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COMBINATIONS, PERMUTATIONS, AND POOLING

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Almost 40 years have passed since Berle and Means published their landmark study, *The Modern Corporation and Private Property,* in which they predicted an increasing concentration of economic power for the United States.[1] They found that in 1930 the 200 largest U.S. corporations controlled over 38 percent of the business wealth, or less than 1 percent of the corporations owned over 38 percent of the wealth.[2] Projecting these trends, Berle and Means predicted that 100 percent of the wealth of the nation would be in the hands of some 200 giant corporations by the 1970's. Although this forecast has been wide of the mark, the 1969 Cabinet Committee on Price Stability reported that the 78 largest corporations controlled 43 percent of total assets on December 31, 1968.[3] The growing trend of mergers and combinations was viewed by the Cabinet Committee as a deterrent to free competition and price stability, and it urged more vigorous enforcement of antitrust legislation.

Federal Trade Commission (FTC) figures show that there has been a veritable epidemic of business mergers in the United States in the late 1960's.[4] The number of mergers in 1968 was more than double the number in 1966, and ten times the number in 1950. Furthermore, the type of merger has changed significantly. In 1968 90 percent of the mergers were conglomerate mergers compared to less than 40 percent two decades before.[5] Critics of this merger escalation claim it has been facilitated by an increasing use of accounting methods that inflate earnings. Sixty percent of the 1968 combinations were accounted for as a pooling of interest compared to only 30 percent in 1965.[6]

THE ROLE OF ACCOUNTING IN MERGERS

One outspoken critic of pooling has expressed the opinion that many acquisitions would be impossible were it not for the cosmetic accounting used by corporate raiders to improve the reported earnings of acquired companies. AMK Corporation's takeover of John Morrell & Co. is a case in

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1 A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

2 *Id.* at 32 (rev. ed. 1947).

3 STAFF OF COMM. ON PRICE STABILITY, CABINET, STUDIES 45 (Jan. 1969).

4 Burck, *The Merger Movement Rides High,* FORTUNE, Feb. 1969, at 79-80.

5 *Id.* at 81.

6 *Id.* at 82.

point. AMK acquired Morrell at the close of business on December 31, 1967, yet combined the revenues and earnings of both parent and subsidiary for all of 1967. Consequently, AMK reported gross revenues of $841 million and net earnings of $7.0 million on a pooled basis, compared to only $41 million and $1.8 million of gross revenues and net earnings respectively, from its own operations. Pooling inflated the reported earnings of AMK by 250 percent and boosted reported sales by a factor of 20.

For 1968 AMK resorted to further manipulations to inflate earnings. It reported earnings of $2.25 a share compared to $1.51 the previous year; however, this 50 percent increase would have been a reduction were it not for drastic changes in accounting at Morrell. Depreciation was switched from the constant percentage method to straight-line; inventories from LIFO to FIFO; and the annual provision for pension cost was substantially reduced. Were it not for these changes, earnings would have been only $1.26, a decrease of 15 percent instead of an increase of 50 percent. Some Wall Street observers believe that many acquisitions of the 1960's would not have taken place without the alchemy of accounting changes such as these.

Companies pursuing a policy of expansion by mergers and acquisitions have found it particularly important to demonstrate a history of growth in earnings per share. Many have achieved this, in part, through the traditional means of boosting sales and cutting costs. Additionally, some have employed a variety of financial devices, namely: (1) using the pooling approach in accounting for acquisitions where it has been favorable, (2) applying massive accounting changes in newly acquired subsidiaries, and (3) using a variety of ingenious securities that conveyed to the holder the benefits of common stock ownership without an immediate dilution in reported earnings. These securities have been called "funny money."

If it is true that accountants play a significant role in mergers and acquisitions through their reporting of wealth and earnings, two major questions arise. What actions can accountants take to dampen the merger movement? What actions should they take?

The Question of Goodwill

In October of 1969 the APB circulated a first draft of a proposed opinion on business combinations which would attenuate the pooling principle of accounting. According to this proposal, when the purchase price of a business exceeds the values assigned to the tangible assets, the excess is an intangible presumed to be goodwill. This goodwill would be amortized against earnings over the period expected to be benefited but in no case longer than 40 years.

The compulsory amortization of goodwill was not an idea entertained in 1969 exclusively by the APB. Members of the SEC suggested earlier in the year that they favored a five year compulsory amortization for goodwill.

The resulting charge against income would, of course, reduce reported earnings. This posture of a governmental agency was consistent with the extended antitrust activities of the Justice Department and with the vigorous efforts by Representative Wilbur Mills to revise the tax laws so as to disallow interest on debentures used in corporate take-overs.

The APB proposal for a mandatory amortization of goodwill is in line with its basic philosophy of narrowing the area of differences in principles, even though some diversity of opinion regarding the particular issue prevails throughout the accounting profession. It represents a marked departure from ARB No. 43, which permitted management to elect whether or not to amortize goodwill.[7] Thus, practice has been divided. For example, the AICPA reported in *Accounting Trends & Techniques* for 1966, that of the companies showing goodwill 45 percent amortized, 55 percent did not.[8]

The APB proposal for a mandatory recording and amortization of goodwill is diametrically opposed to the conclusions of Catlett and Olson in *Accounting Research Study No. 10.* They recommend goodwill be deducted from stockholders' equity when the goodwill is acquired.[9] They argue that this approach provides comparability between companies that purchase goodwill and companies that create goodwill over the years through operations.

The goodwill controversy epitomizes the dilemma accountants face today. Few accountants would quarrel with the formulation of uniform rules to report a singular set of transactions; but most would strenuously object to an arbitrarily uniform requirement for reporting different events.

The drafters of ARB No. 43 wisely recognized that "goodwill," unlike a 90-day fishing permit, is an asset with varying life expectancies depending on the firm, industry, and general economic conditions. Essentially, ARB No. 43 calls for attributing the bulk purchase price in an acquisition to inventories, plant, and other tangible assets, as applicable. Any excess is deemed goodwill. In some instances goodwill has a limited life, as when it attaches to a division or project with a finite time horizon. In such cases it should be amortized. In other circumstances it has an unlimited life and should not be amortized.

The question of how to account for goodwill is part of the general problem of financial reporting for business combinations, and the broader issue concerns whether or not pooling is a viable accounting approach. On the broader issue of whether pooling should be abolished, Professor Samuel Hayes and the writer find from a study of stock tender offers that most such bids are made with a view towards eliminating some or all of the previous

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7 AICPA, ARB No. 43, at 37 (1953).

8 AICPA, ACCOUNTING TRENDS AND TECHNIQUES 91 (21st ed. 1967).

9 Catlett & Olson, *Accounting for Goodwill*, ARS No. 10 (1968).

managers or stockholders.[10] Accordingly, few business combinations today meet the criteria for a true merger as originally established in the Celanese-Tubize case,[11] and as codified in ARB No. 43[12] and ARB No. 48.[13] The APB is justified in requiring that the burden of proof be on the acquiring company to demonstrate why it should not record an acquisition as a purchase. However, so as not to force like accounting for unlike events, the guidelines should permit pooling for the miniscule number of combinations that in fact are true mergers. The use of pooling then accords with an historical cost basis for accounting. In other words, when properties of two or more companies are put together, and operations are continued by managers and owners of what formerly were legally separate companies, a question arises as to whether or not a new accounting entity has been created. If legal reorganizations are mere form, and it is decided that the accounting entity continues unchanged, pooling follows as a logical consequence. In short, combinations which are poolings should be distinguished from those which are purchases; and management should not be granted the option to account for poolings as purchases. The burden of proof should be on management to demonstrate that goodwill has an extended life, but they should not be required to amortize it over any arbitrary period.

The Question of Accounting Changes

Critics of corporate take-over bidders allege that in addition to their misuse of pooling they have resorted to a variety of other questionable accounting practices. They point to changes in accounting policies at newly acquired subsidiaries, such as those effected by AMK in its take-over of Morrell. Similar accounting changes have been employed to inflate profits by Ling-Temco-Vought, Gulf and Western, and other conglomerates. However, management's opportunity to increase profits in this manner is not a continuing proposition. Earnings counted one year can not be counted again the next. The acceleration of earnings cannot be made without a subsequent decline, typically with severe market repercussions — as many conglomerates experienced in the late 1960's.

Also, it should be noted that the opportunities for switching accounting policies are not confined to acquisition-minded companies. During the 1960's many firms changed their method of financial reporting for depreciation from accelerated to straight-line. In all cases the auditors took exception to the lack of consistency in the company's application of accounting principles. The problem of how best to eliminate alternative financial reporting practices is being aggressively studied by the accounting profession. Progress

10 Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 Harv. Bus. Rev., Mar.-Apr. 1967, at 135-37.

11 Black, *Certain Phases of Merger Accounting*, 83 J. Accountancy 214 (1947).

12 ARB No. 43, *supra* note 7, at 55.

13 AICPA, ARB No. 48 (1957).

is being made. For example, APB No. 8 on pension plans has substantially reduced accounting differences in a particularly troublesome area.[14] It is expected that more APB opinions, resulting in greater uniformity, will soon be forthcoming.

Careful investors should not be misled by increases in earnings due to accounting changes since the amount of increases due to such changes are disclosed by footnotes. Unfortunately, there is a grave danger resulting from the simplistic overemphasis of earnings per share. It should be recognized that the complete financial story for a company can not be capsulized into a single earnings per share figure.

On close examination, the charge that acquisition-minded companies resort to the practice of changing their accounting rules to inflate earnings appears to be true, but it is a practice not restricted to those companies alone. The areas of differences in accounting principles are being narrowed, and future possibilities for manipulation of profits are being minimized. The AICPA requires that the effect of the changes must be disclosed; thus the intelligent investor should not be misled if he looks beyond a single earnings per share figure.

THE EARNINGS PER SHARE QUESTION

Because of investors' overemphasis on earnings per share, managers of acquiring companies have attempted in the past to purchase companies with securities that would not depress earnings per share (eps). The procedure can be illustrated by a concrete example. Suppose Company *A* issues 10 million of its $50 par debentures in exchange for the outstanding 10 million shares of Company *B* common stock. The annual earnings, capitalizations, prices, dividends and related data for the two companies are as follows:

	A	*B*
Annual net income	$ 2 mil	$30 mil
Shares	1 mil	10 mil
EPS	$ 2.00	$ 3.00
Dividends	none	$ 1.50
Price	$40.00	$39.00
P/E	20×	13×

The resulting annual net income data and earnings per share for *A* (including *B*) after the take-over are shown below. The 10 million of $50 debentures issued by *A* pay 9 percent or $4.50 per debenture.

[14] AICPA, *Accounting for the Cost of Pension Plans,* APB Op. No. 8 (1966).

	AB Co.
Net income before interest and taxes (2 × 32, assuming a 50% tax rate)	\$64.0 mil
Interest on debentures	45.0
Net income before taxes	\$19.0 mil
Income taxes	9.5
Net income	\$ 9.5 mil
Number of shares outstanding	÷ 1.0 mil
Primary earnings per share	\$ 9.5

The stockholders of *B* generally would be pleased with the swap of their stock for debentures, insofar as they get interest of \$4.50 in exchange for dividends of only \$1.50. (Also, during the 1965-1967 period a good \$50 debenture with a 9 percent coupon would sell for more than the old *B* Common price of \$39.)

Meanwhile, *A*'s shareholders fare even better by the exchange. Company *A*'s P/E multiple of 20 might be depressed somewhat by the acquisition of stodgy old *B*, but even if its P/E were reduced to 10, the price of *A* Common would increase from \$40 to \$95. Moreover, the interest on the debentures costs *A* nothing. The \$4.50 of interest, less income taxes at an assumed rate of 50 percent, costs *A* only \$2.25 in after tax dollars, which amount is amply covered by *B*'s earnings of \$3.00 a share.[15]

Because of a growing concern over the quality of earnings per share for companies whose capitalization includes convertibles, options and similar securities, the APB issued Opinion 15, which prescribes the reporting of a fully diluted as well as primary earnings per share. If the 10 million of debentures in the above illustration were convertible into 12.5 million shares of *A* Common, fully diluted eps would amount to only \$2.37. It was the general belief of independent accountants that disclosure of this smaller, diluted eps in addition to the primary eps would have a depressing effect on the price of equities in merger-minded companies. The market for conglomerates in the late 1960's has tended to bear out this belief.

CONCLUSIONS AND RECOMMENDATIONS

Although Berle and Means' dire predictions of the 1930's regarding the increasing concentration of economic power have been wide of the mark, Federal Trade Commission statistics evidence an alarming increase in the number of mergers throughout the 1960's. Some observers believe that many of these mergers would not have taken place except for the use of certain

[15] CCH, EXPLANATION OF TAX REFORM BILL OF 1969 AS PASSED BY THE HOUSE, AUGUST 7, 1969 — H.R. 13270, at 680-82 (1969).

questionable financial and accounting devices. Basically, these include: (1) the use of pooling for acquisitions, (2) the switch to more liberal valuations at newly acquired subsidiaries, and (3) the issuance of "funny money" to inflate earnings per share.

The Accounting Principles Board of the American Institute of Certified Public Accountants has responded to each of these questionable practices. It issued Opinion 15 in May of 1969 which requires that earnings per share be shown on the face of the income statement. Corporations with potentially dilutive securities are required to present dual earnings per share calculations. The first amount is based on common shares and those securities equivalent to common. The second is a pro forma presentation that reflects the potential dilution from all convertible securities or contingent issuances of common stock. Opinion No. 15 creates certainty out of chaos — perhaps undue certainty. For example, suppose that a company issues a massive amount of warrants to purchase common stock. So long as the market price of the stock exceeds the exercise price of the warrants, no dilution is reflected in either of the earnings per share amounts calculated in accordance with Opinion 15.[16] Nevertheless, the warrants constitute a call on the common and therefore are potentially dilutive. Thus APB No. 15 promulgates a singular calculation for "pro forma earnings per share," when many financial analysts and investment bankers are interested in the calculation of different pro forma eps amounts for different purposes. A wide variety of other arrangements, or permutations of pro forma eps calculations can be made, and are of interest. Companies with complex capital structures may eventually wish to publish a range of eps amounts based on alternative assumptions regarding the issuance of additional shares, rather than continuing to publish merely a dual presentation of earnings per share.

The Accounting Principles Board has made considerable progress in narrowing the areas of differences in accounting by its issuance of opinions on pensions, leases, and income taxes. These opinions limit the opportunities for inflating profits of newly acquired subsidiaries by switching from one method of accounting to another. Nevertheless, rearrangements or permutations of earnings between years still exists. No doubt such permutations always will exist due to the judgmental nature of income measurement. However, an intelligent investor is not in as precarious a position as might seem at first glance. Generally accepted accounting principles require companies to disclose the effect of a change in accounting method on reported earnings in the year in which the change is made.[17] The investor has no excuse for naively making decisions based on a single earnings per share figure. He must be alert to the permutations that can arise from business combinations.

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16 AICPA, *Earnings Per Share*, APB Op. No. 15 (1969).

17 AICPA, *Accounting Principles*, APB Op. No. — (1970). The APB has an opinion in process which will elaborate on reporting the effects of changes in accounting procedures.

A further promulgation by the APB that would blunt the "urge to merge" was being considered in December of 1969. It would limit the pooling approach in accounting for business combinations. The initial draft recommends that assets acquired be restated at fair market value, with any excess of acquisition price over tangible assets charged to goodwill. The amount recorded as goodwill would have to be charged to earnings over a period not greater than 40 years.

The author believes such an extreme position is unwise. It fails to recognize the pragmatic nature of financial accounting. The pooling approach grew out of a need for it in a relatively few but important combinations, such as the Celanese-Tubize merger referred to earlier. It would be quite misleading to artificially designate one company as the purchaser when neither buys the other. The misuse of pooling should be eliminated, not its use.

At present, a combination can be accounted for either as a pooling or as a purchase if the criteria for pooling are satisfied. The use of pooling should be mandatory for true mergers. Studies by Professor Samuel Hayes and the author show that former equity holders are bought out in a majority of combinations,[18] in which event a purchase approach to accounting for the event is clearly dictated. Alternatively, pooling is appropriate. When pooling was first recognized as a generally accepted principle of accounting, the criteria for its use consisted of all of the following: (1) continuity of ownership, (2) continuity of management, (3) continuity of business purpose, (4) companies of approximately similar size, and (5) exchange of capital stock for capital stock.[19] ARB No. 48, of January 1957, relaxed these criteria, specifying that none were necessarily determinative.[20] Only the stock-for-stock requirement remains; and even it has been eroded by the use of warrants and similar securities. The author believes that the original criteria for pooling should be restored. As a further safeguard against its misuse, the American Institute of Certified Public Accountants could require that approval of pooling be cleared with a specially appointed panel. Such a panel would render advance rulings on the accounting for proposed combinations.

With the rapid increase in the number of business combinations in the last decade, the American public has witnessed a series of permutations in accounting policies and procedures. The Accounting Principles Board has reacted to these permutations, thus rendering generally accepted principles of accounting more rigid. Hopefully, it will not overreact. The investor needs like accounting for like events — not *like* accounting for *unlike* events.

The primary function of business accounting is to communicate the financial position and results of operations for companies to interested

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[18] Taussig & Hayes, *Cash Takeovers and Accounting Valuations*, 43 ACCOUNTING REV. 68, 73 (1968).

[19] ARB No. 43, *supra* note 7, at 55-56.

[20] ARB No. 48, *supra* note 13, at 2.

parties. The author believes that principles of accounting should neither help nor hinder potential acquisitors in their attempts to grow by mergers and take-overs. Principles of accounting should not be used to retard the concentration of economic power. Antitrust laws serve that purpose. If our society finds these laws inadequate, it can revise them in the usual democratic way. The Accounting Principles Board of the American Institute of Certified Public Accountants does not have the responsibility to establish extralegal regulations designed to restrict mergers and acquisitions.