treatment for goodwill in the United States has developed from a very liberal to a more conservative and restrictive approach. Currently, accounting standards are issued by the Financial Accounting Standards Board. The predecessors to this were the Accounting Principles Board and the Committee on Accounting Procedure.

In December 1944, the Committee on Accounting Procedure issued Accounting Research Bulletin 24, which directed that goodwill could be carried on the balance sheet as an asset indefinitely or amortized against income on a systematic basis. No period for the amortization was indicated. Direct write-offs to retained earnings were discouraged though not totally prohibited.

In December 1947, the Committee issued Bulletin 32, stating that generally all items of profit and loss recognized in a period should be used to determine net income for that period. Some exceptions would be allowed for items that were material in relation to income and not identifiable with or resulting from the usual operations of the period. Several examples were given of items which were excludable from income. One such example was the write-off of a material amount of intangibles, such as the complete elimination of goodwill.

Further changes came in June 1953 with the issuance of Bulletin 43, which called for a write-off charged to current income for the cost of intangibles that had sustained a recognizable loss unless such a write-off would cause misleading inferences about the charges to income, in which case the write-off could be made to retained earnings. Also, lump sum write-offs of intangibles to retained earnings were not to be made immediately after acquisition nor could the costs of any intangibles be charged to capital surplus.

The next major change came with the issuance of Accounting Principles Board Opinion 9 in December 1966, in which the Board concluded that all items of profit or loss recognized during the period should be reflected in net income. Only rare material items, called prior-period adjustments, could now be written off directly to retained earnings. The criteria for identifying prior-period adjustments virtually excluded write offs for goodwill. Goodwill could still be written off or written down in value, but the loss had to be taken through the income statement of the period in which the loss was recognized.

Current Standard

In August 1970, the Accounting Principles Board issued Opinion 17 on accounting for intangible assets, stating that intangibles, including goodwill, were to be considered assets and accounted for as such. Goodwill was to be capitalized as an asset, and the cost was to be systematically amortized to income as an operating expense to match goodwill costs against related future period earnings. The period of amortization was to be the estimated life of the goodwill such that it may not be written off in the period of acquisition and may not be amortized over a period longer than 40 years. A straight-line amortization is required.

Opinion 17 placed many restrictions on earlier methods of treating goodwill. After Opinion 17 was issued, permanent retention as an asset was no longer allowed, amortization charged to current income was mandatory, and a write-off charged to capital surplus or retained earnings was prohibited. Write-down of the goodwill value was allowed only against current income and only with sufficient justification.

U.S. accounting for goodwill has not changed significantly since Opinion 17 was issued. The effect of this current accounting method on U.S. business enterprises is that purchased goodwill represents a charge or burden against future income. The amount of this charge in any given future period depends on the total initial value of the goodwill and the period of useful life, not to exceed 40 years, selected for amortization.

Tax Effects

For purposes of U.S. income taxes, the amortization charge for goodwill is not deductible as an allowable cost. The Internal Revenue Service does not view goodwill as being exhaustible, but rather sees it as a non-amortizible asset. This difference in accounting and tax treatments has led to calls for change in one position or the other, but as yet no change has been made.

Goodwill Accounting in Selected Foreign Countries

Summary of Accounting Practices

The accounting treatments for goodwill in the countries we reviewed—Canada, Japan, United Kingdom, and West Germany—as well as those established by the International Accounting Standards Committee, are presented in table I.1. This table also shows whether the cost of goodwill is deductible for income tax purposes in the various countries.

Table I.1 Accounting Treatment of Goodwill in Selected Countries

Country	Asset with amortization	Maximum amortization period (years)	Write-off against shareholder equity	Tax deductible
United States	Yes	40	No	No
Canada	Yes	40	No	Yes
Japan	Yes	5	No	Yes
United Kingdom	Yes	(a)	Yes	No
West Germany	Yes	15	Yes	Yes
International Accounting Standards	Yes	(a)	Yes	(b)

[a]No maximum or minimum period specified.

[b]Not applicable.

Canada uses an accounting treatment similar to that in the United States. Goodwill must be capitalized and then amortized to future income on a straight-line basis over the estimated life of the goodwill. In no case is the amortization period to be longer than 40 years.

In Japan, goodwill also must be capitalized and amortized to future income. The maximum period for amortization, however, is considerably shorter than in the United States and Canada, since goodwill must be fully amortized within 5 years after its acquisition. For a Japanese company, this shortened amortization period places a greater burden against future income for the first 5 years after acquisition than for a U.S. company, assuming both use the maximum amortization period. Of course, after the first 5 years the Japanese company would have no further costs to amortize, while the U.S. company could still be amortizing costs for another 35 years.

Of all the countries we reviewed, the United Kingdom has the least restrictive accounting standard. It allows goodwill to be either eliminated immediately on acquisition by write-off against shareholder equity or capitalized in the balance sheet and amortized to future income on a systematic basis over its estimated useful life. No maximum or minimum period for amortization is specified. This standard gives companies in the United Kingdom a wide range of possible treatments for goodwill compared to U.S. companies. Immediate write-off against shareholder equity places no dilution on future earnings. If an enterprise should choose to capitalize the goodwill, a period greater than 40 years might be selected for amortization, thereby reducing the yearly charge against future income by spreading it out over the longer life.

The accounting standard for goodwill in West Germany also gives the option of treating goodwill as either a write-off against shareholder equity or as an asset that can be capitalized and amortized against future income over a period up to 15 years.

International Accounting Standards

The International Accounting Standards Committee was founded in 1973 by the major accounting organizations of Australia, Canada, France, West Germany, Japan, Mexico, the Netherlands, the United Kingdom, Ireland, and the United States and now includes accounting organizations from about 50 countries. The purpose of the Committee is to contribute to the development and adoption of international accounting principles and to encourage their observance in the preparation of financial statements. The Committee seeks to promote worldwide harmony and improvement in accounting principles.

International Accounting Standard 22 concerns accounting for mergers and acquisitions. It establishes an accounting method for goodwill that is practically the same as that used in the United Kingdom. Goodwill may either be written off directly against shareholder equity at acquisition or capitalized and amortized over its estimated useful life. No maximum or minimum amortization period is specified.

Although the International Accounting Standards are supposed to encourage parallel accounting principles worldwide, Standard 22 allows several alternative treatments of purchased goodwill. We found no indications that a specific international accounting principle for goodwill will be established in the foreseeable future.

Tax Deductibility

Of the countries we reviewed, Canada, Japan, and West Germany allow goodwill costs to be deducted for the purposes of income taxation. In Canada, the cost of goodwill is pooled with other "eligible capital property" such as trademarks and customer lists, and one half the amount of this pool may be written off for tax purposes at the rate of 10 percent annually on a declining-balance basis. In Japan, goodwill is deductible for tax purposes at the same rate that it is amortized for accounting purposes. West Germany did not allow a deduction for goodwill prior to January 1, 1987, when it became amortizable for tax purposes over a 15 year period for taxable years beginning after December 31, 1986.

Tax deductibility of goodwill costs might be an important factor with regard to providing advantages to foreign companies, since it would give them the potential for improved after-tax cash flow. However, it would be difficult to draw any firm conclusions about the consequences of tax treatment of goodwill without studying each country's entire tax structure.

Conclusions

In theory, because British and West German accounting standards allow direct write-off of goodwill against shareholder equity and avoid future earnings declines resulting from goodwill amortization, these firms may be willing to outbid U.S. firms in acquiring other U.S. firms.

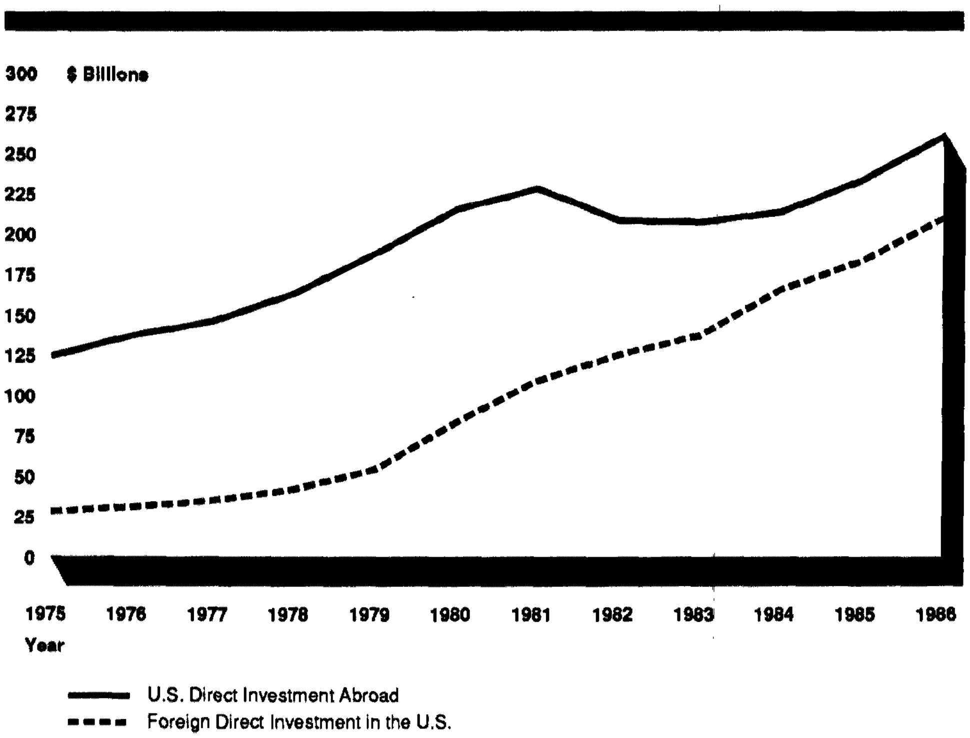
Canadian and Japanese firms, however, use the same standards as U.S. firms or even more stringent ones, and thus they do not have the same theoretical advantages as British and West German firms have in outbidding U.S. firms. Canada, Japan, and the United States require goodwill to be treated as an asset and amortized over a period of years. U.S. and Canadian firms may amortize over a period up to 40 years. The Japanese accounting standard requires goodwill to be amortized in 5 years. For a Japanese company, this shorter amortization period places a greater burden against future income than for a U.S. company, assuming both use the maximum period.

Any advantage due to the deductibility of goodwill for tax purposes would go to Canadian, Japanese, and German companies. However, to correctly determine any tax advantage, the entire tax structure would need to be studied.

Foreign Direct Investment in the United States

Foreign direct investment in the United States[1] has grown significantly since 1975 when measured in absolute amounts. As figure II.1 shows, it grew from $28 billion in 1975 to $54 billion in 1979 and from $83 billion in 1980 to $209 billion in 1986. Since 1980, it has grown 152 percent, whereas U.S. direct investment overseas grew only 21 percent. In 1986, foreign direct investment in the United States represented about 80 percent of U.S. direct investment in other countries, compared with about 23 percent in 1975.

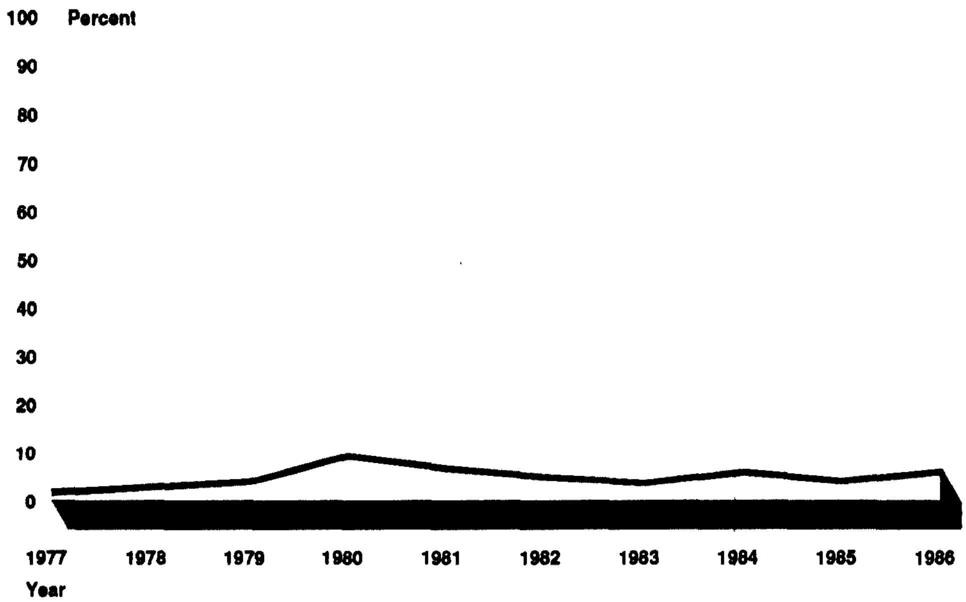
Figure II.1: Comparison of U.S. Direct Investment Abroad to Foreign Direct Investment in the United States



Measured as a percentage of U.S. private non-residential domestic investment, however, foreign direct investment in the United States has been fairly stable, averaging about 5 percent over the last 10 years and reaching a peak of 9.1 percent in 1980. (See fig. II.2.)

[1]The Department of Commerce defines foreign direct investment in the United States as the ownership or control by a single "foreign person" of 10 percent or more of the voting securities of a U.S. enterprise. A foreign person includes any foreign individual, branch, partnership, association, estate, trust, corporation, government, or any other organization. Foreign portfolio investment is defined as all other foreign holdings of U.S. assets.

Figure II.2: Foreign Direct Investment as a Percentage of Gross Non-Residential Domestic Investment



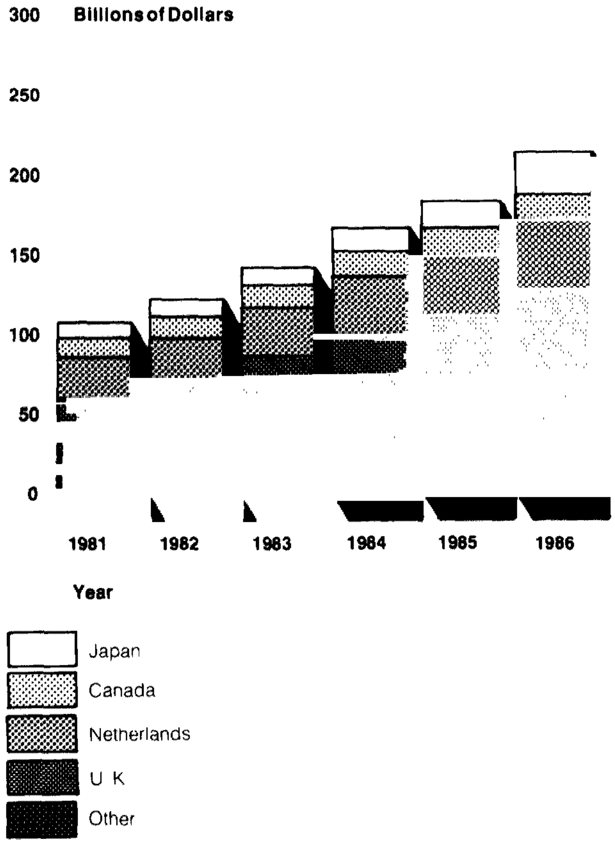
The countries most actively investing in the United States have been the United Kingdom, the Netherlands, Canada, and Japan, as shown in figure II.3. British investments grew by the largest dollar amount between 1981 and 1986, from $18.5 billion to $51.4 billion. Japanese investments grew by the largest percentage amount (204 percent), from $7.7 billion to $23.4 billion, reflecting growth from a smaller base.

Trends in Foreign Merger and Acquisition Activity

Foreign mergers with and acquisitions of existing U.S. firms are a major form of foreign investment activity, comprising about half of all 1986 foreign direct investment transactions and about 80 percent of total transaction dollar volume.[2] Important to note, however, is that government efforts to collect information on U.S. merger activity have not been continuous or comprehensive. The Federal Trade Commission used to publish an annual report on corporate mergers and acquisitions, but this report was last published in 1981 and excluded mergers in the financial, communications, and transportation industries. The Securities and Exchange Commission began publishing some data on corporate mergers

[2]Other types of investment activities include joint ventures, equity interests, new plant construction, expansion of existing plants, and real estate transactions.

Figure II.3: Foreign Direct Investment in the United States, by Country



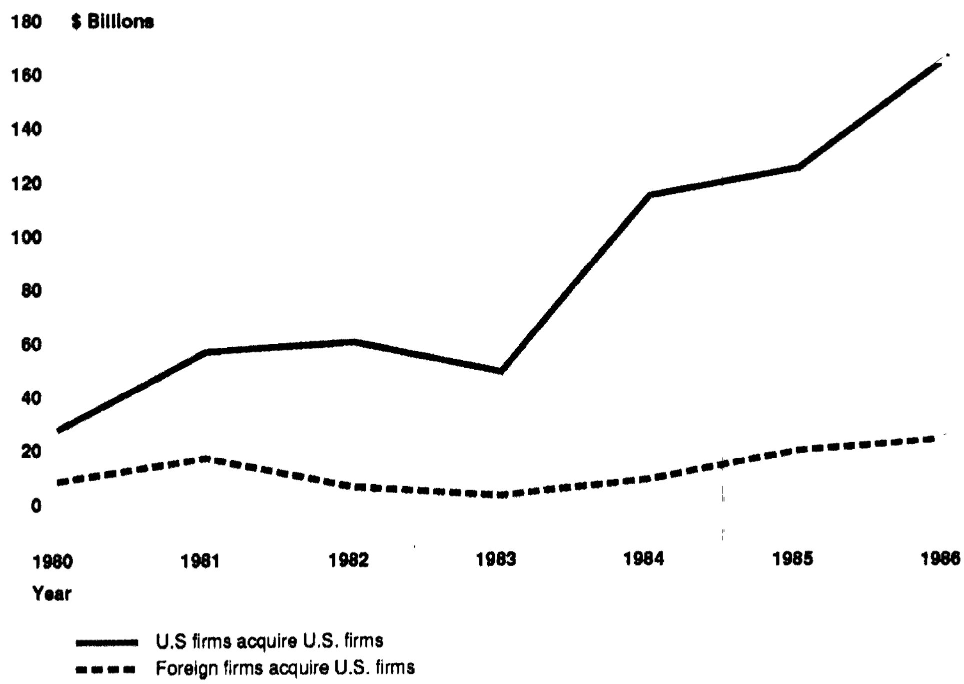
Source: Department of Commerce

in February 1987, but this data only includes tender offers. In a tender offer, the bidder makes an offer to acquire shares of a target company directly from the company's shareholders.

Because of these shortcomings in data collection, interested parties must rely on private sources, such as the W.T. Grimm and Co. consulting firm and the publication Mergers and Acquisitions. W.T. Grimm reports on purchases of at least 10 percent of a company's assets or equity when the purchase price is at least $500,000, while Mergers and Acquisitions lists all mergers or acquisitions greater than or equal to $1 million. We used data from the publication Mergers and Acquisitions.

As shown in figure II.4, foreign merger and acquisition activity has increased in recent years—from about $2 billion in 1983 to about $23 billion in 1986—but still it is a small part of total U.S. merger and acquisition activity. For example, in 1986, foreign mergers and acquisitions of U.S. firms totaled about 14 percent of total merger and acquisition dollar volume, a decline from its level of about 27 percent in 1980.

Figure II.4: U.S. Mergers and Acquisitions Completed by U.S. and Foreign Firms



Source: Mergers and Acquisitions. Based on available price data

Figure II.5: Merger and Acquisition Transactions by U.S. And Foreign Firms

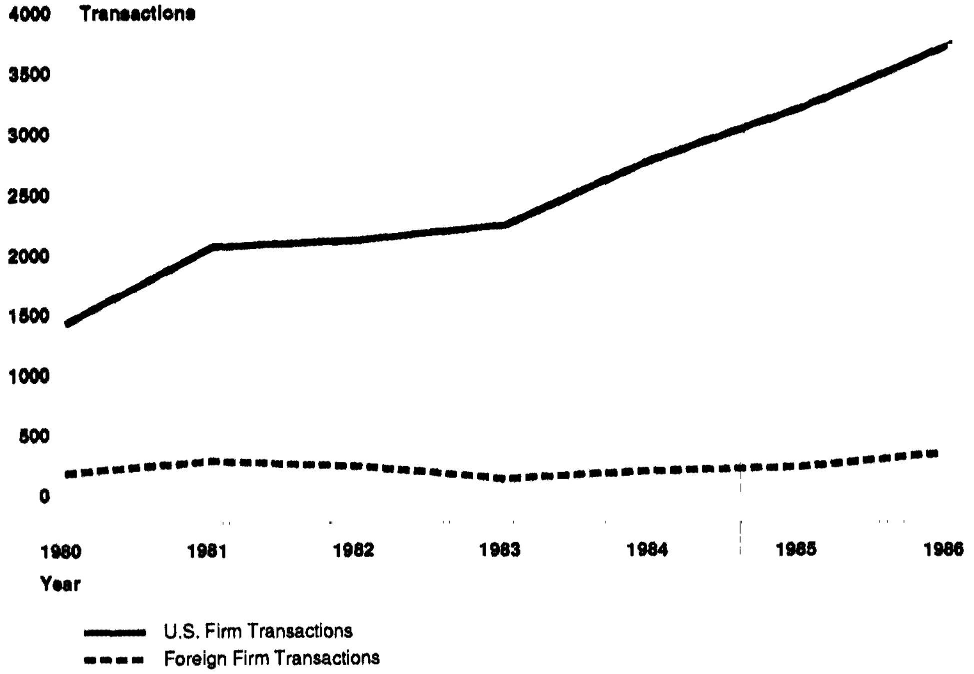
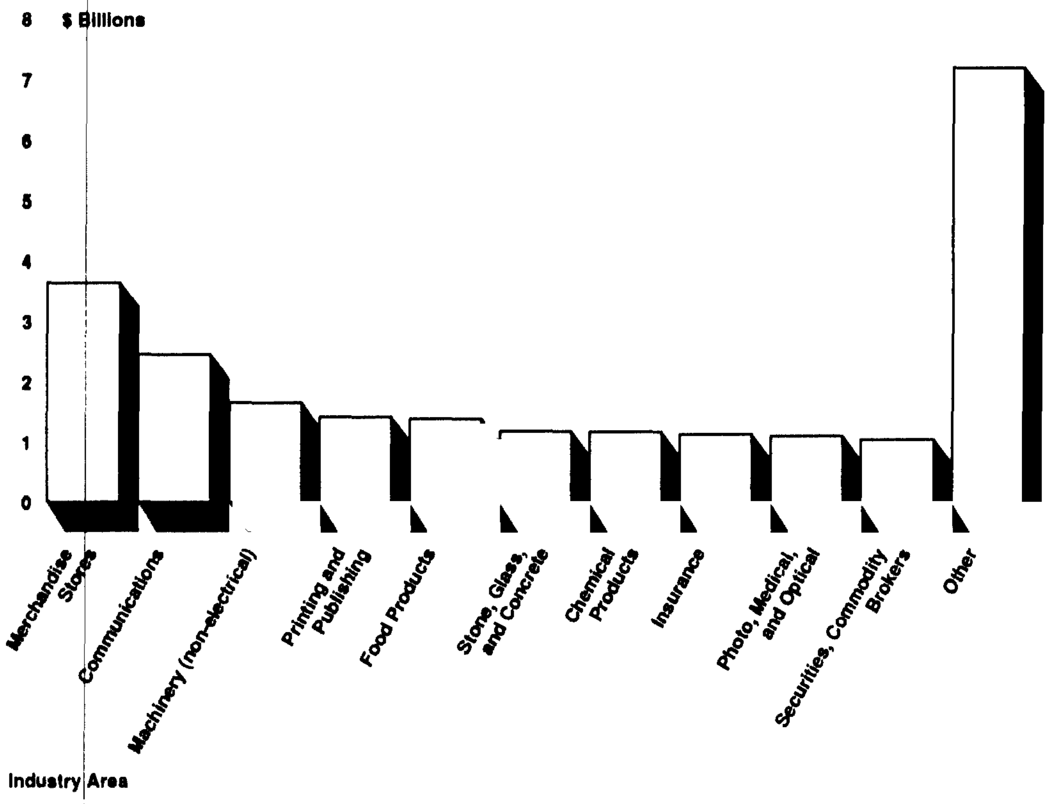


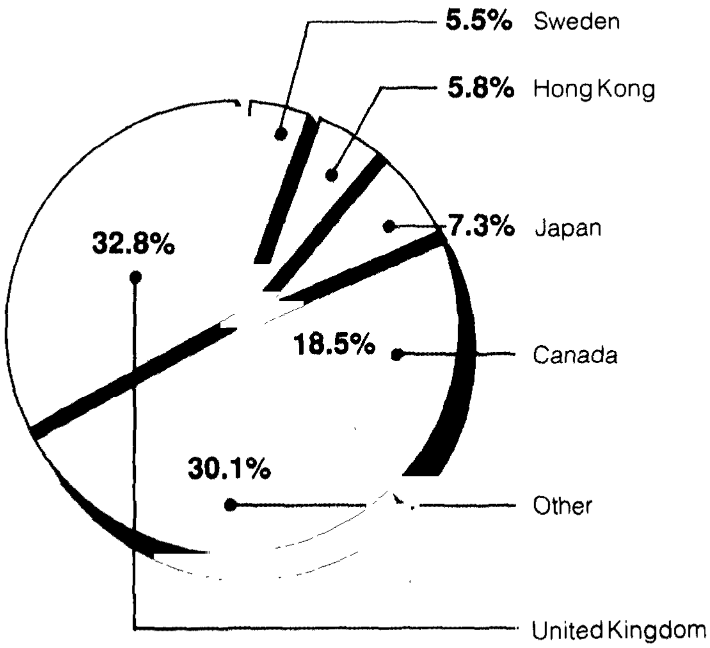
Figure II.5 shows the trend in the number of merger and acquisition transactions from 1980 to 1986. Foreign mergers with and acquisitions of U.S. firms grew from 170 to 329 transactions—a 94 percent increase—whereas U.S. mergers and acquisitions grew from 1413 transactions to 3,695 transactions—a 162 percent increase. Thus, foreign activity has decreased as a share of total activity (from 12 percent in 1980 to 9 percent in 1986).

Figure II.6: Areas Attracting Most Merger and Acquisition Activity in 1986



In 1986, most foreign merger and acquisition activity was in the merchandising, communications, and machinery sectors and in the total of miscellaneous "other" sectors, as shown in figure II.6.

Figure II.7: Countries Most Active in 1986 U.S. Mergers and Acquisitions
(Transactions)



Source: Mergers and Acquisitions. Includes transactions > or = to $1 Million.

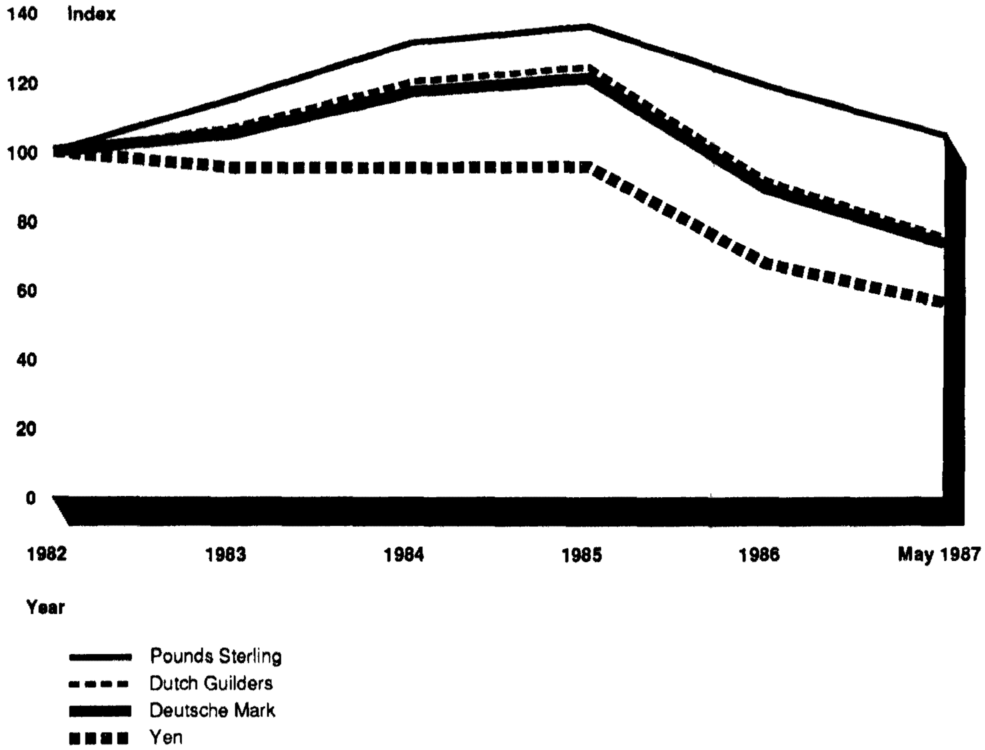
As figure II.7 shows, the foreign countries most commonly involved in these transactions were the United Kingdom and Canada.

Reasons for Investing in the United States

In the 1980s, foreign investment has increased in the United States for several reasons. One reason is the large increase in the U.S. trade deficit, which sharply increased foreign holdings of U.S. dollars. Foreigners have used these dollars to invest in a wide variety of U.S. assets.

The strong U.S. economy of the 1980s compared with the relatively weaker economies in most other major industrialized countries also helped make the United States an attractive place to invest. Domestic demand, for example, grew at an average annual rate of 5.6 percent in the United States during 1982-85; comparable rates were 3.1 percent in Japan and the United Kingdom and 1.9 percent in West Germany.

Figure II.8: Fluctuations of the Value of the Dollar Against Major Currencies (1982 = 100)



The fall in the value of the dollar since early 1985 lowered the foreign-currency prices of U.S. assets and made U.S. prices attractive when compared with foreign asset prices. From 1985 to May 1987, the dollar depreciated about 40 percent against the Deutsche Mark, Japanese Yen, and Dutch Guilder. (See fig. II.8.)

This fall in the price of U.S. assets as expressed in foreign currency stimulated foreign purchases of U.S. physical assets. The fear of protectionist measures being imposed on imports may have also led foreign manufacturers, such as the Japanese, to build and invest in the United States.

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

United States
General Accounting Office
Washington, D.C. 20548

Official Business
Penalty for Private Use $300

Address Correction Requested

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100