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Accounting for Excess Purchase Price: Goodwill or Expense?

Instructional Issues

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We have entered a challenging era with regard to accounting for the excess purchase price over the net assets received in the acquisition of one business by another. The current trend for accounting for the excess purchase price relating to intangible items not identified as separate assets is to account for it as one wishes to, by either expensing or capitalizing it. Current standards would suggest that companies capitalize the excess as goodwill, but in many instances the current practice is to expense it. Thus, current practice allows for a choice between methods, but if the practitioner chooses to expense the amount, the excess should be associated with something that is identifiable and normally expensed.

To an instructor teaching financial accounting courses and presenting material related to this topic, it may first appear that accounting for the acquisition of one business by another is straightforward. However, it may be quite complex in some of the allocation of fair market values to certain assets. Financial accounting standards require the acquiring company to record the acquired net assets at fair market value and capitalize any excess price paid to goodwill. The goodwill is subsequently amortized. However, in today's service and technology-based industries, complications arise in accounting for the

ABSTRACT. The current trend of accounting for excess purchase price that relates to intangible items not identified as separate assets, in a business acquisition, is to account for it either by expensing or capitalizing it. Even though current standards suggest that companies capitalize the excess as goodwill, in many instances, the current practice is to expense it. In this article, we discuss the issue as an example of how accounting is being challenged constantly by unique and sometimes very aggressive accounting policies for managing net income by management. The example also gives instructors an opportunity to incorporate several issues related to accounting policy, accounting alternatives, and subjective judgment into their financial accounting courses.

acquisition because the excess purchase price may be identifiable to specific intangible areas of the organization, such as intellectual capital, specific product platforms, and research-in-progress. These specific intangible areas are generally expensed as costs are incurred and not capitalized as assets, but they may provide tremendous creativity and potential for future cash flows. Thus, the acquiring company may easily identify those intangibles and include them in the value of the business and, consequently, as part of the purchase price. The acquiring company can argue easily that the excess purchase price is not goodwill, but rather specifi-

cally identifiable to these intangible items. Because these types of intangible items are not recognized as assets when costs are incurred but are expensed, it only makes sense that the excess purchase price specifically identified to the research-in-progress also be expensed.

That line of reasoning has led to a new direction in accounting for the excess purchase price by many companies and has created a major inconsistency in accounting for acquisitions. That inconsistency has resulted in a lack of comparability of financial statements across companies and industries. As one might expect, the Financial Accounting Standards Board (FASB) and the Securities Exchange Commission (SEC) are highly concerned with this new trend in accounting. Many business publications, including the *Wall Street Journal* and the *Journal of Accountancy* among others, have indicated that accounting for the acquisition of a business by another is a significant issue that has to be addressed (Bartlett, 1998; Briloff, 1996; Francis, 1998). The FASB and SEC are examining this issue thoroughly but currently are accepting both methods, provided that the expensing approach is justified.

Our purpose in this article is not to address the merits of the accounting issues involved for either method or to develop an argument for the accounting

of the excess purchase price. Our article has four purposes: (a) to provide faculty with material for expanding the discussion about company acquisitions in financial accounting classes, (b) to provide information on how practical accounting applications evolve with changes in our business practices, (c) to expose students to creative and unique applications of generally accepted accounting principles (GAAP), and (d) to demonstrate to students the subjectivity involved in the applications of GAAP.

Financial accounting textbooks often lack discussions on judgmental areas of accounting; however, instructors want their students to be exposed to such issues. As a result, both instructors and students need to research these issues on their own. In this article, we provide instructors and students with relevant material to discuss this contemporary accounting issue in the classroom. This material achieves several important learning objectives for students. It can be used to demonstrate how subjective and creative the accounting treatment can be, even in situations in which current standards appear to exist. The material provides useful information for demonstrating the alternative views in management thinking that occur from the same transaction and in the establishment of accounting policies. Further, it can demonstrate to students how the financial statements are affected by alternative accounting treatments, and how regulators become more interested in the application of aggressive income recognition techniques. Finally, the material shows the problems that the standard setters face in establishing accounting standards.

Current Trend in Accounting for the Excess Price in an Acquisition

Accounting Principles Board (APB) Opinion 16 addresses accounting for business combinations and acquisitions and any excess (or deficiency) of purchase price over the fair market value of the net assets received. The accounting standards that specify the accounting rules for this issue were written in the late 1960s and early 1970s, when the U.S. economy was still manufacturing

based. The accounting rules made reasonable sense then, because the acquisition of a business may have been largely for the tangible assets. But today the U.S. economy has moved to a service orientation and has a high level of technology involved in the infrastructure. In particular, companies that are engaged in hi-tech industries have investments in human intellectual capital rather than physical capital. It is the human resource asset that is the essential ingredient for research and development of the future products of these companies. Thus, in many cases, part of the acquisition price includes amounts for intellectual capital, research-in-progress, and intangibles.

The resulting question is, How does one treat the excess (or deficiency) of purchase price over the fair market value of the net assets received when a company can specifically identify this excess to intellectual capital, research-in-progress, and intangibles? Many companies expense this excess in the year of acquisition rather than capitalize it as goodwill. That creative approach for handling the excess creates inconsistencies in the application of the excess purchase price. Thus, it really gives companies the choice to capitalize or expense because the specific identification of the excess to intellectual capital and research-in-progress is quite a subjective process. As one might expect, the FASB and the SEC are concerned about the flexibility in this area because of the lack of comparability across companies. However, they have been slow in preparing an appropriate response because the issue is part of the bigger picture related to business combinations and accounting for intangibles, which is currently under review by the FASB and has become quite controversial.

Current Authoritative Standards for Acquisitions

Accounting for mergers and acquisitions currently comes under the rules set forth in APB Opinion 16, *Business Combinations*, and APB Opinion 17, *Intangible Assets*. Those opinions have been discussed further in 41 interpretations of the American Institute of Certified Public Accountants (AICPA), four

FASB interpretations, over 50 FASB Emerging Issues Task Force (EITF) interpretations, and 17 SEC rulings (Ficker, 1999).

There are currently two methods of accounting for an acquisition of one firm by another, "purchase" and "pooling of interests." Although the negotiated price paid may be identical under the two methods, they are not alternatives for the same transaction. There are 12 criteria for a pooling of interests to take place. Each criterion must be evaluated; if all the criteria are met, the pooling method must be applied. Otherwise, purchase accounting is applicable. The pooling of interests method is quite restrictive in its use because of the 12 criteria that have to be met. In essence, the pooling of interests method follows the assumption that the companies are combining their resources, rather than that one company is acquiring another. The accounting result is that the book values of the assets and liabilities of the company being acquired are carried forward to the new merged organization after the pooling. In the purchase method, the logic is that one company is acquiring another company; thus, the acquired company's net assets are restated to "fair market values," which are likely different from the book values.

It is quite common for the purchase price to exceed the book value of the net assets of the company acquired. Under a pooling of interests, the assets of the acquired company continue to be carried at their book values. The contributed capital of the acquired company is reassigned to the equity accounts of the issuing company, and the retained earnings are brought into the acquiring company intact, if possible. Thus, it is not necessary to allocate the excess price or cost to any assets. Under purchase accounting rules, the excess must be allocated among the assets of the acquired company.

APB Opinion 16 prescribes the manner in which any excess cost over book value should be assigned to the assets of the acquired firm. All current assets, all investments in marketable securities, and all liabilities should be recorded at fair market value. Then, if there is any remaining excess cost, long-term assets and "specific intangible assets" such as

patents are increased to fair market value to the extent possible. Finally, after all of the above assets have been brought to fair market value, any remaining excess cost is attributed to goodwill. Any increases or decreases in assets or liabilities are to be amortized or depreciated against future earnings over the remaining useful life of the assets or liabilities.

A major dilemma today involves the excess cost assigned to specific intangible assets. As the economy has become more service and technology oriented, a premium has been placed on research and development along with its related intellectual capital. In those industries in which these are major elements, it is likely that a large amount of any excess acquisition price paid over book value of the net tangible assets can be attributed to them.

The Expensing Issue

In Statement of Financial Accounting Standard (SFAS) 2, the FASB concluded that all research and development costs be charged to expense when incurred; and the total research and development costs charged to expense in each period for which an income statement is presented should be disclosed in the financial statements (SFAS 2, Par. 12 and 13). FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, states: "Accordingly, costs assigned to assets to be used in a particular research and development project and that have no alternative future use shall be charged to expense at the date of consummation of the combination" (FASB Interpretation No. 4, Par 5). Some companies, therefore, can argue that, in an acquisition, the part of the excess cost paid attributed to ongoing research and development should be immediately expensed in the current period. Traditionally, research and development costs have not been identified as a separate intangible asset and, as a result, such costs have been included as part of goodwill. These costs are then amortized over a period not to exceed 40 years.

To illustrate, let us assume that two hypothetical companies, Expensing Inc.

and Capitalization Company, each acquire the net assets of another company with a book value of \$2,000,000 for \$2,500,000 in a transaction that qualifies as a purchase. In each case it has been determined that inventories are being overvalued by \$50,000 and that property, plant, and equipment (net of accumulated depreciation) are being undervalued by \$100,000. Expensing Inc. believes that any remaining excess price paid can be attributed to research and development in progress, whereas Capitalization Company believes that the excess represents goodwill that should be amortized over 20 years. In Table 1, we compare the distribution of the \$500,000 excess acquisition price paid over book value through a determination and distribution of excess schedule approach.

Expensing Inc. would expense the \$450,000 research and development costs against income in the year of the acquisition and disclose the details related to the merger. Earnings and earnings per share would be heavily affected in the year of acquisition only. Having recorded the \$450,000 as goodwill, Capitalization Company would amortize \$22,500 each year for 20 years.

Proponents of expensing acquired research and development costs will argue that there is a high degree of uncertainty regarding future benefits of such projects, and can cite supporting research. Those adhering to the traditional approach of capitalizing excess cost to

goodwill can point out that it is difficult to assign a dollar value to intangible assets, especially as one moves away from specific research projects to the more general area of intellectual capital. It can also be argued that both superior research and development and intellectual capital should lead to future earnings above the industry average; therefore, it is appropriate to amortize any excess cost against the periods benefited.

Current Developments

The FASB, EITF, and the SEC have all taken a renewed interest in mergers, acquisitions, and consolidations. In August 1996, the FASB added a project on business combinations to its agenda. As a result, APB Opinion 16, *Business Combinations*, and APB Opinion 17, *Intangible Assets*, are being reconsidered. The first of what is expected to be a series of exposure drafts has been issued, and its comment period ended May 24, 1999. It is entitled *Consolidated Financial Statements: Purpose and Policy*. Another exposure draft, *Business Combinations and Intangible Assets*, was issued on September 7, 1999 with a December 7, 1999 comment deadline.

Several issues being considered by the FASB are relevant to this article. The Board is considering reducing the amortization period for goodwill to its useful life, not to exceed 20 years. Ini-

TABLE 1. Comparative Determination and Distribution of Excess Schedules

	Expensing, Inc.	Capitalization, Co.
Paid price for investment	\$2,500,000	\$2,500,000
Book value of the net assets acquired	2,000,000	2,000,000
Excess cost over book value	\$ 500,000	\$ 500,000
Adjustment of priority accounts:		
Inventory write-down	50,000	50,000
Amount available for adjustment of long-term assets and specific intangible assets	\$ 550,000	\$ 550,000
Adjustment of long-term assets and specific intangible assets:		
Property, plant, and equipment	(100,000)	(100,000)
Research and development in progress	(450,000)	-0-
Amount assigned to good will	\$ -0-	\$ 450,000
Goodwill to be amortized (over 20 years)	\$ -0-	\$ 450,000

tially the Board decided that all purchased research and development costs accounted for by the purchase method could no longer be expensed but would have to be capitalized as an intangible asset, to be amortized over its useful economic life (FASB, April 12, 1999). However, in July the Board decided that it was not possible to address purchased in-process research and development costs separately from the other research and development costs and postponed consideration of this topic (FASB,

ness Week, Fortune, and other business periodicals. Two celebrated cases in which the expensing approach of accounting for an acquisition was involved were America Online's (AOL) acquisition of the NetChannel, an Internet television channel, and IBM's purchase of Lotus Development Corporation, referred to hereinafter as Lotus. A discussion of the IBM acquisition of Lotus in 1996 and the accounting implications follows.

IBM purchased Lotus for the price of

nations, such as SFAS No. 86, SFAS No. 2, and FASB Interpretation 4. It incorporated numerous valuation methods, such as the cost approach, the market approach, and the discounted cash flow model, and used outside business appraisers to determine the value of the research and development in progress.

The end result for IBM was that it accounted for the acquisition as a purchase, and rather than capitalize the excess purchase price of the net tangible and intangible assets, it expensed the major amount of that excess. Its rationale for expensing was that it could identify what it was buying, which was research and development in progress, and that accounting for that should be the same as other research and development. When one examines the consequences to IBM's financial statements, one quickly sees that the current year's assets and net income are dramatically affected because of the lack of capitalization. This effect influences the future periods because there is no amortization of the goodwill to offset the future revenues that would result from the benefits of the research and development in progress. Briloff (1996) provided a very interesting analysis of this acquisition in a *Barron's* article. He strongly argued against expensing the excess purchase price because of the future mismatching of revenues and expenses.

Current FASB Standards on Intangible Asset Valuation

The FASB has issued many rules for accounting measurements over the years; however, none of the rules are particularly helpful for valuation of intangibles such as research and development. The proposed FASB Concepts Statement *Using Cash Flow Information in Accounting Measurements* may lack sufficient guidance because it is based on traditional rules, assumptions, and systems of measurement from Newtonian physics. Contemporary chaos theory offers a set of paradigms that might assist in this valuation by embracing uncertainty with ranges of values for the uncertainty involved. In fact, the FASB offers a range for the valuation rather than a single minimum or maximum of values for these intangibles. Accounting

The FASB has issued many rules for accounting measurements over the years; however, none of the rules are particularly helpful for evaluation of intangibles such as research and development.

October 12, 1999). The FASB has been a participant in the development of a G4 +1 Position Paper, *Recommendations for Achieving Convergence on the Methods of Accounting for Business Combination*, that concluded that the purchase method of accounting is the preferable method to be used when businesses combine (FASB Status Report, January, 1999). The G4 +1 is trying to determine which method of accounting should be applied to business combinations, and could decide on the elimination of "pooling of interests." As a result of its deliberations, the FASB has since voted unanimously to eliminate pooling of interests as an alternative method of accounting for business combinations (FASB Status Report, May 18, 1999). This would cause an increase in the number of mergers involving an acquisition price in excess of book value.

Examples of Recent Company Acquisitions

There are numerous cases in which companies are applying the expensing approach of accounting to business acquisitions, and one can find general discussion about them in numerous issues of the *Wall Street Journal*, *Busi-*

\$3.2 billion, of which \$2.9 billion was in cash. The business combination was accounted for through the purchase method of accounting. The tangible net assets of Lotus consisted primarily of cash, accounts receivables, land, buildings, leasehold improvements, and other personal property. IBM placed a fair market value on these assets of \$325 million dollars. In addition, IBM identified other intangible assets, such as trademarks and leasehold improvements. The trademarks had a fair market value of \$369 million, and the other intangibles had a value of \$173 million. There were deferred tax liabilities associated with the identifiable intangible assets of \$291 million. IBM identified \$1.84 billion fair value to purchased in-process research and development technologies and expensed that entire amount upon acquisition.

IBM's main reason for acquiring Lotus was for some of its existing software products as well as research and development in progress and intellectual capital. Current software products acquired by IBM were capitalized, but research and development in progress was expensed. IBM applied a variety of accounting standards that related to technological feasibility and business combi-

measurements use an observable marketplace-determined amount, such as cash paid, current cost, or current market value. Because none of these possibilities fits into the scheme of excess purchase price over individual assets received, accountants may need to use estimated future cash flows as a basis for measuring an asset or a liability.

The proposed statement provides a framework for using future cash flows as the basis for an accounting measurement of identifiable intangible assets. Most important, this framework considers the amounts of future cash flows, the timing, and the uncertainty involved. The proposed statement does not address the recognition question, only the measurement issues. The objective of using present value in an accounting measurement is to capture, to the extent possible, the economic difference between sets of estimated future cash flows. Without present value, a \$1,000 cash flow due tomorrow and a \$1,000 cash flow due in 10 years appear the same. Present value gives us a more accurate measurement of those timing differences. In fact, the \$1,000 to be received in 10 years is worth only \$386 (assuming a 10% discount rate). To provide relevant information in financial reporting, present value must represent some observable measurement attribute of assets or liabilities.

The original FASB Exposure Draft on the Proposed Concept Statement (October 1997) addressed present value techniques for either estimation of fair value or to develop entity-specific measurements (value in use or value to the entity). The entity-specific measurement piece has been eliminated from the final draft. The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties. The cash flows and discount rates should reflect assumptions, demonstrate consistency between the two models, be free from bias and unrelated factors, and provide a range of possible cash flows rather than a single minimum or maximum possible amount. Though liabilities are addressed in the proposed statement, they are outside the purview of our article and will be ignored. The proposed concepts statement would lend guidance to the

accounting profession and business community relative to objectives and identification of fundamental concepts.

Objectives are expected to give direction, and concepts are tools for solving problems. All of the above measurement techniques have their advantages and disadvantages. However, because the FASB is taking the position in its proposed concepts statement that discounted cash flow is more appropriate, one may expect to see that model used in the future. There are existing models that can assist the company and auditors in understanding the measurement process in this material estimate.

Implications for Instruction

Although mergers and acquisitions are relevant in any financial accounting course, they are addressed most frequently in advanced accounting courses. We examined eight advanced accounting textbooks to determine the amount of coverage devoted to intellectual capital and/or purchased research and development costs in a merger or acquisition. They were the following:

- *Advanced Financial Accounting*, 4th edition, by Baker, Richard E., Lembke, Valdean C., and King, Thomas E., 1999, Irwin/McGraw Hill

- *Advanced Accounting*, 7th edition, by Fischer, Paul M., Taylor, William J., and Cheng, Rita H., 1999, South-Western College Publishing/International Thomson Publishing

- *Advanced Accounting*, 7th edition, by Beams, Floyd A., Brozovsky, John A., and Shoulders, Craig D., 2000, Prentice Hall Inc.

- *Advanced Accounting*, 3rd edition, by Engler, Calvin, Bernstein, Leopold A., and Lambert, Kenneth R., 1995, Richard D. Irwin Inc.

- *Advanced Financial Accounting*, 5th edition, by Huefner, Ronald J., Largay, James A. III, and Hamlen, Susan S., 1999, Dame Publications Inc.

- *Advanced Accounting*, 5th edition, by Hoyle, Joe B., Schaefer, Thomas F., and Douppnik, Timothy S., 1998, Irwin/McGraw Hill

- *Advanced Accounting*, by Jeter, Debra C., and Chaney, Paul K., 2001, John Wiley & Sons Inc.

- *Modern Advanced Accounting*, 8th edition, by Larsen, E. John, 2000, McGraw Hill

All of the textbooks discussed the allocation of cost to "identifiable intangible assets" and goodwill. Patents were the most frequently used example of an identifiable intangible asset, and leaseholds were used in one book. A majority of the textbooks briefly discussed research and development costs; however, only three specifically addressed purchased research and development (Fischer, Taylor, & Cheng, 1999; Jeter & Chaney, 2001; Larsen, 2000). All three basically point out that it is appropriate to identify purchased research and development as an identifiable tangible or intangible asset and to expense such assets as required by SFAS No 2, *Accounting for Research and Development Costs*, unless they may be used for activities other than research and development in the future.

Whether or not authors of advanced accounting textbooks should devote more attention to purchased research and development is debatable. However, the topic provides an excellent opportunity for classroom discussion, group work, and writing projects related to the judgmental aspects of GAAP. In addressing the issue, students should be aware that professional judgment must be used often in applying professional standards to accounting practice and that, in many instances, textbooks do not address the issues. In researching accounting issues such as the one we have discussed, students will need to think in a critical and analytical manner and find and use reference sources that exist in the professional literature. Articles such as ours could provide them with a discussion of the issues and a reference for their discussion that goes beyond textbooks.

Conclusion

In this article, we have presented a discussion about a contemporary accounting treatment that relates to the acquisition of one business by another, and the question of how to account for any excess purchase price over the fair value of the net assets received. Many

accounting professionals may conclude that the authoritative standards are quite clear and that the excess should be capitalized as goodwill. However, as our economy moves into a more technological environment, the excess purchase price may be identified with intangibles, such as research in progress. Many companies are turning to practice and interpretation of GAAP to justify expensing the research-in-progress rather than capitalization. This article provides faculty with additional information that could be useful in addressing this contemporary issue in the classroom.

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