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ACCOUNTING FOR BUSINESS COMBINATIONS: CHOICE OR DILEMMA

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The major purpose of accounting is to present the results of business and financial transactions. This is accomplished within a set of rules developed by the accounting profession and established and administered in recent years by an organ of the American Institute of Certified Public Accountants known as the Accounting Principles Board (APB).[1] The rules thus enumerated are known as "generally accepted accounting principles" (g.a.a.p.).[2]

Inasmuch as the state corporation laws governing corporate management and corporate finance speak in terms of accounting concepts, it is evident that accounting plays an important role in these areas.[3] To the extent that these concepts change or that a choice is permitted between two or more equally accepted principles, the legal result is influenced directly by the accounting principle changed or chosen, as the case may be. The influence of accounting has been expanded in recent years as the result of the risks now faced by directors under federal law for material misstatements or omissions of fact,[4] as well as the so-called exoneration type statutory provisions which permit directors to be free of liability in discharging their duties when reliance is placed in good faith upon financial statements or reports prepared by independent public accountants.[5]

In this very influential role, accounting prefers to think of itself as being neutral in recording and presenting the facts. Practically, however, the profession has not achieved this neutrality, largely due to the fact that

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1 To the extent that a business entity is subject to the federal securities laws, it and the accountants who prepare and certify its financial statements are also subject to accounting rules, principles and guidelines enunciated by the Securities and Exchange Commission (SEC), by means of the rules and releases promulgated by this agency. In recent years, the SEC has attempted to permit the private sector, *i.e.*, the APB, to shape the principles, expressing its views during the development period so that the ultimate rules are not different in substance from what it desires.

2 The promulgations of the AICPA were originally formulated by the Committee on Accounting Procedure and were known as Accounting Research Bulletins (ARB), but in recent years, following the creation of the Accounting Principles Board, the promulgations have been called "Opinions of the APB" or "APB Opinions."

3 Thus, we find that the payment of dividends and the reacquisition by a corporation of its own shares are circumscribed by limitations which are couched in accounting terminology, such as "surplus," "earnings and profits," "net assets in excess of capital," *etc.*

4 *See* 15 U.S.C. §§ 77f(11), (12) (1964); 17 C.F.R. 240.10b-5 (1969).

5 *See, e.g.*, N.J. STAT. ANN. § 14A: 6-14 (1968); N.Y. BUS. CORP. LAW § 717 (McKinney's 1963); MODEL BUS. CORP. ACT § 48 (1969).

in many situations alternative choices in recording and financial presentation are available under g.a.a.p. In the area of business combinations, not only are such alternatives available, but the choice of one or the other may produce substantially different results on the balance sheet and the income statement.

I. The Accounting Alternatives in Business Combinations

A business combination comes about as a result of the acquisition by one corporation (the "acquiring corporation," "acquiring entity" or "acquirer") of the assets of another corporation (the "acquired corporation" or "acquired entity") on a going concern basis, either directly, as in a merger, consolidation or purchase[6] of substantially all of the assets, or indirectly, by way of acquisition of at least 51 percent voting control of the shares of the acquired corporation. The acquiring corporation may part with cash or its equivalent (*i.e.*, debt)[7] as the consideration therefor, or it may issue its own voting shares in payment. The consideration involved is a major factor in governing the accounting alternatives available, these being denominated, respectively, as the so-called "purchase" method and the "pooling of interests" method.

Purchase Accounting

Where the consideration issued consists of cash or cash equivalents, or where the other criteria for pooling of interests accounting do not exist, purchase accounting is mandatory. Moreover, even when all the criteria for pooling accounting do exist, management can still elect purchase accounting.

As the term implies, the acquisition is recorded as a purchase of the going concern's assets by allocating the actual price paid among the assets acquired as agreed by the parties. Liabilities assumed, or to which the assets are subject, are recorded at the amounts owing. In other words, the purchase is recorded at cost. Any excess of the purchase price paid over the cost of the actual recorded assets, tangible or intangible, is deemed paid for the goodwill of the acquired entity and is recorded as such. If the goodwill has a limited life, g.a.a.p. require periodic amortization to expense over its useful life.[8] Otherwise, it remains as an asset on the balance sheet. On the other hand, in those relatively rare instances when the cost of the assets acquired is in excess of the purchase price, a so-called "nega-

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6 The term "purchase," as used in this definition, is being used in the generic or popular sense of "buying," and is not to be confused with the word "purchase" in "purchase accounting" as later defined.

7 For the purpose of this discussion, and in the interests of simplicity, reference will be made to cash or cash equivalents from time to time. Actually, non-voting preferred stock is treated the same as cash for the purpose of structuring the transaction from a financial accounting point of view.

8 AICPA, *Restatement and Revision of Accounting Research Bulletins*, ARB No. 43 ch. 5, ¶¶ 5-10 (1953).

tive goodwill" is recorded, and should thereafter be amortized on a regular basis.[9]

The foregoing accounting treatment differs somewhat as to form when the acquisition is that of the shares of the acquired corporation. Under such circumstances, its assets are not actually recorded on the books of account of the acquiring corporation, but instead, the acquired shares are recorded at cost. However, since the acquisition results in the acquired corporation becoming a subsidiary of the acquiring corporation, in the normal accounting process of consolidation, the assets of the subsidiary are written up to acquired cost to the extent this is ascertainable in available records and information, *i.e.*, as part of the underlying factors comprising the cost of the acquired shares.[10]

In all cases the cost of acquisition to the acquiring entity is measured by cash or cash equivalents if that is the consideration paid. If, however, shares are issued by the acquiring entity, then cost represents the fair value of the acquirer's shares issued or the fair value of the property acquired, whichever is more clearly evident.[11]

The purchase method results in the reflection of current costs on the combined balance sheet and the elimination thereon of the earned surplus (*i.e.*, historical retained earnings) of the acquired entity. Moreover, the combined earnings thereafter may often reflect the weight of goodwill amortization. Since this type of charge is nondeductible for federal income tax purposes, a depressing effect is reflected on the future income statements of the combined entity.

Pooling of Interests Accounting

Accounting Research Bulletin No. 48 (ARB No. 48) issued in 1957, outlines the present criteria for pooling in a fairly imprecise manner. Generally however, in order to qualify for this accounting treatment, a business combination must involve: (a) foremost, the issuance of voting stock by the acquired entity as the purchase price for the acquired business;[12] (b) the continuation by the former owners of the acquired entity

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[9] AICPA, *Consolidated Financial Statement*, ARB No. 51 ¶ 8 (1959).

[10] The consolidation process involves the addition of assets to assets and of liabilities to liabilities of the respective parent and subsidiary, the elimination of intercompany accounts, and the elimination of the account on the books of the parent reflecting the cost of the subsidiary's shares (usually called "Investment in Shares of Subsidiary ————") against the parent's percentage of book value of the subsidiary's stated capital and surplus as they were on the date of acquisition. To the extent that the investment account exceeds such percentage, the excess may be considered first attributable to revalue assets of the subsidiary in the consolidated statement, the remainder of the excess being goodwill. For a discussion of the consolidation process for the benefit of lawyers, see J. AMORY & R. HARDY, MATERIALS ON ACCOUNTING (3d ed. 1959).

[11] AICPA, *Business Combinations*, ARB No. 48 ¶ 8 (1957).

[12] *Id.* at ¶¶ 4-5. Sometimes nonvoting preferred shares convertible into voting shares are used, and can qualify the transaction for pooling accounting.

as holders of ownership interests in the combined entity;[13] (c) an intent by these persons to retain such shares;[14] (d) continuity of management;[15] and (e) retention of the business of the constituents to the combination for a reasonable period of time thereafter.[16]

When the criteria are met, management can still elect purchase accounting. If, however, pooling is chosen, the acquired assets are recorded at the book value as carried by the acquired entity and liabilities assumed or to which the assets are subject, are recorded at the amounts due. In addition, the earned surplus of the acquired corporation is carried forward and entered upon the books of the acquirer. Naturally, no goodwill can arise under these circumstances since the shares issued by the acquiring corporation are recorded at the book value of the net assets acquired, *i.e.*, the aggregate credit to stated capital and capital surplus (prior to any necessary adjustments to capital surplus) is recorded as being equal to the book value of the net assets acquired.[17] If shares rather than assets are acquired, the earned surplus of the acquired corporation is, nevertheless, entered on the books of the acquiring corporation, and the investment account on the books of the acquirer reflects a cost equal to the book value of the net assets acquired.[18] A necessary adjustment to capital surplus may also be required.

The major financial accounting benefits to the combination are two-fold, to wit:

(a) The combined entity reflects earned surplus (historical retained earnings) of the acquired corporation on its balance sheet;
(b) The two entities are deemed combined retroactively to their inceptions and, consequently, income statements may be restated for the past years to show combined earnings.[19]

In addition, and not incidentally, no goodwill having arisen, the depressing effect upon earnings of possible amortization thereof cannot occur.

Comparison of Purchase Versus Pooling Accounting

A comparison of the two methods of accounting for business combinations makes it abundantly evident that pooling is more desirable from the point of view of the acquiring entity if the acquired entity is being purchased because of its earnings history and potential. In such a case, the acquirer is probably paying a price (in terms of market value of its shares

13 *Id.* at ¶ 5.

14 *Id.* The SEC has engrafted on this principle the rule of thumb requirement that such persons may not dispose of more than 25 percent of such shares in the year following the closing, a second 25 percent in the following year and perhaps the balance thereafter.

15 *Id.* at ¶ 6.

16 *Id.*

17 *Id.* at ¶ 9.

18 *Id.* at ¶ 10.

19 *Id.* at ¶ 12, *as amended*, AICPA, *Omnibus Opinion*, APB OP. No. 10, ¶ 5 (1966).

being issued for the acquisition) substantially in excess of the fair value of the book assets being acquired. Such excess represents goodwill, of course. By electing the pooling method, the acquiring corporation (a) obviates the need to record goodwill and to cope with the decision regarding its amortization, (b) acquires the benefit of the prior earnings of the acquired corporation by reflecting these on its balance sheet and by restating prior income statements on a combined basis (commonly referred to as "instant earnings"),[20] and (c) by recording assets acquired at book value, circumvents the recording of depreciation of acquired assets computed upon higher costs, thereby achieving higher future earnings.

Needless to say, the foregoing advantages represent a great stimulant to the utilization of pooling accounting in business combinations, a fact which might be quite acceptable were it not for the abuses that developed.

II. The Case Against Pooling

Severe criticism has been leveled against the pooling method by eminent persons in the accounting profession.[21] The method has been so applied that actual distortions in financial presentation result to such an extent that the neutrality of accounting is jeopardized, and fair presentation[22] in financial statements does not always occur.

Whereas the criteria for application of the pooling concepts are somewhat flexible, they do contemplate that relative size of the constituents should not be too disproportionate, *i.e.*, there should be a joinder of two streams, so to speak (hence, "pooling").[23] In recent years, however, pooling has been applied in the so-called elephant-flea type of combination, where the sole apparent purpose was to pump the earnings of the tiny acquired entity into the large but unprofitable acquiring entity.

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20 Inasmuch as most acquisitions paid for by issuance of shares of the acquiring corporation are likely to qualify as tax-free reorganizations under the provisions of section 368 of the Internal Revenue Code, the fact that the assets of the acquiring entity are recorded at book value under the pooling method results in no tax detriment. For tax accounting purposes, these assets would likewise be picked up at a depreciated tax basis, thereby giving rise to no increased tax depreciation as a deduction. *See* Int. Rev. Code of 1954, § 358. This would be equally true were the acquiring entity to elect the purchase method and record the acquired assets at cost, unless the acquisition were for cash or equivalents to the extent necessary to disqualify the transaction as a tax-free reorganization.

It is to be noted that state corporation laws countenance this aggregation of earned surplus of the constituent entities. *See* N.J. Stat. Ann. § 14A: 7-8 (3) (1968); N.Y. Bus. Corp. Law § 517(a)(1)(B) (McKinney's 1963); Model Bus. Corp. Act § 21 (1969).

21 Briloff, *Dirty Pooling*, Barron's, July 15, 1968, at 1; Seidman, *Pooling Must Go*, Barron's, July 1, 1968, at 9.

22 *Cf.* United States v. Simon, — F.2d — (2d Cir. 1969), *cert. denied*, — U.S. — (1970), a criminal case against accountants predicated upon misleading information appearing on a balance sheet and a footnote thereto, wherein Judge Friendly made it quite clear that the terms "fairly presents" or "presents fairly" used by accountants in their certifications of financial statements, have independent meaning over and above naked compliance with the g.a.a.p.

23 AICPA, *Business Combinations*, ARB No. 48 ¶ 6 (1957).

In addition a new concept, known as "part purchase, part pooling," has developed. This method is not even referred to in ARB No. 48. Where the criteria for pooling exist, except for the fact that cash or cash equivalents constitute more than an immaterial portion of the acquisition price, that is, more than 5 to 10 percent thereof, and the remainder of such price is paid in voting shares, (and if the other criteria for pooling are met) pooling is applied pro tanto and purchase accounting to the remainder.[24] Aside from the fact that no real authority exists for this concept, where substantial cash is paid for an acquisition, it seems hard to justify the failure to reflect in full the new costs involved and the true effect upon earnings. Actually, costs, including goodwill, are really being swept under the rug.

Lastly, a major abuse lies in the employment of the retroactive feature, which is being utilized to improve earnings of the business combination in such a manner that acquisitions in the accounting period, and even shortly thereafter, are able to reflect an injection of profitability for such entire period, and even on a retroactive basis, to prior periods, so that the reader of the income statements is led to believe that things have always been rosy and bright.

Because of this dilemma, the APB has been examining the accounting principles applicable to business combinations, and two major studies have been completed over the past several years.[25] At first, the criticism was directed to the pooling concept only. It soon came to be realized, however, that even the abolition of pooling as such, would not foreclose continued possibility for abuse. If business combinations were required to account for same solely by use of the purchase method, the handling of goodwill would still present an area where accounting discretion or choice of alternatives could affect the results of financial presentation. Principally this occurs at the time the acquisition price is allocated to the assets acquired. To the extent that a greater proportion of this is allocated to goodwill rather than specific assets,[26] lower depreciation costs with respect to these assets find their way into the income statement. If, coupled with this misallocation, a decision is made not to amortize goodwill, costs will be hidden for the indefinite future.[27]

24 Gunther, *Part Purchase-Part Pooling: The Infusion of Confusion into Fusion*, 39 N.Y.C.P.A. 241 (April 1969).

25 Catlett & Olson, *Accounting for Goodwill*, ARS No. 10 (1968); Wyatt, *A Critical Study of Accounting for Business Combinations*, ARS No. 5 (1963); for a very fine commentary on the subject of ARS No. 10 containing constructive recommendations, see Kripke, *Accounting for Corporate Acquisitions and the Treatment of Goodwill: An Alert Signal to all Business Lawyers*, 24 BUS. LAW. 89 (1968).

26 Appraisals of assets are very flexible and often influenced by management's thinking. Furthermore, many intangible assets, such as patents, copyrights, franchises, leaseholds and the like, may have been expensed initially on the books of account of the acquired entity or may have been fully depreciated by it, yet could have substantial values which entered into the computation of the acquisition price.

27 Briloff, *Much-Abused Goodwill*, BARRON'S, April 28, 1969, at 3.

Accordingly, the present thinking of the APB has been crystalizing in the direction of a compromise solution, whereby the criteria for pooling would be severely limited and the dividing line between purchase and pooling accounting clearly delineated. Thus, the degree of discretion remaining with management or the accountants would be insignificant. Retroactivity would also be curtailed, and finally, goodwill amortization would be required.[28]

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[28] The APB has been applying itself intensively to the problem. During the spring of 1969, and again, in the fall of 1969, APB circulated confidential drafts of an incipient opinion, which at those times recommended elimination of pooling, careful allocation of acquisition price to specific existing assets, tangible and intangible, whether or not these appeared on the books of the acquired entity, see *supra* note 26, and amortization of goodwill over a period of not more than 40 years. Symposiums were held respectively on June 17, 1969, and October 22, 1969, which the author, in his capacity as a member of the Panel on Corporate Law and Accounting of the American Bar Association, attended. Thereafter, the APB continued its work on the subject and finally issued its position letter of December 15, 1969, which outlined the points to be incorporated in an official exposure draft as follows:

(a) *Relative Size of Constituents*
Shareholders of the smaller company should receive not less than a 25 percent interest in the combined common stock equity interest (referred to as a 3-to-1 size test).

(b) *Medium of Exchange*
Only common stock can be used to effect a business combination accounted for as a pooling. Use of convertible preferred stock whether or not it is a common stock equivalent for earnings per share computations will not be acceptable.

(c) *Single Transaction*
The acquisition for stock must be carried out within one year — no part-purchase, part-pooling.

(d) *Minority Interest*
No more than an aggregate of 10 percent of the outstanding common stock of the acquired company may be acquired by consideration other than common stock or remain as a minority interest.

(e) *Contingent Issuances*
There should be no agreement to issue additional common shares or other consideration at a later date, except where significant contingent liabilities exist.

(f) *Retirement of Stock Issued*
There should be no commitment or plan to buy back within two years any of the common stock issued, nor should there be other financial arrangements made for the benefit of the former stockholders of the acquired company.

(g) It is contemplated that a combination accounted for as a pooling and consummated after the end of a fiscal year shall not be reflected in financial statements to shareholders covering the year being reported on. (This would be a rescission of ¶ 5 of APB Op. No. 10.)

(h) Major conclusions expressed in the October 8, 1969 draft Opinion with respect to purchase accounting remain essentially unchanged at this date. Goodwill shall be amortized over a period not to exceed 40 years.

(i) Where the criteria for pooling exist, pooling would be required.

On February 23, 1970, The APB circulated an exposure draft of a proposed APB opinion to be entitled "Business Combinations and Intangible Assets." The exposure draft largely embodies the points described above with the additional material requirement that the combined corporation does not intend to dispose of a significant part of the assets of the combining companies in a pooling situation within two years after combination except to eliminate duplicate facilities or excess capacities.

III. CONCLUSION

Because of the advantages usually accruing to the acquiring entity in a business combination when the pooling method is applied, pooling, as such, has become an affirmative factor or catalyst influencing the trend toward the business combinations so prevalent in the decade just ended. Thus, management of a corporation seeking acquisition is always concerned with earnings, because these, in turn, influence the market price of the corporate shares and the price at which the corporation can raise additional capital or issue its shares in a later combination, thus enabling it, in turn, to expand further. That this is recognized by those seriously concerned with this trend toward business combinations was made graphically evident when the Federal Trade Commission recently recommended the abolition of pooling-of-interests accounting in a recent report.[29]

Do the foregoing abuses and problems, therefore, constitute a valid reason for the abolition of pooling accounting? The answer must be a loud and emphatic NO! If accounting is to remain neutral, it cannot allow its rules to be influenced by government antitrust policy, economic trends, or the like. The sole criterion must be the validity of the ultimate exposition of financial data to the persons who read financial statements. It is submitted that pooling of interests is a valid accounting method which fills a definite need in that area where a going concern is acquired, as distinguished from an isolated asset. One should not analogize between a single acquisition and a true joinder of going concerns and streams of earnings. Moreover, it would be wrong in the process of acquiring earnings to destroy historical earnings (*i.e.*, not to carry over accumulated earned surplus), which is what abolition of pooling entails. Furthermore, abolition of pooling would be missing the point, in a sense, because the goodwill issue is perhaps the major problem.

Accordingly, it is submitted that limited pooling within a specific area but on a nonelective basis is the desirable answer. Amortization of goodwill must be required in the context of a total solution of the problem. Therefore, the present tentative position of the APB is most sensible as a solution for the business community, and perhaps, even a saviour for the ultimate integrity of accounting.

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29 FTC REPORT TO THE SUBCOMM. ON ANTITRUST AND MONOPOLY OF THE SENATE COMM. ON THE JUDICIARY, in CCH FED. SEC. L. REP. ¶ 77,759 (Nov. 4, 1969).