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AN HISTORICAL DEVELOPMENT OF POOLING OF INTERESTS

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INTRODUCTION

The term "pooling of interests" was first used by the AICPA in a report issued in 1945 by the Committee on Public Utility Accounting. Since that time, the pooling of interests concept went through much debated change and revision.

The Accounting Principles Board issued their first opinion on pooling of interests in Accounting Research Bulletin Forty. This bulletin was followed by three more. During this time the criteria proposed in these bulletins as a basis for classifying a business combination as a pooling of interests were being constantly modified. Many of the changes began to liberalize the accounting treatment of a business combination. It finally reached the point where many of the guidelines set down by the AICPA were being ignored in actual practice. After reviewing the situation the Accounting Principles Board decided there was a definite need to clarify the distinction between a pooling of interests and a purchase. Finally, in 1970 the Board issued Opinion Sixteen.

This paper will review the pronouncements issued by the Accounting Principles Board concerning pooling from 1950 to the issuance of Opinion Sixteen. It will also analyze the change in application of pooling and the environment of pooling from 1950 to the present. Finally, it will discuss the need for and the recommendations of Opinion Sixteen issued in October, 1970.

CHAPTER I

PRONOUNCEMENTS OF THE AICPA CONCERNING POOLING

The first major statement to describe the appropriate accounting treatment in a corporate combination was Accounting Research Bulletin Forty. It differentiated between the two types of combinations, a pooling of interests and a purchase, and described the accounting treatment appropriate to each type.

"The distinction between a pooling of interests and a purchase is to be found in the attendant circumstances rather than in the legal designation as a merger or a consolidation . . ."[1] The bulletin went on to say that it was necessary for all or substantially all of the equity interests in the predecessor corporation to continue in a surviving corporation in order for the combination to be considered a pooling. There should also be continuity of management, the constituent companies should be comparative in size, and the activities of the companies to be combined should either be similar or complementary. All these factors were to be considered in determining whether the combination was a pooling or a purchase, but "no one of these factors would necessarily be determinative, but their presence or absence would be cumulative in effect."[2]

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[1]AICPA, Committee on Accounting Procedure, Accounting Research Bulletin No. 40, (New York: AICPA, 1950), par. 2.

[2]Ibid., par. 3.

When the combination was considered to be a pooling of interests, the book values of the assets and retained income of the constituent companies would be carried forward on the books of the surviving corporation.

If one of the combining companies was acquired as a subsidiary by another party to the combination prior to the plan of combination, " . . . the parent's share of the retained income of the subsidiary prior to such acquisition should not be included in the retained income account of the pooled companies."[3]

When the aggregate of stated capital of the surviving corporation in a pooling was more than the total of the stated capital of the predecessors, the excess should first be deducted from the aggregate of any capital surplus and next from any retained earnings. If the stated capital of the predecessors was more than the stated capital of the surviving corporation, the difference should appear as contributed capital.

In 1953 Research Bulletin Forty was restated in chapter seven (c) of Research Bulletin Forty-Three with two minor additions. ". . . any adjustment of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination would be equally so if effected in connection with a pooling of interests."[4]

When a combination results in carrying forward the earned surpluses of the constituent companies, statements of opera-

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[3] Ibid., par. 5.

[4] AICPA, Committee on Accounting Procedure, Accounting Research Bulletin No. 43, Chapter 7(c), (New York: AICPA, 1953), par. 5.

> tions issued by the continuing business for the period in which the combination occurs and for any preceding period should show the results of operations of the combined interests.[5]

The next statement on business combinations was Research Bulletin Forty-Eight issued in 1957. It carried forward the basic concepts of Bulletin Forty-Three and also tried to clarify some of the uncertainties of the pooling concept that was puzzling the accounting profession.

It agreed to the continuance of one or more of the constituents in the combination as a subsidiary to another of the constituents without preventing the merger from being viewed as a pooling. There would have to be important tax, legal, or economic reasons for maintaining the subsidiary relationship and also there would have to be no significant minority interests outstanding.

It presented further criteria in determining whether a combination would be considered a pooling or a purchase. If relative voting rights between the constituents were materially altered, a purchase rather than a pooling was presumed to result. Also a plan or firm intention to retire a substantial part of the capital stock issued to the constituent corporations would indicate a purchase.

Continuity of all the constituents in one business enterprise and continuity of management were also stressed. A plan to sell or abandon a large part of the business of one or more of the constituents would rule out a pooling of interests. "If the management of one of the constituents

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[5] AICPA, Committee on Accounting Procedure, Accounting Research Bulletin No. 43, Chapter 7(c), (New York: AICPA, 1953), par. 7.

is eliminated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated."[6]

The size of the constituents to the combination was reinterpreted and restated. The relative size of the constituents would not necessarily determine whether there was a pooling or a purchase, especially where the smaller corporation contributed desired management personnel. However, the position was taken " . . . where the stockholders of one of the constituent corporations obtain ninety to ninety-five per cent or more of the voting interest in the combined enterprise, there is a presumption that the transaction is a purchase rather than a pooling."[7]

Bulletin Forty-Three had mentioned that retained earnings of a purchased subsidiary could not be carried forward in combination. This condition was changed in Bulletin Forty-Eight. If one of the constituents continued as a subsidiary and the requirements of a pooling were met, the combining of retained earnings in the consolidated balance sheet was proper.

One of the conditions in determining whether the combination was a pooling or a purchase was whether the activities of the businesses to be combined were either similar or complementary. This factor had been included in both Bulletins Forty and Forty-Three. In Bulletin Forty-Eight it was completely eliminated as a necessary condition.

Reporting requirements were also expanded.

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[6]AICPA, Committee on Accounting Procedure, Accounting Research Bulletin No. 48, (New York: AICPA, 1957), par. 6.

[7]Ibid., par. 6.

> . . . if combined statements are not furnished, statements for the constituent corporation prior to the date of combination should be furnished separately or in appropriate groups. Results of operations of the several constituents during periods prior to that in which the combination was effected, when presented for comparative purposes, may be stated on a combined basis, or shown separately where, under the circumstances of the case, that presentation is more useful and informative.[8]

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[8] Ibid., par. 12.

CHAPTER II

THE CHANGING APPLICATION AND ENVIRONMENT OF POOLING

The previous discussion concentrated on the criteria that set off a pooling from a purchase. During the early 1950's these guidelines were being strictly followed. However, when Bulletin Forty-Three changed the practice of accounting for goodwill, the accounting profession began to change from a strict application of pooling to a liberal application.

Besides its revision of Bulletins Forty and Forty-Three, the Accounting Principles Board made a significant change in the accounting for goodwill. Previously Bulletin Twenty-Four had discouraged, but did not prohibit the practice of eliminating goodwill by a write off against any existing retained earnings or capital surplus. Bulletin Forty-Three, however, prohibited lump-sum write-offs.

> Lump-sum write-offs of intangibles should not be made to earned surplus immediately after acquisition, nor should intangibles be charged against capital surplus. If not amortized systematically, intangibles should be carried at cost until an event has taken place which indicates a loss or a limitation on the useful life of the intangibles.[1]

Prior to the release of Bulletin Forty-Three the accounting profession was very reluctant to systematically amortize goodwill, when there

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[1]AICPA, Committee on Accounting Procedure, Accounting Research Bulletin No. 43, Chapter 5, (New York: AICPA, 1953), par. 9.

were definite advantages in immediate write-off of goodwill.

> The amortization of any excess of fair value over underlying book value would result in a charge against income. In a "tax-free" combination such a charge would not be a deductible item for tax purposes. The amortization would, therefore, reduce net profit, by an increase of expense, but would not decrease the amount of tax payable.[2]

Since the systematic amortization of goodwill brought about discrepancies between reported business earnings and taxable earnings, accountants favored immediate write-off.

During the late 1940's and in the decade of the 1950's there was a tremendous emphasis on growth and the desire for higher reported earnings. If the surviving corporation in a combination amortized goodwill, there would be charges made annually to income, after taxes. This reduction in net income could be significant. The market value of the surviving company's securities could be adversely affected as a result in the reported decline in earning power.

Because of the advantages of immediate write-off of goodwill, the practice in a combination accounted for as a purchase was to record the assets acquired at the fair value of the assets given in exchange.

> Immediately after recording the combination transaction, however, any excess of the cost recorded over the underlying book value of the assets acquired was charged off to surplus. The net effect of these entries was, as far as the asset side was concerned, to account for the assets of the acquired or disappearing company in the combination at the underlying book value of those assets. This resulted, of

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[2]Arthur Wyatt, A Critical Study of Accounting for Business Combinations, Accounting Research Study No. 5, (New York: AICPA, 1963), p. 60.

course in the same asset values as if the pooling concept had been used.[3]

Since the net effect as far as the assets were concerned was comparatively the same in either a purchase or a pooling combination, the accounting profession was willing to follow the guidelines set down in Bulletin Forty. After Bulletin Forty-Three was issued, " . . . the combination transaction had to be accounted for as a pooling in order for any excess of cost over underlying book value to be, in effect, eliminated from accountability."[4]

When the advantages of direct write-off of goodwill were no longer available, there was the irrestible urge to treat the combination as a pooling. In order to make use of the pooling treatment in a combination, the accounting profession began to ignore the strict distinction between a pooling and a purchase as presented in Bulletin Forty-Three.

As time went on the difference in actual practice and the criteria set down by the Accounting Principles Board dictated the need for revision in determining the treatment of a given business combination. Accordingly, when Bulletin Forty-Eight came out, the guidelines permitted much more freedom in determining the treatment of a given business combination than had previously existed. The net effect of Bulletin Forty-Eight was summarized by Arthur Wyatt, the author of A Critical Study of

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[3] Ibid., p. 59.

[4] Ibid., p. 59.

Accounting for Business Combinations:

> Thus by the late 1950's, the approach to the analysis of a combination transaction appeared to be that the absence of a given criterion should not prevent the transaction from being a pooling of interests if other features suggested that the treatment was appropriate.[5]

Because of the pressure to make use of the pooling treatment, accountants were qualifying many combinations as a pooling of interests even though the combination had all the conditions to be considered a purchase. One example of the permissiveness was the use of the partial pooling treatment. This practice was often used when the acquiring corporation would give up a significant amount of cash as well as equity shares. There would be purchase accounting for the cash portion and pooling accounting for the stock portion.

The earliest partial poolings were transactions in which the combination was arranged through different procedures or steps. If there was a time interval between the cash purchase and the exchange of equity shares, the accountants could justify the use of partial pooling on the theory that the combination really occurred at the later date. Eventually the time interval was not considered necessary in order to use the partial pooling treatment. Both purchase and pooling accounting could be applied in a single cash-stock combination.

An example of the partial pooling treatment was when Diamond Alkali Company acquired forty per cent of the shares of Harte and Company, Incorporated, in May, 1962, for cash. In September, 1965,

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[5]Ibid., p. 61.

Diamond acquired the remaining sixty per cent of Harte's outstanding shares in exchange for 95,000 shares of $4.00 convertible preferred stock-series B. Since the 1962 transaction was treated as a purchase and the 1965 transaction was treated as a pooling of interests, the entire combination arrangement was in effect a forty-sixty per cent partial pooling.[6]

Another example was in 1965 when Evans Products Company acquired the capital stock of Rand Acceptance Corporation for 34,500 shares of common stock. At the same time Evans acquired the assets and businesses of each of three enterprises affiliated with Rand for $8,244,000 cash. The acquisition of Rand was accounted for as a pooling of interests, while the concurrent acquisition of the three affiliates was recorded as a purchase.[7]

The partial pooling practice was really never sanctioned in Bulletin Forty-Eight and was incompatible with Bulletin Forty-Eight. Samuel Gunther in his article "Part Purchase-Part Pooling: The Infusion of Confusion into Fusion" said:

> No reference is made in any of these documents to partial poolings. Moreover, the criteria presented in these Bulletins indicate clearly that the drafters viewed purchase accounting as the antithesis of the pooling approach. Nevertheless, the partial pooling treatment has become generally accepted practice.[8]

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[6]Dean Eiteman, Pooling and Purchase Accounting: The Effect of Alternative Practices on Financial Statements, (Lansing, Michigan: University of Michigan, 1967), p. 28.

[7]Ibid., p. 28.

[8]Samuel Gunther, "Part Purchase-Part Pooling: The Infusion of Confusion into Fusion," New York Certified Public Accountant, XXXIX (April, 1969), 242.

In the early years of Bulletin Forty-Eight the view was generally held that only common stock could be issued in a pooling of interests. In a few years convertible preferred stock was being issued in a combination qualifying as a pooling. In the Melville Shoe-Miles Shoe Combination of 1952 Melville Shoe issued 21,500 cumulative preferred shares along with 450,000 common shares to effect the combination. In the General Dynamics-Material Service Corporation Combination of 1959 convertible preferred stock was the only consideration given to pool Material Service Corporation.[9]

There was also the increasing use of treasury stock as sole or partial consideration in a combination qualifying as a pooling of interests. With a treasury stock pooling the management of the buying company was able to acquire treasury stock for cash, issue the stock to the acquired corporation, and yet cleverly avoid the requirement of accounting for the excess of cost over book value which arose in the usual cash acquisition.

In the 1966 combination of Warner-Lambert Pharmaceutical Company and Texas Pharmacal Company, Warner-Lambert issued 360,000 treasury shares to effect the combination. By using a treasury stock pooling, the company was able to avoid the recording of a $11,760,000 excess of cost over book value. Other examples of a treasury stock pooling were the Gillette Company-Sterilon Corporation, 1962, Johnson and Johnson-Stim-U-Dent, Incorporated, 1963, and the American Cyanamid

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[9]Samuel Sapienze, "Pooling Theory and Practice in Business Combinations," Accounting Review, XXXVII (April, 1962), 268.

Company-Preen Company, 1965.[10]

Contrary to this general practice, Dean Eiteman, the author of Pooling and Purchase Accounting, was strongly opposed to the treasury stock pooling practice.

> Accountants have every reason to be skeptical of the treasury stock pooling practice. When the combination transaction is viewed in its entirety, it can be seen that this practice generally yields the same results as the method described as a purchase with the immediate write-off of the excess to retained earnings, a treatment which most accountants have not sanctioned since 1953.[11]

In Bulletin Forty the statement was made that " . . . a purchase may be indicated when one corporate party to a combination is quite minor in size in relation to the other. . . "[12] However, as time went on there seemed to be a gradual decline in emphasis on the relative size of net assets involved in a combination.

When Bulletin Forty-Eight was issued, the size criterion was given a more liberal interpretation. A requirement was made that the company pooled was to receive not less than five to ten per cent of the voting interest in the combined corporation. However, size alone would not prevent a combination from being accounted as a pooling if the weight of the other conditions qualified the combination as a pooling.

Samuel Sapienze in his article "Distinguishing Between Purchase

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[10] Dean Eiteman, "Pooling and Purchase Accounting," pp. 90-92.

[11] Ibid., p. 93.

[12] AICPA, Committee on Accounting Procedure, Accounting Research Bulletin No. 40, (New York: AICPA, 1950), par. 3.

and Pooling" noted a number of examples where the size criterion was completely ignored and the combination treated as a pooling.

> In a more recent instance involving American Machine and Foundry and Cuno Engineering, Cuno Engineering on August 16, 1960, contributed 2.7 per cent of the net assets and received 1.9 per cent of the common stock of the combination, a figure well below the suggested five per cent tolerance. An even more notable case involving American Machine and Foundry Co. was the pooling with Wein Mac Corporation recently. Wein Mac contributed .0016 per cent of the net assets and received .0012 per cent of the common stock . . . The factor of relative size, whether in terms of net assets or stock equity interest, is gradually being reduced to a minor role in deciding a purchase or pooling application.[13]

Because of the variety of interpretations under Bulletin Forty-Eight, the natural tendency of the combining companies was to choose the method which would create the most favorable financial impression. In most combinations they tried to use the pooling treatment. In some combinations the purchase treatment was more favorable.

This was the case when the book value of the net assets acquired was greater than the cost of the acquisition as measured by the fair market value of the stock issued. This type of combination was commonly referred to as a bargain purchase. If the combination was recorded as a purchase, the amortization of the excess of book value over cost generally had the result of increasing annual income.

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[13]Samuel Sapienze, "Distinguishing Between Purchase and Pooling," Journal of Accountancy, III (June, 1961), pp. 39-40.

CHAPTER III

NEED FOR AND RECOMMENDATIONS OF APB OPINION SIXTEEN

The permissive nature of Bulletin Forty-Eight allowed the accountant to choose either the pooling or the purchase treatment according to the method which presented the most favorable income picture. With this inconsistency in accounting practice there was a definite need for the Accounting Principles Board to establish new guidelines. Dean Eiteman had this view.

> Unless accounting guidelines are established so that the permissive quality is reduced in the selection of the pooling approach or the purchase approach, the usefulness and reliability of financial information remains questionable. The existence of radically different accounting procedures to record essentially similar economic events (business acquisitions and mergers) is especially questionable from the point of view of the financial analyst.[1]

Eventually the Accounting Principles Board came to the same conclusion. In August, 1970 they issued new guidelines in accounting for business combinations in Opinion Sixteen. They concluded that both the pooling and purchase of interests methods were acceptable, but they were not to be alternatives in accounting for the same business combination. If the business combination met all the conditions specified in

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[1] Dean Eiteman, Pooling and Purchase Accounting: The Effect of Alternative Practices on Financial Statements, (Lansing, Michigan: University of Michigan, 1967), p. 9.

Opinion Sixteen, it would have to be accounted by the pooling of interests method. If it did not, it would have to be accounted by the purchase method.

The Principles Board concluded that a single method should be applied to an entire combination. This stipulation ruled out the past practice of treating the combination as a part-purchase and a part-pooling. The only exception would be in those transitional situations in which an issuing corporation held fifty per cent or less of the voting common stock of another combining corporation on October 31, 1970 and subsequent to that date (1) would issue its voting common stock in exchange for at least ninety per cent of the voting common shares of the nonissuing combining company that it had not owned on October 31, 1970 (2) satisfied all other new pooling conditions and (3) consummated the pooling on or before October 31, 1975.

The conditions in Opinion Sixteen that the combination had to meet in order to use the pooling treatment were presented under three major categories comprising twelve main requirements. The three major categories were attributes of the combining companies, manner of combining interests, and absence of planned transactions.

Under attributes of the combining companies each of the combining companies would have to be autonomous and could not have been a subsidiary or division of another corporation within two years before the plan of combination was initiated. Also each of the combining companies would have to be independent of the others. To be independent the com-

bining companies could hold no more than ten per cent in total of the outstanding voting common stock of any combining company.

Seven requirements were specified under the category, manner of combining interests.

(1) The combination would have to be completed in accordance with a specific plan within one year after the plan was initiated.[2]

(2) A corporation could only offer common stock with rights identical to those of the majority of its outstanding voting common stock in exchange for substantially all of the voting common stock interest of another company at the date the plan of combination was consummated. Substantially all of the voting common stock meant ninety per cent or more. The number of shares exchanged excluded those shares of the combining company acquired before and held by the issuing corporation and its subsidiaries at the date the plan of combination was initiated. . . acquired . . . after the date the plan of combination was initiated other than by issuing its own voting common stock, and outstanding after the date the combination was consummated.[3]

(3) The equity interest of the voting common stock used to effect a combination could be changed within two years before the plan of combination was initiated or between the dates the combination was initiated and consummated.

(4) Treasury stock acquired by any of the combining companies could only be for purposes other than Business Combinations.

(5) Each individual common stockholder who exchanged his stock in the combination would receive exactly the same proportionate stock interests as he had before.

(6) The stockholders could not be deprived or restricted in exercising their voting rights in any period.

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[2]AICPA, Accounting Principles Board, APB Opinion No. 16, (New York: AICPA, 1970), par. 47(a).

[3]Ibid., par. 47(b).

(7) The combination was resolved at the date the plan was consummated and no provisions of plans relating to the issuance of securities or other considerations were pending.

Under the category, absence of planned transactions, there were three requirements.

(1) The issuing corporation would not directly or indirectly retire or reacquire all or part of the common stock issued to effect the combination.

(2) The combined corporation could not enter into other financial arrangements for the benefit of the former stockholders of a combining company.

(3) The combined corporation could not dispose of a significant part of the assets of the combining companies within two years after the combination other than in the ordinary course of business.

The procedures in Bulletin Forty-Eight for recording a pooling of interests were similarly restated in Opinion Sixteen. There were also some new procedures added.

(1) If treasury stock previously acquired was issued to effect a combination considered a pooling, the issuing corporation would first have to account for those shares as though retired. The latter issuance of these shares to effect the combination would be accounted as the issuance of previously unissued shares.

(2) If a combining company held common stock in the issuing company, the issuing company would account for the investment as treasury stock.

(3) If one of the combining companies held stock in one of the other combining companies, the stock would be eliminated in the combination and the combined corporation would account for that investment as stock retired.

(4) All expenses related to effecting a pooling of interests should be deducted in determining the net income of the resulting combined corporation for the period in which

the expenses were incurred.

(5) A pooling combination should be recorded as of the date the combination is consummated.

CONCLUSION

Business combinations effected through the use of pooling of interests became increasingly common during the 1950's and 60's. The accounting treatment used in combinations grew gradually less well defined during this period, until by 1960 either of two acceptable accounting treatments could be used to reflect a given combination.

The existence of alternative accounting treatments and the application of the pooling treatment to combinations in which its propriety was questioned gave rise to a need for an overall change in policy by the Accounting Principles Board.

The major changes that were needed were finally satisfied by the issuance of Opinion Sixteen. The purchase and the pooling method are no longer alternatives in accounting for the same business combination. A combination will have to meet specified conditions in Opinion Sixteen in order to be accounted as a pooling of interests. Only time will determine whether Opinion Sixteen has been successful in clarifying the accounting principles governing business combinations.

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