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From: Stephen Zeff [mailto:sazeff@rice.edu]
Sent: Sunday, August 14, 2005 12:44 PM
To: Director - FASB
Subject: File Reference 1204-001

Letter of Comment No: 2
File Reference: 1204-001
Date Received: 8.14.05

Dear Sir or Madam,

I attach a short historical note on one aspect of the proposed standard (para 49). I have submitted the same note as a letter of comment to the IASB.

Kind regards.

Stephen Zeff.

The Entity Theory of Recording Goodwill in Business Combinations – Old Stuff

Stephen A. Zeff

Rice University

The proposal by the FASB and the IASB to adopt the “entity theory” for recognizing the amount of goodwill in a business combination is hardly new to the US accounting literature. This literature has dealt with the preparation of the consolidated statements, but the principle is the same for the journal entry on the acquiring company’s books to record the goodwill arising out of the business combination.

To be sure, the FASB’s discussion memorandum, *Consolidation Policy and Procedures*, issued in September 1991, treats the “entity theory” and its consequences for the amount at which goodwill should be recognized when a minority interest exists (pages 23-33, 61-71), but it provides no citations to previous literature. It is the purpose of this note to bring out the antecedents.

Henry Rand Hatfield in his highly acclaimed textbook, *Accounting: Its Principles and Problems* (Appleton-Century-Crofts, 1927), argued for recognition of 100 percent of consolidated goodwill even though less than 100 percent of the shares had been acquired. He wrote, “Inasmuch as in the consolidated balance sheet the full value of each of the assets is shown, although the holding company has only a fractional interest therein, it seems needlessly inconsistent in regard to the single asset goodwill to show only part of its value and to neglect entirely that portion representing the equity of the outstanding stockholders” (page 448). Maurice Moonitz, a student of Hatfield’s, made a similar argument in “The Entity Approach to Consolidated Statements” (*The Accounting Review*, July 1942) because, he wrote, the practice of recognizing only the purchased share of goodwill when there is a minority interest “makes goodwill a function of the number of shares acquired, not a function of any attribute such as superior earning power of either a legal or an economic entity” (page 241). Moonitz expanded on his argument in a monograph, *The Entity Theory of Consolidated Statements*, published in 1944 by the American Accounting Association. Hatfield and Moonitz were renowned accounting

academics at the University of California, Berkeley during the periods 1910-1940 and 1940-1980, respectively.

No less an authority than William A. Paton, at the University of Michigan, advocated recognizing the goodwill associated with the minority interest. He wrote, "In general, it is reasonable to assume, the market value of the minority slice is consistent with the demonstrated value of the majority interest." By not recognizing the minority share of the excess of the purchase price of the shares over the acquired company's book value, including the goodwill, he added, "the consolidated statement is a hodgepodge rather than a clear-cut, consistent presentation from the point of view of the dominant interest—the point of view which should be emphasized in consolidated reporting" (William A. Paton with the assistance of William A. Paton, Jr., *Corporation Accounts and Statements* (Macmillan, 1955), pages 636, 637). Even though Paton did not embrace the "entity view" in principle, he nonetheless argued for grossing up the goodwill to 100 percent.

In the third edition of the *Accountants' Handbook* (Ronald Press, 1943), edited by W. A. Paton, the chapter on consolidated statements, written by Perry Mason, a Paton disciple, stated a preference for recognizing the goodwill equivalent to the minority interest (page 1080). This preference was carried forward into the fourth edition of the *Handbook* (Ronald Press, 1956), edited by Rufus Wixon and Walter G. Kell (page 23-19).

In the 1950s, the authors of the two leading "advanced accounting" textbooks evinced sympathy with Moonitz's "entity theory" and its implication for the amount to be assigned to consolidated goodwill. In their leading textbook, *Principles of Accounting, Advanced* (Prentice-Hall, 1952), H.A. Finney and Herbert E. Miller explained the theory and showed in a numerical example how it would affect the amount that should be attributed to consolidated goodwill (pages 527-528). Wilbert E. Karrenbrock and Harry Simons (*Advanced Accounting, Comprehensive Volume* (South-Western, 1955)) did likewise (pages 345-347).

Louis H. Jordan, in the *Handbook of Modern Accounting* (McGraw-Hill, 1970), edited by Sidney Davidson, discussed the theory and pointed out that one of its implications was that the minority share of goodwill should be recognized in the consolidated balance sheet (pages 32-8 and 32-9).

The "entity theory" has also been discussed in several "accounting theory" textbooks, most notably in Vernon Kam's *Accounting Theory* (Wiley, 1990). Kam, a student of Moonitz's, wrote, "The entity theory has the advantage of having been formulated rationally" (page 397).

Opinion

I have long believed that the goodwill in a business combination, and also in the consolidated statements, should reflect the total goodwill and not the amount that happens to coincide with percentage of the acquired company's total number of shares outstanding that are actually purchased. Viewing the transaction and the consolidated statements from the perspective of the entity as a whole, and not just from the viewpoint of the owners of the acquiring company/parent, produces much more useful information to both the majority and minority interests. As I have demonstrated above, the boards' joint proposal has received considerable favorable attention in the US accounting literature since the 1920s.

August 14, 2005