AICPA EFFORTS TO CURB ABUSES IN ACCOUNTING FOR CORPORATE ACQUISITIONS: THEIR INADEQUACIES AND A PROPOSED SOLUTION

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When, through merger or consolidation, two or more corporations combine their operations, the financial statements of the resulting entity must reflect the change in the nature of the business. The accounting method used in such corporate acquisitions may take one of two distinct forms. When the combination is characterized by a continuity of ownership interests of the constituent companies, the pooling of interests method may be used. By contrast, the purchase method is used in those situations where such continuity does not exist.

Although both methods are said to comply with generally accepted accounting principles,[1] a heated controversy has developed in recent years over the validity and accuracy with which they reflect a combined corporation's financial status. At the base of this controversy is the substantial difference in reporting results under the two methods. These differences may be exploited by an acquisitive corporation to show instant profits on its income statement without any actual increase in profitability. The problems presented, however, are not amenable to simple solutions, as one commentator has recently indicated:

> The accounting for business combinations problem involves more basic concepts and principles than any other problem which has ever faced the business community and the accounting profession. It involves the effects of inflation and the vast differences between values on a current basis and original costs on a conservative basis. It reflects the effect of stock market prices and relatively high price-earnings ratios. It causes us to look at goodwill for what it is and not as a piece of a journal entry. It highlights in an embarrassing way the current deficiencies in accounting.[2]

Recognizing the problems involved, the accounting profession has conducted two research studies in an attempt to devise a means to reflect

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1 It is important to note at the outset that the collection of accounting principles collectively referred to as "generally accepted accounting principles" is not a rigid body of accounting rules requiring a single specified treatment in a certain situation. To the contrary, several methods are frequently allowed for the same type of transaction. An example of such diverse accounting treatments is found in the acceptability of computing depreciation either on the straight-line method or under an accelerated method. The selection of the method of depreciation by the corporation will have a substantial effect upon the net income to be reported during the years the asset is in service, yet either method is allowable under generally accepted accounting principles.

2 Spacek, *The Merger Accounting Dilemma—Proposed Solutions*, 25 BUS. LAW. 611, 625 (1970).

the true economic substance of business combinations.[3] These concerted studies, as well as those by other interested members of the business community, culminated in the issuance of two opinions by the Accounting Principles Board (APB) in August, 1970. Opinion 16 prescribes accounting principles for use in business combinations and Opinion 17 deals with the related problem of accounting for intangible assets such as goodwill.[4] The new opinions reaffirm the notion that the pooling of interests and purchase methods both conform to generally accepted accounting principles.[5] They establish strict criteria which dictate the adoption of the method to be used depending upon specific factors present in the particular combination. Moreover, they require the recording of any goodwill in purchase transactions and provide that it is to be amortized over a period not exceeding 40 years.

The purpose of this note is to analyze and evaluate accounting for business combinations. First, a comparison will be made of the application and development of the purchase and pooling methods. The new APB rules will then be examined to determine whether the shortcomings of prior accounting usage have been remedied and whether the changes present additional difficulties. Finally, in order to insure that accounting uniformly reflects the economic substance of similar business transactions, a proposal will be offered to eliminate the disparity that still exists between the two methods.

Although the concepts involved in this discussion are indigenous to the accounting profession, attorneys and businessmen must understand them if they are to function responsibly and creatively in their respective roles in business combinations. A working knowledge of the principles discussed here is especially critical to the attorney who will negotiate and construct business combinations and who must prepare the agreements necessary to effectuate the transactions.

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[3] G. CATLETT & N. OLSON, ACCOUNTING FOR GOODWILL (1968) (Am. Inst. Cert. Pub. Accountants [hereinafter cited as AICPA] Accounting Research Study No. 10); A. WYATT, A CRITICAL STUDY OF ACCOUNTING FOR BUSINESS COMBINATIONS (1963) (AICPA Accounting Research Study No. 5). These studies were sponsored by the AICPA for the purpose of stimulating thought and comments on areas of difficulty in accounting. Accordingly, they do not necessarily represent the position of the AICPA.

[4] These opinions are authoritative pronouncements of the 18-member Accounting Principles Board [hereinafter cited as APB] which is the only agency of the AICPA having the authority to make or approve public statements on accounting principles. The authority of such pronouncements rests upon their general acceptability. Any departures by AICPA members must be disclosed in a corporation's financial statements when material. The significance of these pronouncements of generally accepted accounting principles is indicated by the requirement that the CPA's opinion relating to financial statements must include a statement that the financial statements are presented in accordance with generally accepted accounting principles.

[5] The opinions are effective for business combinations initiated after October 31, 1970. APB OPINION 16, ¶ 97 (Aug. 1970); APB OPINION 17, ¶ 33 (Aug. 1970). For recent articles analyzing these new opinions, see Louis, *A Fat Maverick Stirs Up the Accounting Profession*, 82 FORTUNE 96 (Dec. 1970); *Corporate Law and Accounting in the 70's*, 26 BUS. LAW. 199 (1970).

POOLING V. PURCHASE—DIVERGENCE OF RESULTS

The application of the pooling of interests and purchase methods renders strikingly different results in financial statements. Pooling of interests accounting is described as applicable in the case of

> the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the combined corporation at their recorded amounts. Income of the combined corporation includes income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods is combined and restated as income of the combined corporation.[6]

The theoretical basis for this treatment is that a union of the stockholder groups of two or more entities has occurred without any exchange of the corporations' assets. Consequently, the transaction does not require the establishment of a new basis of accountability for the assets of the combined corporation. The purchase method is appropriate where there is an

> acquisition of one company by another. The acquiring corporation records at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill. The reported income of an acquiring corporation includes the operations of the acquired company after acquisition, based on the cost to the acquiring corporation.[7]

The use of the purchase method is founded upon the concept that when one corporation acquires another, control over the latter passes to the survivor and the acquired corporation ceases to exist as an independent entity. In this situation, assets have been purchased and traditional accounting principles require that the purchaser record them at his cost. The purchase price is allocated among the assets according to their fair market value and any excess is allocated to the intangible asset goodwill. Prior to the issuance of the new opinions, goodwill recorded under the purchase method could either be retained on the balance sheet at its acquisition value or amortized against income over its expected useful life.[8] Under these opinions, amortization is required.

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6 APB OPINION 16, ¶ 12 (Aug. 1970).

7 *Id.* ¶ 11.

8 COMMITTEE ON ACCOUNTING PROCEDURE, RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, ch. 5 (1953) (AICPA Accounting Research Bulletin 43). This bulletin was prepared and published by the Committee on Accounting Procedure, which was the forerunner of the APB. The bulletin was a codification of all prior pronouncements of the committee and took the position that intangibles having no evident limited term of existence need not be amortized. Goodwill was specifically included in this category.

A hypothetical business combination best typifies the disparity in the nature of the financial statements produced under each of the two methods. Assume that *B* Corporation merges into *A* Corporation. At the date of acquisition, the fair market value of *B's* stock is $700,000, although the net value of its assets is carried on its books at $400,000 as shown in schedule I.

SCHEDULE I: COMPARISON OF NET BOOK VALUE TO NET FAIR MARKET VALUE OF *B* CORPORATION'S ASSETS AT DATE OF ACQUISITION

	Book Value	Fair Market Value
Cash	$ 40,000	$ 40,000
Inventory	60,000	70,000
Plant (net)	400,000	600,000
Goodwill		90,000
Total Assets	500,000	800,000
Liabilities	100,000	100,000
Net Value	$400,000	$700,000

If the pooling method were used in the combination, *A* Corporation would issue to the shareholders of *B* Corporation stock having a par value of $160,000 and a market value of $700,000.[9] In the purchase transaction, on the other hand, *A* Corporation could finance the purchase by a secondary offering of the same amount of its stock, using the proceeds to acquire *B* Corporation.[10] The two methods of accounting would present widely divergent financial statements for the first year of joint operation.

A comparison of the financial statements produced under the two methods demonstrates the wide disparity. The pooling of interests method results in little more than an arithmetical combination of the individidual financial statements of the two corporations. The only deviation from this rule relates to the change in the capital stock and paid-in surplus accounts. The capital stock account of the combined corporation is composed of the $1,000,000 of *A* Corporation stock outstanding prior to the combination plus the $160,000 of *A* Corporation stock issued to acquire *B* Corporation. Since the capital stock of *B* Corporation was replaced by $160,000 of stock of *A* Corporation, the $140,000 difference is credited to the paid-in surplus of the combined corporation.

The changes occurring under the purchase method require a more detailed explanation. The total difference in asset value between the two

[9] See text accompanying notes 16-21 *infra* for a discussion of the federal income tax consequences involved in this trasaction.

[10] Federal income tax provisions and other considerations will influence the structure of this transaction. *A* Corporation may purchase either the assets or the stock of *B* Corporation. See text accompanying notes 23-32 *infra* for a discussion of the considerations involved.

SCHEDULE II: FINANCIAL STATEMENTS

	Assuming No Combination Effected		Combination Accounted For As:	
	A Corporation	*B* Corporation[11]	Purchases	Pooling
Balance Sheet				
Assets				
Cash	$ 100,000	$ 88,000	$ 188,000	$ 188,000
Inventory	100,000	100,000	210,000	200,000
Plant (net)	1,300,000	360,000	1,840,000	1,660,000
Goodwill			87,750	
	$1,500,000	$ 548,000	$2,325,750	$2,048,000
Liabilities	$ 200,000	$ 100,000	$ 290,000	$ 300,000
Stockholders' Equity				
Capital stock	1,000,000	300,000	1,160,000	1,160,000
Paid-in surplus			540,000	140,000
Retained earnings	300,000	148,000	335,750	448,000
	1,300,000	448,000	2,035,750	1,748,000
	$1,500,000	$ 548,000	$2,325,750	$2,048,000
Income Statement				
Sales	$2,000,000	$ 700,000	$2,700,000	$2,700,000
Depreciation	130,000	40,000	190,000	170,000
Other expenses	1,670,000	564,000	2,234,000	2,234,000
Amortization of goodwill			2,250	
	1,800,000	604,000	2,426,250	2,404,000
Income before income taxes	200,000	96,000	273,750	296,000
Income taxes[12]	100,000	48,000	138,000	148,000
Net income	$ 100,000	$ 48,000	$ 135,750	$ 148,000

methods is $277,750, accounted for in Schedule III.

The liabilities are $10,000 less under the purchase method than if pooling had been used. This is attributable to a decrease in federal income tax liability which results from the $20,000 depreciation on the stepped-up basis of the assets acquired.[13] The paid-in surplus is $400,000

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[11] The changes in asset values reflect the $48,000 net income for the year reconciled as follows:

	Beginning Balance Per Schedule I	Increase (Decrease)	Ending Balance Per Schedule II
Cash	$ 40,000	$ 48,000	$ 88,000
Inventory	60,000	40,000	100,000
Plant (Depreciation)	400,000	(40,000)	360,000
	$500,000	$ 48,000	$548,000

[12] Income taxes are estimated at 50 percent of "Income before income taxes," giving effect to the nondeductibility for tax purposes of goodwill recorded in the purchase transaction.

[13] This result assumes that the acquiring corporation receives a stepped-up federal income tax basis in the assets purchased and that the allocation of purchase price for federal income tax purposes is identical to that for financial accounting purposes. It should be noted, however, that the allocation for financial accounting purposes is not determinative for federal income tax purposes. *See* Copperhead

SCHEDULE III: SUMMARY OF ASSET INCREASE UNDER PURCHASE METHOD

	Excess Fair Market Value Above Book Value at Date of Acquisition	Depreciation or Amortization	Net Increase
Inventory	$ 10,000	$	$ 10,000
Plant	200,000	20,000	180,000
Goodwill	90,000	2,250	87,750
	$300,000	$ 22,250	$277,750

greater under the purchase method because of the $300,000 excess of the fair market value of the assets acquired over their historical cost and the inclusion of *B* Corporation's pre-acquisition retained earnings of $100,000.[14] The final balance sheet difference is found in the retained earnings account, which is $112,250 less under the purchase method. The decrease is related to two factors. Under purchase accounting, the $100,000 of pre-acquisition earnings of *B* Corporation may not be carried over as retained earnings of the combined corporation. The remaining $12,250 difference is explained by the fact that the current year net income is $12,250 less under the purchase method accounted for in Schedule IV.

SCHEDULE IV: ANALYSIS OF DECREASE IN NET INCOME UNDER PURCHASE METHOD

Additional depreciation	$20,000
Amortization of goodwill	2,250
	22,250
Less decrease in tax liability	10,000
Total decrease in net income under purchase method	$12,250

The foregoing combination of *A* and *B* Corporations indicates that employment of purchase rather than pooling of interests accounting results in recording higher asset values where the purchase price is above the book value of the assets acquired; therefore, a lower net income is reflected in subsequent years because of higher depreciation charges. The pooling of interests method may encourage subsequent increases in the price of the combined corporation's stock where the acquired corporation has a lower price earnings ratio than the acquiring corporation and the market value of the stock issued is closely tied to earnings per share.

Coal Co., Inc. v. Commissioner, 272 F.2d 45 (6th Cir. 1959); Philadelphia Steel & Iron Corp., 23 TCM 558 (1964). See text accompanying notes 23-32 *infra* for a discussion of the federal income tax considerations involved.

14 Under the purchase method of accounting the acquiring corporation is not allowed to carry forward the pre-acquisition retained earnings of the acquired corporation.

Assuming *A* Corporation offers one of its shares for every three of *B* Corporation, Schedule V illustrates this point.

SCHEDULE V: PROJECTION OF POOLING OF INTERESTS' EFFECT ON STOCK PRICE

	Before Combination		
	A Corporation	*B* Corporation	Combined Corporation
Shares Outstanding	100,000	48,000	116,000
Net Income	$100,000	$48,000	$148,000
Earnings Per Share	$1.00	$1.00	$1.28
Price/Earnings Ratio	50/1	15/1	50/1
Market Value of Stock	$50.00	$15.00	$63.50

In Schedule V, the assumption is made that the price earnings ratio of the acquiring corporation remains the same after the combination, as would often be the case. The significance of these results is underlined by the reliance placed upon net income and earnings per share by investors.[15]

The use of the pooling of interests method, aside from its inherent reporting advantages, may afford tax benefits to the stockholders in the form of a tax-free reorganization.[16] As an example of how these tax considerations might influence a transaction, assume that Growth Corporation, an Arizona conglomerate, wishes to combine with Close Corporation, a small Arizona corporation with assets having a fair market value in excess of their book value. Close Corporation is owned by two individuals, *X* and *Y*, who have a combined stock basis equal to the corporate asset book value.

Assume the corporations effect the combination by a consolidation or merger, as provided for by statute in Arizona,[17] with Growth Corpora-

[15] Many writers have suggested that net income and earnings per share are the most important items presented in the financial statements. *See, e.g.*, ARTHUR ANDERSEN & CO., ACCOUNTING AND REPORTING PROBLEMS OF THE ACCOUNTING PROFESSION 39 (2d ed. 1962); Kripke, *A Good Look at Goodwill in Corporate Acquisitions*, 78 BANKING L.J. 1028, 1038 (1961).

[16] A reorganization can be accomplished in several ways as prescribed in INT. REV. CODE OF 1954 § 368(a)(1), including: (1) a statutory merger or consolidation, *id.* § 368(a)(1)(A), (2) an acquisition of at least 80 percent of the stock of the acquired corporation solely in exchange for voting stock, *id.* § 368(a)(1)(B), or (3) an acquisition of all or substantially all of the assets of the acquired corporation solely in exchange for voting stock, *id.* § 368(a)(1)(C). The tax consequences of a reorganization are as follows: (1) No gain or loss is recognized by the acquired corporation, *id.* § 361; (2) the acquiring corporation receives a transferred basis, *id.* § 362(b); and (3) the stockholders of the acquired corporation recognize gain only to the extent that they receive property other than stock or securities of the acquiring corporation. *Id.*, §§ 354(a), 356.

[17] ARIZ. REV. STAT. ANN. § 10-341 to -349 (1956). The statutes provide that two or more corporations may be consolidated if certain requirements are met. Among the more important of these requirements are: (1) agreements by the majority of the directors of each corporation affected. *Id.* § 10-342. (2) Public notice of the proposed consolidation. *Id.* § 10-343. (3) Approval of the consolidation by two-thirds of the ownership of each corporation. *Id.* § 10-344. The rights of each corporation consolidated vest in the consolidated corporation and all debts, duties and liabilities of the corporations consolidated pass to the consolidated corporation. *Id.* § 10-346.

tion surviving. If the conversion of Close Corporation shares is solely for stock or securities in Growth Corporation, *X* and *Y* will not be required to recognize any gain on the transaction.[18] Growth Corporation will take a transferred income tax basis in the assets of Close Corporation[19] and will be required to account for the transaction under the pooling of interests method. On the other hand, if the conversion of Close Corporation stock is for cash or property in addition to stock, *X* and *Y* will be required to recognize their realized gain to the extent of cash or property received.[20] Growth Corporation will receive a transferred tax basis increased by the amount of gain recognized by the transferors.[21] Under financial accounting practices prior to the issuance of the new APB Opinions, Growth Corporation would have been allowed to account for the combination by the hybrid part-purchase, part-pooling method.[22]

As a final alternative, if *X* and *Y* demand all cash or property in exchange for their interests, the transaction will be treated as a taxable exchange and the purchase method of financial accounting will be required. Depending upon various factors, Growth Corporation will purchase either the assets or the stock of Close Corporation.[23] Assuming Growth buys the assets, it will have a cost basis in them equal to the amount paid.[24] Close Corporation can avoid federal tax upon the gain from the sale by adopting a plan of complete liquidation prior to the sale and then distributing all of its assets[25] within a 12-month period thereafter.[26] The stockholders of Close will be required to recognize all of their gain upon receipt of the liquidation distribution.[27]

Assuming, on the other hand, that Growth buys the stock, Close

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[18] INT. REV. CODE OF 1954, §§ 354, 368(a)(1)(A).

[19] *Id.* §§ 362(b), 368(a)(1)(A).

[20] *Id.* § 356(a)(1). It should be noted that an excessive use of non-equity consideration will defeat the treatment of the transaction as a reorganization because of the absence of a continuity of interests. *See* Treas. Reg. § 1.368-1(b); Roebling v. Commissioner, 143 F.2d 810 (3d Cir.), *cert. denied* 323 U.S. 773 (1944) (merger of two corporations held outside of section 368(a)(1)(A) because shareholders of absorbed corporation did not retain a continuing proprietary interest in the merged corporation).

[21] INT. REV. CODE OF 1954, § 362(b).

[22] See text following note 40 *infra* for a discussion of this accounting method.

[23] Generally, the acquiring corporation will want to purchase assets rather than stock in order to avoid being susceptible to the acquired corporation's liabilities. On the other hand, the stockholders of the acquired corporation will generally want to sell their stock rather than the corporate assets in order to assure capital treatment on their gain and end their liability as stockholders.

[24] INT. REV. CODE OF 1954, § 1012. *See, e.g.,* Copperhead Coal Co., Inc. v. Commissioner, 272 F.2d 45 (6th Cir. 1959); Bryant Heater Co. v. Commissioner, 231 F.2d 938 (6th Cir. 1956).

[25] The statute provides that the corporation may retain a reasonable amount of assets beyond the end of the twelve month period to meet outstanding claims of creditors. INT. REV. CODE OF 1954, § 337(a)(2); Treas. Reg. § 1.337-2(b).

[26] INT. REV. CODE OF 1954, § 337. There are exceptions to the general rule as follows: (1) dispositions of certain depreciable property, *id.* §§ 1245, 1250, (2) disposition of certain installment obligations, *id.* §§ 453(d)(1), 453(d)(4)(B) and (3) dispositions of rights to income. Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962).

[27] INT. REV. CODE OF 1954, §§ 331(a), 1001, 1002.

Corporation will become a wholly-owned subsidiary with its asset basis unchanged and *X* and *Y* will be required to recognize the gain on the sale of their stock.[28] Growth Corporation can liquidate Close[29] within two years after the stock acquisition and receive a stepped-up basis in the assets[30] without any recognition of gain.[31]

It is significant to note that the tax savings to Growth Corporation resulting from a stepped-up basis might not be substantial since a portion of the purchase price may be allocated to goodwill, the amortization of which is not deductible for income tax purposes.[32] Tax benefit would only result from the increased deductions derived from the stepped-up basis of the assets, excluding goodwill.

The foregoing income tax advantages to the acquiring corporation under the purchase method generally will not outweigh the combined advantages—tax benefits to the stockholders, reporting benefits to the acquiring corporation and decreased cash outlay by the acquiring corporation—under the pooling method. Evidence of the preference of the latter is found in the fact that, in recent years, the majority of acquisitions have been effected through the issuance of stock and, accordingly, by the pooling method.[33]

The foregoing demonstration of the difference in financial reporting results, and the corresponding benefits that may inure from a preference of one method over the other, makes an analysis of the accounting methods necessary.

MERGERS AND POOLING OF INTERESTS

A business faced with rapidly increasing demand can satisfy its need to expand either by relying upon internal growth or by combining with other corporations. After World War II, vastly increased consumer needs arose which were attributable to demands deferred during the war

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[28] *Id.* §§ 1001, 1002.

[29] The general rule is that the liquidating corporation will not be required to recognize gain or loss on the distribution of its property. *Id.* § 336. There are three statutory exceptions to this rule. *Id.* §§ 453(d) (recognition of gain required on distribution of installment obligations to the extent of their fair market value in excess of their basis), 1245 (recognition of gain required on disposition of section 1245 property), & 1250 (recognition of gain required on disposition of section 1250 property). A fourth exception, effected by common law tax concepts, requires recognition of gain if accounts receivable are distributed by a cash basis corporation. Williamson v. United States, 292 F.2d 524 (Ct. Cl. 1961).

[30] The cost of the stock is allocated to the respective assets received in the liquidation of Close Corporation. INT. REV. CODE OF 1954, § 334(b)(2). It should be noted that the acquiring corporation does not succeed to the earnings and profits and other tax attributes of the liquidating corporation in this situation. *Id.* § 381(a)(1).

[31] *Id.* § 332. But see note 29 *supra* suggesting that Close Corporation may incur gain as an event of its liquidation. The tax on this gain will be borne by Growth Corporation.

[32] Treas. Reg. § 1.167(a)-3 (1956); *cf.* Philadelphia Steel & Iron Corp., 23 T.C.M. 558 (1964).

[33] Seidler, *Mergers—The Accountant as the Creative Artist,* 44 ST. JOHN'S L. REV. 828 (spec. ed. 1970).

and to substantial postwar population increases.[34] Most corporations selected business combination as the means to meet this surging demand.[35]

The development of the pooling of interests method of accounting accompanied this postwar merger movement.[36] Its increased use resulted from a shift in emphasis "from the legal form of the combination to distinctions between a continuance of the former ownership [and] a new ownership."[37] Previously, business combinations had been accounted for by what is now essentially the purchase method, except that goodwill was recognized only rarely. When it was recognized, it could be written off directly against capital surplus under then generally accepted accounting principles.[38] A contributing, if not controlling, factor in the prevalence of the pooling concept was a rule promulgated by the Securities and Exchange Commission (SEC) in 1945, which prohibited writing off goodwill against capital surplus.[39] Pooling of interests accounting was utilized to circumvent the new rule by avoiding the necessity of recording goodwill. The development of the pooling method is traced in APB Opinion 16:

> The method was first applied in accounting for combinations of affiliated corporations and then extended to some combinations of unrelated corporate ownership interests of comparable size. The method was later accepted for most business combinations in which common stock was issued. New and complex securities have been issued in recent business combinations and some combination agreements provide for additional securities to be issued later depending on specified events or circumstances. Most of the resulting combinations are accounted for as poolings of interests. Some combinations effected by both disbursing cash and issuing securities are now accounted for as a 'part purchase, part pooling.'[40]

The hybrid method marks the farthest reach of the pooling of interests method. The hybrid is applied to transactions in which some stockholder interests are acquired in exchange for stock while others are acquired for cash or other property. The percentage acquired in each

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[34] W. HUSBAND & J. DOCKERY, MODERN CORPORATION FINANCE 581 (6th ed. 1966).

[35] *Id.* Indeed, studies of business concentration indicate that large scale business combinations primarily occur in prosperous times during favorable securities markets—a situation which the postwar period typifies. H. GUTHMANN & H. DOUGALL, CORPORATE FINANCIAL POLICY 513 (4th ed. 1962).

[36] APB OPINION 16, ¶ 10 (Aug. 1970).

[37] *Id.*

[38] COMMITTEE ON ACCOUNTING PROCEDURE, ACCOUNTING FOR INTANGIBLE ASSETS (1944) (AICPA Accounting Research Bulletin No. 24), recognized this as an acceptable accounting method for disposing of the intangible asset balance. This practice is no longer proper under generally accepted accounting principles. COMMITTEE ON ACCOUNTING PROCEDURE, RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, ch. 5, ¶ 9 (1953).

[39] SEC, Accounting Series Release No. 50 (1945).

[40] APB OPINION 16, ¶ 13 (Aug. 1970).

manner is determined and pooling and purchase accounting is applied to the respective parts of the transaction. As a practical matter, the book values of all identifiable assets are usually carried over to the acquiring corporation and goodwill is charged for the consideration paid above book value in the purchase portion of the transaction. The hybrid method does injustice to the continuity of interests basis of pooling accounting.[41]

The economic climate during the early years of development of the pooling method was radically different from that of today. That period was one of general price stability in which there was likely to be little difference between an asset's fair market value and its book value.[42] By contrast, since 1945 the Consumers Price Index has doubled[43] and the American Appraisal Construction Cost Index has increased threefold.[44] The wide disparity which is likely to exist today between book value and fair market value is the cause of the divergence of reporting under the purchase and pooling methods. This divergence has led to abuses in the use of the pooling method[45] and necessitates a critical review of the failure of accounting to reflect general price level changes.

Specifically, the abuses of the pooling method have taken four forms. Instant profits have been created which have served to conceal an unsatisfactory earnings performance of the acquiring corporation. The eventual sale of assets recorded at the historical cost of the acquired corporation has resulted in inflated earnings for the surviving corporation upon disposition. Further, the market value of the surviving corporation's stock has been increased artificially, in some cases, by its acquisition of a company with a lower price earnings ratio. Finally, the use of non-equity securities has qualified for pooling treatment where there has been no sharing of ownershp risk as required by the continuity of ownership interests concept of the pooling method. The source of these abuses is the use of the historical cost basis after combination and the misguided inferences drawn by investors from increases in earnings per share.

An example of the most flagrant abuse involving the sale of assets occurs where one corporation "combines" with another using the pooling

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[41] Seidler, *supra* note 33, at 837.

[42] Spacek, *supra* note 2, at 614:

> We should note here a condition present in 1945 which is vastly different today. The probability of fair values of assets being different from their costs in 1945 was practically nil. The Consumer's [sic] Price Index in 1944 was 60.9 as compared to 61.9 in 1921—twenty years before. The American Appraisal Construction Cost Index in 1944 was 38.6 and in 1921, 31.7. The absence of revaluation of physical assets was of practically no concern when the pooling of interests concept originated.

[43] UNITED STATES BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 345 (90th ed. 1969).

[44] *Id.* at 691-93.

[45] The Federal Trade Commission has urged that the pooling of interests method be eliminated. FTC Report to the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, in CCH FED. SEC. L. REP. ¶ 77,759 (Nov. 4, 1969). *Cf.* Briloff, *Dirty Pooling*, BARRON'S, July 15, 1968, at 1; Seidman, *Pooling Must Go*, BARRON'S, July 1, 1968, at 9.

treatment and, in a subsequent year, disposes of the assets acquired. In the year of disposition, the corporation's financial statements would include income for the difference between the historical cost basis and the sale proceeds. Hence, increased income would be reported to investors solely through the manipulation of the pooling of interests method of accounting. Even though this type of disposition will be disclosed as an extraordinary item if it has a material effect upon the financial statements,[46] the gain resulting from the sale of an asset recorded at less than its acquisition cost will nevertheless be reported.

An example of abuse involving non-equity securities is found in combinations financed by the use of convertible debentures, stock warrants or convertible preferred stock, described as "funny money" by some writers.[47] The use of "funny money" has resulted in two undesirable events. First, since prior to 1969 it was not considered in the computation of earnings per share, its use enabled the acquiring corporation to present an incomplete picture of earnings per share after the combination.[48] In addition, pooling treatment has been allowed for transactions in which there has been no continuity of ownership interests. In 1969, the APB strengthened the requirements for disclosing earnings per share by requiring a presentation of both diluted and primary earnings.[49] This has lessened the possibility of abuse of the pooling method but has not eliminated it entirely because of the likelihood that many stockholders may fail to understand the import of diluted earnings. Moreover, pooling treatment continued to be afforded to transactions in which there was no sharing of ownership risks by the stockholders of the acquired corporation. The dilemma in accounting for business combinations has been magnified by these abuses.

THE CAUSES OF THE DILEMMA

The problems in accounting for business combinations are rooted in inflation and goodwill. Inflation is "an increase in the volume of money and credit relative to available goods resulting in a substantial and continuing rise in the general price level . . . ."[50] Goodwill represents the portion of acquisition price paid for anticipated "profits in excess of a normal return on the investment . . . ."[51] During a period of inflation,

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46 APB OPINION 9, ¶ 21 (Dec. 1966).
47 Smith, *Conglomerates and Take-Overs,* 44 ST. JOHN'S L. REV. 905, 911 (spec. ed. 1970).
48 Primary earnings per share are computed on the basis of the weighted average number of common shares and common stock equivalents which are outstanding during the period presented and which have a dilutive effect. *See* De Lancey, *APB Opinion No. 15 (Earnings Per Share) From a Lawyer's Standpoint,* 25 BUS. LAW. 419 (1970), for an analysis and evaluation of earnings per share disclosure.
49 APB OPINION 15 (May 1969).
50 WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1159 (1961).
51 Walker, *Why Purchased Goodwill Should be Amortized on a Systematic Basis,* 95 J. OF ACCOUNTANCY 210, 213 (1953).

the fair market value of assets is generally greater than their depreciated historical cost.[52] In addition, because of the time required to establish a viable business, the purchase price of a business is usually more than the aggregate fair market value of its assets.[53]

These observations are applicable to every business combination and pose several accounting questions. A decision must be made regarding when and to what extent the excess fair market value over the historical cost of identifiable assets acquired is to be recognized in the accounts of the combined corporation. The possibility of recording the intangible asset found in the excess of the purchase price over the fair market value of the identifiable assets must be considered. Further, methods must be developed to govern the treatment of this intangible asset in subsequent years.

A discussion of the controversy over the use of the pooling and purchase methods requires a careful analysis of the various elements of cost inherent in the constituents of every business combination. An understanding of the various cost factors is necessary to evaluate the methods for recording them in business combinations.

A period of continued inflation is assumed in this note for purposes of analyzing the cost factors existing in a business unit.[54] The lowest cost element is the historical cost of the assets when originally acquired by the constituent corporation. This cost represents the actual outlay required to purchase an asset. Under present generally accepted accounting principles, this is the basis for assets acquired.[55]

The second cost element is the increment attributable to general price level increases since the acquisition of the assets.[56] The value of most assets increases by virtue of the mere passage of time. If an asset were purchased for $100 and, in the following year the purchasing power of the dollar decreased by five percent, it would cost approximately $105 to purchase the same asset in the later year. This increase would be attributable to a change in the unit of measurement. A business purchasing the asset in the later year will recognize a greater depreciation charge

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52 Sneed, *Some Fundamentals of Corporate Acquisitions*, 5 TULSA L.J. 13, 21 (1968).

53 *Id.*

54 During a period of continued deflation, the reverse consequences would follow. The highest cost element would be historical cost since the assets on hand would necessarily have been purchased during a period when the purchasing power of the dollar was less. Even though the result would be the opposite, the argument in favor of purchase rather than pooling is the same whenever historical cost differs from fair market value.

55 P. GRADY, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 30 (1965) (AICPA Accounting Research Study No. 7).

56 *See* STAFF OF ACCOUNTING RESEARCH DIVISION, REPORTING FOR FINANCIAL EFFECTS OF PRICE LEVEL CHANGES (1963) (AICPA Accounting Research Study No. 6) for a detailed discussion of general price level change accounting. See text accompanying notes 111-113 *infra* for a description of how this accounting technique is applied.

than the business which purchased the asset earlier even though each asset would make the same contribution to income.

The third cost element is due to changes in the market value of the particular assets different from the general price level change. The difference between the actual asset value and the asset value restated for the general price level change is attributable to the change in the value of the specific asset.

The final cost element is the excess of the value of the business as an entity over the aggregate of its identifiable assets. This element represents the synergistic value of the constituent as a cohesive income-producing unit, and is commonly referred to by accountants as goodwill.

Pooling of interests accounting for business combinations recognizes only the first cost element with acquired assets recorded at historical costs. Under the purchase method, all four cost elements are recorded. The accounting practices prevailing prior to the new rules based the distinction between the two methods primarily upon the type of financing arrangement employed to effect the combination.[57] Hence, if stock were transferred, the transaction would be accounted for as a pooling of interests[58] while if cash or other assets were given, the purchase method would be used. Whether this distinction was a proper one upon which to base such divergent accounting results became the crucial question around which the deliberations of the APB centered.

VARIOUS ALTERNATIVES OPEN TO THE APB

Before analyzing the position ultimately taken by the APB, the alternative solutions which were before it should be considered. Initially, the inquiry related to which method or methods should prevail. Once it was determined that the purchase method would continue to be acceptable, the method of accounting for goodwill required investigation.

Abolition of Purchase Method

The Board could have abolished the purchase method and required that all business combinations be accounted for by poolings of interests.

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[57] One writer summarized the criteria existing prior to the new opinions for applying pooling of interests accounting as follows:

> (a) foremost, the issuance of voting stock by the acquired entity as the purchase price for the acquired business; (b) the continuation by the former owners of the acquired entity as holders of ownership interests in the combined entity; (c) an intent by these persons to retain such shares; (d) continuity of management; and (e) retention of the business of the constituents to the combination for a reasonable period of time thereafter.

Stanger, *Accounting for Business Combinations: Choice or Dilemma*, 44 ST. JOHN'S L. REV. 864, 866 (spec. ed. 1970).

[58] The combined corporation was not bound to use the pooling of interests method since it could elect to apply the purchase method even though stock had been exchanged. This election is no longer available since the new opinion specifically provides that the two methods are not alternatives in accounting for the same business combination. APB OPINION 16, ¶ 43 (Aug. 1970).

This treatment would have produced accounting consistency for all business combinations, but would have conflicted with settled principles for recording acquired assets in those combinations which are clearly acquisitions of one company by another.[59] Because of the general belief that the pooling method is at the heart of most of the problems attendant to business combination accounting and the basic conflict with generally accepted accounting principles for asset acquisitions, this alternative was probably not seriously considered by the Board.

Abolition of Pooling of Interests Method

More realistically, the opportunity was present to abolish pooling of interests as a generally accepted accounting method and to require all business combinations to be accounted for under the purchase method.[60] Consideration of the results to be anticipated following such a move, however, raises serious questions as to its utility.

The major objection to this solution is that comparability between companies relying upon internal growth and those effecting growth by business combination would be lost. Generally accepted accounting principles do not allow companies growing internally to write-up the bases of their assets. Acquiring corporations, on the other hand, would record assets acquired by business combination at their fair market value at the date of acquisition. There would seem to be little justification for allowing such a vast difference in asset bases between these two types of expanding companies. A substantial portion of the difference is attributable to general price level changes which affect both types of companies equally but are recorded only in the company growing by acquisitions.

The advantage of this alternative is that it would substantially eliminate the acquisition of companies for the primary purpose of effecting increases in the price of the corporate stock through an increase in earnings per share, since the purchase method only allows prospective income combination based upon a new basis for the assets acquired. If the historical cost of the assets acquired is less than their fair market value, the result to the acquiring corporation would be higher future depreciation charges against income.

Restricted Use of Poooling of Interests

The APB ultimately decided that both the purchase and pooling of interests concepts are valid, but that stricter guidelines are needed to

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59 Generally accepted accounting principles require that assets acquired be recorded at the date of acquisition at their aggregate cost. GRADY, *supra* note 55.

60 This was the position suggested by the first exposure draft issued and circulated by the AICPA to stimulate thought and comment. PROPOSED APB OPINION: BUSINESS COMBINATIONS AND INTANGIBLE ASSETS (AICPA Exposure Draft, Oct. 8, 1969).

limit the abuses of the pooling method.[61]

The major problems of this approach lie in the difficulty of determining acceptable distinguishing criteria for the use of the two methods, and in the continuance of disparate results under them. The difficulty in prescribing criteria stems primarily from the imprecise line between the acquisition of a company and the union of the equity interests of two or more companies. Even though criteria are established, the coexistence of two methods raises questions regarding the acceptability of the resultant differences between them. It can be forcefully argued that the differences in the economic substance of the two types of transactions hardly warrant such extreme accounting divergencies.[62]

Nonetheless, under this alternative the pooling method will continue to be preferred by the business community. Accordingly, most businesses will remain comparable in the method of valuing assets since companies growing internally and those using business combinations will continue to record assets at their initial historical costs.

Mitigation of Problem by Price Level Accounting

All of the previous alternatives may be criticized because corporations relying upon growth by acquisition are treated differently from those growing internally. If the pooling of interests method is employed, the combining corporation is not required to account for the added cost inherent in growth by business combination. On the other hand, the corporation using the purchase method is required to record assets at amounts significantly in excess of their competitors' expansion through the reinvestment of earnings.

The inadequacy of both methods is directly attributable to the failure of present accounting to reflect general price level changes. The only cost which an acquiring corporation should be required to record in excess of that recorded by other corporations is that cost representing the premium paid for selecting a rapid expansion method. Under the purchase method, the acquiring corporation records not only this premium but also the cost increment of price level changes while neither cost element is recorded under the pooling method.

The Board could have decided to require general price level change accounting for all enterprises and retain both methods of accounting for business combinations. The effect of such a change would be to place all financial statements on a more comparable basis as well as to eliminate from business combinations the cost element attributable to general price level changes. The problems associated with such a change would be pri-

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61 APB OPINION 16 (Aug. 1970).

62 *See* Briloff, *Financial Motives for Conglomerate Growth*, 44 ST. JOHN'S L. REV. 872, 879 (spec. ed. 1970).

marily related to the implementation of the new practices and the education of users of financial statements.

The Goodwill Issue

Once it is determined that the purchase method is to be retained, the issue of goodwill arises:[63] Should goodwill be amortized and, if so, over what period? The Board could have decided that no amortization was required. This would have avoided the difficult task of determining the period of amortization, but it would have resulted in a permanent balance sheet asset. On the other hand, amortization could have been required and the asset balance would then be periodically charged against income.

The significance of goodwill is found in the fact that its amortization results in a direct reduction of reported net income without a corollary federal income tax deduction. The major problem encountered in the amortization of goodwill is determining the period over which it should be amortized.

APB POSITION

The APB deliberations were conducted in an atmosphere of criticism and controversy.[64] The complexity of the problems facing the APB is indicated by the various positions taken in its exposure drafts. Initially, it considered the abolition of the pooling of interests method.[65] This position received so much criticism that it was promptly abandoned. The next position considered was the retention of the pooling method with its use severely limited by the imposition of a comparative size test under which pooling would not be allowed for business combinations if any of the combining companies were less than one-third the size of the others.[66] The size of a company was to be measured by its voting common stock ownership interest at the date the plan of combination was consummated.

The size requirement was based upon the theory that there can only be a true combination of ownership interests when none of the combining companies is clearly dominant. Again, a wave of criticism followed. The size test under consideration was modified to a nine to one relationship,[67] and then completely abandoned.[68]

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[63] The issue does not arise under the pooling method because the assets are carried forward at their historical cost.

[64] *See, e.g.,* Heinemann, *CPA's Take Aim at Merger Device,* N.Y. Times, Dec. 8, 1969, at 75, col. 8; Financial Executives Institute Statement on the Proposed APB Opinion on Accounting for Businss Combinations 3 (Oct. 22, 1969).

[65] PROPOSED APB OPINION: BUSINESS COMBINATIONS AND INTANGIBLE ASSETS, (AICPA Exposure Draft, Oct. 8, 1969).

[66] PROPOSED APB OPINION: BUSINESS COMBINATIONS AND INTANGIBLE ASSETS, (AICPA Exposure Draft, Feb. 23, 1970).

[67] *See APB Reaches Agreement on Business Combinations Opinion,* 130 J. OF ACCOUNTANCY 10 (Aug. 1970).

[68] APB OPINION 16 (Aug. 1970). Criticism has been leveled at the AICPA

Persons opposed to any restrictions upon the pooling of interests method labeled the Board's purpose as anti-merger.[69] One writer argued that "[a]ccounting principles must have only one objective, and that is to communicate to the reader of a financial report the economic facts surrounding transactions that occur."[70] It seems that the action of the APB was prompted by the latter purpose since the review was obviously needed to remedy abuses which caused existing accounting methods to fail to reflect the economic substance of business combinations.

The Board concluded that there is a basic difference between combinations effected through the issuance of common stock by the acquiring corporation and those effected by payment in other types of stock or assets to the stockholders of the acquired corporation.[71] This basic distinction is the cornerstone of the position taken.

Accounting for Business Combinations

Specifically, the APB concluded that both methods continue to be generally accepted for business combinations.[72] The new rules, however, restrict the use of each method and abolish the use of the part-purchase, part-pooling hybrid.

Opinion 16 establishes conditions precedent for the use of pooling and requires that all other combinations be accounted for under the purchase method. The conditions necessary for the use of pooling are (1) independence and autonomy of the combining companies, (2) continuity of interests and (3) absence of certain pre- and post-combination transactions. The opinion further provides technical guidelines and important disclosure requirements.

The first condition requires that the combining companies must have been completely autonomous business units, not subsidiaries of another corporation,[73] for two years prior to the initiation of the combina-

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that the foregoing chain of compromises indicates a basic weakness in the independence of the AICPA. The suggestion has been made that the AICPA, because of its members' dependence upon fees from the corporations affected, cannot objectively establish standards which will result in adequate disclosure to stockholders and investors. *Words, Words, Words,* FORBES, Oct. 1, 1970, at 54.

[69] *See* Heinemann, *CPA's Take Aim at Merger Device,* N.Y. Times, Dec. 8, 1969, at 75, col. 8.

[70] Spacek, *supra* note 2, at 612.

[71] APB OPINION 16, ¶ 42 (Aug. 1970). The opinion was adopted by the required minimum 12 votes of the 18-member Accounting Principles Board. Three of the six members dissenting—Broeker, Burger and Weston—took the position that the pooling of interests method should be applied only when the constituents to the business combination are of relative size and that all other combinations are the acquisition of one company by another which should be accounted for by the purchase method. The remaining three dissenters—Davidson, Horngren and Seidman—advocated that the pooling of interests be abolished.

[72] *Id.*

[73] One result of this requirement is that purchase accounting will apparently now be required in the situation in which a parent liquidates one subsidiary into another. This is consistent with the equity method for consolidation of subsidiaries.

tion.[74] Further, they must be independent of each other.[75] The opinion specifically provides that companies shall be considered independent for these purposes if the combining companies hold no more than ten percent of the outstanding voting common stock of any combining company at the date the plan of combination is initiated.[76]

It would appear that these conditions are imposed in order to assure that the costs carried over to the combined corporation are realistic historical costs objectively determined on an arm's length basis. These conditions will preclude a corporation from reporting inflated earnings in years subsequent to combination with a subsidiary of another corporation whose asset cost is understated because of inadequate allocation of cost from its parent company.

Various conditions relating to the procedural method of effecting the combination are imposed. The opinion prescribes guidelines to govern the manner in which a pooling of interests may be effected and the type of stock that is allowed to be exchanged upon the combination. The first requirement is that the combination must be effected in a single transaction or under a plan of combination entailing several transactions carried out within one year.[77] This requirement is entirely consistent with the basic principle of the pooling method that there has been a union of two or more companies. The pooling method contemplates a cessation of the functioning of the separate entities accompanied by an undertaking of the combined enterprise.

The new opinion sets forth precise rules limiting the type of stock that may be issued to effect a pooling of interests. The corporation may only offer and issue "common stock with rights identical to those of the majority of its outstanding voting common stock"[78] in exchange for "substantially all"[79] of the voting common stock interest of another company.[80] The corporation issuing the common stock is given considerable latitude in arranging the remaining capital structure.[81] In addition, "the ratio of the interest of an individual common stockholder to those of other com-

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[74] APB OPINION 16, ¶ 46a (Aug. 1970).
[75] *Id.* ¶ 46b.
[76] *Id.*
[77] *Id.* ¶ 47a. A delay beyond the one-year requirement is permitted if consummation is beyond the control of the combining companies because of litigation or proceedings related to the combination before a governmental agency.
[78] A class of stock that has voting control of a corporation is the majority class. *Id.* ¶ 47b, n.6.
[79] "Substantially all" for the purposes of this condition means 90 percent or more. *Id.* ¶ 47b.
[80] *Id.*
[81] *Id.*:

> [A] corporation issuing stock to effect the combination may assume the debt securities of the other company or may exchange substantially identical securities or voting common stock for other outstanding equity and debt securities of the other combining company. An issuing corporation may also distribute cash to holders of debt and equity securities that either are callable or redeemable and may retire those securities.

mon stockholders in a combining company [must remain] the same as a result of the exchange of stock to effect the combination"[82] and the voting rights of the common stock ownership interest must not be restricted in any manner.[83]

The most significant result of these conditions will be the elimination of so-called "funny money"[84] from the pooling transaction. In other words, the combination must be a full, unrestricted fusion of the equity interests of the constituents. This should bring poolings of interests more in line with the theory upon which they rest, the union of equity interests.

Certain activities of the constituents are forbidden both before and after the combination if pooling treatment is to be allowed. These prohibitions are aimed at the elimination of certain business practices utilized in the past to circumvent the rules governing the use of the pooling method.

Equity changes of voting common stock, in contemplation of effecting the combination within two years before the plan of combination is initiated and consummated, are now forbidden under the pooling method.[85] The effect of this rule is to prohibit the acquired corporation from converting, prior to the pooling, a substantial amount of its equity interest into debt payable to stockholders.[86] Without this prohibition, some stockholders could convert a substantial amount of their investment to cash shortly after the combination. Hence, this rule tightens a substantial loophole previously available for circumvention of the limitations placed upon conversion to cash under the pooling of interests method.

The new rules also prohibit the use of treasury stock to effect a pooling of interests.[87] Pooling treatment is not defeated if voting common stock is reacquired solely for purposes other than business combination.[88] Otherwise, it would be relatively easy to obtain pooling of interests accounting for a combination which was essentially a cash exchange wherein one company purchased its own stock in the market and then transferred it to the acquired company or its shareholders. This rule is essential and eliminates another opportunity to avoid the undesired results of purchase accounting.

The pooled corporation's post-combination activities are also restricted by APB Opinion 16. It may not agree directly or indirectly to

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[82] *Id.* ¶ 47e.

[83] *Id.* ¶ 47f.

[84] *See* text accompanying note 47 *supra.*

[85] APB OPINION 16, ¶ 47c (Aug. 1970). For purposes of this condition, distributions to stockholders which are not greater than normal dividends are not considered as changes.

[86] See note 109 *infra* for the federal income tax considerations involved.

[87] APB OPINION 16, ¶ 47d (Aug. 1970).

[88] *Id.* The Opinion provides that stock reacquired for purposes other than business combinations includes shares of stock reacquired for use in stock option and compensation plans provided a systematic plan of reacquisition is established at least two years prior to the initiation of the plan of combination.

retire or reacquire any of the stock transferred in the combination.[89] Nor may it enter into, for the benefit of former stockholders of a combining corporation, other financial agreements which effectively negate the exchange of equity securities.[90] It is not entirely clear, however, what financial agreements fall within the scope of this prohibition. The opinion specifically mentions that a guaranty of loans secured by stock issued in the combination would violate the provision.[91] On the other hand, it would seem that agreements such as employment contracts would not create a problem. A fine dividing line between the two extremes is not discernible. The purpose of this requirement, however, is to prevent the use of the pooling method where the economic substance of the transaction is that of a purchase; accordingly, evaluations of contemplated financial agreements should be made with this purpose in mind.

Further, the pooled corporation may not plan to dispose of a significant part of the assets of the combining corporations within two years after the combination except for those dispositions made in the ordinary course of business or to eliminate duplicate facilities or excess capacity.[92] This particular provision is designed to curb the instant profits obtained shortly after combination by the liquidation of all or part of one of the combining companies. It appears that this provision would allow the liquidation of an unprofitable portion of a combined business as excess capacity if there is inadequate demand for its output.

It is interesting to note that the opinion does not impose any restrictions upon the holding period of stock received in the pooling of interests transaction. If the new stockholder can convert his stock to cash immediately, he has not lost the advantages of the purchase method. SEC, however, has applied a rule of thumb in the past that the new stockholders must not sell more than 25 percent of the stock in the year following the combination and 25 percent in the second year thereafter in order for the combination to qualify for pooling treatment.[93] It is not clear whether the APB considers this subsequent sale limitation unnecessary or whether its failure to deal with the subject indicates that it will continue to rely on the judgment of the SEC. It is doubtful that the new opinion on business combinations will influence the SEC's position. The Commission will continue to be concerned about a transaction which is essentially a sale by the stockholders but still qualifies for pooling treatment under the accounting rules.

The opinion prescribes technical procedural methods by which the two accounting treatments are applied. The methods allowed are the

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89 *Id.* ¶ 48.
90 *Id.* ¶ 48b.
91 *Id.*
92 *Id.* ¶ 48c.
93 Podolin, *Tax and Other Considerations in the Sale of a Business: A Panel Discussion*, N.Y.U. 27TH INST. ON FED. TAX. 471, 514 (1969).

same as those existing prior to the Opinion except that the hybrid method[94] and the retroactive reflection of business combinations consummated after the combined corporation's fiscal year are now specifically forbidden.[95]

Supplemental disclosure requirements regarding business combinations reflected by the pooling method are significantly increased by the new opinion. Most important is the requirement of a reconciliation of the total revenue and earnings of the combined corporation with the revenue and earnings of the individual combination constituents.[96] The new rules also require disclosure of the method used to account for business combinations[97] as well as the details of operating results of the various separate companies for periods prior to the combination.[98] The notes to financial statements must reflect the profit or loss from dispositions of assets of the previously separate companies made in other than the ordinary course of business if such dispositions are made within two years after the combination.[99] Finally, the details of business combinations consummated before the issuance of the financial statements but after the end of the current fiscal year must be presented.[100]

Accounting for Intangible Assets

APB Opinion 17 prescribes new generally accepted accounting principles related to accounting for intangible assets[101] if a business combination is a purchase within the meaning of APB Opinion 16. Under the pooling of interests method there is no acquisition of assets and no new accounting basis is established. The opinion concludes that intangible assets of an acquired company should be recorded at their cost at the date of acquisition[102] and should be amortized over their useful lives.[103] The period of amortization, however, should not exceed 40 years.[104] APB Opinion 17 is the result of a determination by the Board that the recording of intangible assets is required to reflect properly the economic

[94] APB OPINION 16, ¶ 43 (Aug. 1970).
[95] *Id.* ¶ 61.
[96] APB OPINION 16, ¶ 64g (Aug. 1970). In the situation in which a new corporation is formed to effect the combination, disclosure of the earnings of the separate combining companies for prior periods will be required.
[97] *Id.* ¶ 64b.
[98] *Id.* ¶ 64d.
[99] *Id.* ¶ 60. This disclosure is only required if the profit or loss is material in relation to the net income of the combined corporation.
[100] *Id.* ¶ 65.
[101] "Intangible assets" is used here in its accounting context, referring primarily to goodwill. It should be noted that the accountant's use of the term is not so broad as that of the attorney. For example, common stock when used in a legal context is considered to be an intangible asset while in balance sheet asset parlance it would be classified as an investment.
[102] APB OPINION 17, ¶ 26 (Aug. 1970).
[103] *Id.* ¶ 27. The opinion indicates that the straight-line (equal annual amounts) method of amortization should be applied unless a company demonstrates that another method is more appropriate. *Id.* ¶ 30.
[104] *Id.* ¶ 29.

substance of certain asset acquisitions and to show that such assets decrease in value over a period of years. The 40-year maximum is evidence of the perplexity involved in determining the useful life of intangible assets. The opinion sets forth numerous factors to be considered in making the determination[105] and the implication is clear that an amortization period considerably less than the 40-year maximum frequently will be required.

The requirement of amortization of intangible assets renders the purchase method less attractive to the corporation concerned about reported earnings if the purchase price is greater than the net book value of assets acquired. It results in the reflection of increased costs in the periodic income statements of years subsequent to the acquisition.

NEW RULES—SOLUTION OR DEFERRAL OF ISSUE?

The position taken by the APB is based upon the assumption that there is a difference between a combination effected through the issuance of common stock and one in which the acquiring corporation gives some other form of consideration. All limitations imposed are aimed exclusively at the curtailment of abuses which have occurred in recent years because of the laxity of standards governing the application of the pooling of interests method.

Undoubtedly, certain decisions reached by the Board are long overdue. For example, the mandate forbidding the hybrid method abolishes an accounting technique that is not reconcilable with the continuity of interests concept of the pooling method. In addition, the new supplementary disclosure requirements should provide information essential to an objective analysis of management's performance as well as an explanation of certain results unique to business combinations which are not otherwise evident. Further, since goodwill represents a premium paid for excess future earnings, the requirement that it must be amortized against those future earnings is sound.[106]

A review of the new opinions leads to the conclusion that significant improvement in the reflection of economic facts will result from their application. An analysis of the probable consequences is necessary, however, to assess objectively the sufficiency of the new rules.

The new rules do not seem to detract significantly from the de-

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[105] *Id.* ¶ 27.

[106] One writer supports the amortization of goodwill in the following manner:

> The cost of goodwill included in the purchase price of a going concern is essentially the discounted value of the estimated excess earning power—the amount of the net income anticipated in excess of income sufficient to clothe the tangible resources involved with a normal rate of return. Thus purchased goodwill represents an advance recognition of a debit for a portion of income that is expected to materialize later. It follows that the amount expended for goodwill should be absorbed by revenue charges during the period implicit in the computation on which the price paid was based . . . . Walker, *supra* note 51, at 212.

sirability of accounting for a business combination under the pooling of interests method. Assets will still be carried over to the combined corporation at historical costs. This will result in significantly lesser charges against revenue in future years than would be the case under the purchase method. The "chilling" effects placed on the use of the pooling of interests method by the new rules would not seem to outweigh the financial reporting advantages inuring under a continued use of the method.

If the conclusion is correct that "poolings" will continue to prevail over "purchases," certain advantages will follow. Under the pooling of interests method, difficult valuation problems do not arise and assets take on the same basis as they would in internal growth companies.

The detriments, however, of continued prevalence of the pooling of interests method are extensive. The new accounting rules will only retard and not eliminate the previously existing abuses. Consideration of the possibilities for abuse will illustrate this point.

The provision prohibiting the pooled corporation from planning to dispose of a significant part of the assets of the combining companies within two years is weakened significantly by the exception allowed for the elimination of duplicate facilities or excess capacity. Many combinations envision substantial economies of large scale operation and, hence, justifiable plans to eliminate some duplicate facilities or excess capacity are frequently present.[107] Accordingly, some assets recorded at their original historical cost by a combined corporation may still be disposed of at their fair market value shortly after the combination, with the possible result of substantial gains being reported to the stockholders of the combined corporation. It is true, however, that if such gains are material, their effect on stock price may be minimized to some extent by the requirement that such material gains be disclosed separately in the income statement as extraordinary items.[108]

Further, the combined corporation may dispose of a substantial portion of the assets more than two years after the combination, and may recognize gain on the disposition. It is difficult to see how this would be less of an abuse than the combined corporation's disposition of the assets shortly after the combination. Again, the corporation will be required to disclose the details of such a transaction separately if the gain is material in relation to total net income. The same gain is reported, but in a later

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[107] *See* Briloff, *Financial Motives for Conglomerate Growth,* 44 ST. JOHN'S L. REV. 872, 874 (spec. ed. 1970), for a view that these economies of scale have not been so substantial as many merger advocates would contend. It is noted that economies of scale are, at any rate, a much less significant consideration in conglomerate mergers since the operations of the conglomerate are often dissimilar to those of the business acquired. Minimum economies would nevertheless be possible in such mergers through the integration of certain functions such as management, accounting and transportation.

[108] APB OPINION 9, ¶ 21 (Dec. 1966).

accounting period. Thus, the effect on stock price is only delayed.

The new rule forbidding equity adjustments within two years prior to the pooling combination is of limited utility in prohibiting abuse. It would seem that this requirement could be circumvented by advanced planning on the part of a corporation which expects to be acquired in the future. Consider, for example, a close corporation where some stockholders wish to convert their interest into a more marketable stock while others wish to liquidate their investment. Those who wish to liquidate could exchange their equity for debt more than two years before the corporation actively attempts to combine.[109] The result would be the best of all worlds. The new rules would allow pooling treatment and some stockholders of the close corporation could arrange for the rapid liquidation of their investment with the combined corporation assuming the debt payable to them. This outcome is the same as it would be if the acquiring corporation directly purchased the interest of the retiring stockholders.

Finally, the practice of combination with a corporation having a lower price earnings ratio in order to influence the market value of the surviving corporation's stock will still be possible under the pooling of interests method. The new disclosure rules should diminish the pooling's influence upon stock price but the remaining opportunity to effect dramatic increases will be a continuing incentive for such combinations. The practical impact of the new rules may well be to force corporate management to do more advance planning or business combinations in order to achieve the desired effect upon future financial reporting.

The APB's chosen solution is primarily a stopgap measure. It restricts abuses which have prevailed as integral parts of the pooling of interests method, but does not eliminate the substantial differences in results between the two methods. The problems stem not from the lack of definite criteria for determining whether the combination was a merger or an acquisition—as the approach of the APB would indicate—but rather from the fact that generally accepted accounting principles do not reflect the effects of general price level changes.

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109 There is a danger of unfavorable federal income tax consequences to the stockholder when a corporation redeems its stock. A redemption may be treated as a dividend. INT. REV. CODE OF 1954, §§ 301, 302(d). But the stockholder may be allowed to treat the redemption as a sale of the stock under § 302(a), if: (1) The redemption is not equivalent to a dividend. *Id.* § 302(b)(1). (2) The redemption is substantially disproportionate in relation to other stockholders. *Id.* § 302(b)(2). (3) The redemption is a complete termination of the stockholder's interest. *Id.* § 302(b)(3). For purposes of section 302, the stock ownership attribution rules of section 318(a) apply except to redemptions under section 302(b)(3) which meet the requirements of section 302(c)(2).

It would seem that the redemption of some stockholder interests prior to the combination would be within the exception of either section 302(b)(2) or 302(b)(3); accordingly, they would be treated as a sale or exchange rather than as a dividend.

An Alternative Solution

The business combination illustrates most graphically the underlying accounting problem of failure to recognize the effects of price level changes. It squarely poses the problem of how to recognize increases in asset values for the assets of the acquired corporation when comparable assets in a company growing from within remain at historical cost. If the increases are not recorded, as under the pooling of interests method, subsequent financial statements of the combined corporation risk being misleading because of the continuance of historical costs. The task of justifying the coexistence of both purchase and pooling is a formidable one because the economic substance of the two types of transactions is so similar,[110] while the differences between financial reporting consequences under the two methods are extreme.

The substance of nearly all business combinations is that one corporation has employed its bargaining power to effect expansion. That dichotomous accounting results should be reached where only the form and not the substance of the transactions is different is dubious. The conclusions reached by the APB do not reach the main issue involved and are inadequate. It is necessary to look beyond the business combination in search of an adequate solution.

The primary basis of an alternative solution is found in general price level change accounting. From the outset, it must be emphasized that this accounting technique is not a departure from the historical cost principle of accounting. Under general price level change accounting, historical cost remains the foundation of the recorded asset value.[111] An index is applied to historical cost to restate the assets to a common unit of measurement.[112] From the standpoint of comparability among various companies, the method adds a desirable dimension to accounting. Accounting treatment should reflect the economic substance of the operations of a business and properly indicate the performance of management in employing the corporation's assets in the income producing process. Accounting can do this only if it recognizes the gains and losses attributable to changes in the unit of financial statement measurement. Gains and losses related to the management of the assets will then be adequately presented. At present, the stockholder or investor attempting to analyze the performance of a company is hindered by the inadequate accounting statements made available to him. The determination of the effect of general price level changes is left completely to his imagination.

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110 The only difference is found in the type of consideration paid to the stockholders of the acquired corporation. In the pooling transaction, common stock is the primary consideration given while in the purchase situation either noncommon stock or assets are given.

111 APB Statement 3, ¶ 28 (June 1969).

112 The APB has noted that the Gross National Product Implicit Price Deflator is the most comprehensive indicator of the general price level in the United States. *Id.* ¶ 9.

The primary problem related to the implementation of general price level change accounting involves the education of financial statement users so that misleading inferences are not drawn. This presents a challenge to the accounting profession that can be met through clear, concise notes to the financial statements.[113] The mechanics of the transition present some difficulty. This is, however, an internal matter within the accounting profession that can be quite easily met. Evidence of the desirability and practicality of price level change accounting is found in a recent APB Statement[114] which concluded that such accounting presentation provides useful information not available in historical financial statements. The APB Statement presents substantial guidelines for the application of this accounting technique,[115] but concludes that it is "not required at this time for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles in the United States."[116]

The accounting profession should have seized upon the current purchase-pooling controversy as an opportunity to require general price level change accounting under generally accepted accounting principles. Further, the APB should have severely restricted the pooling of interests method of accounting to those combinations in which there is no dominant constituent. It is envisioned that such combinations without dominant constituents would rarely occur. This conclusion is reinforced by recent antitrust developments which tend to discourage large acquisitions by large corporations.[117] All other combinations should be accounted for as purchases.

Adoption of this proposed solution would properly reflect the economic substance of business combinations and avoid the extreme differences between the bases of comparable assets recorded in a purchase combination and those in an internal growth corporation. The only added cost recorded in the business combination would be that cost attributable to the rapid method of expansion chosen.

The practicality of presenting financial statements restated for general price level changes is indicated by the financial statements of Indiana Telephone Corporation.[118] These statements, restated for general price level changes, provide their users with essential financial information. The importance of this accounting treatment is dramatically emphasized

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113 A good example of the accounting profession's ability to meet such a challenge is found in its recent implementation of new reporting rules which require the presentation of both primary and diluted earnings per share. *See* APB OPINION 15 (May 1969).

114 APB STATEMENT 3 (June 1969).

115 *Id.* ¶¶ 28-46 and App. C.

116 *Id.* ¶ 25.

117 *Bureau of Economics*, FTC, Ecnoomic Report on Corporate Mergers 1-15 (1969).

118 INDIANA TELEPHONE CORPORATION, 1969 ANNUAL REPORT (1970).

by the following excerpt from the auditors' report on these financial statements:

> In our opinion, however, the accompanying financial statements [restated for general price level changes] *more fairly* present the financial position of the Corporation as of December 31, 1969, and the result of its operations for the year then ended, *as recognition has been given to changes in the purchasing power of the dollar* . . . .[119] (emphasis added).

Certainly requiring general price level change accounting is drastic, but that factor alone should not retard the accounting profession's quest for adequate financial statement presentation. A less drastic alternative would be to provide the financial statement reader with historical cost statements as well as statements reflecting price level changes. This method would serve to educate the reader to understand the new information and the dual presentation would give the accounting profession an opportunity to evaluate general price level change accounting in practice.

CONCLUSION

The present methods of accounting for business combinations came into use at a time when inflation was not a factor for consideration since general price levels had not changed appreciably in prior years. Their development has occurred in a haphazard manner with confusion centering around the determination of a dividing line between the two methods. The result has been flagrant abuses which resulted in misleading financial statements.

The APB recognized the problem and sought to remedy it. The Board attacked the problem by trying to find an acceptable dividing line between what it considered to be a union of corporations and the acquisition of one company by another. These deliberations were plagued by difficulties in arriving at a decision as to which factors distinguish union from acquisition. The analysis did not deal with the influence of price level changes upon the business combination. The Board concluded that the exchange of voting common stock is the most significant factor distinguishing the union situation and, accordingly, decided to continue to allow the pooling of interests method of accounting for transactions of this nature. The conclusions reached by the APB are probably the best possible without facing the issue of general price level changes. The opportunity for abuse still exists however.

It would have been far better had the Board taken affirmative action to require general price level change accounting in all businesses and to limit firmly the availability of the pooling of interests method to those combinations in which there is no dominant constituent. Had these

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[119] Auditors' Report, Arthur Andersen & Co., INDIANA TELEPHONE CORPORATION, 1969 ANNUAL REPORT (1970).

issues been addressed constructively in the suggested manner, the investing public would be provided with financial statements more conducive to knowledgeable, accurate appraisal.

Although the attorney has no authority to determine accounting treatment, he does have a responsibility to protect the rights of those affected by business combinations. This responsibility will be met only when the financial disclosure relating to business combinations completely and fairly reflects such rights as determined by the economic substance of the transactions. To this end, the attorney should attempt to influence accounting change.