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AN IN-DEPTH INQUIRY INTO CURRENT PRACTICES  
IN ACCOUNTING FOR BUSINESS COMBINATIONS

by

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## CHAPTER I

## INTRODUCTION

When two or more accounting alternatives exist for recording a specific transaction, the method ultimately selected to account for the transaction could have a significant impact on the reported financial position and on the future results of operations. Although two methods of accounting for business combinations (pooling and purchase) are not considered alternatives because they are not elective, these two methods are both in use and, depending on which method is used, could produce vastly different financial statements. Because of these differing results, the accounting for business combinations is extremely controversial and has plagued the accounting profession and financial community for almost 30 years. The controversy is far from settled! In fact, the American Institute of Certified Public Accountants' (AICPA) Financial Accounting Standards Board (FASB) placed the accounting for business combinations on its technical agenda during November 1973, where it still remains. On August 19, 1976, almost three years later, the FASB issued a Discussion Memorandum entitled "Accounting for Business Combinations and Purchased Intangibles." The Discussion Memorandum presents the issues pertaining to the problem, but offers no solution to the problem. The state of the art of accounting for business combinations will be the object of this research.

When a firm purchases an asset for cash, generally accepted

accounting principles (GAAP) mandate that "Assets acquired in exchanges are measured at the exchange price, that is, acquisition cost."<sup>1</sup> The rationale for this treatment is that the cash price is assumed to be arrived at by arm's-length bargaining and represents the current market value at the exchange date. It is also an objective valuation. The purchase of a group of assets will not alter this treatment; however, an allocation will be required. Accounting Principles Board (APB) Statement No. 4 states: "A group of assets acquired in a single exchange is measured at the exchange price. The total price is allocated to the individual assets based on their relative fair values."<sup>2</sup> This procedure ignores the seller's book values; they are considered irrelevant to the exchange transaction, since a new basis for accountability exists. The previous owners are not involved in the business where the assets are presently employed; the new owners are responsible for the utilization of the assets acquired.

Frequently property other than cash is used to acquire assets. Where this is done, the measurement of the exchange price is "... the fair value of the assets given up. However, if the fair value of the assets received is more clearly evident, the assets acquired are measured at that amount."<sup>3</sup> Similar wording exists in Accounting Research Bulletin (ARB) No. 43<sup>4</sup> and APB Opinion No. 29.<sup>5</sup>

Present Methods of Accounting  
for Business Combinations

A business combination is classified as a merger if one, and only one, of the parties survives; as a consolidation if all parties to the combination are merged into a new surviving corporation, or as an acquisition if a parent corporation acquires more than 50% of the stock of other corporations and all parties continue in existence.

Presently, two methods of accounting for business combinations are sanctioned by GAAP. One method, called "purchase accounting," requires that the transaction be recorded at its fair value since a new basis for accountability is said to exist. This method is used where cash, debt and/or securities other than common stock are used, or if these are used in conjunction with common stock. If a small amount of cash, debt and/or securities other than common stock (10% or less, as explained in Chapter VI) is used in conjunction with common stock, an exception will be made, and the other method (pooling) will be used.

The second method of accounting for a business combination, called "pooling accounting," is used where only common stock (or at least 90% is common stock, as explained in Chapter VI) is used to effect the combination and certain other criteria are met. When pooling accounting is used, a new basis for accountability is said not to exist. In pooling, the book values of the parties to the combination are combined for reporting purposes, and the fair market

values are not used as in purchase accounting. Each method will now be explored.

Purchase Accounting

The treatment of a business combination as a purchase is compatible with the treatment of any asset acquired by a business entity; the fair value of the transaction is the basis of recording the exchange. When purchase accounting is used:

1. It is assumed that one party to the transaction is the dominant one (in practice, this is true for poolings but theoretically need not be).
2. The parties have bargained in good faith using fair values rather than book values (this is true for poolings).
3. The transaction is recorded at the fair value of the price paid (cash, debt, preferred stock, etc., or combinations of these with common stock).
4. The components of the assets acquired will be recorded at their respective fair values. Any excess of cost over the fair values of total tangibles will be assigned to intangibles.
5. The Retained Earnings of the former owners shown on the balance sheet is not carried forward to the books of the acquiring corporation.
6. The revenues subsequently generated by the acquired assets are matched with the expired costs, using prices paid for the assets rather than the book values of the selling corporation.

### Pooling

The treatment of a business combination as a pooling is a special case of accounting for a business combination. This treatment must be used when the attributes of the combination meet the specified criteria discussed later in Chapter VI. A major attribute is that the combination be effectuated by the exchange of common stock (90% or more of the selling stockholders must accept common stock). When common stock is exchanged for common stock, arguments have been advanced to support the pooling concept. Proponents of pooling maintain that:

1. A pooling of interests is a transaction taking place between the stockholder groups of the parties to the combination. The entities have not changed; the stockholder interests have merely been realigned.
2. The stockholders have pooled their risks and resources and now each stockholder group shares the risks of each other while continuing to share a part of its former risks.
3. No assets or liabilities of the firms are altered. Common stock is not an asset, and consequently no assets have been disbursed. (This argument is considered specious by "purchase" advocates. They maintain that, while it is true that unissued capital stock is not an asset, issued capital stock has an opportunity cost equal to the cash it could have brought into the firm. In fact, if issued shares are issued for less than fair value, the stockholders of the firm would consider management derelict in the performance of its duties

since the stockholders' investments will be diluted by the shares issued for less than fair value.)

4. The income streams of the separate entities converge into one income stream, that of the combined entity. Therefore, there is no need to revalue the assets producing the income stream. (This argument is valid for joint ventures, but is questionable when an exchange of stock has taken place which alters the rights of the shareholders. This question will also be examined more closely in the next section dealing with the "entity approach" vs. the "stockholder approach.")

"Operating (Entity) Approach"  
vs. "Stockholder Approach"<sup>6</sup>

Part of the controversy regarding the accounting for business combination hinges on whether the combination is viewed from the "operating (entity) approach" or from the "stockholder approach." The former approach views a business entity as being a unit separate and distinct from its stockholders, with stockholders supplying part of the capital to operate the entity and creditors supplying the balance. Accordingly, when an entity combines with another entity, a new basis of accountability is said not to exist, since there has been no change in the operations of the separate entities, except that they are now additive.

The "stockholder approach" views the results of operations as an adjustment of stockholders' equity and any asset acquisition as being stockholder oriented. Therefore, any asset acquisition

requires a new accountability, and this is equally true for a bundle of assets such as a complete operating business.

An analysis of the conflicting approaches can best begin by examining the accounting treatment for a joint venture. Each party to the joint venture contributes to the venture and, when the venture is completed, each party will participate to the extent of his share. The operating approach is clearly relevant here, since the parties have joined forces in the operations of the venture without any stockholder realignments.

Where separate entities continue to operate as one unit after a combination, a realignment of stockholder interests has taken place based on many factors. Some of these are: (1) market values of the respective companies, (2) desirability of sharing in each other's future, (3) ability to negotiate, (4) risk factors, (5) urgency, etc. When factors such as these are introduced, it appears that the "stockholder approach" is more relevant since:

1. The market values of the respective shares represent stockholder evaluations of the worth of the combining parties. This is best borne out by the fact that, when a combination is announced publicly, the market prices of the respective shares of stock change, sometimes radically (a realignment of stockholder interests). If the combination is subsequently abandoned, price changes usually revert to former levels. These price changes cannot be justified solely upon expected economies of scale. In fact, many times the entities are continued as separate segments, and economies of scale

are nil. Obviously, the exchange ratio will be a factor that affects market price behavior.

2. If the "operating approach" were the relevant one, market price behavior would reflect only the expected economies of scale, and, if present value techniques were applied to the economies, market price changes would be much smaller.

3. If a combining stockholder is free to terminate his association with the combined entity immediately after the exchange of shares, this indicates "stockholder" behavior rather than "entity" behavior. In "entity" behavior, a termination of interest usually involves a termination of operations.

#### Need for Study of Problem

An examination of Table 1 will reveal that the current (1960 to present) level of business combinations is high in relation to earlier periods.

This study was undertaken for the following reasons:

1. The level of business combinations is high in relation to earlier periods.
2. A major overhaul of the accounting for business combinations was made in 1970 when AEB Opinions No. 16 and No. 17 were issued (the historical development of these Opinions will be discussed in Chapter II). Thus far, no empirical evaluation of these Opinions has been made.

TABLE 1  
 MANUFACTURING AND MINING  
 MERGERS AND ACQUISITIONS 1920-73

Years	Number	Years	Number
1920-24	2,235	1965	1,008
1925-29	4,583	1966	995
1930-34	1,687	1967	1,496
1935-39	577	1968	2,407
1940-44	906	1969	2,307
1945-49	1,505	1970	1,351
1950-54	1,424	1971	1,011
1955-59	3,365	1972	911
1960-64	4,366	1973	874

Source: U.S. Bureau of the Census, Statistical Abstract of the United States: 1975 (96th Edition). Washington, D.C., 1975.

3. On July 12, 1973, the FASB invited interested parties to comment on the need to replace or revise existing pronouncements of the AFB. In November 1973, Marshall S. Armstrong, FASB chairman, said that "the letters of comment indicated that the overall subject of business combinations is one that most urgently required the Board's attention."<sup>7</sup> Three years later (1976), the FASB is no closer to a solution despite the issuance of a Discussion Memorandum on the topic.

4. This study will evaluate the present treatment of accounting for business combinations to determine if, in fact, the present treatment provides investors and decision-makers with financial information that is reliable and useful.

### Research Methodology

It is generally agreed that financial reporting should provide information that is both useful and reliable for economic and investment decision-making. The information should show the entity's resources, its obligations, its economic progress, any changes in resources and obligations, and information that is useful for predicting future performance. In addition, the information must be reliable, neutral and as free from bias as possible, relevant, understandable, verifiable, timely, consistent (comparable) and complete.<sup>8</sup>

Chapter III of this inquiry discusses the parameters that will be used to determine if current reporting practices for business combinations meet the previously stated objectives of financial reporting in situations involving combinations.

Chapters IV and V discuss and interpret the results of an empirical study of corporate reporting practices relative to accounting for business combinations. The purpose of the empirical study was to determine if corporate reporting practices meet the previously stated objectives of financial reporting.

All New York Stock Exchange listing applications for 1972 and 1973 were examined for those listings involving a business combination. The listings were then categorized between pooling treatment and purchase treatment. Each combination was also analyzed and categorized for: (1) size of participants, (2) market value of shares exchanged, (3) book value of company acquired, (4) return

on investment using market value as the base, (5) return on investment using book value as the base, (6) analysis of treasury stock transactions, and various other factors.

Chapter VI analyzes APB Opinions No. 16 and No. 17 and Interpretations of these Opinions, and Accounting Series Releases (ASR) of the Securities and Exchange Commission (SEC) relating to business combinations. Each of these is then evaluated in light of the empirical studies of Chapters IV and V.

Conclusions and recommendations follow Chapter VI.

## FOOTNOTES

1. Accounting Principles Board, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises (Statement No. 4; New York: American Institute of Certified Public Accountants, 1970), p. 72.
2. Ibid.
3. Ibid.
4. Committee on Accounting Procedure, Restatement and Revision of Accounting Research Bulletins (Accounting Research Bulletin No. 43; New York: American Institute of Certified Public Accountants, 1953), p. 56.
5. Accounting Principles Board, Accounting for Nonmonetary Transactions (Opinion No. 29; New York: American Institute of Certified Public Accountants, 1973), par. 18.
6. John C. Burton, Accounting for Business Combinations: A Practical and Empirical Comment, New York: Financial Executives Research Foundation, 1970, pp. 13-15.
7. Financial Accounting Standards Board, "Business Combinations Added to Board's Technical Agenda," Status Report, No. 6, Nov. 28, 1973, p. 1.
8. Accounting Principles Board, Statement No. 4, op. cit., pp. 32-43.

## CHAPTER II

## SIGNIFICANT HISTORY OF POOLING ACCOUNTING

With the exception of some brother-sister (different corporations owned by the same stockholders) poolings in the 1920's, the first significant pooling made its debut shortly after World War II. The chairman of the American Institute of Accountants' Committee on Co-operation with the Securities and Exchange Commission, a partner in Peat, Marwick, Mitchell & Co., published a paper about a petition his firm filed with the SEC regarding the merger of the Celanese Corporation and Tubize Rayon Corporation.<sup>1</sup> The paper was concerned with the following:

1. The merger was consummated because the two firms would operate more efficiently under one management.

2. Since the firms had actually "pooled" their operations and resources, it seemed unfair that the earned surplus of Tubize Rayon Corporation would be capitalized and not be available for dividends.

3. A large goodwill account would be created if purchase accounting were used, and, since it appeared that the combined entity had little or no goodwill, it would require an immediate write-off of the goodwill account to surplus. (This argument advanced by the author of the petition appears to be specious. If there was no goodwill implicit in the transaction, the price paid should be for tangibles only. Hence, there should not be any goodwill in the

transaction.)

With these seemingly innocuous reasons to justify the birth of a new method of accounting for business combinations, William M. Black, the author of the paper and brief, created a flood of inquiry that became one of the most pervasive and controversial topics written about in recent accounting literature and that occupied the minds and talents of many important leaders of the accounting profession.

It was not too long (three years) after the Celanese brief that the Committee on Accounting Procedure of the American Institute of Accountants (chaired by Samuel J. Broad, a partner in Peat, Marwick, Mitchell & Co.) issued Accounting Research Bulletin No. 40 (September 1950). This bulletin attempted to differentiate the criteria to be used in accounting for pooling of interests versus purchase accounting. Mentioned therein were the following pooling requirements:

1. Continuance of the former ownership--shares received by the several owners of the predecessor companies should be substantially proportionate to their respective interests in the predecessor companies.

2. A plan or firm intention to retire capital stock issued to any of the parties--otherwise, any substantial changes in ownership immediately before or after the combination would require a purchase treatment.

3. Relative size--having a party to the combination that is

minor in size would warrant purchase accounting.

4. Management--if either of the managements are eliminated or the ability to influence the surviving management is small, purchase accounting is indicated.

This bulletin contained an interesting caveat. One is warned that "Due to a variety of conditions under which a pooling of interests may be carried out it is not practicable to deal with the accounting presentation except in general terms."

The draftsmen of ARB No. 40 were prophetic indeed. The variety of conditions where pooling was applied, specifically in the area of the size of the combining parties, led the 1956-57 Committee on Accounting Procedure to attempt a more sophisticated delineation of the criteria for pooling accounting. Accounting Research Bulletin No. 48, issued in January 1957, retained most of ARB No. 40 (revised and restated in ARB No. 43, Chapter 7, Section C), but deleted the relative-size concept which was stated in general terms in ARB 40(43) and substituted a definitive range. If a participant obtains less than 5% to 10% of the combined voting interests, purchase accounting is presumed. ARB No. 48 did state, however, that "Relative size of the constituents may not necessarily be determinative. . . ." This attempt to delineate relative size had the following effects:

1. FMC Corporation combined with Buffalo Electro-Chemical Company, Inc., in 1952 (before the issuance of ARB No. 48), and Buffalo stockholders received 10.5% of the combined voting interests. This was recorded as a purchase, which was in accordance with SEC

guidelines at the time. Intangibles of \$8.2 million were recorded out of a total price of \$13.6 million. When ARB No. 48 was issued (five years later), this purchase was retroactively recorded as a pooling, using the 1952 book values of Buffalo. The previously booked \$8.2 million of intangibles was thereby eliminated, and the explanation given was that this was in accordance with generally accepted accounting principles.

2. Similar results were achieved with Philip Morris and Benson and Hedges with 15.4% of the voting interests being exchanged. Out of a total price of \$21 million, \$14 million of intangibles recorded in 1954 was wiped off in 1957 as a result of the issuance of ARB No. 48.

3. In fact, during the period 1957-63 approximately 25 companies amended their original listing applications to change from purchase accounting to pooling, indicating that ARB No. 48 permitted a pooling.

4. The ARB No. 48 size criterion eroded with time, as evidenced by these previously recorded purchases that were changed to poolings retroactively.<sup>2</sup>

TABLE 2  
PURCHASES RETROACTIVELY CHANGED TO POOLINGS  
1957-1959

Acquirer	Size of Pooling Based on Shares Issued
American Machine & Foundry	4.2%
American Machine & Foundry	5.3%
Aluminum Corporation of America	1.6%
Raytheon Company	1.2%
Riegel Paper Corporation	4.1%
Universal Match Corporation	1.7%

5. Finally, the erosion of the size criterion continued until poolings were booked where less than 1/10 of 1% of the voting stock was issued to acquirees.

ARB No. 48 also made the following acceptable for pooling:

1. A parent-subsidary relationship.
2. Senior securities and restricted stock.
3. Retirement, redemption or conversion of senior securities.

The following table<sup>3</sup> appeared in Accounting Research Study No. 5:

SIZE RELATIONSHIP OF CONSTITUENTS IN  
BUSINESS COMBINATIONS

Relative Size of Smaller Company in Surviving Co.	Business Combination Accounted for as					
	Pooling of Interests			Purchase		
	1949- 1952	1954- 1956	1958- 1960	1949- 1952	1954- 1956	1958- 1960
Under 3%	1	1	22	3	7	33
3%-5%	0	2	15	2	6	11
5%-10%	5	3	23	26	22	13
10%-15%	5	6	12	12	7	4
15%-20%	0	4	10	6	8	2
20%-30%	9	5	0	5	3	1
Over 30%	6	15	7	0	2	2
Total	26	36	89	54	55	66

From the foregoing table it is apparent that:

1. Most business combinations during the periods 1949-1952 and 1954-1956 were accounted for as purchases.
2. For the period 1958-1960 a shift from purchase accounting to pooling accounting occurred.
3. Poolings during 1949-1952 and 1954-1956 generally exceeded a size relationship of 5%-10%, whereas for the period 1958-1960 the bulk of poolings were less than 10% in size.

4. Since ARB No. 48 was issued in 1957 for clarification purposes, and a drastic change in accounting for business combinations occurred in the immediately following period of 1958-1960 as indicated above, it is evident that ARB No. 48 proved to be a boon to pooling users instead of the clarification that was needed.

Between 1957, when ARB No. 48 was issued, and 1970, when APB Opinion No. 16 was issued, several astute academicians and practitioners apprehensively witnessed the development of various kinds of abuses of the pooling accounting concept. The eminent George C. May called attention to some potential abuses in his article "Business Combinations: An Alternate View."<sup>4</sup> Other practitioners saw some of the pitfalls of pooling, but it was Prof. Abraham J. Briloff who apprised the academic and financial communities of the seriousness of the pooling abuses in his article "Dirty Poolings,"<sup>5</sup> an address before the New York Society of Security Analysts on January 10, 1968, and subsequently published in Barron's.<sup>6</sup> Various kinds of abuses emerged during this period, the more notables ones being:

1. Retrospective pooling: Combining with a company after the close of the fiscal year but before a report is issued. A company with a loss could combine with a company showing a profit and the loss could be buried in the combined (restated) report. This treatment was mandated by APB Opinion No. 10, issued in December 1966.

2. Part purchase/part pooling: Using cash and securities and treating each as a separate transaction. The cash portion (purchase accounting) can be applied to cash, receivables and other assets whose book values are stated at fair market values. The stock portion (pooling accounting) can be applied to inventories and plant assets whose book values may be significantly below fair market values, and these assets could then be carried forward at book value.

3. Instant earnings: Combining with a company having low book values for certain assets (marketable securities, LIFO inventories, amortized assets) and then selling them at substantial gains after the combination. Since the fair market value of these assets was not booked, the reporting of a gain is virtually assured. Admittedly, some of these gains would appear as separately disclosed, but any gains on LIFO inventory disposals would be incorporated into operating income, with no apparent separate disclosure.

4. Funny money: Using securities which are not common stock, but have common stock properties (warrants, etc.) which did not dilute the earnings per share (EPS) statistic, prior to the issuance of APB Opinions No. 9 and 15.

5. Contingent payouts: Issuing additional shares of stock after the combination is completed. The number of additional shares of stock would be contingent upon the earnings of the seller and/or the market price per share of the purchaser.

6. Treasury stock: Acquiring treasury stock either before or after a combination. If one considers this a "step transaction," then the combination was actually effectuated with cash, the two steps being:

- a. Using cash to acquire the treasury stock,
- b. Using the stock to combine as a pooling of interests.

Since the above-named practices were extensively used by pooling-oriented acquirers, it is reasonable to ask, "Why did the acquirers engage in these abuses?" Two possible reasons are worth noting. The first reason, an obvious one, is that the managements of acquiring firms wished to enhance the reported results of their firm's operations for purposes of self-interest. Reporting a growth in sales volume, a growth in earnings, and a favorable trend in ratios commonly used by financial analysts is bound to have a favorable impact on any incentive compensation granted to the managers. (These effects are demonstrated in Chapter IV.) The second reason is to possibly enhance the return to stockholders. By attempting to fool the marketplace with earnings growth that is really accounting gimmickry, the managers, if successful, could enhance the market value of the firm. This area is a topic for future research and is discussed in Chapter VII under the heading "Future Research."

And so, with these abuses hanging so clearly within the perspective of the Accounting Principles Board, the Board decided that a new approach was necessary if faith in the accounting

profession was to survive. While it is true that current-value accounting would obviate the need for pooling reform, it was equally true that a proposal for current-value accounting was unlikely to be adopted in the near future. This meant coming to grips with the problems associated with ARB No. 48. Accounting Research Study No. 10 was commissioned and emerged in 1968. Entitled "Accounting for Goodwill," the study's conclusions were generally rejected by both academician and practitioner. Yet, one conclusion reached by the authors regarding the accounting treatment of business combinations was the same as that reached in the earlier, more sophisticated study (ARS NO. 5), namely, that combinations should be accounted for as purchases. At its September 10-13, 1969, meeting the APB reached a tentative position that poolings would be eliminated; it reaffirmed this position at its October 23-25 meeting. A change in thinking occurred between October 25 and December 6 because, after its December meeting, the Board reversed itself and concluded that pooling would still be permitted, but under severely restricted usage. The Board stated: "Most business combinations would be accounted for as purchases. The pooling method would be retained on a restricted basis. . . ."<sup>7</sup>

The Board then delineated the criteria for pooling, one of which was a size test of 3 to 1 or a minimum of 25% of the combined outstanding common stock would have to be issued. This proposed size test was met with opposition from the Financial Executives Institute and the SEC. Langer<sup>8</sup> contends that the SEC's failure

to support this size test set the stage for its demise. At this point, the SEC was indifferent to a 9-to-1 size test, but it indicated that it would support this test if it were enacted. When the 9-to-1 test was proposed in place of the 3-to-1 size test, an intense lobbying effort against any size test was commenced by the Organization for Consistent Accounting Principles, and a class action for \$1 billion was commenced against the AFB. Again, the SEC failed to support the 9-to-1 size test, and the final draft of Opinion No. 16 excluded any size-test requirement.<sup>9</sup> Finally, after much politicking, the accounting for business combinations was split into two opinions, Nos. 16 and 17 (a two-thirds majority was otherwise unattainable).

## FOOTNOTES

1. William M. Black, "Certain Phases of Merger Accounting," The Journal of Accountancy, v. 83, March 1947, pp. 214-220.
2. Samuel R. Sapienza, "Distinguishing Between Purchase and Pooling," The Journal of Accountancy, v. 111, June 1961, pp. 38-40.
3. Arthur R. Wyatt, A Critical Study of Accounting for Business Combinations (Accounting Research Study No. 5; New York: American Institute of Certified Public Accountants, 1963), p. 27.
4. George O. May, "Business Combinations: An Alternative View," The Journal of Accountancy, v. 103, April 1957, pp. 33-36.
5. Abraham J. Briloff, "Dirty Pooling," Accounting Review, v. 42, July 1967, pp. 489-496.
6. Abraham J. Briloff, "Dirty Pooling: How To Succeed in Business Without Really Trying," Barron's, v. 4<sup>th</sup>, July 15, 1968, p. 1.
7. Accounting Research Association, Accounting for Business Combinations, Newsletter, New York: American Institute of Certified Public Accountants, v. II, No. 9, December 15, 1969.
8. Russell Davis Langer, Accounting as a Variable in Mergers (unpublished Ph.D. dissertation, University of California, Berkeley, 1976), pp. 185-88.
9. Ibid.

## CHAPTER III

## OBJECTIVES OF ACCOUNTING FOR BUSINESS COMBINATIONS

Basic Reporting Objectives

Since the accounting treatment of a business combination is a part of the overall accounting reporting process, an examination of the general objectives of financial statements is useful to determine the objectives of accounting for business combinations.

In 1970, the AICPA, through its APB, stated: "General objectives determine the appropriate content of financial accounting information. These objectives are to present reliable information about enterprise resources and obligations, economic progress, and other changes in resources and obligations; to present information helpful in estimating earnings potential, and to present other financial information needed by users, particularly owners and creditors."<sup>1</sup>

This statement by the APB has been questioned by many writers in the financial community. Prof. Joshua Ronen<sup>2</sup> states: "Arguments were put forth stating that, in view of the generally demonstrated efficiency of the marketplace, Adam Smith's invisible hand will cause the appropriate kind and quantity of accounting information to be communicated; and that therefore the regulation of accounting information by a group of interested preparers and users will be wasteful." In his paper he discusses the implications of the

efficient-market hypothesis and the need for accounting objectives and information. He concludes: "Considering the existing theory and evidence related to efficient markets, the choice of accounting alternatives cannot be determined solely through the examination of market price reactions to accounting information. Explicit formulation of accounting objectives is needed."<sup>3</sup>

Professors Dyckman and Downes, after examining the works of Fama, Jensen, Geonedes, and Beaver and after reviewing the studies of Ying, Lorie-Niederhoffer, Cheng and Deets, Kaplan and Roll, Homa and Jaffe, Douglas, Jacobs and others, state: "Accounting information may have a significantly greater societal impact than current writers on efficient markets would have us believe. Unfortunately, testing will be difficult . . . because of both the problems of data availability and valid cost-benefit measurements."<sup>4</sup>

Prof. Leopold A. Bernstein<sup>5</sup> states: "Financial analysts, and particularly the academic sector of that profession, relying on theories such as 'efficient capital markets,' have in recent years veered away from rigorous fundamental analysis which, in the past, has been the mainstay of a rational approach to investment decisions. This is an unwarranted and ominous development from the point of the accounting profession. . . ." He continues: "Most serious researchers working at the frontier of accounting improvement seem to agree that the key to proper accounting standards is correct identification and assessment of the objectives and

needs of users of financial statements." In challenging Professor Beaver's hypothesis regarding the FASB role in light of the efficient-market theory, Professor Bernstein points out: "It would, in my opinion, be a grave mistake for the FASB to accept, at this early stage, the tentative implications of the 'efficient market hypothesis' as a basis on which accounting standards are formulated. Accounting needs a far more solid base. . . ."<sup>6</sup>

In 1973, the AICPA, through its Accounting Objectives Study Group (AOSG), stated: "An objective of financial statements is to provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty."<sup>7</sup> The AOSG also concluded that ". . . the information needs of creditors and investors are essentially the same. Both groups are concerned with the enterprise's ability to generate cash flows to them. . . ."<sup>8</sup> Prof. George H. Sorter<sup>9</sup> states: "Providing information concerning the ability of an enterprise to generate cash for payment to creditors and investors is a primary function of financial statements. . . ."

The objectives of special reports for use by special groups will not be examined in this study; the examination of objectives will be limited to those pertaining to general purpose financial statements. Since the management of an enterprise has access to information not reported in stockholder and creditor financial statements, the objectives pertaining to management's needs are

not pertinent to this study.

The APB stated: "Certain qualities or characteristics make financial information useful. Providing information that has each of these qualities is an objective of financial accounting. These qualitative objectives are (1) relevance, (2) understandability, (3) verifiability, (4) neutrality, (5) timeliness, (6) comparability, and (7) completeness."<sup>10</sup> It is these objectives, and others enumerated by the AOSG, that will now be examined.

#### Problems of Achieving Basic Objectives

In many instances, the seven attributes cited in the preceding paragraph are in conflict. For example, a pervasive measurement principle states that the acquisition of assets shall be recorded at the "exchange price." This principle is derived from the third objective, verifiability. Yet a modifying convention, conservatism, conflicts at times with the "exchange price" principle, and when this occurs, a trade-off approach will release the stringency of the principle in favor of the modifying convention. Assets are generally carried at "exchange prices" until sold, when the earning process is complete and gains are recognized. However, in many cases, if an asset has had a diminution in market value, conservatism requires the loss to be reflected prior to the time when the earning process is complete. This is an inconsistency bearing on the objectives of comparability and

and verifiability, yet is desirable from the standpoint of conservatism.

Another prevalent problem is the one dealing with different methods of recording transactions. There are valid reasons for permitting alternative treatments of accounting transactions. Since many accounting alternatives are in use, it is not necessary to explore all of them; two examples will suffice. Although the selection of an alternative for depreciation of plant and equipment and/or an alternative for inventory valuation can have a profound effect on an enterprise's earning power, the alternatives are permissible for the following reasons:

1. Plant and equipment assets are consumed in different ways. Some may be consumed uniformly over a period of time where the straight-line approach is appropriate, and some are consumed based on activity usage where a usage approach is appropriate. Gradations in between these alternatives are also possible, and other methods are used for these gradations.

2. Market conditions vary. In periods of rising prices, LIFO inventory valuations produce a better matching of cost with revenue. Although LIFO causes poor valuation on the statement of financial position, the advantage of better matching on the income statement is considered a proper trade-off. This is true, however, only where inflationary price changes are material. Otherwise, FIFO or average valuation would be deemed appropriate.

Much has been written about the selection of accounting

alternatives for purposes other than achieving a proper matching of cost with revenue. Many writers contend that it is possible to select an alternative for the purpose of reporting a desired net income or for income manipulation. While this may be true to some extent, existing constraints tend to mitigate this practice. The imposed constraints are:

1. When an accounting principle or method is elected, it must be used consistently. If a change in principle or its application is made, and it is material, the independent auditor's opinion will be qualified with respect to consistency.
2. If a change in principle is made, the following disclosures are required:
  - a. The reason for the change and why the new principle is preferable.
  - b. The effect on reported income (before extraordinary items and net income) for the period of the change.
  - c. The cumulative effect on retained earnings to the beginning of the period of the change.
  - d. The independent auditor must either concur with the change in principle or take exception to it.<sup>11</sup>

Other problems associated with the achieving of basic objectives which will not be dealt with are:

1. The tentative nature of financial statements because of uncertainty problems.
2. The changing value of the monetary unit of measure (price-level problems).

Reporting Objectives of Business  
Combinations--Conceptual Ideal

Ideally, the reporting of a business combination should:

1. Reflect the true economic substance of the transaction.
2. Be free from bias.
3. Have substance prevail over form.

Further, the method of accounting for the combination should not be a condition precedent in the negotiations for, and the closing agreement of, the combination.

Generally, a nontaxable reorganization is accounted for as a pooling (under Sec. 368, I.R.C. and existing accounting principles), but need not be, since tax and accounting criteria differ. For example, the use of preferred stock can qualify for a nontaxable reorganization, but will not qualify for a pooling. Certainly, the tax status of a combination will influence the terms of the agreement, since the tax attributes will affect the future cash flows and earning power. Cash flow (as opposed to net income) is not affected by the method of accounting for a particular combination. The AICPA states: "Enterprise earning power has as its essence the notion of ability to generate cash in the future. Cash generating ability and earnings are closely related and the longer the period, the closer the relationship. . . . That is, earnings can only come from cash generated by operations; cash generating ability and earning power are equivalent."<sup>12</sup> Therefore, since cash flow cannot be affected by the

accounting treatment of a business combination, it follows that earning power, so computed, should not be affected by the accounting treatment.

Accounting for Business Combinations--  
Practical Problems

Current practice permits the use of two alternatives, "purchase" and "pooling" accounting. Although the alternatives are not elective, the conditions that are prescribed for the use of either one permit de facto selection of either. For example, if a "pooling" is desired, the acquirer can exchange its common stock for at least 90% of the acquiree's common stock. However, if a "purchase" is desired, the acquirer can exchange its common stock for less than 90% of the acquiree's common stock and use cash, debt, or preferred stock for any remainder. There are other ways to trigger a "purchase" such as using "tainted" treasury shares (discussed in Chapter VI), using contingent agreements, etc. Suffice it to say that if "purchase" accounting is desired, the transaction can be easily structured to fit the prescribed conditions. As will be shown in succeeding chapters, the reported net income for an enterprise can vary greatly, depending upon whether purchase or pooling accounting is used. This is inconsistent with the objectives of financial statements as enunciated by the AICPA, cited previously.

Further, where an elective alternative is chosen, constraints are imposed upon the user who wishes to change his election. However,

since the accounting for business combinations does not permit election of an alternative, no constraint is imposed upon the user of the alternative. Yet the user can engage in de facto selection of an alternative and incur no inconsistency penalty. This, therefore, permits an acquirer to enhance earnings by using purchase accounting or by using pooling accounting in a different combination, all in the same fiscal period. This is in clear violation of the AOSG report and the APB Statement No. 4: "An objective of financial statements is to provide users with information for predicting, comparing, and evaluating enterprise earning power."<sup>13</sup> The report also states: "Users' continuing needs for assessing performance make the measurement of periodic earnings an overriding matter. . . . Economic decision-makers want information which is sufficiently timely to assist them in assessing a company's accomplishments over relatively short periods. This information should help decision-makers to predict future accomplishments."<sup>14</sup>

It is interesting to note that the firm of Arthur Andersen & Co. wrote to the FASB on June 28, 1973, discussing APB Opinions No. 16 and 17: "We have reached the point in time when the application of the provisions of these Opinions by our clients results in an impossible and intolerable situation and one that is unworkable on any sensible basis." The same letter states: "We believe that the application of these Opinions in many cases has been inequitable and discriminatory as between companies, has

had an adverse effect on our national economy as well as on individual companies, has been damaging to investors, and has produced misleading results for the users of financial statements. . . ."

The letter continues: "Opinions No. 16 and No. 17 were doomed to failure from the beginning. They were the result of compromises that were not based on any sound objectives, standards or concepts. They were the product of an ill-advised effort to patch up alleged abuses in existing practices by establishing a long list of rules that are inconsistent and unsupportable. This arises in part because an effort was made to draw arbitrary lines between forms of consideration in transactions (such as cash vs. stock) when such lines can have a huge effect on the results. Such arbitrary lines can only be enforced by many detailed rules that, in turn, lead to even more such rules, and this goes on endlessly."<sup>15</sup>

It is now two and one-half years after the receipt of this letter by the FASB and it has yet to take any action other than to place the topic of "Business Combinations" on its agenda for consideration.

Despite George R. Catlett's condemnation of pooling in Accounting Research Study No. 10<sup>16</sup> and his firm's (Arthur Andersen & Co.) indictment of Opinions 16 and 17, his firm commenced a civil action against the SEC and filed an affidavit with the court when the SEC issued Accounting Series Release No. 146 covering treasury stock transactions. The complaint states in part: "There are two methods of accounting for a business

combination--the 'pooling of interests' method and the 'purchase' method. These two methods have substantially different accounting results in the presentation of a company's financial statements. Frequently a business combination is not considered economically feasible unless it may be accounted for as a pooling of interests."<sup>17</sup> The complaint was dated September 11, 1973, only two months after the letter to the FASE.

It is difficult to understand how cash flows resulting from a business combination can be affected by the accounting treatment accorded the combination. The statement quoted above contradicts the position taken in the research study that cash or stock exchanged in a business combination does not change the nature of the transaction and that all combinations should be accounted for as purchases. The same conclusions and similar wording as used in the research study were stated again in comments submitted to the SEC on November 12, 1973 (two months after the complaint).<sup>18</sup> This was after the SEC agreed to accept comments on ASR No. 146 and Arthur Andersen & Co. vacated its complaint. ASR No. 146 will be discussed more fully in Chapter VI.

#### Economic Reality vs. Form of Transaction

The current accounting treatment for business combinations permits bias to occur in favor of acquirers. Pooling accounting is not a neutral method of accounting for a business combination. Comparability of statements between years could be distorted by

the pooling method. Examples are:

1. Treasury Stock--The use of treasury stock acquired within a short time before or after a pooling is a two-step transaction equivalent to the use of cash. (The abuses in this area will be discussed in greater detail in Chapters IV and VI.)

2. Bailout--A 30-day bailout is hardly different from an immediate bailout. The 30-day waiting period does not improve the weakness of not requiring a continuity of interest for pooling accounting.

3. Instant Earnings--Instant earnings (especially from LIFO inventories and appreciated investment portfolios) are not really earnings. They are really paid-in capital that has been omitted in accounting for the business combination. They also tend to distort growth trends.

4. External Growth vs. Internal Growth--Present procedures for restating financial statements after a pooling make it difficult, if not impossible, to separate internal growth from external growth. The separate components should clearly be indicated in restatements. This will enable users to assess probabilities of future growth patterns.

5. Duplicate and/or Excess Facilities--Permitting a business combination to be accounted for as a pooling and disposing of excess or duplicate facilities can be equivalent to pooling with selected assets.

Synthesis

The objectives of accounting for business combinations are:

1. They must be compatible with the objectives of financial statements as discussed in this chapter.
2. They must report economic reality.
3. They must be relatively free from bias.
4. They must reflect substance rather than form.
5. The method of accounting for the combination should not determine whether or not the combination takes place, since the accounting treatment should be neutral.

## FOOTNOTES

1. Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," AICPA (New York: 1970), p. 9.
2. Joshua Ronen, "The Need for Accounting Objectives In an Efficient Market," (In American Institute of Certified Public Accountants. Accounting Objectives Study Group. Objectives of Financial Statements, v. 2, Selected Papers, New York: 1974, p. 36.)
3. Ibid., p. 52.
4. Davis Downes and Thomas R. Dyckman, "A Critical Look at the Efficient Market Empirical Research Literature As It Relates to Accounting Information," The Accounting Review, v. 48, April 1973, pp. 300-17.
5. Leopold A. Bernstein, "The CPA's Stake in Financial Statement Analysis," The CPA Journal, v. 45, February 1975, pp. 24-25.
6. Ibid., p. 25.
7. American Institute of Certified Public Accountants, Objectives of Financial Statements, New York: American Institute of Certified Public Accountants, 1973, v. 1, p. 20.
8. Ibid.
9. George H. Sorter and others, "Earning Power and Cash Generating Ability," (In American Institute of Certified Public Accountants. Accounting Objectives Study Group. Objectives of Financial Statements, v. 2, Selected Papers, New York, 1974, p. 112.)
10. Accounting Principles Board Statement No. 4, op. cit., p. 10.
11. American Institute of Certified Public Accountants, "Codification of Auditing Standards and Procedures," Statement on Auditing Standards No. 1 (New York: American Institute of Certified Public Accountants, 1973), p. 114.
12. Objectives of Financial Statements, op. cit., p. 23.
13. Ibid., p. 24.
14. Ibid., p. 23.

15. Arthur Andersen & Co., SEC Case re Effect of Treasury Stock Transactions on Accounting for Business Combinations (ASR No. 146), (Chicago, Ill., Arthur Andersen & Co., 1974), p. 101.
16. George R. Catlett and Norman O. Olson, Accounting for Goodwill (Accounting Research Study, No. 10; New York: American Institute of Certified Public Accountants, 1968), p. 66.
17. Andersen, op. cit., pp. 30-33.
18. Ibid., pp. 82-98.

## CHAPTER IV

## STUDIES OF CORPORATE PRACTICES--POOLING

## RESEARCH METHODOLOGY

All listing applications filed with the New York Stock Exchange during the years 1972 and 1973 were examined and classified according to those applications that contained a business combination and those that did not. Of the 2,713 listing applications filed during the two years, 1,086 were listed for purposes of a business combination. The 1,086 applications were analyzed and studied as follows:

A1. Dollar amounts and other information were extracted from the balance sheets of each acquiree and classified as follows:

- a. Total assets.
- b. Inventories.
- c. Methods of pricing inventories.
- d. Total current assets.
- e. Plant, property, and equipment.
- f. Accumulated depreciation.
- g. Methods of depreciation.
- h. Current liabilities.
- i. Deferred taxes.
- j. Total liabilities.
- k. Total stockholders' equity.

- l. Capital stock.
- m. Retained earnings.
- n. Dollar value of treasury stock.

A2. Income statement statistics of all acquirees were extracted for the current period (usually less than one year) and for a full year preceding the combination. This enabled me to annualize the short-period results immediately preceding the business combination. The dollar amounts and other data from the income statement included the following:

- a. Revenues.
- b. Officers' salaries.
- c. Depreciation expense.
- d. Net income.
- e. Number of shares issued.
- f. Earnings per share.
- g. Number of months, if less than one year.

A3. Selected data relating to the acquirer were also extracted. They were as follows:

- a. Listing number of application.
- b. Name of acquirer.
- c. Total shares outstanding.
- d. Treasury shares in the treasury.
- e. Number of shares issued to effect the combination.
- f. Other consideration issued to effect the combination, if any.

g. Market price of the acquirer's stock (either from the listing application, if contained therein, or from the Daily Stock Price Index published by Standard & Poor's).

h. Accounting treatment (purchase or pooling).

i. Auditing firm of the acquirer.

j. Par value of the acquirer's stock.

k. Type of business.

A4. Selected data of acquirees included:

a. Name of acquiree.

b. Type of business.

For each combination classified as a pooling, the following operations were performed:

B1. Market value of shares exchanged--The market value of the price paid was computed. In many cases the market value was included in the listing application. In other cases, the number of shares issued in the combination was a function of the specified market value using the market value per share as specified in the contract. When neither of the above was specified in the listing application, the market value was computed by using the number of shares issued in the exchange multiplied by the market price per share as determined in A3(g).

B2. Size of pooling--The number of shares issued by the acquirer to effect the pooling was divided by the sum of the total shares outstanding of the acquirer plus the shares issued to effect the pooling.

B3. A frequency distribution (histogram) of B2.

B4. Amount booked as a pooling--The total stockholders' equity was used. In some cases, stockholders' equity was a negative balance.

B5. Excess of market value over book value not booked in a pooling--Market value as calculated in B2 minus the book value as stated in B4.

B6. Net income of seller--If available, the published net income for the year immediately preceding a pooling was used. If not, the net income for the shorter period was used and was annualized using income data from the full year immediately preceding the short period.

B7. Return on investment based on book value--Net income as computed in B6 divided by the book value as stated in B4.

B8. Frequency distribution of B7 using 10% class intervals.

B9. Return on investment based on market value--Net income as computed in B6 divided by the market value as computed in B3.

B10. Frequency distribution of B9 using 10% class intervals.

B11. Return on investment using market value and amortizing the "excess" at 5% per annum--The same as item B9 except that net income was reduced by 5% of B5.

B12. Frequency distribution of B11 using 10% class intervals.

B13. Return on investment using market value and amortizing the "excess" at 2-1/2% per annum--The same as item B9 except that net income was reduced by 2-1/2% of B5.

B14. Frequency distribution of B13, using 10% class intervals.

B15. Book value as a percent of market value--Item B4 divided by B1.

B16. Frequency distribution of B15 using 10% class intervals.

In addition, the following was also done:

C1. All listing applications filed with the New York Stock Exchange for the years 1969 and 1970 were classified for business combinations and further classified between pooling, purchase, and part pooling/purchase.

C2. Selected annual 10-K reports of acquirers were analyzed for treasury stock transactions and stock option transactions for five-year periods preceding a pooling. Selections were limited to those acquirers that owned a material amount of treasury shares as noted in a pooling listing application.

C3. Selected 8-K reports were examined where listing applications mentioned insider disposal of shares.

C4. For the two-year period preceding a pooling, an analysis was made of all changes in the capital structures of the acquirer and acquiree.

C5. Contingent shares arrangements, if any, were noted where the combination was accounted for as a pooling.

C6. Selected acquirer's 8-K reports were examined in connection with treasury stock transactions.

C7. Selected acquirer's 8-K reports were reconciled to all acquisitions listed in each acquirer's listing application filed with the New York Stock Exchange during the years 1972-73.

The Findings

Frequency of poolings. As I previously mentioned, the APB indicated that Opinion No. 16 would significantly curtail the use of pooling accounting. To determine if the Opinion did, in fact, do so, all New York Stock Exchange business combinations involving exchange of common stock were tabulated for both a two-year period preceding Opinion No. 16 (1969-1970) and for a two-year period following the Opinion (1972-1973). The results of the tabulations are as follows:

Table 3

BUSINESS COMBINATIONS OF NEW YORK STOCK EXCHANGE  
LISTINGS IN WHICH COMMON STOCK WAS USED

	1972- 1973	%	1969- 1970	%
Poolings	903	83.15	1,199	79.51
Purchases	183	16.85	294	19.50
Part Pooling/Part Purchase	0	--	15	.99
Total	1,086	100.00	1,508	100.00

From the foregoing table it can be seen that the total number of business combinations using capital stock decreased from 1,508 to 1,086. The reasons for the decrease in merger activity are varied and are beyond the scope of this paper. However, it can be seen that the proportionate number of poolings has, in fact,

increased in the period subsequent to the issuance of Opinion No. 16. While the increase is not material, it certainly does indicate ~~that~~ a significant decrease in pooling accounting did not occur. Therefore, a valid inference, based on Table 3, is that Opinion No. 16 did not act as a deterrent to the use of pooling accounting in companies whose stock was listed on the New York Stock Exchange.

#### Size Test

In Chapter II, both ARB 48 and the APB's abandonment of the size test were discussed. What would have happened to pooling accounting if the APB had merely left the ARB 48 size test alone, instead of first trying to strengthen it and then abandoning it? The results of my size-test analysis follow in Table 4.

From Table 4 it can be seen that, as a minimum, a 5% size test would have eliminated approximately 89% of the poolings during 1972-1973. A 10% size test would have eliminated approximately 96% of the 1972-1973 poolings.

Critics of a size-test criterion maintain that, if a size test were imposed, and if corporation A were interested in combining with both Y and Z who are each too small to qualify individually, Y and Z could merge first; then YZ would be large enough to meet the size test.<sup>1</sup> While this may be practical in some cases, the APB, if it imposed a size test, could mandate a waiting period of two years before a company such as YZ, which has pooled, could pool

Table 4  
 SIZE OF POOLINGS  
 1972-1973

	Number of Poolings	%	Cumulative %
Less than 1%	514	56.9	56.9
1% < 2%	158	17.5	74.4
2% < 3%	61	6.8	81.2
3% < 4%	50	5.5	86.7
4% < 5%	20	2.2	88.9
5% < 6%	25	2.7	91.6
6% < 7%	9	1.0	92.6
7% < 8%	12	1.3	93.9
8% < 9%	13	1.4	95.3
9% < 10%	6	.7	96.0
10% < 15%	16	1.8	97.8
15% < 20%	9	1.0	98.8
20% < 25%	3	.3	99.1
25% < 30%	4	.4	99.5
30% < 35%	1	.1	99.6
35% < 40%	0	--	99.6
40% < 45%	1	.1	99.7
45% < 50%	0	--	99.7
Over 50%	1	.1	99.8
Totals	903		

again unless YZ could demonstrate that Y and Z were each large enough to meet the size test individually.

In any event, it is safe to infer that, by abandoning the size test, the ARB permitted most of the poolings during 1972-1973 to occur and, if the ARB 48 size test were allowed to remain, most of the poolings during this period would either not have occurred or would have been accounted for as purchases.

A size test also has a self-limiting feature. As a company grows externally, the number of pooling candidates gets smaller and smaller. This is especially relevant to individuals who are concerned with conglomerate concentration.

#### Analysis of Revenues

Revenues for the two-year period (1972-1973) were tabulated, and the result of the tabulation is as follows:

Table 5

ANALYSIS OF REVENUES IN BUSINESS COMBINATIONS  
(1972-1973)  
(Millions of Dollars)

	Total Revenues	%
Pooling	\$6,652	76.39
Purchase	2,055	23.61
Total	\$8,707	100.00

From the foregoing table it can be seen that almost \$9 billion of revenues were added to corporate concentration from external growth during the two-year period.

#### Pooling Accounting

Selected examples of pooling accounting will now be examined. Example A in Tables 6 and 7 is a fast-food chain franchiser that acquired one of its retail fast-food franchisees in a pooling. Referring to Table 7, it can be seen that inventories are only \$10,000. This amount appears reasonable for a food outlet with an annual sales volume of \$825,000. Equipment has been depreciated to \$66,000 from an original cost of \$103,000. Since \$326,245 in excess of the net book value of tangible assets was paid, and this sum cannot be attributed to inventories or equipment, it must be due to an intangible that the franchiser foresees. The reasons can be varied. One possibility is that the franchiser assigned a specific territory to the franchisee and permitted the franchisee to assume the risk of opening the outlet. Now that the franchise is established, the franchiser might be desirous of splitting the territory into two or more franchises and thereby increase franchise fees. By acquiring this outlet and treating it as a pooling, it could split the territory and sell this outlet at a book profit since the acquisition was recorded at book value (\$57,265). If purchase accounting were used and the acquisition were recorded at the market value (\$383,510), it is hardly

Table 6  
SELECTED DATA OF THREE POOLINGS

	Example		
	A	B	C
Shares Outstanding--Acquirer	18,919,256	4,267,882	62,876,800
Shares Issued in Pooling	6,830	55,000	190,250
Size of Pooling	.004%	1.27%	.003%
Market Value per Share	\$ 56.15	\$ 50.00	\$ 55.00
Market Value of Shares Exchanged	\$ 383,510	\$2,750,000	\$10,463,750
Book Value of Acquiree	\$ 57,265	\$ 290,000	\$ 1,238,000
"Excess" of Market Value Over Book Value (Not recorded in a pooling)	\$ 326,245	\$2,460,000	\$ 9,225,750
Net Income of Acquiree--After Taxes	\$ 17,570 <sup>a</sup>	\$ 224,000	\$ 361,000
Return on Investment--Using Book Value as Base (Pooling treatment)	30.7%	77.2%	29.2%
Return on Investment--Using Market Value as Base and 2-1/2% Amortization of "Excess" (Purchase treatment)	2.5%	5.9%	1.2%

<sup>a</sup> Individual proprietor net income was \$35,140. An imputed tax rate of 50% was used.

Table 7

## BALANCE SHEETS OF THREE ACQUIREES

	Example		
	A	B	C
<b>Current Assets</b>			
Inventory	\$ 10,000	\$ 199,000	\$3,144,000
Other	68,000	627,000	753,000
Total Current Assets	\$ 78,000	\$ 826,000	\$3,897,000
<b>Property, Plant and Equipment--Cost</b>	\$ 103,000	\$ 78,000	\$2,461,000
Less: Accumulated Depreciation	37,000	19,000	649,000
Undepreciated Cost	\$ 66,000	\$ 59,000	\$1,812,000
<b>Other Assets</b>	\$ 30,000	\$ 5,000	\$ 38,000
Total Assets	\$ 174,000	\$ 890,000	\$5,747,000
<b>Liabilities</b>	\$ 116,735	\$ 600,000	\$4,509,000
<b>Stockholders' Equity</b>	57,265	290,000	1,238,000
Total Liabilities and Stockholders' Equity	\$ 174,000	\$ 890,000	\$5,747,000

likely that a profit would be recorded on a subsequent sale. In any event, even if the outlet were sold at an economic profit, the profit would be \$321,245 (\$383,510 - \$57,265) smaller if purchase accounting were used instead of pooling accounting.

Example B is that of an equipment manufacturer that acquired an incinerator manufacturer and treated the combination as a pooling. Again, one must look elsewhere than inventories and plant and equipment to determine the reasons for paying \$2,460,000 in excess of book value to acquire the incinerator manufacturer.

First, the acquirer paid \$2,460,000 more than the book value of the acquiree, and, since this "excess" was not booked, future income statements will be relieved of its amortization. Had purchase accounting been used with the entire "excess" being assigned to an intangible, future income statements, instead of showing a pooling net income of \$224,000, would show the following:

Net Income--as reported	\$224,000
Amortization ( $\$2,460,000 \times 2-1/2\%$ )	61,500
	<hr/>
Net Income--purchase accounting	<u>\$162,500</u>

Clearly the accounting treatment used to record the acquisition will have a material effect on future income statements for a long period of time.

Secondly, if after two years the acquirer sold the acquired company for \$2,250,000 and the assets and liabilities of the company remained constant (all earnings were declared as a dividend), the

acquirer would record a gain on sale of \$1,960,000 if pooling were used, instead of the economic loss of \$500,000 which would be reported if purchase accounting were used (amortization of "excess" is ignored). The calculations follow:

	<u>Pooling</u>	<u>Purchase</u>
Sales Price	\$2,250,000	\$ 2,250,000
Amounts Booked	290,000	2,750,000
Gain (Loss) on Sale	\$1,960,000	( <u>\$ 500,000</u> )

In Example C a food processor acquired a sunflower seed manufacturer. This case reinforces the points made in the analysis of Examples A and B. Since the acquiree's inventories were costed out using a first-in, first-out (FIFO) flow and its plant assets were depreciated using straight-line depreciation, most of the \$9,225,750 "excess" must be attributable to some intangible or other asset not readily discernible. The effects on reported net income, if purchase accounting were used and the entire "excess" were treated as goodwill, would be:

Net Income, as reported--pooling	\$361,000
Amortization of "Excess" ( $\$9,225,750 \times 2-1/2\%$ )	230,644
Net Income--if purchase accounting were used	<u>\$130,356</u>

Again, the choice of accounting method has a material effect on the future reported net income. Also, a similar analysis on a sale two years after the combination could be made. If the selling

price were \$10 million, a gain on sale of \$8.8 million would be shown if pooling accounting were used, whereas a loss of \$0.5 million would be shown if purchase accounting were used (amortization of "excess" is ignored).

Relationship of Book Values to Market Values

Table 8 illustrates the relationship of the amount booked in the three poolings in relation to the "excess" not booked.

Table 8

AMOUNTS BOOKED IN THREE POOLINGS  
(Thousands of Dollars)

	Total		A		B		C	
	Amt.	%	Amt.	%	Amt.	%	Amt.	%
Market Values	\$13,597	100	\$383	100	\$2,750	100	\$10,464	100
Booked Values	\$ 1,585	12	\$ 57	15	\$ 290	11	\$ 1,238	12
"Excesses" Not Booked	\$12,012	88	\$326	85	\$2,460	89	\$ 9,226	88

From the foregoing table it can be seen that in some cases almost 90% of the market values have been omitted in recording combinations as poolings. A similar tabulation of all combinations examined for the two-year period (1972-1973) was also made. The results of this tabulation are shown in Table 9.

Table 9  
 ANALYSIS OF BOOK VALUES AND MARKET VALUES OF  
 ALL BUSINESS COMBINATIONS (1972-1973)  
 (Millions of Dollars)

	Total	%	Poolings	%	Purchases	%
Market Value	\$8,577	100.0	\$7,770	100.0	\$807	100.0
Book Value	\$3,008	35.1	\$2,497	32.1	\$511	63.3
Total Excess	\$5,569	64.9				
Excess Booked	\$ 296	3.4			\$296	36.7
Excess <u>Not</u> Booked	\$5,273	61.5	\$5,273	67.9		

From the foregoing table it can be seen that:

1. The market value of combinations effectuated where some common stock was used is in excess of \$8.5 billion for the two years.
2. Approximately 90% of the above market value was accounted for as a pooling.
3. Approximately two-thirds of the market value of all poolings is not recorded.
4. The book value of poolings in relation to market value is approximately one-third, while for purchases the reverse is true. This will be explored further in the next chapter.
5. Although the percentage of "excess" not being booked is 68% for all poolings examined for 1972-1973, and is considerably

higher (88%) in Examples A, B and C, both percentages do highlight the severity of the problem. In some cases book values were negative. For these cases (29, or 3.2%, of all poolings for 1972-1973) return on investment is infinite, and the problems are more extreme than the problems with Examples A, B and C. For example, since the book value is negative, it is impossible to record a loss on a subsequent sale of the business, regardless of what it is sold for. Admittedly, it is possible to record a loss on individual assets when sold, but as a whole, only a net gain can be recorded. Clearly, when shares of stock having some value can be recorded at negative amounts, something must be wrong with the accounting system. Table 10 summarizes the market values and negative book values of the 29 cases.

Table 10

MARKET VALUES OF POOLINGS HAVING NEGATIVE  
BOOK VALUES (1972-1973)  
(Thousands of Dollars)

	Amount	%
Market Values	\$124,478	100
Negative Book Values	\$ 46,329	37
"Excesses" Not Booked	\$170,807	137

It is interesting to note that more than 50% (16) of these acquirees reported net income aggregating \$1.3 million, even though

they all had negative book values.

Two cases of negative book value will be used to illustrate the condition of having net income while having negative book values. Both of these acquisitions produced infinite rates of return for the acquirers on these acquisitions.

From Table 11 it can be seen that the acquirer in Case D paid almost \$3 million for the acquisition, yet the transaction was recorded at a negative stockholders' equity of \$99,000. Case E produced a similar result. These results came about because the acquirees, prior to the acquisition, were operating unprofitably and had accumulated deficits in excess of their paid-in capitals, but were operating profitably at the time they were acquired. It is interesting to note that these earnings are worth twice the amount shown to the acquirer, since carry-forward losses for tax purposes were available to offset these earnings (a 50% tax rate is assumed).

#### Materiality

While it is true that the problems demonstrated in Examples A, B and C are material if the acquiree is used as the base, are the problems material if the acquirer is used as the base? The answer to this question will depend on the frequency and the size of the poolings. If an acquirer pools infrequently (once or twice a year) and the size of the pooling is minute, then materiality will be nil. But, if the pooling is large or if there are many

Table 11  
SELECTED DATA OF TWO POOLINGS

	Case D	Case E
Number of Shares Issued for Acquisition	35,732	166,977
Market Price per Share (Acquirer)	\$ 80.00	\$ 11.43
Market Value of Transaction (Price Paid)	\$2,859,000	\$1,908,000.
Balance Sheets (Acquiree) (Thousands of Dollars)		
<b>Assets:</b>		
Current Assets	\$ 820	\$ 487
Plant Assets--Gross	29	72
Accumulated Depreciation	(9) <sup>a</sup>	(40) <sup>a</sup>
Other Assets	84	---
Total Assets	\$ 924	\$ 519
<b>Liabilities:</b>		
Current Liabilities	\$ 425	\$ 554
Other Liabilities	600	---
Total Liabilities	\$ 1,025	\$ 554
<b>Shareholders' Equity:</b>		
Capital Stock	\$ 200	\$ 373
Other Paid-in Capital	---	18
Deficit	(299) <sup>a</sup>	(426) <sup>a</sup>
Total Shareholders' Equity	\$ (99) <sup>a</sup>	\$ (35) <sup>a</sup>
Total Liabilities and Shareholders' Equity	\$ 924	\$ 519
Revenues	\$ 1,713	\$ 1,364
Net Income--Before Taxes (Carry-forward losses were available)	\$ 124	\$ 37

<sup>a</sup>( )--Deduction.

small poolings, then the problems demonstrated in Examples A, B and C can be material even though the base used is that of the acquirer. Table 12 is one example that demonstrates the frequency/materiality relationship of an acquirer.

From Table 12 it can be seen that \$203 million of assets have been omitted from the acquirer's Balance Sheet as follows:

Market Value of Shares Issued in Two Years (1972-1973)	\$231,103,000
Book Values of Acquirees	27,558,000
	<hr/>
"Excesses" <u>Not</u> Booked	<u>\$203,545,000</u>

Additional information from this table is as follows:

1. The acquirer had 75 acquisitions during 1972-1973 and 73 of them were poolings.

2. The number of shares issued during the two-year period was 86% of the total shares outstanding on January 1, 1972.

3. The average return on investment for the two years using book value (pooling) as the base is 22%, whereas it is less than 0.5% using market value and 40-year amortization (purchase) as the base.

4. The acquirer's annual report for the year ended September 30, 1972, indicates its total assets were \$180 million. Since this is nine months after the start of this study period, a lower figure should be used for the following comparison. But, using the \$180 million makes it obvious that, since an "excess" of \$203 million

Table 12  
ANALYSIS OF POOLINGS--CASE F  
(1972-1973)

Number	Number of Shares Outstanding	Shares Exchanged	Size of Pooling (in %)	Market Price per Share	Market Value (000)	Book Value--Acquiree (000)	Met. Income (Loss)--Acquiree (000)	Sales Revenue (000)	Return on Investment (in %)		(Purchase) Market Value 2-1/2% Mort.
									(Pooling) Book Value	Market Value	
1.	8,588,148	23,000	.27	\$27.50	633	154	70	610	15.45	11.06	9.17
2.	8,588,148	56,000	.65	27.50	1,540	476	67	1,484	18.26	3.65	3.02
3.	8,656,693	25,000	.29	27.50	688	303	29	1,005	9.51	7.22	2.82
4.	8,656,693	21,000	.24	27.50	578	176	46	1,470	26.14	7.96	6.22
5.	8,633,053	31,000	.36	28.00	868	56	70	1,484	125.00	8.06	5.73
6.	8,633,053	40,000	.46	27.50	1,100	172	22	683	12.79	2.00	( )
7.	8,633,053	36,000	.42	27.50	990	131	31	381	27.61	3.63	1.47
8.	8,633,053	55,000	.63	27.50	1,513	217	54	527	24.88	3.41	2.50
9.	8,633,053	125,000	1.43	27.00	3,375	748	150	800	20.95	6.92	5.16
10.	10,234,792	16,000	.16	32.50	580	154	35	912	28.16	5.71	3.46
11.	10,064,300	100,000	1.09	31.00	3,100	340	177	1,240	39.15	2.71	1.46
12.	10,373,499	200,000	2.44	35.00	9,100	826	247	3,192	29.73	1.73	(.50)
13.	9,004,300	28,000	.31	34.00	952	82	17	1,265	81.3	( )	(1.41)
14.	10,493,668	440,000	4.02	34.00	14,960	1,495	126	17,263	4.31	1.47	1.75
15.	9,064,500	93,000	1.02	34.00	3,162	348	15	2,691	12.63	1.82	( )
16.	11,457,418	900,000	7.28	33.00	29,700	4,368	549	8,066	33.33	5.61	1.69
17.	10,373,499	46,000	.44	33.00	1,518	39	13	329	22.22	2.21	3.82
18.	10,493,668	16,000	.15	32.00	588	135	30	267	61.62	2.81	(.58)
19.	10,493,668	70,000	.66	32.00	2,240	110	72	696	27.81	2.70	3.36
20.	11,343,237	325,000	2.79	32.00	10,400	1,057	294	2,523	33.01	5.04	1.05
21.	11,343,237	110,000	.96	32.00	3,520	227	92	844	33.01	2.70	3.30
22.	11,343,237	12,000	.11	32.00	384	64	21	336	26.23	5.04	2.59
23.	11,343,237	28,500	.25	32.00	912	163	46	707	42.76	3.28	1.05
24.	11,457,418	69,567	.60	33.00	2,296	100	77	1,470	17.13	1.58	( )
25.	11,457,418	700,000	5.76	33.00	23,100	2,112	376	5,170	84.13	3.21	(.62)
26.	11,457,418	50,000	.44	33.00	1,650	(63)	31	2,818	27.05	4.82	2.76
27.	11,457,418	200,000	1.72	33.00	6,600	1,174	144	2,967	44.12	5.97	(1.72)
28.	11,457,418	25,000	.22	33.00	825	97	34	1,460	26.29	1.09	4.04
29.	11,457,418	70,000	.61	33.00	2,310	525	130	1,600	13.95	1.09	1.21
30.	11,457,418	50,000	.44	33.00	1,650	129	10	640	13.95	1.09	1.21

Notes: The listing date and commutation date do not always appear in the same order. The number of Shares Outstanding are out of sequence because of this.

Table 12.-Continued

Number	Number of Shares Outstanding	Shares Exchanged	Size of Pooling (In %)	Market Price per Share	Market Value (000)	Book Value--Acquire (000)	Net Income (Loss)--Acquire (000)	Sales Revenue (000)	Return on Investment (In %)	
									(Pooling) Book Value	Market Value
31.	11,457,418	60,000	.52	\$33.00	\$ 1,990	\$ 46	81	\$ 549	176.09	4.09
32.	13,537,263	15,000	.11	32.00	4,900	21	20	208	95.24	.47
33.	13,537,263	90,000	.29	32.00	1,280	264	85	1,165	32.20	6.64
34.	13,537,263	9,000	.07	32.00	288	3	3	1,152	100.00	1.04
35.	13,537,263	150,000	1.10	32.00	4,800	326	80	896	24.54	1.67
36.	13,537,263	50,000	.37	32.00	1,600	166	92	806	55.42	5.75
37.	13,537,263	45,000	.33	32.00	1,440	246	50	823	30.33	3.47
38.	13,889,500	35,000	.25	32.00	1,085	63	17	451	26.98	1.40
39.	13,889,500	145,000	1.06	32.00	4,695	741	244	3,858	32.92	5.42
40.	13,889,500	10,000	.57	32.00	2,480	511	210	984	41.10	8.47
41.	13,889,500	70,000	.50	31.00	2,170	87	( 12)	565	13.79	(.95)
42.	13,889,500	90,000	.64	31.00	2,430	123	96	1,548	78.05	3.95
43.	13,889,500	75,000	.54	31.00	2,025	109	32	394	29.36	1.58
44.	14,340,100	60,000	.42	31.00	1,600	52	14	469	26.92	.83
45.	14,446,100	140,000	.96	31.00	3,780	502	12	976	2.39	.32
46.	14,514,000	150,000	1.02	31.00	4,350	546	146	2,428	26.74	3.36
47.	14,514,000	200,000	1.36	29.00	5,800	426	136	3,046	31.92	2.34
48.	14,514,000	180,000	1.22	29.00	5,220	617	61	2,181	9.88	1.17
49.	14,514,000	50,000	.34	29.00	1,450	707	43	1,447	5.61	2.97
50.	14,514,000	60,000	.41	30.00	1,800	632	212	1,348	33.54	11.70
51.	14,682,300	20,000	.14	30.00	600	54	18	141	33.33	.73
52.	14,682,300	84,500	.57	30.00	2,600	145	46	1,711	31.72	3.00
53.	14,682,300	35,000	.24	30.00	1,085	339	50	665	14.75	.61
54.	14,682,300	6,600	.05	30.00	204	( 8)	2	185	14.75	4.61
55.	14,682,300	127,700	.88	30.00	4,021	483	( 10)	2,533	33.95	.98
56.	14,967,400	4,900	.03	30.00	146	( 33)	( 10)	394	-----	(1.68)
57.	14,967,400	14,000	.09	30.00	422	9	2	179	6.85	(6.85)
58.	14,967,400	26,000	.17	30.00	858	139	27	660	19.42	3.15
59.	14,967,400	10,000	.07	30.00	310	164	( 11)	893	(6.71)	(3.95)
60.	14,967,400	35,000	.23	30.00	1,085	268	27	512	10.07	2.49
61.	14,967,400	600,000	3.85	31.00	18,600	2,455	446	6,103	18.17	4.40
62.	16,073,700	26,000	.16	31.00	780	108	35	456	32.41	2.33

Table 12--Continued

Number	Number of Shares Outstanding	Shares Exchanged	Size of Pooling (in %)	Market Price per Share	Market Value (000)	Book Value-- Acquiree (000)	Net Income (Loss)-- Acquiree (000)	Return on Investment (in %)			(Purchase) Market Value & 2-1/2% Amort.
								Sales Revenue (000)	(Pooling) Book Value	Market Value	
63	16,073,700	52,000	.32	\$31.00	\$ 1,560	\$ 251	\$ 44	\$ 432	17.53	2.82	.72
64	16,073,700	25,000	.16	31.00	785	169	43	331	25.44	5.93	4.01
65	16,073,700	200,000	1.23	31.00	4,000	263	74	968	28.14	1.05	.49
66	16,146,700	185,000	1.13	31.00	4,995	260	62	612	23.85	1.24	( 1.13)
67	16,146,700	14,000		Purchase Accounting							
68	16,146,700	23,000	.14	31.00	598	158	24	367	15.19	4.01	2.17
69	16,146,700	8,700	.05	31.00	234	21	16	135	76.19	6.84	4.56
70	16,439,500	16,700		Purchase Accounting							
71	16,439,500	18,000	.11	31.00	270	23	13	259	56.52	4.01	2.52
72	16,439,500	32,000	.19	31.00	400	5	32	640.00	60.00	6.66	4.19
73	16,656,700	12,800	.08	31.00	218	12	6	142	50.00	2.75	.39
74	16,656,700	13,800	.08	31.00	307	9	6	243	66.67	2.90	.51
75	16,856,700	80,000	.47	31.00	1,300	53	80	631	150.94	6.67	4.28
Totals		7,371,767			\$231,103	\$ 27,558	\$ 6,098	\$101,508	22.13	2.64	.44

was not booked, more assets were left off the acquirer's balance sheet than appear on it.

5. The acquirer's annual reports show net income for the fiscal year ended 9/30/71 as \$8.3 million and for the fiscal year ended 9/30/72 as \$11.6 million. Since the total acquisition income for the two-year period (1972-1973) is \$6.1 million, it is clear that acquisition income is a very material amount of the acquirer's total income.

6. Only 2 of the 73 poolings exceeded 5% in size and none exceeded 10%.

7. One of the poolings in Table 12 involved a negative book value, yet had a net income of \$53,000. The rate of return using book value (pooling) is infinite, but if purchase accounting is used, the rate of return on market value is less than 1%.

8. The market price of these shares fluctuated between \$27.50 and \$33.00 per share during the two-year period. I do not consider this price fluctuation significant for valuation purposes.

Table 13 is an example similar to Table 12. The acquirer had 28 acquisitions (all poolings) during 1972-73.

The following is apparent:

1. Stock with a market value of \$76 million was issued and 92% of the value of the net assets acquired was never recorded by the acquirer; only 8% was booked.

2. The acquired companies earned \$1.6 million annually; yet the acquirer paid 46 times earnings for these companies.

Table 13

## ANALYSIS OF POOLINGS--CASE 0 (5-972-1973)

Number	Number of Shares Outstanding	Shares Exchanged	Size of Pooling (In %)	Market Price per Share	Market Value (000)	Book Value--Acquire (000)	Net Income (Loss) to Seller (000)	Sales Revenue (000)	(Pooling) Book Value	Market Value & Market Value 2-1/2% Acort.	(Purchase) Market Value & Market Value 2-1/2% Acort.
1.	5,232,769	21,782	.41	\$51.00	\$ 1,111	\$ 237	\$ 109	\$ 934	85.99	9.81	7.84
2.	5,232,769	82,400	1.55	51.00	4,806	170	86	1,700	59.29	2.04	1.64
3.	5,232,769	11,490	.22	51.00	586	269	( 33)	74	(18.47)	(7.24)	(0.87)
4.	5,232,769	40,160	.76	51.00	2,048	142	59	1,392	20.42	1.12	(1.93)
5.	5,232,769	24,000	.45	52.00	1,248	4	14	125	360.00	1.12	1.27
6.	5,232,769	4,674	.09	52.00	243	26	183	245	53.85	5.76	3.53
7.	5,437,929	146,800	2.62	53.00	7,780	1,190	183	1,072	15.27	6.25	(1.23)
8.	5,437,929	153,200	2.74	53.00	8,120	1,35	( 55)	1,164	0.00	(9.14)	(4.33)
9.	5,570,076	42,800	.76	60.00	2,568	( 2)	( 20)	340	(275.80)	(5.23)	(1.53)
10.	5,570,076	4,727	.08	53.00	281	11	134	542	101.62	9.87	2.70
11.	5,570,076	28,068	.50	66.00	1,869	119	20	640	11.46	2.70	2.70
12.	5,723,855	66,007	1.04	66.00	3,960	283	( 210)	1,482	( 14.20)	(5.30)	(7.62)
13.	5,723,855	108,480	1.86	66.00	7,160	344	344	2,115	32.46	4.80	2.90
14.	5,723,855	55,200	.96	66.00	3,643	351	115	2,110	32.76	3.16	5.12
15.	5,723,855	18,236	.32	67.00	1,222	127	90	894	70.87	7.36	1.18
16.	5,723,855	20,000	.35	67.00	1,340	25	47	266	4.47	1.05	3.04
17.	5,723,855	120,000	2.05	67.00	8,040	456	246	2,022	53.95	3.44	1.70
18.	5,723,855	56,013	.97	68.00	3,808	368	137	1,422	44.55	3.44	1.14
19.	5,723,855	6,897	.12	68.00	469	64	57	142	40.22	5.33	3.16
20.	5,723,855	54,000	.93	68.00	3,672	92	39	668	30.61	6.82	(1.62)
21.	5,723,855	11,811	.21	68.00	802	25	27	360	104.00	3.36	(.94)
22.	5,723,855	36,500	.67	68.00	2,618	43	42	447	97.67	7.60	(.85)
23.	6,399,347	24,400	.38	62.00	1,513	362	116	494	23.21	1.60	5.76
24.	6,399,153	50,000	.78	57.00	2,850	372	74	1,695	19.30	2.53	3.35
25.	6,399,153	19,700	.31	57.00	1,123	77	38	240	66.67	3.20	1.01
26.	6,399,153	45,810	.71	57.00	2,611	74	22	1,047	30.97	71.77	(1.80)
27.	6,606,123	9,900	.15	43.00	430	72	7	332	71.97	1.64	(.80)
28.	6,606,052	25,078	.38	43.00	1,070	72	16	612	22.22	1.56	(.78)
Totals		1,204,231			\$ 75,936	\$ 6,116	\$ 1,649	\$ 25,457	26.95	2.17	(.13)

Evidently, large economies of scale were expected by the acquirer. However, even this cannot explain the reason for this multiple, since the acquirer paid three times the gross volume and, economies of scale notwithstanding, this is hardly justified.

3. If we look at the rate of return on book value (pooling), we see a handsome 27% average for all combinations with a range from losses up to a profit of 350%. However, if we look at purchase accounting, we see an average of 0.13% loss for all combinations with a range from losses up to 7.8% profit. Given that the highest yield under purchase accounting is 7.8%, it is difficult to imagine that the acquirer would have acquired any of these companies if purchase accounting were mandatory.

4. None of the combinations exceeded 5% in size. In fact, the largest one was only 2.74% in size.

5. Acquisition No. 8 shows that the price was 7 times the annual revenue. Since no income was reported, economies of scale were obviously expected. However, the transaction was booked at \$135,000, even though the price paid was over \$8 million. Only 1.7% of the price was booked. If this laboratory were to be sold, it is clear that a substantial gain will be recorded on the sale, even though the acquirer may suffer an economic loss. Similar examples exist in other combinations.

### Effects on Earnings per Share

Earnings per share is a statistic widely published in financial newspapers as well as investment surveys, such as Value Line, Standard & Poor's, etc. It is also the most widely used financial statistic for investment decision-making, according to a survey conducted by Georgeson & Co., a highly regarded New York investor relations firm.<sup>2</sup> This is true despite sophisticated analysts' caveats the "EPS does not tell how much a company owes, or whether it can raise enough money to keep growing, or whether the earnings were real or simply the result of inflation and 'arcane' accounting practices."<sup>3</sup> Therefore, several pooling acquisitions were investigated to determine the impact these acquisitions had on the acquirer's earnings per share.

In Case H, Table 14, all pooling acquisitions for this acquirer were tabulated from its listing applications filed during 1972-73. They were broken down to coincide with the acquirer's fiscal year ending February 28. An examination of the acquirer's 10-K and 8-K reports was made to reconcile the shares-issued for each year to make certain that no acquisitions were omitted in the listing application tabulation. The tabulation of acquiree's sales revenues and net income was then compared to the pooling restatement of the income statements of the acquirer. While it is true that the restated amounts in the acquirer's 10-K are for the year preceding that in which the poolings took place, the differences between the restated amounts and the tabulated amounts were not significant

Table 14  
ANALYSIS OF POLINESIA CASE II (FISCAL 1972-1973)  
(Thousands of Dollars)

Date	Acquisition Number of Shares	Price per Share	Market Value	Book Value	Excess		Salon Revenues	Net Income	Current Assets	Plant Assets	Accumulated Depreciation	Plant Assets --Net	Total Assets
					Booked	Acquire							

1972													
October	267,000	\$25.00	\$ 6,675	\$ 3,392	\$ 3,373	\$ 9,090	\$ 4,061	\$ 1,010	\$ 788	\$ 266	\$ 4,333		
October	63,000	25.00	1,575	2,106	5,038	7,631	3,695	325	104	31	408		
June	330,000	22.50	7,425	2,106	7,402	4,492	1,096	226	20	112	3,480		
August	400,000	23.00	9,200	1,406	7,794	5,407	1,206	402	40	940	3,860		
October	266,000	24.00	6,384	2,193	3,222	2,315	2,896	570	339	570	3,617		
December	372,500	24.50	9,136	1,420	9,222	3,897	3,462	2,402	239	1,012	3,677		
August	400,000	20.00	8,000	1,369	4,231	4,960	2,230	570	143	433	2,727		
Total PPE 2/28/73    \$47,103    \$12,749    \$31,354    \$41,217    \$ 3,100    \$19,399    \$ 6,659    \$ 2,521    \$ 4,130    \$23,863													

1973													
March	630,000	\$28.00	\$17,640	\$ 2,673	\$14,917	\$ 5,438	\$ 3,101	\$ 1,109	\$ 330	\$ 76	\$ 3,981		
March	300,000	28.00	8,400	3,112	5,008	5,981	2,026	2,502	688	1,512	2,592		
June	130,000	24.00	3,120	1,006	2,096	1,789	467	76	47	29	1,438		
June	2,131,800	23.00	56,000	31,605	41,325	11,095	4,812	5,977	2,624	923	106,674		
July	231,200	22.00	5,086	1,665	2,322	6,015	1,133	1,313	223	172	2,086		
July	272,000	21.00	5,712	1,863	2,849	8,439	1,115	306	223	172	1,529		
August	3,797,100	21.00	79,737	51,206	28,421	106,423	5,839	42,378	16,442	59,072	86,529		
October	271,600	25.00	6,790	1,722	3,118	8,633	1,135	591,635	.....	532	1,115		
November	275,000	23.00	6,325	500	5,825	6,760	939	1,142	306	746	1,890		
Total PPE 2/28/74    \$180,158    \$ 93,810    \$ 86,718    \$143,296    \$13,322    \$ 66,834    \$ 49,172    \$19,084    \$ 30,620    \$103,170													

Total--2 Years    \$227,261    \$106,659    \$219,637    \$150,513    \$ 16,502    \$ 86,303    \$ 55,831    \$ 21,605    \$ 31,758    \$127,033

\*Not included in totals represents an uncommitted insurance liability.

and could be attributed to the one-year difference in timing. Accordingly, an analysis can be made for Case H for its fiscal years ended February 28 as shown in Table 14.

From Table 15 it can be seen that, as a result of the acquisitions, the acquirer increased its earnings per share in each of the two years, namely \$.01 for 1973 and \$.02 for 1973.

Continuing the analysis, what were the effects of the acquisitions on the acquirer's earnings per share growth rate? Starting with fiscal year ended February 29, 1972 earnings as the base year, Table 16 analyzes the earnings per share growth rates.

Clearly, a more advantageous growth rate of earnings per share emerged from the acquisitions of 1974. The growth rate, as shown on the company's annual report, is 15% only because pooling accounting was used.

Since the preceding analysis ignored the market prices of the acquisition, it is logical to examine what the result would be if purchase accounting were used. It is impossible to reconstruct these transactions as "purchases" without the market values of the tangible assets required. Therefore, it will be assumed that the entire difference between "book" value and "market" value ("excess") would have been assigned to an intangible that requires amortization at 2-1/2% per annum, if purchase accounting were used. The pertinent data are shown in Table 17.

Comparing Table 17 with Table 15, we can see that pooling accounting increased earnings per share \$.01 and \$.02 for 1973 and

Table 15

ANALYSIS OF SELECTED DATA--CASE H  
(In Thousands of Dollars Except for Earnings per Share)

<u>1973</u>	Originally Reported	From Pooling Acquisitions	Exclusive of Poolings
Net Income Available to Common Shareholders	\$ 88,582	\$ 3,180	\$ 85,402
Average Number of Common Shares Outstanding	65,134	2,099	63,035
Earnings per Share	\$ 1.36	\$ 1.52	\$ 1.35
<u>1974</u>			
Net Income Available to Common Shareholders	\$115,932	\$13,322	\$102,610
Average Number of Common Shares Outstanding	74,871	7,963	66,908
Earnings per Share	\$ 1.55	\$ 1.67	\$ 1.53

Table 16

ANALYSIS OF EARNINGS PER SHARE--CASE H  
(1972-1974)

Year Ended 2/28	Earnings per Share--After Poolings (Restated)	Growth %	Earnings per Share--No Acquisitions	Growth %
1972	\$1.23		\$1.23	
1973	1.35	10	1.35	10
1974	1.55	15	1.53	13

Table 17

ANALYSIS OF SELECTED DATA--CASE H  
(Thousands of Dollars Except for Earnings per Share)

	Acquisitions	Other Than Acquisitions	Combined
<u>1973</u>			
Net Income Available to Common Stockholders	\$ 3,180	\$ 85,402	\$ 88,582
Less: Amortization of "Excess" over 40 Years (see Table 14) ( $\$34,354 \times 2-1/2\%$ )	859	---	859
Net Income--If Purchase Accounting Were Used	\$ 2,321	\$ 85,402	\$ 87,723
Number of Shares Outstanding	2,099	63,035	65,134
Earnings per Share	\$ 1.11	\$ 1.35	\$ 1.35
<u>1974</u>			
Net Income Available to Common Stockholders	\$13,322	\$102,610	\$115,932
Less: Amortization of "Excess" over 40 Years (See Table 14) 1974 ( $\$86,278 \times 2-1/2\%$ ) plus 1973 ( $\$34,354 \times 2-1/2\%$ )	3,016	---	3,016
Net Income--If Purchase Accounting Were Used	\$10,306	\$102,610	\$112,916
Number of Shares Outstanding	7,963	66,908	74,871
Earnings per Share	\$ 1.29	\$ 1.53	\$ 1.51

1974, respectively, whereas purchase accounting would have at least kept earnings per share the same for 1973 (and decreased it by \$.02 for 1974).

In all probability, the results would have been more dramatic if more information were available, since amortization of the "Excess" over 40 years is probably unrealistic from a "capital budgeting" viewpoint. (This area will be explored in the next chapter in the discussion of the accounting treatment of "purchase" acquisitions.)

Returning to the growth rate analysis in Table 16, it can be seen that the growth rate for purchase accounting would be 10% for 1973 (the same as for pooling) and 12% for 1974 ( $\$1.51 - \$1.35 = \$0.16 \div \$1.35$ ). The 12% is significantly less than the 15% reported in the company's annual report. Another example of the impact of pooling accounting on earnings per share is that of Case F, Table 12.

Using the example in Table 12 in conjunction with the Value Line Investment Survey,<sup>4</sup> I analyzed the effects of Case F's combinations on reported net income and earnings per share. The analysis produced the following:

Shares Outstanding on 1/1/72	8,588,148
Pooling Shares (1972-1973)	7,367,067
Other Shares Issued (1972 and 1973)	901,485
	<hr/>
Shares Outstanding, 12/31/73	16,856,700
	<hr/> <hr/>
Reported Net Income Year Ended 12/31/71	\$ 5,400,000
Earnings per Share Year Ended 12/31/71	\$ .63

Reported Net Income Year Ended 12/31/73	\$15,620,000
Earnings per Share Year Ended 12/31/73	\$ .93
Growth in Earnings per Share for 2 Years	48%

However, if purchase accounting were used and all of the "excess" was assigned to an intangible requiring amortization over 40 years (a mere 2-1/2% per annum), the results for the year ended December 31, 1973 would have been as follows:

Reported Net Income Year Ended 12/31/73	\$15,620,000
Amortization of "Excess"-- .025 (\$231 million - \$27.5 million)	5,087,500*
Adjusted Net Income--Purchase Accounting	<u>\$10,532,500</u>
Adjusted Earnings per Share for Year Ended 12/31/73	<u>\$ .62</u>

\*This is not deductible for income tax purposes. Therefore, no tax effects were imputed.

Based on the above, it can be seen that pooling accounting gave an illusion of 45% growth in earnings per share during 1972-1973, whereas purchase accounting would have produced a slight decrease.

While it may appear that the analysis of Case H showed only a small effect on earnings per share, it should be remembered that Case H had poolings both prior to and subsequent to the years analyzed for this study. The failure to amortize the "excess" is a cumulative error which continues in subsequent years. Therefore,

the effects on earnings per share must be viewed in cumulative (compounded) terms and not in single-year (static) terms.

#### Effects on Ratio Analysis

It is generally accepted that "Ratios are among the best known and widely used tools of financial analysis."<sup>5</sup> I selected several ratios from those generally used<sup>6</sup> to demonstrate the ratio distortions pooling accounting can produce. The ratios selected are:

1. Return on total assets
2. Return on equity capital
3. Net income to sales
4. Sales to total assets.

Certain assumptions regarding the "excess" were made prior to computing these ratios. The next chapter of this study deals with the "excess" problem in depth, but some discussion of this problem is necessary for purposes of this illustration. None of the acquirees listed in Table 14 used the LIFO method for valuing its inventories; FIFO was used except for one case where Average was used. Therefore very little of the "excess," if any, could be attributed to the difference between cost and market value of inventories. Upon examination of plant assets it is evident that a small part of the "excess" can be attributed to the difference between the book and market values of plant assets. However, the major portion is yet to be accounted for. Examination of each year's total net income of the acquirees reveals that the income for 1972 and 1973 is approximately 7% of the price paid by the

acquirer. It is difficult to visualize any of the "excess" being attributed to goodwill. Goodwill is a concept related to "excess earnings" and none is apparent in any of these acquisitions. Therefore, the "excess" that was paid and never booked must be due to factors other than those mentioned.

Where purchase accounting is illustrated, the "excess" will be assigned to an intangible that is to be amortized over a period of 40 years. The acquisition of the unconsolidated insurance subsidiary will be omitted from all calculations in this section.

Selected ratios are summarized in Table 18.

It is clearly apparent that pooling accounting inflates these ratios. While the impact of a particular year's distortion on the acquirer's ratios can be negligible, it must be borne in mind that this acquirer has been "pooling" regularly, and the cumulative effects of distortions over a five-year period can be material. As evidence of this, the following restated data were abstracted from the acquirer's 10-K reports for 1971, 1972 and 1975 as shown in Table 19.

The acquirer reported the following for the years 1970 and 1974:

<u>Fiscal Year</u>	<u>(Thousands of Dollars)</u>	
	<u>Sales</u>	<u>Net Income</u>
1974	\$3,541,216	\$116,991
1970	1,576,065	52,932
Growth	<u>\$1,865,151</u>	<u>\$ 64,059</u>

Table 18

SELECTED RATIO ANALYSIS--CASE H  
 (Fiscal Years Ended February 28, 1973, and February 28, 1974)

	Company H Without Acquisitions	Acquisitions Treated as Poolings	Acquisitions Treated as Purchases
<u>Ratios--1973</u>			
1. Return on Total Assets	8.3%	13.3%	4.0%
2. Return on Equity Capital	15.1%	24.9%	4.9%
3. Net Income to Sales	3.2%	7.7%	5.6%
4. Sales to Total Assets	2.6	1.7	.7
<u>Ratios--1974</u>			
1. Return on Total Assets	8.1%	8.2%	4.2%
2. Return on Equity Capital	15.1%	13.6%	5.5%
3. Net Income to Sales	3.2%	5.7%	4.6%
4. Sales to Total Assets	2.6	1.5	.9

Table 19  
 RESTATED DATA FROM POOLINGS--CASE H  
 (1971-1975)

Fiscal Year	(Thousands of Dollars)	
	Sales	Net Income
1971	\$ 74,344	\$ 3,716
1972	308,402	8,720
1973	41,217	3,180
1974	149,296	13,322
1975	116,537	5,757
Totals	\$689,796	\$34,695

From Table 19 it is apparent that, for the five-year period, at least 35% of the sales growth and 54% of the net income growth came from poolings. If the above data were adjusted for the five-year change in general purchasing power, these percentages would be considerably higher.

Although the pooling effects on the EPS statistic were small, as previously noted, sales growth and net income growth are statistics that are often quoted in management's letter to stockholders in stockholders' reports. These statistics are also quoted in financial newspapers along with EPS. Unless the users of financial information weed out the data to arrive at the pooling growth, misleading inferences about future growth may be made.

It is not safe to assume that a company's future external growth will be a function of past external growth. Conditions that could affect external growth include:

1. The availability of combination candidates.
2. Stock market conditions as they affect P/E ratios and share exchange ratios.
3. Justice Department and Federal Trade Commission anti-trust evaluations.

Accordingly, the disclosure of material external growth is vital to the users of financial statements.

#### Descriptive Data

Percentage of book values booked.--One of the operations performed on the accumulated data was calculating what percentage the book value recorded in each pooling was of the fair market value of the combination. A tabulation of this for all poolings examined follows in Table 20.

Table 20 indicates that 77% of all poolings booked the combination at less than 50% of the price paid (market value) for the acquisition.

#### Return on Investment--Book Value

Additional operations performed on the accumulated data were to calculate the return on investment using the book value as the base, return on investment using market value as the base and return on investment using 2-1/2% amortization of "Excess of Cost

Table 20  
 FREQUENCY DISTRIBUTION OF POOLING BOOK VALUES AS  
 PERCENTAGE OF MARKET VALUES (1972-1973)

% Size	Number of Companies	% of Total	Cumulative %
Less than 10%	196	21.7	21.7
10% < 20%	178	19.7	41.4
20% < 30%	134	14.8	56.2
30% < 40%	109	12.1	68.3
40% < 50%	81	9.0	77.3
50% < 60%	75	8.3	85.6
60% < 70%	48	5.3	90.9
70% < 80%	26	2.9	93.8
80% < 90%	22	2.4	96.2
90% and Greater	34	3.8	100.0
Totals	903	100.0	

Over Book Value." The result of this tabulation is shown in Table 21.

Table 21 illustrates the following:

1. Since pooling accounting was used by the companies in this tabulation, 76% of them showed rates of return on investment greater than 10%. If purchase accounting had been used, only 15% of the companies would have shown rates of return exceeding 10%.

2. Of the total, 55 companies showed rates of return in

Table 21

FREQUENCY DISTRIBUTIONS OF VARIOUS RATES OF RETURN ON  
INVESTMENT (ROI) FOR POOLINGS IN 1972-1973

ROI %	On Book Value		On Market Value		On Market and 2-1/2% Amortization	
	Number of Companies	%	Number of Companies	%	Number of Companies	%
Less than 10%	215	23.8	735	81.4	769	85.3
10% < 20%	246	27.2	135	15.0	107	11.8
20% < 30%	157	17.4	23	2.6	17	1.9
30% < 40%	103	11.4	1	.1	1	.1
40% < 50%	42	4.7	3	.3	3	.3
50% < 60%	37	4.1	1	.1	1	.1
60% < 70%	19	2.1	2	.2	2	.2
70% < 80%	17	1.9	0	.0	0	.0
80% < 90%	12	1.3	0	.0	0	.0
90% and Greater	55	6.1	3	.3	3	.3
Totals	903	100.0	903	100.0	903	100.0

excess of 90%, whereas if purchase accounting were used, this number would dwindle to three companies (0.3%).

3. Of the poolings, 99% would have shown rates of return less than 30% if purchase accounting had been used, whereas only 60% of the companies show rates of return less than 30% because pooling accounting was used.

Obviously, there can be only one economic reality to a business combination. However, depending on the accounting treatment used, the reported economic results of a business combination can and do vary greatly.

#### Analysis of Auditing Firms

An analysis of acquirer auditing firms was made and is shown in Table 22.

From Table 22 it can be seen that Arthur Andersen & Co.'s clients use pooling accounting more frequently than other firms' clients. The clients of Arthur Andersen & Co. and Peat, Marwick, Mitchell & Co. account for 42% of all the combinations and 45% of all the poolings examined during the two-year period.

#### Corporate Reporting Practices

Treasury shares.--Case I concerns a firm's treasury stock transactions. This company acquired another company in 1912 for 30,660 shares and treated the acquisition as a pooling. The acquirer's treasury stock purchases were as follows:

Table 22  
 ANALYSIS OF COMBINATIONS BY AUDITING FIRM  
 OF ACQUIRER (1972-1973)

Firm	Total Combinations	%	Pooling	%	Purchase	%
Arthur Andersen & Co.	305	28	283	31	22	12
Peat, Marwick, Mitchell & Co.	154	14	125	14	29	16
Arthur Young & Co.	124	11	106	12	18	10
Price Waterhouse & Co.	110	10	89	10	21	11
Coopers & Lybrand	101	9	88	10	13	7
Ernst & Ernst	100	9	73	8	27	15
Haskins & Sells	77	7	62	7	15	8
Touche Ross & Co.	48	5	40	4	8	4
Seidman & Seidman	15	2	11	1	4	2
All Others	52	5	26	3	26	15
	1,086	100	903	100	183	100

<u>Year</u>	<u>Shares</u>
1970	98,700
1971	None
1972	45,226

The acquirer's stock option experiences are shown in Table 23.

Table 23

STOCK OPTION TRANSACTIONS OF FIRM WITH 1972 POOLING

Year	Stock Options (Shares)		
	Granted	Cancelled	Exercised
1970	178,400	87,292	0
1971	0	54,317	3,500
1972	25,250	76,656	1,510
Total	203,650	218,265	5,010

It should be borne in mind that the 98,700 shares of treasury stock purchased in 1970 were purchased prior to the effective date of Opinion No. 16 and, therefore, are not "tainted" shares. They can be further justified, however, by the stock options granted in 1970. Practically all these shares were still listed as treasury shares in the listing application (96,006 shares). The problem with this pooling is that 45,226 shares of treasury stock were purchased soon after a pooling which used 38,660 shares. The

options granted in 1972 and/or exercised in 1972 cannot be the reason for the 1972 purchase. (Therefore, the shares purchased in 1972 are really a "step transaction" of a pooling for cash.) The two-year prohibition that precedes a pooling is ineffective by itself, as demonstrated by this example. Further, a subsequent pooling of 453,000 shares would still qualify without being disqualified by this treasury stock purchase.

#### Redemption Prior to a Pooling

In Case J, a firm acquired a needlework mail-order company in July 1972. The acquiree's share statistics were taken from its Balance Sheet as follows:

Shares Issued--5/31/72	10,000
Treasury Shares	3,965
	<hr/>
Shares Outstanding--5/31/72	6,035

Its Income Statement indicated the following:

Average Shares Year Ended 12/31/71--8,043

Average Shares 5 Months Ended 5/31/72--7,110

If the average shares for the five months ended May 31, 1972, were 7,110, it follows that:  $\frac{x + 6,035}{2} = 7,110$  where x is equal to the shares outstanding on January 1, 1972. Solving for x shows that 8,185 shares were outstanding on that date. This is not too far afield from the average shares for the year ended December 31, 1972. Obviously, a redemption of approximately 2,000 shares

(8,185 - 6,035) must have occurred between January 1, 1972 and May 31, 1972. Since the acquiree was pooled in July 1972, the two-year waiting period had not been met. Can this be considered immaterial? Since the redeemed shares are approximately 25% of the outstanding shares, it can hardly be considered immaterial. Was this a redemption in contemplation of a pooling? Was this redemption from a decedent's estate? Unfortunately the answers to the last two questions are not available.

#### Spin-offs

Several cases of spin-offs were encountered in this research. In none of them was there any evidence of a regulatory requirement that the spin-off be made. One example (Case K) will be illustrated. An importer of specialty merchandise acquired a corporation that was an import outlet and carried both specialty merchandise and wholesale foods. The wholesale food business was spun off prior to the acquisition. Total assets of the specialty line of business amounted to \$422,000 and the stockholders' equity for the spin-off amounted to \$274,000. It is obvious that the acquirer did not want to enter the food business and, therefore, insisted that it be spun off. However, the acquiree had operated the food business as an integral part of its business. The food business was certainly a material part of its business, although it certainly was not a material item to the acquirer. However, if the materiality is measured against the acquirer, practically all poolings would qualify

for spin-offs since most poolings are immaterial in size, as discussed previously. If materiality is to be applied to spin-offs, it should be applied to the acquiree and not to the acquirer.

Can this spin-off be justified as a "line of business"?

This topic will be discussed in depth in Chapter VI. It is generally agreed that economic substance rather than legal form should prevail. If two corporations were one economic unit, both would be necessary for an acquisition to qualify as a pooling. The reverse, namely, a single corporation operating two economic units, should theoretically require that each unit could be pooled or not pooled separately. However, the reverse may be more difficult to justify.

In the case cited here, no clear answer can be given. These problems will be explored in Chapter VI.

#### Contingent Shares

Since Opinion No. 16 specifically prohibits contingent share arrangements for "earn-outs" and market price contingencies, it was surprising to find a 1972 acquisition treated as a pooling where a food processor (Case L) acquired a sunflower seed researcher and the contract provides "for the delivery to the [acquiree] shareholders of an additional 4,000 shares of [acquirer] Common Stock if [acquiree] develops a certain hybrid strain of sunflower oil seed prior to December 31, 1975" (emphasis mine). This is clearly a violation of the intent and the provisions of Opinion No. 16. Either the accounting treatment was handled incorrectly,

or the accounting firm relied on the principle of materiality, since the acquisition required the acquirer to issue 190,250 shares, and 4,000 shares might be considered immaterial. Nevertheless, even if materiality is conceded, this still violates the intent of Opinion No. 16 and merely points up the fact that corporate practice does not always coincide with what the drafters of Opinion No. 16 intended.

#### Employment Contracts

I noted an employment agreement specifying a three-year contract at \$50,000 per annum plus a percentage of the net profits of the acquired corporation during the employment period. Since the \$50,000 is much greater than this officer's salary prior to the acquisition, an additional bonus of a percentage of profit is a real sweetener. This raises the question, however, of whether the percentage of profit of only the acquired corporation is a disguised contingent payout. It would seem that an incentive plan that assumes the sharing of risk (underlying philosophy of pooling) should be based on a broader base, possibly the entire business of the acquirer, such as in stock options. It is true that division managers are sometimes compensated on an incentive basis by giving them a percentage of the profits of their division. If it is done as part of a pooling, it can be suspected of being part of a scheme to legitimize contingent "earn-outs."

Immediate Bailout

In 1972, an acquirer (Case M) indicated in the listing application that the seller's shares received in the pooling were being sold as part of the transaction (immediate bailout) and arrangements were made with Lehman Bros. and Merrill Lynch, et al. Of course, this was prior to the issuance of ASR Nos. 130 and 135 which require a 30-day waiting period (to be discussed in Chapter VI). Two questions are raised here: First, were the arrangements such that the acquirer's financial resources were used to place the shares for sale? Second, if the acquirer arranges the sale, and there is an immediate bailout, how different is this from the acquirer's arranging the sale of shares first and then using the proceeds (cash) to buy the selling company?

For obvious reasons the answer to the first question was apparent in the listing application. If the acquisition were contingent on the acquirer's financial resources for a successful bailout, pooling treatment would not be available and this is clearly covered by an interpretation of Opinion No. 16. Therefore, it will be assumed that the acquirer's financial resources were not used.

The answer to the second question is a matter of form over substance. Does it really matter whether payment (cash proceeds) is received before, or immediately after, the closing of title? I see no difference between the acts and the end product; namely, the acquirer purchased a company and the seller got cash for the

sale. Yet--depending on the sequence of handling--selling the shares in the morning requires purchase accounting; selling the shares in the afternoon requires pooling accounting. Even a 30-day waiting period (imposed by the SEC) does not remedy the situation. This merely makes it a step transaction.

#### Financial Arrangements

Coincident with a pooling combination in 1972, the acquirees started a new business to manufacture medical and surgical instruments. In addition to granting the acquirees unusually flexible employment contracts, the acquirer in Case N agreed to purchase \$1 million of 6% subordinated convertible debentures in the new business while the acquirees merely invested a total of \$300,000 for capital stock. The acquirer's debentures could be converted into stock that would give them only a one-third interest in the new business.

This transaction raises several questions: Could the acquirees have raised \$1 million in debt from a bank or other third party, while investing only \$300,000 themselves? Does this constitute a financial arrangement for the acquirees (prohibited by Opinion No. 16)? Can this transaction be considered part of the total package, in which case \$1 million in cash flowed from the acquirer to the acquirees?

In answer to the first question, my answer would be: NO! Unless the acquirees gave proper guarantees, personal guarantees,

or collateralized the loan, they would have been unable to secure the \$1 million.

The answer to the second question is unclear, because Opinion No. 16 states, "The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans secured by stock issued in the combination. . . ." Opinion No. 16 merely gives one example of a financial arrangement. In my opinion, the arrangement in this acquisition is one that is prohibited by Opinion No. 16, but obviously the auditors of the acquirer felt that it was not.

The third question cannot be answered easily. Again, since the acquirer's auditors approved the pooling treatment, the third question posed no problem for them. In my opinion, there is much room for interpretation regarding the third question.

#### Pooling With Selected Assets

An interesting pooling, Case O, noted in the course of this research was one in which the principal asset of the acquiree was an oil drilling right. The acquiree's income came from this right and assets other than this right were negligible. This raises the question of whether the acquirer acquired a specific asset or pooled with a going concern. The auditors who approved the pooling obviously felt it was the latter. This case raises the additional question of the possibility that a manufacturing

company might pool with another company whose only asset was a building. It appears that this type of pooling is not prohibited at this time.

It is obvious that many questions can be raised regarding the propriety of pooling accounting. Examples were given of the severe distortions that pooling accounting has created. There are still many unanswered questions about the proper treatment of specific transactions under the aegis of Opinion No. 16. Purchase accounting problems have not been discussed here; they will be dealt with in the next chapter.

## FOOTNOTES

1. John C. Burton, Accounting for Business Combinations: A Practical and Empirical Comment, New York: Financial Executives Research Foundation, 1970, p. 20.
2. American Institute of Certified Public Accountants, News Report, "EPS Still No. 1 With Annual Report Readers," The Journal of Accountancy, v. 142, July 1976, p. 26.
3. Ibid.
4. Value Line Investment Survey, New York: Arnold Bernhard & Co., Inc. (1976).
5. Leopold A. Bernstein, Financial Statement Analysis: Theory, Application, and Interpretation, Homewood, Illinois: Richard D. Irwin, Inc., 1974, p. 67.
6. Ibid., p. 70.
7. Accounting Principles Board, Business Combinations (Opinion No. 16; New York: American Institute of Certified Public Accountants, August 1970), Par. 48-b.

## CHAPTER V

STUDIES OF CORPORATE PRACTICES--PURCHASE  
RESEARCH METHODOLOGY

All listing applications filed with the New York Stock Exchange during the years 1972 and 1973 were examined. An analysis of business combinations treated as purchases was made, similar to the one made of pooling acquisitions. Specifically, "purchase" listing applications were analyzed and studied using the same approach as for "pooling" and itemized in Chapter IV as follows:

A. 1, 2, 3, 4.

B. 1, 6.

The following additional analysis was done for those acquisitions classified as purchases:

D1. For all "purchase" acquisitions during 1972, I computed the internal rate of return of the acquisition investment. Certain assumptions had to be made. They were:

a. A uniform income stream was used. It was based on the latest income statement of the seller.

b. Economies of scale were ignored, since there was no way to obtain this information.

c. The number of years (n) was assumed to be 50, since the present value of cash flows longer than  $n = 50$  is insignificant.

d. The salvage value of asset investments and the

value of investment in inventories and receivables were ignored because their influence on the calculated rate of return is immaterial.

D2. A frequency distribution of D1 was prepared.

D3. For selected rates of return, a tabulation was made showing at what point in time 90% and 95% of the present values of cash flow would have been reached.

D4. The difference between the fair market value (paid) of the acquisition and the book value of the acquired analyzed for each "purchase" in 1972.

D5. Where the "excess" in D4 was large (greater than 30%) in relation to the fair market value, these acquisitions were then screened for large and small investments in inventories and plant assets.

D6. The acquisitions listed in D5 that had small investments (less than 20%) in inventories and plant assets (total) were then analyzed as follows:

a. The acquirer's 10-K and 8-K reports were examined to ascertain at what amount the transaction was recorded.

b. The amount recorded as "Excess of Cost Over Underlying Equity in Subsidiaries Acquired" was reconciled from December 31, 1971, to December 31, 1972, to account for all acquisitions made by an acquirer during 1972. Amortization schedules of the "excess" were also analyzed to determine the period over which the "excess" was being amortized.

The Findings

Differences between book values and market values.--An analysis was made of each acquisition (pooling or purchase) where book value exceeded market value (price paid). The results of this analysis appear in Table 24.

Table 24

ANALYSIS OF BUSINESS COMBINATIONS--BOOK VALUE  
IN EXCESS OF MARKET VALUE (1972-1973)  
(Millions of Dollars)

Accounting Treatment	Companies	%	Book Values	Market Values	Excess	Excess as a % of Market Value
Pooling	8	21	\$ 44	\$ 35	\$ 9	26%
Purchase	31	79	295	220	75	34%
Totals	39	100	\$339	\$255	\$84	

A similar analysis was made for those cases where market value exceeded book value. These results appear in Table 25.

The relationship of book values and market values was then analyzed and tabulated as shown in Table 26.

From the foregoing tables it is evident that the combinations of this study show:

1. When market values exceeded book values, 85% of the combinations appeared as poolings; but when book values exceeded market values, the reverse is true--79% of the combinations

Table 25

ANALYSIS OF BUSINESS COMBINATIONS--MARKET VALUE  
IN EXCESS OF BOOK VALUE (1972-1973)  
(Millions of Dollars)

Accounting Treatment	Companies		Market Value	Book Value	Excess
	Number	%			
Pooling	895	85	\$7,735	\$2,452	\$5,283
Purchase	152	15	587	216	371
Totals	1,047	100	\$8,322	\$2,668	\$5,654

Table 26

RELATIONSHIP OF BOOK VALUES AND MARKET VALUES  
FOR POOLINGS AND PURCHASES--MARKET VALUE  
EXCEEDS BOOK VALUE (1972-1973)

	Pooling		Purchase	
	Millions of Dollars	%	Millions of Dollars	%
Market Values	\$7,735	100	\$587	100
Book Values	2,452	32	216	37
Excess	\$5,283	68	\$371	63

appeared as purchases (Tables 24 and 25).

2. When market values exceeded book values, the relationship of market values to "excess" is 5% higher for poolings, whereas when book values exceeded market values, the reverse is true--the relationship of "excess" to market value is 8% higher for purchases (Tables 24 and 26).

3. When pooling was used, as indicated in Table 26, \$5.2 billion of "excess" was omitted in recording the combinations. When purchase accounting was used, as indicated in Table 24, \$75 million of "excess" was not recorded.

It can be argued that these events can be considered random, but the changes evidenced by Tables 24 and 25 are so large that it is highly likely that a "game plan" exists. The "game plan" is one in which purchase accounting is "selected" when book value exceeds market value, and pooling accounting is selected when the reverse is true.

It is reasonable to ask, if a "game plan" exists, "Why are there purchases in Table 26? Shouldn't Table 26 be all poolings?" The answer to these questions is that it is easy to shift a pooling into a purchase, but not always possible to shift a purchase into a pooling. If a seller insists on cash, debt or preferred stock in excess of 10% (to be discussed in Chapter VI), the transaction will be treated as a purchase if the acquirer is anxious to consummate the acquisition.

To further demonstrate the existence of a "game plan" an

example (Case P) of two listing applications filed on the same day by the same acquirer will be considered.

The wording in the two listing applications is identical except for the names of the acquirees and the number of shares involved. There are no indications of payment other than common stock. Other listing applications indicate if cash, debt or preferred stock is issued in addition to common stock. There are no indications of why one was treated as a purchase and the other treated as a pooling. However, there must have been a reason for the auditors to approve the different treatments. An attempt was made to ascertain the reason or reasons for the treatments by checking with the Division of Stock List at the New York Stock Exchange. I was informed that "pooling letters" (auditor's comments and letter of approval) are received by the division, but purchases are passed without the auditor's letter. The 1973 acquisitions contained the following:

	Pooling	Purchase
	<hr/>	<hr/>
Number of Shares	50,000	20,000
Market Price per Share	\$ 28	\$ 28
Market Value of Acquisition	\$1,400,000	\$ 560,000
Book Value of Acquirees	304,000	750,000
	<hr/>	<hr/>
Excess Market Value	\$1,096,000	\$ (190,000)
	<hr/> <hr/>	<hr/> <hr/>
Net Income--Acquiree	\$ 179,000	\$ 48,000
	<hr/> <hr/>	<hr/> <hr/>

The transactions were recorded on the books of the acquirer, as follows:

Pooling	\$304,000
Purchase	\$560,000

The listing application for the purchase goes on to state:

"for accounting purposes the [acquiree] transaction will be treated as a purchase, and appropriate accounting entries consistent with such treatment will be made on the books of [acquirer]. In accounting for a transaction as a purchase, the excess of cost, if any [fair market value of securities exchanged] over the fair market value of the assets received as a result of the exchange is categorized as goodwill and carried as an intangible asset, which is amortized over a period of not more than forty years. This transaction is not expected to result in the creation of any goodwill on the books of [acquirer]." A statement such as this one does not appear on the pooling application, since a pooling is recorded at the book value of the acquiree and an "excess" can never be recorded.

Based on the information available, these two listing applications certainly appear to be part of the "game plan."

Further evidence of a "game plan" can be obtained by examining the contract of sale between the acquirer and acquiree. In many of the contracts examined, I noticed that a clause was inserted which said the contract would be void if the acquirer's independent auditor ruled that the combination did not qualify for pooling treatment. An escape clause is understandable with

regard to the tax status of a business combination, since the tax status will affect future cash flows. An escape clause tied into the accounting treatment is suspect, since cash flow is unaffected by the accounting treatment of a business combination.

Evidently, if the method of accounting for a business combination can result in the negation or consummation of the combination, the accounting treatment is not neutral. It should be! Reference is made to Chapter III of this study where George R. Catlett, partner in Arthur Andersen & Co., is quoted as stating: "Frequently, a business combination is not considered economically feasible unless it may be accounted for as a pooling of interests." The "game plan" evidence demonstrated in this study, the escape clause in merger agreements pertaining to pooling accounting and the statement made by Catlett can only mean that managers of acquiring companies are determined to have their way with pooling accounting.

One must ask, "Why?" Can this be explained solely by management's self-interest with regard to incentive compensation? My feeling is that this cannot be so explained. Certainly, self-interest can explain part of the "game plan." However, incentive compensation does not relate to statements such as Catlett's. What, then, is the remainder of the answer? Management must believe that it is able to fool the marketplace with "fudged" pooling earnings. Whether or not the marketplace is fooled by "pooling" earnings is a topic for further study. However, management's perception that "pooling" earnings are

fooling an efficient market is indicated by the research demonstrated in this study.

#### Case Studies of Purchase Accounting

Many other applications of purchase accounting were noted in the course of this research. Case Q will illustrate some of the problems encountered. A manufacturer of wire and cable acquired an 80% interest in a repetitive data processing service. The compensation consisted of \$490,000 in cash and 10,000 shares of stock with a market value of \$260,000, or a total of \$750,000. The composition of the acquiree's Balance Sheet was as follows:

Cash	\$778,000
Receivables	122,000
Equipment	78,000
Accumulated Depreciation	(21,000)
Other Assets	7,000
	<hr/>
Total Assets	\$964,000
	<hr/> <hr/>
Current Liabilities	\$130,000
Convertible Debentures	500,000
Capital Stock	905,000
Accumulated Deficit	(571,000)
	<hr/>
Total	\$964,000
	<hr/> <hr/>

The listing application states that purchase accounting will be used. In addition, it states: "The excess of the purchase price over the fair value of the net assets acquired will be carried as an intangible on the company's balance sheet. Such intangible will be amortized over a period not in excess of 40 years."

My calculation of this "excess" is as follows:

Price Paid	\$750,000
Book Value (80% of \$905,000 - \$571,000)	267,200
	<hr/>
Excess	\$482,800
	<hr/> <hr/>

It is obvious that this excess cannot be assigned to cash or receivables and probably not to the equipment. The equipment was only two years old and consisted of office equipment. Computer time was rented.

The acquiree's income statement data are as follows:

	1971	1970
	<hr/>	<hr/>
Revenues	\$364,000	\$227,000
Costs and Expenses	650,000	516,000
	<hr/>	<hr/>
Net Loss	(\$286,000)	(\$289,000)
	<hr/> <hr/>	<hr/> <hr/>

A reading of the notes to the financial statements discloses that the acquirer agreed to pay the acquiree \$46,000 per month

to render computer management services to the acquirer. The acquiree agreed to pay the acquirer \$46,000 per month for the rental of certain data processing equipment and facilities. The lease for the facilities and equipment is for a five-year term.

This transaction raises several interesting questions: First, on what basis was the "excess" assigned to an intangible? Second, on what basis was the amortization period determined to be 40 years? Third, is the nature of the transaction something other than what it appears to be, namely, a matter of form vs. substance?

In answer to the first question, it is hard to visualize any goodwill in this transaction in light of the earnings history of this company. If there is no goodwill, might there be some research and development that applies to the excess? The answer might be yes, since the company spent \$465,000 in development costs in 1971 (this was a 1972 acquisition). However, if the acquirer capitalized it as research and development, a 40-year amortization period would not be appropriate. Probably 5 years, at most, could be used. (Capitalizing research and development was permissible in 1972.)

The answer to the second question is that I cannot see any basis for using a 40-year life! The only reason that a 40-year life was mentioned here is Opinion No. 17. The Opinion was meant to be a guide; it was not meant to give a 40-year life to intangibles where the life was much shorter.

The answer to the third question is extremely interesting.

As I view it, the reciprocal payments of \$46,000 per month are really a wash transaction. In essence, the acquirer purchased human resources with computer and operations research expertise. Accordingly, the excess payment represents prepaid employment compensation and should be amortized over the life of the contract, specifically, five years.

Another example, Case R, is one in which an entertainment facility acquired the minority interest in a company that owned two race tracks and a hotel located near one of the race tracks. The listing application states that an appraisal will be made to determine what the excess is and, once determined, the excess will all be assigned to land. This seems somewhat strange. If the excess is not known and no appraisal of the properties was made, how can it be determined that none of the excess is applicable to the hotel building? The interesting fact in this acquisition is that, if any excess is assigned to the hotel building, this would have to be depreciated over its remaining useful life. If any excess is attributable to goodwill, it would have to be amortized over a period not to exceed 40 years. However, by allocating it all to land, no amortization is necessary. A very interesting case, indeed!

In a third example, Case S, an acquirer issued 187,992 shares for 100% of the stock of an acquiree. My calculation of the price paid came to \$5.26 million based on an average price of \$28.00 per share (market price of the acquirer's stock on the date

of the acquisition as recorded in the Daily Stock Price Record published by Standard & Poor's Corporation). Upon examining the acquirer's 10-K and 8-K reports, I noted with dismay that the transaction was recorded at \$3.84 million. The 10-K form noted that the shares were issued to key managerial personnel of the acquiree, which planned to continue with the combined entity. Accordingly, these shares were not registered since there was no intention by the recipients to dispose of these shares. (How nice and assuring this phrase would sound in a pooling; this was a purchase, however.)

The difference of \$1.42 million (\$5.26 - \$3.84 million) is explained in the 10-K. Here, quoted verbatim, is the key paragraph:

Considering the restrictions on the sales of the stock issued, the size of the block of shares issued and the specific market conditions prevailing at the date issued, two national brokers of securities gave their opinions that the market value of this block of securities would be approximately 25% less than the price at which these shares traded on the New York Stock Exchange. Based on these opinions, the common stock of Registrant issued was given a per share market value of \$20.44 and an aggregate market value of \$3,842,556.

Several questions arise in my mind because of the way this transaction was handled. First, I question whether a 2% block (the shares issued were 2% of outstanding shares) or a \$5 million block is so large that a 25% discount is in order? Next, does the failure to register the securities (a management decision) call for a discount of this magnitude? Third, might there be some bias on the part of the securities dealers who were engaged by the

acquirer?

The answer to the first question, in my opinion, is that a 25% discount is abnormally large. Blocks of this size of other companies have successfully passed in the primary market, and also as secondary offerings without a 25% discount. The size of the block, by itself, should not require a 25% discount.

The failure to register the shares was a management decision that could be reversed at management's will. A discount would be appropriate to the extent of the registration costs, but these costs could hardly be expected to approach anywhere near \$1.42 million. Accordingly, the discount cannot be explained by the failure to register the securities.

Regarding the bias of appraisers, it is obvious that there is considerable room for interpretation. If not bias, why then have two appraisals? One would suffice! It is impossible for me to evaluate the appraisers' integrity. However, it appears to me that a 25% discount is unwarranted based upon the size of the block of shares and/or the fact that the shares were not registered.

Using the standard discussed in Chapter III--the concept of fair market value as being the fair value of the consideration given, or the fair value of the consideration received, whichever is the more clearly evident--I will now turn to the consideration received. The acquiree's Balance Sheet showed the consideration in Table 27.

Table 27  
 BALANCE SHEET--CASE S  
 JUNE 30, 1971  
 (Thousands of Dollars)

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Assets:	
Inventories	\$ 367
Other Current Assets	954
	<hr/>
Total Current Assets	\$1,321
	<hr/>
Plant Assets--Gross	\$4,078
Less Accumulated Depreciation	1,200
	<hr/>
Plant Assets--Net	\$2,878
	<hr/>
Other Assets	\$ 485
	<hr/>
Total Assets	\$4,684
	<hr/> <hr/>
Liabilities and Stockholders' Equity:	
Liabilities	\$2,454
Stockholders' Equity	2,230
	<hr/>
Total Liabilities and Stockholders' Equity	\$4,684
	<hr/> <hr/>
Net Income for the Year	\$ 902

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Using the price paid as computed by the acquirer of \$3.84 million, and assuming that the acquirer's income of \$902,000 will remain constant, the internal rate of return on the investment is approximately 2% if the depreciation expense add-back is ignored and  $n = 50$  years. The computation of 2% was arrived at as follows:

$$\$3.84 \text{ million} = \$902 \text{ thousand} (A \overline{n} | i)$$

where  $A \overline{n} | i$  is the present value of an annuity of \$1, and  $n$ , number of periods;  $i$ , interest rate per period.

$$A \overline{50} | .24 = 4.167$$

Since the acquirer's financial statements were submitted for one year only and depreciation expense for the year was not indicated, I assumed that depreciation expense for the year was \$408,000 (10% of gross plant assets). Adding the \$408,000 to the net income of \$902,000, I get a cash flow of \$1,310,000, which produces an internal rate of 40%. This rate seems quite high for this type of investment.

If, however, I use the market price that I computed (\$5.26 million) together with a cash flow of \$1.31 million, the internal rate of return is 2%, which appears reasonable for this type of investment. Based on the preceding analysis, it appears that the writedown of \$1.42 million is merely an abuse of purchase accounting as pointed out by Professor Briloff.<sup>1</sup>

If management assigns the "fair values" to specific assets in a "purchase" acquisition and if management is interested in doing this assignment process in a self-serving manner, there

is considerable room for this to be done, as Case S illustrates. Additionally, if management is interested in lowering the charges to income, it can lower the values of those items that will be charged to income (inventories, equipment, prepaid expenses) over relatively short periods of time and increase the value of "goodwill," which can be charged to income over a long period of time (40-year amortization).

Valuation problems similar to the ones cited in this section of the study were investigated by Professor Tearney.<sup>2</sup> His analysis of 209 listing applications filed with the New York Stock Exchange in 1969 and accounted for as purchases disclosed the following reasons for purchasing another company:

1. Market objectives	9.8%
2. Expansion in new territory	4.3%
3. Management and technical skills	5.6%
4. Product diversification	40.1%
5. Integration	33.2%
6. Other--no disclosure	7.0%

His main thesis is that firms acquire other firms for a variety of reasons and, although he does not specify any valuation techniques,<sup>3</sup> he maintains that values should be assigned to these reasons for the acquisition (marketing costs, personnel skills, etc.) thereby eliminating, or reducing substantially, "goodwill" or "excess of cost" problems.

In a later study,<sup>4</sup> he notes that, of the 108 listing applica-

tions filed with the New York Stock Exchange in 1971 that were accounted for as purchases, an alarming 60.2% of the acquirers used the book values of the acquirees' assets to record the transaction with the remaining amount paid in excess of book value recorded as "goodwill." In essence, although purchase accounting was used, the distortions attributable to pooling accounting were permitted to filter through to purchase accounting by the incorrect use of the method. Admittedly, this is a compliance problem, but it highlights the lengths that a company will resort to. This particular compliance problem will be dealt with in Chapter VIII, "Recommendations for the Improvement of Accounting for Business Combinations." An approach to solving the earlier problem relating to valuation techniques of purchased intangibles will now be discussed.

#### Internal Rate of Return

During the year 1972, 95 acquisitions, listed on the New York Stock Exchange, were accounted for as purchases. The internal rate of return (growth rates and inflation rates were ignored) was computed for these acquisitions incorporating the following assumptions:

1.  $n = 50$
2. The income stream will remain constant.
3. Depreciation expense, if given, was added back to net income for cash flow computation.

4. If depreciation expense was not given, 10% of gross assets was used as the add-back for cash flow computations.

A frequency distribution of this analysis is presented in Table 26.

Table 26

FREQUENCY DISTRIBUTION OF INTERNAL RATES OF RETURN  
OF "PURCHASE" ACQUISITIONS LISTED ON  
NEW YORK STOCK EXCHANGE--1972

Rate of Return	Number of Companies	% of Total
Less than 10%	38	40
10% < 13%	16	17
13% < 16%	8	9
16% < 19%	7	7
19% < 22%	5	5
22% < 25%	11	12
25% < 28%	--	--
28% < 31%	3	3
31% < 34%	--	--
34% < 37%	--	--
37% < 40%	--	--
40% and higher	7	7
Totals	95	100

From the foregoing table it is obvious that the rates of return vary considerably. The reasons are varied. A partial listing includes:

1. Imprecise information.
2. Differing risks.
3. Different cutoff rates.
4. Components of purchased assets are varied.

Even with the imprecise input data, it is reasonable to assume that the frequency distribution would not be materially different if precise data were available. Although the rates of return are biased on the low side because of the failure to consider the effects of growth and inflation, the distribution does indicate a wide degree of variability in the rates of return of business combinations. Amortization of the "excess" over a period of 40 years is clearly inappropriate, and economic reality demands that this difference be assigned to specific intangibles (marketing costs, personnel costs, etc.) and be amortized over the respective lives of the items acquired.

Amounts that clearly belong to goodwill (due to excess earnings--a higher than normal rate of return) should be amortized to income using the rate of return calculated (the "interest" method should be used). Straight-line amortization (presently used) violates the time-value of money concept and is not acceptable in accordance with APB Opinion No. 21.<sup>5</sup> Therefore, it should not be acceptable for APB Opinion No. 17.<sup>6</sup> (to be discussed in Chapter VI).

Further, the 40-year life permissible under APB Opinion No. 17 is far removed from economic reality. Selected rates of return were analyzed to determine at what point 90% and 95% of the present value of an income stream will have been received at those rates of return. Table 29 summarizes this analysis.

Table 29  
PRESENT VALUE OF SELECTED RATES OF RETURN (n = 50)

Year	Cumulative Present Values			
	9%	11%	15%	20%
1st	8.4%	10.0%	13.1%	16.7%
2nd	16.0	19.9	24.4	30.6
3rd	23.1	27.0	34.3	42.1
4th	29.6	34.3	42.9	51.8
5th	35.5	40.9	50.3	59.8
10th	58.5	65.1	75.3	83.9
13th	---	---	---	90.0
16th	---	---	90.0	95.0
21st	---	---	95.0	---
22nd	---	90.0	---	---
25th	90.0	---	---	---
27th	---	95.0	---	---
32nd	95.0	---	---	---
50th	100.0	100.0	100.0	100.0

Even at the modest rate of 9%, 95% of the present value of an income stream will have been received by the 32nd year. At the more realistic rate of return of 20%, 95% of the present value will have been received by the 16th year. In any event, 40-year straight-line amortization cannot be logically sustained.

The broadcasting, trucking and newspaper industries have submitted position papers to the FASB regarding the amortization of goodwill. The position papers conclude:

The intangibles acquired in business combinations in these industries are typically the most important assets of the companies, have virtually unlimited duration, and generally increase in value over a period of time. They urge the Board to eliminate the mandatory amortization requirements for those intangibles and leave to managements the determination of amounts, if any, to be amortized and the periods over which any amortization would be taken.

Conceptually, the approach taken in this chapter and the recommendations made in Chapter VIII with regard to the amortization of intangibles are compatible with the request of the industries noted above. To grant the request made by these industries would only lead to requests by other industries for special consideration and the erosion of the concept. A uniform approach, based on economic substance, is fair to all parties and can be logically sustained. This study recommends the use of such an approach. The next chapter will analyze Opinions No. 16 and 17.

## FOOTNOTES

1. Abraham J. Brilloff, Unaccountable Accounting, New York: Harper & Row, 1972, pp.79-82.
2. Michael G. Tearney, "Accounting for Goodwill: A Realistic Approach," The Journal of Accountancy, v. 136, July 1973, pp. 41-45.
3. Michael G. Tearney, "Letter to the Editor in Reply to William Robert Smith," The Journal of Accountancy, v. 136, November 1973, pp. 38-40.
4. Michael G. Tearney, "Compliance with AICPA Pronouncements on Accounting for Goodwill," The CPA Journal, v. 43, February 1973, pp. 123-124.
5. Accounting Principles Board, Interest on Receivables and Payables (Opinion No. 21; New York: American Institute of Certified Public Accountants, August 1971), par. 15.
6. Accounting Principles Board, Intangible Assets (Opinion No. 17; New York: American Institute of Certified Public Accountants, August 1970).
7. Financial Accounting Standards Board. Accounting for Business Combinations and Purchased Intangibles. Stamford, Conn., 1976. (FASB discussion memorandum, August 19, 1976, Appendix I, par. 921.)

## CHAPTER VI

## ANALYSIS OF APB OPINIONS 16 AND 17

Since APB Opinions 16 and 17 were issued for the purpose of eliminating the abuses of accounting for business combinations (mentioned in Chapter II), the opinions will be analyzed to determine if they have accomplished this goal and also to ascertain if any new abuses emerged as a result of the issuance of these opinions.

The attributes of the opinion will be analyzed in terms of those areas that may be classified as:

1. Well defined,
2. Loosely defined, and
3. Ignored.

In addition, the analysis will be supplemented with a listing of the types of abuses that are still possible under the aegis of the Opinions and their interpretations.

WELL DEFINEDNegative Goodwill

Prior to the issuance of APB Opinion 16, negative goodwill was a controversial and troublesome topic. If a corporation acquired another corporation under a purchase transaction and the acquiree's book value exceeded the consideration paid by the acquirer, this excess frequently was treated as negative goodwill. The proper treatment would have been to adjust the

balances of the individual assets acquired, especially plant and equipment. When the negative goodwill approach was used, it was amortized to income, usually over a short period of time (less than 10 years). Admittedly, the long-lived assets were simultaneously being amortized to expenses, but the amortization to income was usually over a shorter period than the expense amortization, and the income injection was free from income tax expense, thereby making the income injection twice as potent (using a 50% tax rate).

APB Opinion 16 has effectively cured this problem, since a transaction such as the one described above is unlikely to occur. The opinion requires that an excess of book value over cost must first reduce all long-lived assets to zero, except for long-term investments, before a negative goodwill can be recorded. It is unlikely that a business combination would occur where the consideration paid would be less than current assets minus total liabilities. No combinations of this type were noted in this research and it appears that APB Opinion 16 has effectively solved the negative goodwill problem. (An exception, with limited applicability, applies to LIFO inventories.)

However, this treatment may create other problems. There is always a trade-off for a particular solution to a problem. If an acquirer has an acquisition which meets the criteria for a pooling, and it is obvious that a situation such as the one described above will prevail, the terms of the contract can be altered to mandate the use of purchase accounting and, by writing down the

value of long-lived assets to the extent of the negative goodwill involved, thereby relieve future income statements of depreciation charges that would have occurred if pooling had been used. Chapter V presented cases where it appeared this was done.

#### Part Purchase/Part Pooling

This thorny abuse was in vogue prior to the issuance of AEB Opinion 16.<sup>1</sup> This problem appears to be substantially cured by the Opinion; however, it is still possible to have some part purchase/part pooling, if the transaction were initiated prior to November 1, 1970, and has not been completed. If the transaction is to be treated under the old rules, the one-year time limit for completion does not apply and a part-purchase/part-pooling transaction can still emerge.<sup>2</sup> Admittedly, the half-breed transaction from this source should disappear.

However, another facet of this problem could arise where affiliated companies are acquired in a multiple acquisition. If one company is acquired for cash and another affiliated company is acquired for common stock, there are possible situations where the cash transaction will be treated as a purchase and the stock transaction will be treated as a pooling when if the companies, in fact, were one company, only one treatment would be possible. This topic will be more fully explored in the next section under "Loosely Defined Autonomy."

### A Single Transaction

To prevent a pooling from being a series of transactions over an extended period of time and thereby minimizing the risk of uncertainty (similar to contingent shares), the AFB prescribed in paragraph 47-a of AFB Opinion 16 that "the combination is effected in a single transaction or is completed in accordance with a specific plan one year after the plan is initiated." The one-year time limit is weakened somewhat by the allowance of an extension of time if the failure to consummate the pooling in one year is beyond the control of the parties. Examples of this condition are proceedings before a governmental authority (a regulatory body where approval is needed; the SEC is excluded) and litigation (i.e., Justice Department or minority stockholder suit to prevent the combination).<sup>3</sup>

### The Use of Warrants

An interpretation was necessary to clarify the AICPA position regarding the use of warrants in a pooling. Since the opinion specifies that only common stock may be exchanged for common stock, it would appear that the use of warrants would defeat a pooling. This is true if the warrants are issued to stockholders on a pro-rata basis. However, warrants may be used to exchange preferred stock and/or debt. They may also be used to acquire up to 10% of common stock, provided the 90% rule (hereinafter

discussed in the section "Loosely Defined") has been met.<sup>4</sup>

#### Preferred Stock and Debt

Preferred stock and debt can be exchanged for similar securities, retired for cash or exchanged for common stock. There is no prohibition against issuing common stock for these securities, nor do they have to be maintained after the combination.

#### Pooling With Net Assets Instead of Acquiring Stock of Seller

Instead of acquiring the common stock of the acquiree, a pooling is permissible if the acquirer acquires all the net assets on the consummation date. Assets (cash, receivables and marketable securities) may be retained by the acquiree to settle liabilities, contingencies, etc., provided the agreement specifies that any assets left after all settlements are transferred to the acquirer. The 90% rule (discussed later) relating to intercorporate investments is equally applicable to the transfer of net assets or to an exchange of common stock.<sup>5</sup> The acquirer's stock issued to the acquiree will be distributed to the acquiree's stockholders upon liquidation.

#### Voting Stock-Voting Rights

Voting common stock used in a business combination may not be stock with restricted voting rights if pooling accounting is to be used.<sup>6</sup> Common stock placed in a voting trust will preclude pooling treatment.

### Acquiree Remains a Subsidiary

An acquired corporation does not have to be merged or consolidated. The acquired corporation can remain a subsidiary corporation of the parent corporation and still qualify for pooling treatment.<sup>7</sup>

### Pooling Using Treasury Stock

If treasury shares are issued in connection with a pooling, the accounting treatment is as follows:

1. Record the treasury shares as if they were retired, and then
2. Record the issued treasury shares as if they were previously unissued.<sup>8</sup>

The effect of the above is to charge against capital in excess of par value and retained earnings amounts paid in excess of par value for the treasury stock, and to record the subsequent issue of these shares at par value.

### Expenses Related to a Combination

Since the respective book values of the parties are combined in a pooling, no expenses that arise in connection with the combination are to be capitalized. Accordingly, all costs including registration fees, finders' fees, salaries and stockholders' information expenses are treated as expenses when incurred.<sup>9</sup> The cost of maintaining an acquisitions department is similarly expensed.<sup>10</sup> If, however, the agreement specifies that the broker's fee is to

be paid by the sellers with shares received in a pooling, the fair value of the shares should be treated as an expense on the combined income statement in the year of the combination.<sup>11</sup>

#### Gains and Losses on Disposition of Assets After Pooling

Material gains and losses on the sale of a significant part of the assets of a segment of one of the parties to the combination should be classified as an extraordinary item.<sup>12</sup> This position has not been modified by APB Opinion 30.<sup>13</sup>

#### Disclosure Requirements

The disclosure requirements specified in paragraphs 63, 64 and 65 of APB Opinion 16 are fairly well defined and need not be listed or discussed.

#### Purchase Accounting

Since the Opinion does not set down any new concepts for purchase accounting, but merely discusses existing valuation problems of purchase accounting in greater detail, an analysis of purchase accounting is not required in this chapter.

#### LOOSELY DEFINED

##### Autonomy

Paragraph 46-a of APB Opinion 16 states: "Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated."

This provision was apparently inserted to prevent a spin-off of specific assets to a new corporation and thereby permit a pooling to occur for specific assets instead of pooling with an entire economic unit. However, no less than twelve interpretations have been issued by the AICPA regarding this attribute. Setting aside the specified exceptions, such as government-ordered divestitures, and those specified by the interpretations, other questions remain unanswered. Specifically, since materiality plays a role in AFB Opinions and AFB Opinion No. 16 is silent in this respect, is an immaterial spin-off permissible for a pooling? If it is, what is an immaterial spin-off? Is the two-year requirement rigid, or are immaterial time variations permissible? In Chapter IV Case K is cited as one example wherein several spin-offs occurred in transactions noted in this research and were treated as poolings.

Another problem deals with the acquisition of proprietorships and partnerships. The interpretations cite an example of a proprietorship owning two grocery stores or a grocery store and an automobile dealership. In the former case, both stores are required for pooling treatment, but in the latter case either business can qualify. However, if both are acquired, both must be pooled.<sup>14</sup> This brings to mind the question of an automobile dealership that operates a gasoline filling station. Would both be necessary for a pooling? The answer, based on the interpretations thus far issued, is unclear.

Still another problem exists where a multiple acquisition

is contemplated with affiliated companies. If Corporation X is owned by A and B equally and Corporation Y is owned by B and C equally, can Corporation Z acquire X and Y and account for one as a pooling and the other as a purchase? The answer appears to be "yes." Since the ownerships of Corporation X and Corporation Y are different these acquisitions appear to qualify for separate treatment. However, as indicated in the preceding paragraph, a grocery store and an automobile dealership owned by a proprietor or partnership must "pool" both if he is to "pool" one. The question then raised is, "What about common ownership of separate corporations?" This, too, appears clear. Where the companies are one economic unit (vertically integrated corporations), both would have to utilize the same treatment, i.e., purchase or pooling. However, there are many gray areas between the extremes cited above, and no clear answer is available. For example, if A owns 95% of Corporation X and 95% of Corporation Y and the 5% of X is owned by B and the 5% of Y is owned by C, is this common ownership? Each case between the extremes would have to be decided on an individual basis.

#### Independence

Paragraph 46-b of AFB opinion 16 states: "Each of the combining companies is independent of the other combining companies." The Opinion goes on to explain that up to 10% of intercorporate investments in common stock is permissible for a pooling. The 10% limitation will be discussed in a succeeding section when paragraph

47-b is considered. Besides the interpretations of the 10% rule that pertain to both paragraphs (46-b and 47-b), one additional interpretation applicable to paragraph 46-b was issued. It concerns itself with shares in excess of 10% between the initiation and consummation dates. If 10% or less of intercorporate investments is held on these dates, but more than 10% is held in between the dates, purchase accounting is required.<sup>15</sup>

Using the 10% rule as a test of independence would be a valid test in many cases, yet in some cases it may not be valid. Consider a 10% relationship between General Motors and DuPont or between Hartford Insurance Company and International Telephone and Telegraph. In cases such as these, a 10% relationship would not be "independent," in my opinion.

#### Combining Interests

It is interesting to note that paragraph 47 discusses the concept of "mutual sharing" and states, "The combination of existing voting common stock interests by the exchange of stock is the essence of a business combination accounted for by the pooling of interests method. The separate stockholder interests lose their identities and all share mutually in the combined risks and rights." (Emphasis mine.) If one is to share mutually in the combined risks and rights, he must hold his shares for a period of time, since, if an immediate "bailout" is permitted, there is no risk or right to share in.

This paragraph implies that a continuity of interest is necessary for a pooling; yet, the opinion does not specifically prescribe the continuity doctrine for a pooling. In fact, it is well established that "bailouts" are permissible, and it was the SEC that imposed a waiting period (an extremely short one). This is strange since Accounting Research Bulletin No. 48 states: "Since the assumption underlying the pooling-of-interests concept is one of continuity of all of the constituents in one business enterprise. . . . Similarly, the continuity of management or the power to control management is involved. Thus, if the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is small, a purchase may be indicated."<sup>16</sup> It seems as if the AFB loosened the requirements for a pooling in this respect instead of making them more stringent. Case M in Chapter IV illustrates an immediate bailout with a pooling.

Common Stock Must Be Exchanged for  
Substantially All Common Stock of Acquiree

The intent of Paragraph 47-b was to eliminate the use of convertible securities, options and warrants, debentures and cash, and still qualify for some pooling treatment. To allow for small minority interest dissent, a 90% rule was established to mean "substantially all." The common stock exchanged must have "rights identical to those of the majority of its outstanding voting common stock."<sup>17</sup>

An illustration of the 90% rule will help to clarify the

difficult wording in the Opinion and will also help to demonstrate the problems associated with its application. The Opinion states:

An investment in 10 percent or less of the outstanding voting common stock of the issuing corporation affects the measure of percent of shares exchanged in the combination as follows:

The number of shares of voting common stock of the issuing corporation held by the investor combining company at the date the plan is initiated plus shares it acquired after that date are restated as an equivalent number of shares of voting common stock of the investor combining company based on the ratio of exchange of stock in the combination.

The equivalent number of shares is deducted from the number of shares of voting common stock of the investor combining company exchanged for voting common stock of the issuing corporation as part of the plan of combination.

The reduced number of shares is considered the number exchanged and is compared with 90 percent of the outstanding voting common stock of the investor combining company at the date the plan is consummated to determine whether the terms of condition 47-b are met.<sup>18</sup>

The following will illustrate the foregoing rule:

P Company

Shares Issued	5,000,000
Investment in S Co. shares	50,000

S Company

Shares Issued	600,000
Treasury Shares	6,000
Investment in P Co. Shares	4,000

Each S Co. share is exchangeable into 3 shares of P Co.

The 10% calculation follows:

S Co. Shares Issued	600,000
Less: S Co. Treasury Shares	6,000
	<hr/>

Total Outstanding	594,000
Less: S Co. Shares Owned by P Co.	50,000
	<hr/>
	544,000
Less: P Co. Shares Owned by S Co. Converted into Equivalent of S Co. Shares (4,000 x 3)	12,000
	<hr/>
Number of Shares Exchanged	<u>532,000</u>

Since 90% of 594,000 shares of S Co. equals 534,600 shares, and only 532,000 shares are exchanged, the 90% rule will not have been met and purchase accounting will be required. Of course, if pooling accounting is desired, P Co. could have sold 2,700 shares of its investment in S Co., or S Co. could have sold 900 shares of its investment in P Co., prior to the initiation date to qualify for pooling treatment.

It is interesting to note that P Co. owns less than 10% of S Co. and S Co. owns less than 10% of P Co., but the application of the well-defined rule will combine both holdings which, together, exceed 10%.

An interpretation was necessary regarding the 90% rule. A stockholder who tenders shares must tender all his shares. He cannot tender some and still be a dissenter. Also, if a stockholder tenders shares he cannot receive cash for some and tender the rest in order to meet the 90% rule, except that cash for fractional shares is permissible.<sup>19</sup> The "all or none" rule, in my opinion,

is inconsistent with the lack of a "continuity of interest" rule. In fact, the interpretation states that the "all or none" rule is necessary because ". . . two or more entire common stockholder groups join together as a single entity in a pooling of interests to share the combined risks and rights represented by the previously independent interests. . . ."20 That this statement is not equally true for a continuity of interests rule is surprising, to say the least.

Since cash is permitted for fractional shares but a pro-rata cash distribution is prohibited, will a reverse stock split prior to a combination defeat a pooling if cash is paid for fractional shares, which amounts would have been for full shares prior to the reverse split? The answer is unclear, since the interpretation previously mentioned merely states, "Therefore, the payment of more than a reasonable amount of cash to a shareholder for a fractional share would be contrary to the pooling concept expressed in the Opinion. Thus the payment for fractional shares among shareholders must be reasonable in amount. . . ."21 What is reasonable? This is not defined.

#### Use of Restricted Stock

Restricted common stock with rights identical to outstanding common stock is permissible for a pooling provided the restriction is pending until the shares are registered. A restriction other than one imposed by a governmental regulation (i.e., imposed by the

issuing corporation) would probably have rights different from the unrestricted stock.<sup>22</sup> This interpretation uses the word "probably" when it speaks of a company restriction. Obviously, there is room for manipulation when an interpretation uses a word such as "probably." However, the accounting firm of Touche Ross & Co. has stated that "Although the last paragraph of the AICPA interpretation states that an issuing corporation imposed sale restriction would 'probably' create different rights, we believe it would always create different rights, and therefore preclude the use of pooling-of-interests accounting. We are not aware of what type of acceptable restriction the AICPA writer had in mind. We have observed none. Careful consideration should be given to any proposed sale restriction."<sup>23</sup>

Selling Shareholders Agree to Buy  
Convertible Securities

If, as part of a combination, selling shareholders agree to acquire convertible securities for cash in addition to receiving their common shares, is this a condition that will defeat a pooling? The Opinion and interpretations do not cover this condition. However, it is generally agreed that this will be equivalent to a contingent earnings arrangement, which is prohibited by paragraph 47-g of the Opinion. In substance, this condition is reverse "boot."<sup>24</sup>

Changes in Equity in Contemplation  
of a Business Combination

Paragraph 47-c of Opinion No. 16 states, "None of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within the two years before the plan of combination is initiated. . . ." <sup>25</sup> This section of the opinion was inserted to prevent a realignment of equity interests prior to a combination. If not for this prohibition, a realignment of equity interests prior to the combination could accomplish the same result as a pro-rata distribution of cash, which is clearly prohibited.

However, would any change within the specified two-year period preceding the combination ~~mandate~~ purchase accounting? The answer to this question is unclear for the following reasons:

1. Does the word "none" mean no changes whatsoever, or are immaterial changes permitted? Since a blanket exemption applies to immaterial items, it appears that immaterial changes in equity are permissible for a pooling. Since materiality is, as yet, not defined, there is considerable room for interpretation as to what constitutes a material change in equity. Case J in Chapter IV illustrates a change in equity of 25%, yet pooling accounting was used.

2. Distributions to stockholders are specifically mentioned in the Opinion. A distribution that is no greater than normal dividends (earnings for the period in relation to prior earnings

and dividends) will not prevent pooling accounting. Here, too, there can be room for interpretation as to the size of a normal dividend.

3. An extra dividend paid in lieu of a bonus earned by a stockholder of a closely held corporation will defeat a pooling unless the dividend is reclassified as a bonus.<sup>26</sup> Application of an interchange between a bonus and a dividend can be less than exact.

4. Would a change in terms of outstanding convertible securities designed to force a conversion constitute a violation of paragraph 47-c of the Opinion? The answer depends upon whether or not there is a business purpose unrelated to the combination.<sup>27</sup> Exactly what this means may be unclear.

5. Does a spin-off of assets constitute a change in equity assets? The answer to this is "yes."<sup>28</sup> However, as mentioned earlier in this section, is an immaterial spin-off permissible? Paragraph 46-a seems to preclude any spun-off corporation from being pooled. Yet Arthur Andersen & Co. states that an immaterial spin-off of extraneous assets (not an integral part of the business) that are less than 10% of total assets can still qualify for pooling treatment. Cash and minority interests would have to be reduced to the extent of any spin-off, so that cash, minority interest and spin-offs aggregate no more than 10% as specified in the 90% rule discussed in the preceding section. If the assets are operating assets, any spin-off (even an immaterial one) would preclude pooling

treatment.<sup>29</sup> This interpretation is at variance with the way Case K was handled.

#### The Treasury Stock Problem

In response to a request for comments on the proposed Accounting Series Release No. 146, Arthur Andersen & Co. stated:

Opinions 16 and 17 were doomed to failure from the beginning and considerable evidence of this is accumulating rapidly. These Opinions reflect another unsuccessful attempt to draw lines of distinction by means of numerous arbitrary rules between forms of consideration in transactions where the distinctions may have a huge effect on the subsequent accounting results. The difference in accounting for economic resources resulting from forms of consideration--such as between the issuance of stock and the payment of cash, or as between the issuance of convertible preferred stock and the issuance of common stock--cannot be sustained. Such distinctions, which make no business sense whatsoever, can only be implemented and enforced by means of a large number of detailed rules that, in turn, lead to many more rules and interpretations, and this goes on endlessly.<sup>30</sup>

Although the form of consideration should not affect the method of accounting for a business combination, APB Opinion No. 16 does differentiate the methods of accounting for a combination based on the form of consideration. From this it follows that the use of treasury shares to effect a business combination is, in substance, the use of cash and purchase accounting is required.

However, the Opinion excepted certain types of treasury stock purchases as being unrelated to business combinations.

These are:

1. ". . . shares for stock option and compensation plans. . ."
2. ". . . other recurring distributions provided a systematic

pattern of reacquisitions is established at least two years before the combination is initiated. . . ."31

A systematic plan can be established for less than two years preceding a combination if it is a new stock option or compensation plan.<sup>32</sup> An interpretation of "other recurring distributions" was issued in September 1971. These are:

1. Distribution for stock dividends.
2. Shares used in a "purchase" combination.
3. Resolution of a prior contingent share arrangement in a pre-APB No. 16 pooling.

Any treasury shares that were not used for the specific purpose acquired would be considered "tainted" and could be "cured" by being sold prior to the consummation of a pooling.<sup>33</sup> The interpretation also states that shares acquired for purposes other than a pooling must be issued or reserved for the purpose acquired. Also, an immaterial amount of "tainted" treasury shares may be used in a pooling. Since an immaterial amount is not quantified, it can be assumed that the 10% rule will be applicable.

Several questions come to mind as a result of the above interpretations. They are:

1. If shares are presently reacquired in the amount of stock options granted and are reserved for this purpose although the options are not exercisable until five years later, does this negate a pooling? Based on the interpretation, it appears that a pooling is permissible.

2. What if shares are acquired for stock options, the options lapse, and the shares acquired are in excess of the 10% allowable? Is it necessary to change a pooling consummated during this holding period from pooling treatment to purchase accounting? Based on the interpretation, my opinion is that it is not necessary to change to purchase accounting.

3. If a purchase is in the negotiation stage and shares are reacquired, is there a time limit as to what is considered a negotiation stage during which the shares can be reserved for the purchase? The answer appears to be that there is no time limit, and the shares can be reserved until the negotiations break off. When they do break off, if the shares are in excess of the 10% limit does a pooling consummated during this stage have to be changed to purchase accounting? Again, in my opinion, it appears that the answer is negative.

4. If the shares are reserved for any of the permissible purposes and they are in excess of the 10% limit, they become "tainted" shares when the reservation lapses. If the reserved shares were in excess of the 10% limit when a pooling occurred, can these shares be used in a subsequent pooling, if the subsequent pooling is a larger one and the "tainted" (formerly reserved) shares are now less than 10% of the subsequent pooling? My answer is in the affirmative, even though the earlier pooling would not have qualified as a pooling if the treasury shares were not reserved.

5. Does a pattern of share purchases such as 1,000 shares

per month or 5,000 shares whenever the price per share drops below \$10 qualify as a systematic pattern? Apparently these patterns qualify.

It was in this environment of uncertainty, and because many practitioners maintained that a "systematic pattern" of acquisitions was no longer required because the interpretation dealing with treasury stock purchases failed to mention it even though the Opinion prescribed a "systematic pattern," that the SEC saw fit to issue Accounting Series Release (ASR) No. 146, dated August 24, 1973. The release was issued as an interpretation of Opinion 16 and, therefore, the SEC did not publish the release in the Federal Register and did not give interested parties an opportunity to submit views and arguments concerning this release.

George R. Catlett, a general partner in the firm of Arthur Andersen & Co., commenced an action on September 11, 1973, against the SEC, claiming that ASR 146 was not merely an interpretation of Opinion 16, but "constituted a substantive change in the then prevailing generally accepted principles of accounting as reflected in practice. . . ." <sup>34</sup> Accordingly, his action sought withdrawal of the release until such time as it was published as required, and arguments could be submitted prior to its adoption. On October 5, 1973, the SEC requested comments regarding ASR 146, and Arthur Andersen & Co. withdrew its complaint against the SEC.

The major problems surrounding ASR 146 were:

1. Stating the purpose for which shares are reacquired (even

if mentioned in the minutes of the Board of Directors) is not a presumption that they have not been acquired for a pooling. The focus should be on the disposition of the shares (as proof that they were not acquired for pooling purposes) rather than focusing on the purchase of the shares. Case I in Chapter IV illustrates a treasury stock problem.

2. Did Interpretation No. 20 (footnote 33) change Opinion No. 16 by deleting the requirement of a "systematic pattern" by failing to reinforce it in the interpretations, or is a systematic pattern still required for items other than those specifically reserved for a designated or contractual purpose?

3. Where companies relied on the advice of auditors and purchased treasury shares without a "systematic pattern," must these companies sell these shares (possibly at large losses) if they wish to combine using pooling accounting? ASR 146 states that it is applicable to all subsequent combinations even though shares were acquired prior to the date of the release.<sup>35</sup>

After giving interested parties an opportunity to submit comments, the SEC issued ASR 146A to clarify the issues.<sup>36</sup> As a result of this ASR, treasury stock purchases will not create "tainted" shares if the following three conditions are met. The conditions are:

1. Purpose--The purpose of acquiring the shares can be:
  - a. Those that do not require a "systematic pattern" test:

- 1) Combinations accounted for as purchases.
- 2) Contingent share agreements from prior business combinations.
- 3) Contractual obligations such as purchase of stock upon death of a stockholder, lawsuit settlements relating to the original issuance of the stock and repossessed stock pledges as collateral for a receivable.

b. Those that do require a "systematic pattern" test:

- 1) Stock option plans.
- 2) Stock purchase plans.
- 3) Stock compensation plans.
- 4) Convertible debentures.
- 5) Convertible stock.
- 6) Warrants.
- 7) Stock dividends.

2. Reasonable expectation of reissuance--for stock option plans, warrants and convertible securities the market price of common is not less than 75% of the exercise or conversion price unless convincing evidence can be offered that a lower price is relevant.

3. Systematic Pattern Test--unless exempted as in paragraph 1a above, a systematic pattern must be established two years prior to a business combination. Exceptions to the two-year period were previously noted.

In addition, shares acquired prior to the date of ASR 146A

(April 11, 1974) which do not meet these tests and do not violate Opinion No. 16 rules can be used in subsequent poolings. The retroactive feature of ASR 146 has been eliminated.<sup>37</sup> The materiality test of 10% mentioned earlier was accepted by the SEC.

That there is still much room for interpretation of treasury stock transactions in accounting for business combinations is evidenced by the discussions between SEC staff and AICPA representatives, published in the November 1974 issue of The Journal of Accountancy.<sup>38</sup>

#### Proportionate Interests of Stockholders

The proportionate interest of each selling stockholder prior to a pooling must be the same in the total shares received by all stockholders exchanging common stock. For example, if stockholder A owns 40% of the shares in the selling company, he must receive 40% of the shares issued in the exchange, if pooling treatment is desired. The intent here is not to deny any stockholder his proportionate voting rights and not to alter the sharing of risks. Further, since no stockholder can tender some shares and get cash or debt for other shares, a minority stockholder (one owning more than 10%) can prevent a combination from being a pooling even though the majority stockholders (less than 90%) are desirous of combining as a pooling. If the minority stockholder owning more than 10% insists that the majority stockholders bear all costs of the combination (legal and accounting fees, finders' fees, etc.)

as the price for his consent, this type of arrangement appears still to permit a pooling.<sup>39</sup> An agreement to offer shares as an inducement to a minority stockholder would negate a pooling, but an agreement giving the equivalent of cash would not negate a pooling.

#### Contingent Shares and Escrow Agreements

Prior to the issuance of AFB Opinion No. 16, pooling agreements contained contingency provisions for items such as future earnings, future sales, future market prices of shares exchanged. These contingency provisions provided for the issuance of additional shares and/or shares were held in escrow and returned to the acquirer if the contingencies were not achieved.

The Opinion prohibits all the contingency agreements specified above but still permits contingency and escrow agreements for items recorded on the consummation date at specified amounts and later settled for different amounts.

Specifically, the items that can be escrowed include liabilities that are estimated, such as warranties, lawsuit settlements, income tax accruals, etc.,<sup>40</sup> and assets that are estimated, such as collectibility of accounts receivable, tax refund claims, etc.

However, the prohibition against contingent "earn-outs" can be circumvented by including them in compensation agreements if the selling stockholders are employed by the acquirer.<sup>41</sup> Of

course, the selling stockholders must be employed if they are to receive compensation. The granting of employment contracts, stock options or other deferred compensation to stockholders who will not be active in management, or the letting of consultant contracts to selling stockholders will most likely defeat a pooling.<sup>42</sup>

The materiality problem can be troublesome when it comes to earn-outs. Is the prohibition absolute, or does it apply only to material items? Case L In Chapter IV points out the dilemma that can arise.

Stock options (if reasonable in relation to those granted other employees) granted to stockholder-employees of the selling corporation will not prevent a pooling. If, however, the options are really a form of contingent shares resulting from the pooling, then the pooling would be negated.<sup>43</sup> How this interpretation is to be applied in practice is quite vague.

Since the tax attributes of a business combination affect the "price" of a pooling, does a contingent agreement based on a favorable tax-free reorganization ruling from the Internal Revenue Service negate a pooling? The answer appears to be that a pooling is not permissible.<sup>44</sup> However, what if a favorable ruling is obtained prior to the consummation of a pooling, and a contingent agreement is made for a remote contingency of IRS revocation such as in the I.T.T.-Hartford Insurance case? The effect is unclear.

The acceptable type of escrow agreement (sometimes referred to as a "general management representations" agreement) must allow

for the voting of the shares held in escrow and can specify that any dividends follow any shares returned to the acquirer, and the escrow agreement shall be for a short period of time (no longer than the issuance of the first audited report subsequent to the consummation of the merger).<sup>45</sup>

#### Absence of Planned Transactions

This section of Opinion No. 16 deals with intentions and plans of transactions after a pooling that are inconsistent with a pooling. They are:

a. "The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination."

b. "The combined corporation does not enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guaranty of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities."

c. "The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate companies and to eliminate duplicate facilities or excess capacity."<sup>46</sup>

As with treasury stock, if these transactions are inconsistent with a pooling, shouldn't the emphasis be on the actions after the pooling rather than the plans and intentions prior to the pooling? If there are prohibitions against certain types of transactions, it follows that these transactions will not be specified in the combination agreement. Since the prohibition relates to the agreement stage only and no prohibition relates to actions after the agreement stage, any prohibition of this type will be ineffectual. Touche

Ross & Co. recognized this problem when it stated that "Hindsight will be an important factor in determining whether intent to violate the conditions of paragraph 48 existed at the time of the combination. If a prohibited transaction occurs subsequent to the combination and it is clear that the intent to violate paragraph 48 existed at the date of combination [emphasis mine], it is logical that the pooling should retroactively be accounted for as a purchase. Auditing the facts in such a situation will likely be more difficult than auditing the 'intent' at the date of combination."<sup>47</sup>

Specifically, paragraph 48-a limits the intent to reacquire the "pooled" shares to the combined corporation. Can a stockholder of the combined corporation reacquire the "pooled" shares? There appears to be no prohibition against a shareholder of the combined corporation doing what the corporation itself is prohibited from doing. If the shareholder were a major officer of the combined corporation, this may be open to interpretation; however, it is not specifically prohibited.

Although the combined corporation cannot itself reacquire the "pooled" shares, can the corporation assist the selling stockholders in finding third parties to buy the shares in a bailout (discussed in the next section under the heading, "Ignored")? The answer is, "yes!"<sup>48</sup>

Paragraph 48-b prohibits financial arrangements for the benefit of selling stockholders in a pooling. Would an arrangement whereby the combined corporation agrees to pay the costs of

registering the "pooled" shares in the future negate a pooling? No, since this would not be considered a financial arrangement.<sup>49</sup> What constitutes a financial arrangement can be interpreted differently, and there is much room for interpretation in this area. A case in point is Case N, discussed in Chapter IV.

Paragraph 48-c was inserted as an attempt to deal with one of the pre-Opinion 16 abuses pointed out by Prof. A. J. Brillhoff and known as "instant earnings."<sup>50</sup> This section looks to the subsequent two years for disposals of significant parts of the acquired assets, and if there is an intention or plan to dispose of the assets, purchase accounting is required. Again, the question of intent versus subsequent action becomes the problem. In addition, a new interpretive question arises. What is a significant part of the acquired assets? Obviously, assets that have low historical cost values (because of accelerated depreciation or because of specific price changes and general price level changes) might not be considered "significant" in relation to the whole, but these are the very candidates to create "instant earnings" because of the low historical values.

The Opinion specifically exempts disposals in the ordinary course of business and disposals to eliminate duplicate facilities or excess capacity. This exemption can open a Pandora's box since the meaning of "excess capacity" can be broad, indeed. In essence, "instant earnings" can still be developed effectively.

An APB interpretation states that a significant disposal or

spin-off to comply with a governmental or judicial order within two years after a pooling will not negate a pooling; neither will a disposal of assets negate a pooling, if the failure to dispose would result in the issuance of such an order based on the available evidence.<sup>51</sup>

#### Pro-Forma Disclosures in a Purchase

Although paragraph 96 requires pro-forma disclosure of a purchase, both for the year of the purchase and the year preceding it, no mention is made of pro-forma disclosure in the year subsequent to the purchase. This information is important if one is to be able to assess the impact of external growth from that of internal growth. In fact, whenever comparatives are shown, pro formas should be shown for all years, and the SEC expects this disclosure in the five-year comparatives submitted to it.<sup>52</sup>

#### AREAS IGNORED

##### Continuity of Interest

While it is true that Opinion No. 16 alludes to the continuity of interest concept in paragraph 26, the concept was forsaken, since this paragraph is in the discussion section and not in the opinion section where the binding principles are enumerated. In fact, it was the SEC that prodded the AFB into an interpretation that prohibits a pooling where a "bailout" is part of the transaction.<sup>53</sup> However, it is still possible for the acquirer to help the selling stockholders find buyers for the "bailout." Prior to Opinion No. 16, the Securities and Exchange Commission

had a continuity policy that required a retention of 75% of the shares during the first year and 50% retention during the second year, and after the second year complete disposition was permitted. With the issuance of Opinion No. 16, this SEC policy was abandoned, and the new policy is covered by Accounting Series Releases No. 130 and 135 which require that the shares be held until a report is issued that includes 30 days of post-merger operations. To all intensive purposes, the continuity-of-interest period is so shortened that it ceases to be an important factor. It is worth noting, however, that only ASR 130 and 135 impose any period at all.

#### Treasury Stock

Returning to the treasury stock problem, Opinion No. 16 sets up a two-year waiting period prior to the combination, but completely ignores a waiting period after the combination. ASR 146 refers to this oversight and indicates that if shares are reacquired closely related to a pooling, this would negate the pooling. Obviously, if a corporation were to acquire treasury shares, it would do so after a waiting period (three months) to avoid the apparent relationship. This oversight of failing to provide a two-year post-pooling waiting period can negate the pre-pooling waiting period.

Admittedly, any shares acquired after a pooling would be "tainted" if they do not meet the tests described previously, and the "tainted" shares would have a bearing on a subsequent pooling.

If the frequency of poolings is sporadic, "tainted" shares can be held until a new pooling is imminent, and they can then be "cured" by selling them. In this fashion, a corporation can hold "tainted" shares for a good portion of a year and, since a weighted average number of shares is used to compute earnings per share, they can be effectively used to increase the EPS statistic.

#### Voting Preferred Stock

Is voting preferred stock covered by the 90% rule of "substantially all"? Since the Opinion is silent on this subject, some practitioners maintain that it does not, while others maintain that it does. The answer is unclear.

#### OPINION NO. 17

The only restriction imposed by Opinion No. 17 regarding the amortization of "Excess of Cost Over Fair Value of Assets Acquired" in a purchase transaction is that the "excess" cannot be written off in the year of acquisition and must be amortized over a period of time not to exceed 40 years.<sup>54</sup> A period of time in excess of one year but less than 40 years is an extremely wide interval. In Chapter V, I discussed the implications of the internal rate of return on an acquisition investment decision. It is inconceivable that an acquirer would purchase another company without making some analysis akin to that necessary for computing the internal rate of return. Given that an acquirer will have made this analysis, shouldn't the matching of cost (amortization of investment cost) with revenue be based on how this cost (price paid)

was arrived at? The answer is emphatically yes! Any other approach, such as 40-year amortization, is arbitrary and far removed from economic reality. Opinion No. 17 is sorely deficient in its recommended treatment of "excess" amortization.

Thus, it is evident that, although Opinions No. 16 and 17 provide answers to many of the problems practitioners face in accounting for business combinations, there are still many troublesome areas that require solutions not found in the Opinions and their interpretations. These areas will be discussed in the next chapter, "Recommendations for the Improvement of Accounting for Business Combinations."

## FOOTNOTES

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## CHAPTER VII

## SUMMARY AND CONCLUSIONS OF STUDY

The problems associated with accounting for business combinations have been significant since the advent of pooling in 1947. Various attempts have been made to improve upon the accounting treatment and each "improvement" has seemed to breed more problems than it solved. This study points out that this is true, even with the attempted panacea of Opinions No. 16 and 17.

Since it is generally agreed that investors and creditors have a "need to know" and that earning power is equivalent to cash generating ability (cash flow) in the long run, it is important that earnings be just that, earnings, and not paid-in capital disguised as earnings.

ARB No. 40 tried to establish the ground rules for dealing with the emerging problems of pooling accounting. By the time AEB Opinions No. 16 and 17 were on the scene, so many permutations of the pooling concept had been born that drastic action was deemed necessary by the AEB to cure the prevailing ills. Forsaking the excision of the malignancy, the AEB prescribed sets of rules that required a myriad of interpretations that still leave room for further interpretation. That there is still much room for interpretation of the existing rules is evidenced by the discussion in Chapter VI, which itself is not all-inclusive. Evidently, a set of specific rules cannot be drawn to cover all possible events

in pooling accounting.

Substance Over Form

Clearly, accounting is concerned with communicating economic reality rather than the form of a transaction. Otherwise, what are the principles of consolidated statements, capitalization of leases as installment purchases, etc.? Yet when it comes to economic reality regarding the accounting for business combinations, the development of principles has been deficient. To maintain that the issuance of common stock in a pooling is not a disbursement equal to its opportunity cost is equivalent to maintaining that the purchase of treasury stock for cash is a gift from the corporation to the seller of the shares, or that the sale of treasury stock for cash is a gift from the purchaser of the shares. Whenever a disbursement is made in an arm's-length transaction, it is assumed that the exchange price (fair market value) is the proper value for the recording of the transaction. Where property other than cash is disbursed, APB Opinion No. 29 governs the approach for assigning the fair market value to the exchange, and should be used.

A purchase of treasury stock either before or after an exchange of stock in a pooling is really a step transaction of a purchase for cash. Pooling accounting should not be permissible unless the treasury stock is used specifically for stock options, redemptions, etc. Also, the time that has elapsed between the purchase of the shares and the pooling exchange of stock should be long

enough to satisfy a prudent person's skepticism of a step transaction. Therefore, a two-year waiting period for treasury stock purchases appears to be reasonable for both before and after a pooling. (See Case I.)

Treasury stock purchases within a two-year period of a pooling should be specifically designated for a specific purpose, and to the extent this purpose fails to materialize (examples were illustrated in Chapter IV and discussed in Chapter VI), poolings during this period should be retroactively adjusted and be treated as purchases. The reverse of this procedure was done when ARB No. 48 was issued (examples of this are given in Chapter II).

#### Size of Pooling

As originally envisaged, pooling was the merging of two firms of relatively equal size to conduct a unified business. The parties would share the risks of, and participate in the management of, the combined enterprise. It was felt a new accountability was not necessary under these circumstances. Few academicians or practitioners will challenge the use of pooling accounting in situations such as these.

However, at the other end of the spectrum are situations where a behemoth attacks a fly, and the fly escapes using an immediate bailout. Under these circumstances many will argue vehemently that this is not a pooling. It is also generally conceded that a pooling with individual assets is prohibited (the

APB inserted provisions in Opinion No. 16 in an effort to prevent this). A possible reason for this is that pooling with a piece of machinery has none of the requisites of the concepts of a pooling. There is no sharing of risks, no continuity of management. In short, this type of pooling lacks the requisites mentioned in ARB Nos. 40 and 48. Yet, how can these requisites be present where the parties are a behemoth and a fly? They can't be. Nor can they be present when an immediate bailout occurs. This study pointed out that most poolings (90%) are between behemoths and flies. Bailouts are a common occurrence. Clearly, the size of the participants to current poolings is not compatible with the requisites of the concept of pooling. (See Cases F, J and M.)

Effectiveness of APB Opinion No. 16  
to Curb Poolings

One of the specified purposes of APB Opinion No. 16 was to curtail severely the use of pooling accounting. The APB's original position of eliminating pooling and then severely restricting its use was documented in Chapter II. The Board reaffirmed its position at the time Opinion No. 16 was issued. On July 31, 1970, the APB stated:

The Board had proposed restricting the "pooling of interests" method of accounting for business combinations to those in which combining companies are at least one ninth as large as each other. This restriction was dropped after further study. The Board did reaffirm limiting use of the method to combinations which are arranged through an exchange of common stock and which meet certain other restrictive conditions. [Emphasis mine.]

All other business combinations must be accounted for as purchases.<sup>1</sup> [Emphasis mine.]

From the above statement, it can be inferred that the AEB expected Opinion No. 16 to act as a deterrent to the use of pooling accounting, and that significantly more business combinations would be accounted for as "purchases."

Chapter IV demonstrated that the number of business combinations have decreased. The reasons are varied (economic conditions, P/E multiples, anti-trust considerations, etc.) and beyond the scope of this study. This study, however, demonstrated in Table 3 that the proportionate number of poolings did not decrease as a result of the issuance of Opinion No. 16. As a matter of fact, the proportionate number of poolings increased. If Opinion No. 16 does not act as a deterrent to pooling, and this is a desirable goal, then some other course of action is necessary to effectuate that result.

#### Compliance Problems--Pooling

This study has demonstrated that many corporate practices circumvent the intent of Opinion No. 16, and, in some cases, violate the provisions (possibly using materiality as an umbrella). Clearly, any attempt to set down extensive rules is not without pitfalls, as witnessed in the fields of taxation and the law. The treasury stock problem is one case in point and, despite the amount written on the subject (including the SEC position), the problem is far from solved. Attempts to appease interested parties with different

vested interests can be a solution worse than taking a stand and adhering to it. (See Cases J, K, L, N and O in Chapter IV.)

#### Inherent Nature of Pooling Problems

Most of the problems with pooling, as demonstrated in this study, are in the process itself. Everyone is merely doing what is required under the aegis of Opinion No. 16. Some undesirable covert activity is evident in pooling practices, but Opinion No. 16, as it is presently structured, is causing most of the distortions that are made evident in this study. If these distortions are to be eliminated, the process itself must be changed. (See Cases A, B, C, D, E, H and P.)

#### Efficient Market Hypothesis--Area of Additional Research

Based on the evidence accumulated in this study, it appears that the method of accounting for a business combination is a significant event. Accordingly, business managers will continue to opt for pooling accounting. This study did not examine the effect that pooling accounting has on the market prices of a pooling acquirer's shares of stock. A study of these effects would be a significant contribution to the field of study known as "Efficient Market Theory."

A study can examine stock market behavior of New York Stock Exchange pooling acquirers for the five-year period 1971-1975. A firm would be considered a pooling acquirer if it had five or more

poolings in any twelve-month period. Since general market conditions during the five-year period were not static, an adjustment of security returns would have to be made for general stock market conditions. In addition, an acquiring pooler could be classified according to the date that it first has five poolings in a twelve-month period. The date of the first pooling will be designated  $t_0$ . The months subsequent to  $t_0$  will be  $t_1, t_2, \dots, t_n$  and the months preceding  $t_0$  will be  $t_{-1}, t_{-2}, \dots, t_{-n}$ . Attention can then be focused on months surrounding  $t_0$  by using cross-sectional averages of regression residuals. This study could be patterned in a similar manner to a study done by Fama, Fisher, Jensen and Roll.<sup>2</sup>

#### Current-Value Accounting

At this writing, there is a trend toward providing current-value data. If financial statements were prepared using a current-value model, pooling reform would be unnecessary. However, much work needs to be done before current-value statements can serve the needs of decision-makers. And even if the model were sufficiently refined, there is still a question of whether or not the model will be adopted. Therefore, because of the lead time necessary before a current-value model can become a reality, there is a present need for pooling reform.

### Purchase Accounting

Purchase accounting is not without its problems, too. As seen from examples demonstrated in this study, corporate practices in purchase accounting also fail to report economic reality. In purchase accounting, however, the practices are more overt than in pooling. Corporations take actions to violate economic reality, and these become compliance problems, whereas in pooling the problems are in the process itself. What is needed in purchase accounting is an adherence to the principles enunciated and an evaluation by truly independent third parties that the principles have been applied fairly.

Although the FASB considers the problem of accounting for business combinations as one requiring attention, it has yet to present any indication of what changes, if any, are being considered. It is clear that drastic changes, however unpalatable they may be, are necessary if accounting for business combinations is to reflect economic reality. These changes will be considered in the next chapter. (See Cases Q, R and S.)

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## CHAPTER VIII

RECOMMENDATIONS FOR THE IMPROVEMENT OF ACCOUNTING  
FOR BUSINESS COMBINATIONSPOOLING ACCOUNTINGSize Test

The APB's original position of eliminating pooling raised a tremendous furor when it was originally proposed. This is probably the best solution to the thorny problem--complete excision. This would avoid the necessity of setting arbitrary cutoff points and setting up rules which are eroded in practice. However, because of the furor that arose in 1969 when this was proposed and because there is some theoretical justification for pooling accounting as envisioned in the 1940's, a practical solution would be to impose the APB's original 3-to-1 size test.

If a size test were imposed, critics would undoubtedly ask, "What is so different about a pooling candidate that is 24.9% in size from one that is 25.1%?" the answer to this question is, "None!" Yet, if a cutoff point must be established, an arbitrary one must be used. Without discussing the merits of APB Opinion No. 15, this Opinion does use a cutoff point of two-thirds of the prime rate, and it is effective. The concept may be invalid, but the cutoff point is operative. Similarly, ARB No. 43 contains a "border zone" approach (20%-25%) in dealing with stock dividends. This approach also is effective. Whether a "border zone" approach or a cutoff point is used, a 25% cutoff would eliminate most of the

problems with pooling as evidenced in this study.

There is considerable support for this recommendation.

Philip L. Defliese, managing partner of the firm of Coopers and Lybrand and formerly chairman of the APB, stated in ARS No. 10, Accounting for Goodwill, that business combinations fall into two categories. They are:

1. Type A--those of relatively comparable size, and
2. Type B--all others.

He goes on to state that Type A should be accounted for as poolings and Type B should be accounted for as purchases. Many academicians and other practitioners support this view.

In dealing with the size-test problem discussed in Chapter IV, it would be necessary to impose a two-year waiting period before a recently pooled company could pool with someone larger than itself.

#### Treasury Stock

All treasury stock purchases must be earmarked for a specific purpose (no systematic patterns would be permissible). Any shares not used for the purpose designated become tainted shares as of the date originally purchased. If the tainted shares exceed 10% (as presently defined) all poolings that become disqualified will be adjusted to purchase accounting, and income statement adjustments for prior years will be treated as a change in accounting principle. The two-year period shall be both before a pooling and after a pooling

for a total of four years. The two-year periods mentioned in this chapter are not wholly arbitrary; they were selected for the following reasons:

1. If one wishes to avoid the step-transaction doctrine in Federal income taxation, the two transactions must have a sufficient time interval between their occurrences that is beyond suspicion. A time interval of less than one year would be suspect and the two transactions (e.g., liquidation of a corporation and reincorporation by the previous stockholders) might be treated as a step transaction (one transaction with no effect for tax purposes). A two-year time interval usually avoids any suspicion.

2. In Opinion No. 16, the AFB used a two-year period for treasury stock transactions, for purposes of autonomy, etc.

3. It would be extremely difficult to structure related transactions for periods in excess of two years.

#### Materiality

Materiality shall not apply to the following items (none are permissible):

1. Contingent share arrangements other than escrow agreements for unresolved liabilities.

2. Stock redemptions, unusual dividends, treasury share purchases of acquirees.

3. Spin-offs, unless mandated by a governmental agency.

### Continuity of Interest

Bailouts shall be prohibited for a period of two years except by reason of death of an acquiree.<sup>5</sup> This applies only to acquirees that are closely held companies. Acquirees that are publicly held will be exempt from this provision unless one of the stockholders is a principal stockholder, in which event this provision shall apply to that holder.

### Financial Arrangements

The present policy should be strengthened by including a prohibition against the type of examples encountered in this study. (See Case N in Chapter IV.) In addition to prohibiting the guarantee of a loan by the acquirer where the acquiree makes a non-recourse loan pledging the stock received in the pooling as collateral, Opinion No. 16 should have prohibited the acquirer from doing any of the following:

1. Making a loan, directly or indirectly, to the acquiree.
2. Guaranteeing any loan of the acquiree.
3. Investing in any successor business of the acquiree.
4. Making arrangements for the acquiree to dispose of shares of stock received in a pooling. (However, see recommendation entitled "Continuity of Interest.")

### Compensation Agreements

This is one area that requires considerable strengthening.

The following should be prohibited:

1. Employment contracts where compensation, in whole or part, shall be based on profits of the acquiree. However, incentive compensation shall be permitted, provided it is congruous with company policy in other divisions of the acquirer. The independent auditor shall be responsible for evaluating the congruity.

2. Part-time employment contracts, consulting contracts and any other contracts for other than full-time employment of the acquiree, unless justified by acquirer company policy.

3. Employment at a salary level materially higher than that received as an employee of the acquiree. If the acquiree were operated as an individual proprietorship or a partnership, the salary level shall be compared to those of similar employees of the acquirer.

4. Employment at a salary level materially higher than that received by other employees of the acquirer performing similar duties.

### Pooling With Selected Assets

Companies that are not regular operating units, such as owners of a building, mineral rights, land, etc., should be prohibited from pooling. (The recommended size test will ordinarily act as a deterrent in this area.)

### Sale of Assets After a Pooling

For any year or part of a year subsequent to the date of a pooling, the following shall be disclosed in "Notes to Financial Statements":

1. Inventories--The book values on the pooling date of inventories sold during the year and the selling price of these inventories. (Totals only.)
2. Plant assets--The book value at the pooling date of plant assets disposed of during the year, the amount of depreciation charged off from the pooling date to the date of the sale or trade-in, the depreciation method used, and the sales proceeds or trade-in value on the disposal date.
3. Marketable securities--The book value at the pooling date, the market value at the pooling date and the sales proceeds for any marketable securities sold during the year.
4. Investments--The book value at the pooling date, the carrying value when the equity method is used, the sales proceeds and any gain or loss on subsidiaries sold during the year.
5. Other assets--The book value at the pooling date, amortization or write-downs since the pooling, and the sales proceeds for any sales in the current year.

### Purchase Accounting

Purchase accounting requires several changes. Whenever a firm acquires a group of assets and uses a payment other than cash

exclusively (stock, debt, donation or a combination of these with/without cash), the firm and its auditors shall comply with the following requirements.

#### Disclosure

Management shall include in its "Notes to Financial Statements" a note disclosing the valuation techniques used to assign values to a "purchase" acquisition. If appraisers were used, their identity, the specific assets appraised and the values assigned thereto by them should be disclosed. If "goodwill" or "excess" is used, a statement setting forth the reasons for its use and the amounts assigned shall be disclosed. Instead of the present proforma disclosure, restatements shall be disclosed.

#### "Goodwill" or "Excess"

Management shall demonstrate to the firm's auditors that "goodwill" is present because of present excess earnings, projected excess earnings, or both. If management cannot demonstrate "goodwill" as herein defined, then any "excess" must be assigned to another intangible (marketing costs, personnel costs, etc.) and amortized over the estimated useful life of that intangible. Errors in estimated useful life shall be treated in the same manner as depreciation estimate errors.

Where "goodwill," as herein defined, is demonstrated to exist, it shall be amortized by the "interest" method, using the internal rate of return of the transaction. Projected excess

earnings should be matched with actual results, if possible, and the failure of projections to materialize should require a charge to income for any capitalized cost that no longer meets the definition of "goodwill" as herein defined. The auditor shall examine the internal rate of return on an investment in relation to the firm's cost of capital before any evaluation of excess earnings can be claimed.

#### Auditor's Opinion

The auditor shall review management's treatment of the values assigned to the "purchase" acquisition. His opinion should state: "We have reviewed the values assigned to specific assets, with which we concur, for all acquisitions accounted for as purchases during the year. We also concur in the amounts of 'goodwill' or 'excess' amortized during the current year with respect to prior years' acquisitions."

#### Prognosis

All other provisions of Opinions No. 16 and 17 not mentioned in this chapter should remain in force.

\* \* \* \* \*

The enactment of the suggested changes would be a large step forward in helping the accounting for business combinations reflect economic reality.

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