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MERGERS — THE ACCOUNTANT AS A CREATIVE ARTIST

LEE J. SEIDLER*

In recent years, a number of accounting publications have chronicled the "abuses" under the "pooling of interest" treatment. These include Arthur Wyatt's study,¹ which concluded with a suggestion for "fair value poolings," a proposal that sent chills to the hearts of merger-oriented corporations. Abraham Briloff has condemned pooling with evangelical fervor in several financial publications, while the recent AICPA study, ARS No. 10,² used a dinosaur-age interpretation of accounting theory to suggest that accountants give up on the entire problem. A timorous minority of accounting commentators have tried to defend the pooling treatment.

This clamor had virtually no effect on the actual practices of accountants, and in blissful disregard of their critics, accountants continued to treat the vast majority of acquisitions and mergers as "poolings."

STARTING AT THE BEGINNING

Most discussions of pooling and purchase accounting seem to assume that readers clearly understand the mechanics involved in the transactions. Experience suggests, however, that a brief, basic review at this point may make the remaining discussions somewhat more useful.

For purposes of this illustration, assume two companies, *A* and *B*, whose condensed balance sheets are given in Exhibit I. *A* and *B* arrange a merger.

	EXHIBIT I	
	A	B
Assets	<u>\$4,000</u>	<u>\$2,000</u>
Liabilities	2,000	1,000
Capital ^a	<u>2,000</u>	<u>1,000</u>
	<u>4,000</u>	<u>2,000</u>

^a Includes capital stock, paid-in surplus and retained earnings.

The purchase price of all the shares of *B* from the *B* shareholders will be \$2,000, in terms of *A* stock at market value. Since *B* has a net book value (or capital) of \$1,000, *A* is paying for \$1,000 excess of cost over book value — goodwill. *A* will issue additional shares to effect the merger.

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¹ Wyatt, *A Critical Study of Accounting for Business Combinations*, ARS No. 5 (1968). Wyatt left the AICPA immediately after ARS No. 5 was released.

² Catlett & Olson, *Accounting for Goodwill*, ARS No. 10 (1968). The two authors are partners of the accounting firm of Arthur Andersen & Co.

Purchase Accounting

Under purchase accounting, *A* would record an investment in *B* at its cost, \$2,000, and record the issuance of the new shares at their fair market value, \$2,000. In the instant prior to the merger, *A*'s balance sheet would appear as illustrated in Exhibit II.

EXHIBIT II

	<u>A</u>
Assets	\$4,000
Investment in <i>B</i>	<u>2,000</u>
	<u>6,000</u>
Liabilities	2,000
Capital	<u>4,000</u>
	<u>6,000</u>

B's balance sheet remains unchanged. The merger, that is, the combination of *A* and *B* into one entity, *AB*, is accomplished by adding *B*'s net assets of \$1,000 (\$2,000 of assets less \$1,000 of liabilities) to *A*'s net assets. The investment in *B* of \$2,000 is netted against *B*'s capital account and the \$1,000 difference representing the excess *A* paid over *B*'s book value is recorded as goodwill (see Exhibit III).

EXHIBIT III

	<u>A</u>	+	<u>B</u>	Elimination <u>B Capital</u>	=	<u>AB</u>
Assets	\$4,000		\$2,000		=	\$6,000
Investment in <i>B</i>	<u>2,000</u>			(1,000)	=	<u>1,000 Goodwill</u>
	<u>6,000</u>		<u>2,000</u>			<u>7,000</u>
Liabilities	2,000	+	1,000		=	3,000
Capital	<u>4,000</u>	+	<u>1,000</u>	(1,000)	=	<u>4,000</u>
	<u>6,000</u>		<u>2,000</u>			<u>7,000</u>

Pooling Accounting

Despite the complexities that the pooling of interest seems to produce, accounting for a pooling is actually simpler than under the purchase assumption. All that is done is to add the two balance sheets as they appeared before the merger. There are no eliminations or changes in values; it is just as if the pages of the general ledger of *B* have been interleaved with those of *A* (see Exhibit IV).

EXHIBIT IV

	<u>A</u>	+	<u>B</u>	=	<u>AB Pooled</u>
Assets	\$4,000		\$2,000	=	\$6,000
Liabilities	<u>2,000</u>	+	<u>1,000</u>	=	<u>3,000</u>
Capital	<u>2,000</u>	+	<u>1,000</u>	=	<u>3,000</u>
	<u>4,000</u>	+	<u>2,000</u>	=	<u>6,000</u>

The perceptive reader may now ask what has happened to the \$2,000 market value of the *A* stock issued to pay the *B* shareholders. *A* started with \$2,000 of capital and issued \$2,000 worth of additional shares, which suggests a total capital of \$4,000. The combined capital of *AB Pooled* is only \$3,000. The answer is simple, so simple that it often tends to be confusing. The stock issued to the *B* shareholders is valued precisely at the net book value of *B*, \$1,000 in this case. The market value of the shares issued, the purchase price paid to the *B* shareholders, is *completely ignored*.

The failure under the pooling of interest to record the market value of the consideration given in an acquisition, points out the fundamental reason why the pooling is available only when stock is given as payment for the shares acquired. While there is no difficulty in arbitrarily stating the shares given at some figure other than their value (certainly this has been done often enough in the past), it is hard to see how even the most ingenious bookkeeper could reduce the \$2,000 paid by *A*, if it were paid in cash, to only \$1,000. Thus, the pooling treatment is limited to stock-for-stock acquisitions, and purchase is used for cash transactions.³ As noted below, however, ingenious accountants have been able to circumvent this restriction, and allow considerable cash to be involved by the implausible concept of part-pooling, part-purchase.

To ignore the market value of the shares given to *B* shareholders has an attraction. The surviving company under the pooling, *AB Pooled*, shows exactly the same book values as the constituent companies did before the merger. *If all things remain equal, AB Pooled will show a profit exactly equal to the profit earned by the two companies prior to the merger.* The company that treated the merger as a purchase, *AB*, shows \$1,000 more of assets. If this goodwill has to be amortized, then *AB*, all other things being equal, will have a *lower* profit than *A* and *B* had before the merger. *Under purchase accounting, if the management does nothing after the merger, but has to amortize the goodwill, it will appear as if the merger has resulted in a less successful operation.* The amortization is not tax deductible, which makes it doubly unattractive. Thus, it is not difficult to predict which type of accounting the management will prefer.

Other "Benefits" of the Pooling

In many cases goodwill is no longer amortized. Even if amortization is omitted, pooling has other attractions. Assume that in the previous example, *A* has been earning \$200 while *B* consistently earns \$100; each shows a 10 percent rate of return on book equity. By giving \$2,000 worth of stock to purchase *B*'s \$100 of earnings, *A* obtained only a 5 percent return on the investment. Purchase accounting clearly reflects this situation, since *AB* will earn \$300 (assuming no amortization of goodwill) on a book equity of \$4,000, an average rate of 7.5 percent.

³ Purchase accounting, however, can also be used in stock-for-stock acquisitions.

AB Pooled will also earn \$300, but it shows a book equity of only \$3,000 and thus maintains the 10 percent pre-acquisition rate. That *A* shareholders made an investment returning 5 percent is totally obscured. If *AB* Pooled were now to give \$10,000 (market value) of stock to acquire a company *C*, which had an identical balance sheet to company *B*, *ABC* Pooled would still show a return on book equity of 10 percent, even though the new investment yielded only 1 percent.

AB Pooled instead finds a company *D*, which is earning \$200 on a book equity of only \$1,000, a 20 percent return. If the going multiple were 10, *A* would have to pay \$2,000 for *D*, an investment returning 10 percent. However, adding *D*'s earnings to *AB* Pooled would provide a total of \$500 of earnings on a total book equity of \$4,000, raising *ABD* Pooled to a rate of return on equity of 12.5 percent. That is a bit like printing money.

A LITTLE HISTORY

The pooling treatment appears a little more logical if its historical background is considered. It apparently was first used in some of the mergers effected in the 1920's, when groups that owned several companies combined them into one unit. Thus, if the *same* group of shareholders owned *A* and *B* corporation, it did not seem logical that a merger should be effected under the classical assumption that one was buying out the other. Instead, the books of the two companies were merely added together. This treatment had the additional advantage at that time, when the ability to pay dividends was of greater significance, of preserving the earned surplus of both companies. One of the first uses of the term "pooling of interests" was in the 1940's, in an FPC ruling which denied two utilities the right to revalue their assets (upward) when the interests of the same group of stockholders were combined.⁴ The companies were required to retain their original book values.

The AICPA discussed the matter during the late 1940's and issued Accounting Research Bulletin No. 40 (ARB No. 40) in 1950.⁵ ARB No. 40 gave official sanction to the broadening of the idea of pooling the interests of *one group of shareholders* to the concept of continuing the ownership of *two different groups of shareholders* in one surviving entity. Clearly, a stock-for-stock exchange fitted these circumstances. ARB No. 40 vaguely suggested that the constituent companies should be of similar size, but did not define relative size in any objective manner.

In January 1957, the AICPA issued ARB No. 48,⁶ which was somewhat more specific about the conditions under which a pooling could be undertaken. While ARB No. 40 had been rather noncommittal, ARB No. 48 clearly indicated the "forbidden fruit" nature of the pooling. That is, by

⁴ *In re Montana Power Co.*, 4 F.P.C. 213, 234 (1945).

⁵ AICPA, *Business Combinations*, ARB No. 40 (1950).

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

this time it was evident that in most cases companies wanted to use pooling rather than the purchase treatment, and ARB No. 48 attempted to stem the tide. Therefore, it stipulated requirements of similar size, continuity of ownership, continuity of management and similarity of business. The gradual erosion of these requirements provides a classic proof of a corollary to Gresham's Law, namely, that accounting principles which produce higher income tend to drive out those that produce lower income.

The Shrinking Size Criterion

ARB No. 48 stipulated that the smaller of two companies in a pooling should constitute at least 5 percent of the total entity; otherwise, purchase accounting should be used.

In March 1968, Teledyne, Inc. merged with Electronic Instrumentation Inc. and accounted for the merger as a pooling of interests. The owners of Electronic received 769 shares of Teledyne stock in exchange for all the outstanding stock of their company, giving them an interest in the "combined enterprise" of 0.0086 percent. The original Teledyne shareholders retained 99.9914 percent control, a percentage somewhat higher than the purity attributed to a popular soap.

ARB No. 48's criterion was based, of course, on the fundamental premise that for two companies to "pool their interests," they had to have some relative similarity in size. The original standard, that the smaller of the companies had to be at least 5 percent of the total entity, seemed to be a generous interpretation of the basic concept — but it was not generous enough.

The 5 percent limitation held for only a short period after ARB No. 48 was released. Some bright accountant, who remains anonymous, concluded that there was no significant difference between pooling a company that constituted 5.00 percent of the combined company and one that constituted 4.99 percent, and did so. It took less time for the next accountant to decide that 4.98 percent was not significantly different from 4.99 percent, and the salami slicing started. The 2 percent mark seems to have been a barrier for a short while, but it was breached around 1959, and all pretense at worrying about size then ended. The Teledyne pooling, heretofore described, is somewhat smaller than usual, but it is doubtful that it is a record.

The Retroactive Pooling

The release of ARB No. 48, with its specific numerical criterion for a pooling, opened a chapter in accounting that many accounting theorists would rather forget. The debacle started when ARB No. 48 cited a standard for poolings, 5 percent, which was considerably lower than the standard being allowed by the Securities and Exchange Commission (SEC) at that time. Almost immediately thereafter, several companies, among them FMC Corporation (then Food Machinery and Chemical Corporation) and Philip Morris,

initiated some unique and innovative accounting changes. FMC had acquired Buffalo Electro Chemical Corporation in 1952 and treated the acquisition, in which the Buffalo shareholders received a 10.5 percent interest in the combined company, as a purchase. Similarly, Philip Morris had treated its 1954 exchange of shares with Benson and Hedges, in which the latter received a 15.4 percent interest, as a purchase. The FMC purchase treatment had resulted in recording \$8.2 million of intangibles out of a total purchase price of \$13.6 million; Philip Morris had recorded \$14 million of the total acquisition price of \$21 million as goodwill.

In January 1957, both corporations, citing the changed standards in ARB No. 48, "retroactively" reflected the transactions as poolings of interest. This was accomplished essentially by reversing the original recording as a purchase and reentering the transactions as poolings; \$22.2 million of goodwill was wiped out.

These early retroactive poolings set the stage for even greater aberrations. As the 5 percent criterion of ARB No. 48 gradually fell, companies which had initially observed the limitation began to feel discriminated against. The retroactive pooling provided perfect justification for their contention that "had we known then what we know now, we would have pooled." In July 1959, W.R. Grace acquired Hatco Chemical (2.6 percent) for \$5.4 million and treated it as a purchase. In December 1960, Grace retroactively pooled Hatco, eliminating \$3.9 million of goodwill which was being amortized, and according to a calculation by Professor A. N. Mosich, raised income by \$443 thousand.⁷ The years 1960 and 1961 saw a rash of retroactive poolings as more companies reconsidered their previous accounting each time a new lower percentage pooling was announced. The practice was utilized less frequently in 1962, when today's "mini-poolings" became standard and only a few companies, which had presumably been somewhat slower on the uptake, remained to try these reversals.

(Almost) Anything Goes

While retroactive pooling has now become merely an embarrassing chapter in accounting history, its effects remain with us. The acceptance of the concept by the SEC and reputable accounting firms clearly established a precedent that accounting for business combinations would be a series of attempts to find even the most far-fetched rationalizations for the pooling treatment — except, of course, when negative goodwill was involved — under almost any merger situation other than a straight cash purchase.

In the past few years, as the merger boom accelerated, the pooling of interests has been stretched to a point where it bears virtually no resemblance to the original concept of the merger of two jointly owned enterprises. It has now been accommodated to the demands of mergers which are consummated for both stock and cash, where debt and preferred stock

⁷ See Mosich, *Retroactive Poolings in Corporate Mergers*, 41 J. Bus. 352, 359 (1968).

are given instead of common shares, where merging shareholders sell out large portions of their holding immediately, and even where only portions of businesses are merged. The original attraction of the pooling in avoiding the recognition of goodwill still remains, but it has been supplemented by techniques that allow other improvements in the profit picture. Having now presented the basic principles of pooling of interest accounting, we will provide the means for understanding the accounting results of the more complex poolings which have become increasingly common in the past few years.

Man Does Not Live by Stock Alone

We noted above that the pooling of interest treatment, as originally rationalized, was to apply to situations where shareholders of companies of relatively comparable size joined forces, that is, "pooled" their interests into combined enterprises. Under this definition, no one "buys" anyone else and, therefore, the accounting for the merger consists of simply joining together the two sets of books. There is no recognition of a "purchase" and, hence, no requirement to account for the market price which was actually paid.

As noted, the fiction of a requirement for "comparable" size of pooled companies rapidly disappeared, a victim of merger fever. Another fundamental problem of the ever-widening application of the pooling concept was the inherent idea that since the "pooling" referred to the combining of equity interests in companies, it was only applicable to mergers in which the acquiring company gave its shares to the former shareholders of the acquired company. This requirement became a problem because some sellers had the quaint notion that they would like some cash along with the shares they received. In other, perhaps less common circumstances, buyers preferred to pay with cash, but wanted to avoid the subsequent use of the purchase treatment. In conformity with the now-accepted idea that basic merger accounting concepts could be modified to suit the aims of the parties to the merger, several new techniques were developed.

When the Buyer Has Cash

There are times when an acquiring company would prefer to give cash, rather than stock, when it merges with another company. We have previously explained that it is difficult to reduce the value of the cash given to make it conform, in a pooling of interests, to the book value of a company purchased. Nevertheless, with a will there is a way, and accountants have devised it — use treasury stock.

During 1966, the Corporation [Westinghouse Electric] delivered 676,806 shares, (including 538,701 previously unissued) of its common stock in exchange for the net assets and business of . . . [companies named]. These transactions were treated as poolings of interests. . . .

The amount of \$4,531,000 shown in the consolidated Statement of Retained Earnings represents the retained earnings of the pooled companies . . . less the excess over par value of the allocated cost (\$5,640,000) of reacquired shares used in the poolings.⁸

In other words, Westinghouse purchased shares of its own stock for cash and then utilized these shares to acquire another company, thus providing the rationale for treating the merger as a pooling. The *cost* of the shares given was apparently \$6,503,000; \$5,640,000 plus \$863,000, representing \$6.25 par value per share. The *market value* of the shares given was somewhat higher: Westinghouse made an almost embarrassing profit in dealing in its own stock. In its 1965 balance sheet, Westinghouse carried treasury stock as an asset, "available for the Employee Stock Plan and other corporate purposes":

Westinghouse Electric Corporation common stock—	
at cost (1965 market value \$14,114,938)	\$9,939,928

If the habitual use of treasury stock in acquisitions (it was also done in 1965) had a part in Westinghouse's dropping the archaic presentation of treasury stock as an asset, and switching to the more conventional deduction of the amount from total equity (as it was presented in 1966), then at least this stretching of the pooling concept was not entirely without merit. This use of treasury stock in a pooling, however, raises a whole series of issues related to the nature of treasury stock. For practical purposes, however, it permits an acquiring corporation to effectively pay cash while continuing to use the pooling method. The difference between the book value of the acquired company and the cost of the treasury stock, which would represent goodwill if purchase accounting were followed, is effectively written off against capital at the acquisition date, as previously described in the Westinghouse explanatory note.

Give a Little Cash Or Sell a Little Stock

The original AICPA standards defining the circumstances which permitted use of pooling accounting also called for continuity of ownership after the merger was accomplished. The restriction that the acquisition be totally for stock in order to qualify for a pooling is often relaxed, however, to the extent of allowing up to 10 percent of the price to be paid in cash. It has also become common practice to allow the "bought out" stockholders to sell off a portion of the shares they have received, without affecting the ability of the acquiring company to use the pooling treatment. At present, however, the SEC frowns on selling off more than 25 percent of the shares given. Effects on the market of the sales of large blocks of shares might also limit the attraction of this alternative.

When neither of these alternatives satisfied the twin demands of sellers

⁸ WESTINGHOUSE ELECTRIC CORPORATION 1967 ANNUAL REPORT, at Note 2.

who wanted cash and buyers who wanted the pooling of interest, something new had to be devised. Once again, the victim was rational accounting, as the quest for pooling spawned another embarrassing chapter in accounting history.

The Part-Pooling, Part-Purchase

The acquisition of Paramount represented by the company's purchase of approximately 16.77% of the outstanding Paramount stock in April, June and September of 1966 for a total of \$22,090,000 in cash will be accounted for as a purchase, with the excess of the purchase price over the book value of the shares acquired being allocated to television film library . . . pending an evaluation of Paramount's assets. The acquisition of approximately 1.85% of the outstanding Paramount stock in exchange for [G&W Series B Preferred Stock] in June 1966 and acquisition of the balance of the Paramount stock in exchange for [G&W stock] as a result of the merger will be accounted for as a pooling of interests.⁹

The popular part-pooling, part-purchase, described in this note from the Gulf & Western Listing Application connected with acquisition of Paramount Pictures, provides considerable flexibility in the arrangement of merger terms, while still permitting most of the benefits of the pooling treatment. The net assets of the acquired company are split into two parts which are accounted for much like two separate acquisitions—one a purchase, the other a pooling. In most cases, the cash of the acquired company and other, often non-amortizable assets are considered to have been the assets purchased. The remaining portion of the acquired company, 83.23 percent here, is treated as another acquisition on the pooling basis. The portion paid for in cash is recorded at the purchase price, while the pooled portion comes in at the book value it had under the acquired company.

Judicious allocation of appropriate assets to each portion can improve subsequent net income. If the purchased portion is clearly denoted as assets which are not subject to amortization or later charged to income, no harm is done to future income and any goodwill can be ascribed to the pooled portion of the transaction. In the Paramount case, the purchased assets were specified as films held for television, which consisted of pictures already exhibited in theaters, generally already amortized down to book amounts far below current value. While the new cost basis created by the purchase treatment will have to be charged to income when the films are sold, the "purchase" of the films for cash appears to make this a taxable transaction, assuring the deductibility of that cost when the films are sold or rented. Had the cash payment gone for nondeductible "Goodwill," it would never be recoverable for tax purposes.

Swingline Has Its Cake and Eats It

The exchange of 139,933 shares of Class "A" Stock of Swingline Inc. for all the common stock of Wilson Jones Company held by persons other

⁹ Gulf & Western Listing Application to New York Stock Exchange, No. A-23737, Oct. 19, 1966, at 2.

than Swingline Inc. will be accounted for by Swingline as a "pooling of interests". The previous acquisition of 203,463 shares of Wilson Jones Stock has been accounted for as a purchase. The excess of equity acquired in Wilson Jones over the original cost thereof is to be credited to income ratably over a period of ten years from the date of consolidation.¹⁰

Swingline obtained control of Wilson-Jones in 1959, through the acquisition of about 58 percent of its stock. The book value of 58 percent of Wilson-Jones exceeded the price paid by Swingline by \$624,000. That is, *negative goodwill* of \$624,000 arose from the first transaction. Swingline accounted for this transaction as a purchase, thus allowing for the recording of the negative goodwill and its subsequent amortization as a tax-free credit (increase) to income. In the second acquisition of about 41 percent of Wilson-Jones, Swingline gave shares with a total market value of \$4,664,000, when the net book value of this interest in Wilson-Jones was approximately \$4,100,000. Had this transaction also been recorded as a purchase, it would have given rise to \$564,000 of goodwill, which would have almost completely offset the previously created negative goodwill. But, Swingline exercised its option, as it were, to treat the second acquisition as a pooling and no goodwill was recorded. Thus, through the use of the part-pooling, part-purchase technique, Swingline was able to increase income through the amortization of the negative goodwill on the "purchased" portion of Wilson-Jones, while it escaped the "penalty" of goodwill which would have arisen on the later acquisition by using pooling accounting for that portion.

Is It Right or Wrong?

It takes no great perception to see that the part-pooling, part-purchase does fundamental injustice to the underlying rationale for the pooling of interests treatment. It is but another chapter in the continuing story of the distortion of business combination accounting concepts to suit the purposes of the parties to mergers, rather than to record circumstances which occurred.

Illwill Brings Profits

The preceding illustrations in this paper have dealt with the use of the pooling-of-interest method to reduce charges to income following mergers. However, the pooling method need not serve only the passive function of reducing amortizable expenses; skillfully applied, in combination with hybrid securities, it can result in an absolute *increase* in reported earnings. Nor is the pooling method the only form of merger accounting which will raise earnings. The purchase method, selected in the right circumstances, can also raise the earnings of companies combined in a merger to a figure *higher than the total reported by the companies prior to the merger*.

The acquisitions during 1963 of the common stock of [companies named]

¹⁰ Swingline Inc. Listing Application to New York Stock Exchange, No. A-20986, Mar. 29, 1963, at 1.

. . . resulted in excess of equity in net assets of these subsidiaries over cost of \$2,727,819 and \$9,925,386 respectively. The amounts in this account are being amortized by credits to income over ten years, or in such sufficient amount to offset any loss on sale of non-earning assets received in the original acquisition, or proratably credited to income if significant portions of a subsidiary's earning assets are sold. Two subsidiaries of Marshall-Wells Company sold most of the originally acquired installment accounts receivable without recourse in September 1963 at a discount of \$533,168, accordingly, an equivalent amount of the excess of equity in these two subsidiaries over cost was credited to income. In addition, amortization of \$699,680 and \$710,159 was credited to income in the accounts of Marshall-Wells Company and Larchfield Corporation and all subsidiaries, respectively.¹¹

The amounts of negative goodwill amortized in the above note are particularly interesting when one finds that the 1963 income of Larchfield, including the amortization credit of \$710,000, was only \$95,246. The amortization of the negative goodwill did not show as a separate item in the income statement, although the statement contains a half dozen other smaller items. It was clearly disclosed, however, in the above cited Note 12, among 13 other Notes which filled five pages of small print.

How Does Illwill Arise?

While "Goodwill" is the commonly accepted term to describe the excess a company pays over the book value of another company it purchases, no accepted term denotes the opposite case — when the purchase price is less than the book value or the equity of the acquired company — although negative goodwill is most widely used. In most statements, the item, found somewhere near the equity section of the balance sheet, is mechanically described as "Excess of equity in net assets of subsidiaries over cost."

Illwill, less common than goodwill, usually arises in the acquisition of a loss company, when the book asset values are higher than the earnings (or losses) justify, and hence exceed the purchase price. The purchased company (poolings are rarely used in such cases) is recorded at its book value, the purchase price at the actual figure, and the resulting credit tucked away near the equity section of the balance sheet. The accounting principles of the AICPA suggest that an attempt be made to determine which assets are overstated, but the conclusion, from Larchfield's resulting negative goodwill, is that the amount could not be attributed to specific assets. At this point, the AICPA, in an almost total departure from the sanctified historical cost rule, allows the assets to be carried at *more than their purchase price* and *permits the amortization of the credit as an increase in income*. Note too, that as with goodwill, the amortization of illwill is not a taxable item. It raises after-tax net income dollar for dollar.

¹¹ LARCHFIELD CORP. AND MARSHALL-WELLS CO. 1963 ANNUAL REPORT, at Note 12. Marshall-Wells and Larchfield had substantial mutual ownership and therefore reported together in a single annual report.

While there is some possibility of rationalizing this pragmatic non-accounting when it is truly impossible to attribute the illwill to specific assets, one wonders why, as described in the Note, Larchfield found it possible to specify precisely the related assets when they were sold, but not when they were acquired.

How To Evaluate Illwill?

It was demonstrated above how recognition and amortization of *goodwill*, under a purchase, reduces the profits of a merged enterprise to less than the profits of the constituents prior to the merger. The reduction results because a new *amortizable* debit balance is created which did not previously exist. In the case of negative goodwill, a new *amortizable credit balance* is created, which also did not previously exist. When it is amortized it results in "earnings" which are higher than those which existed prior to the merger.

Should the analyst merely disregard the illwill and look to the operating earnings? Or, is it a legitimate item of profit? A simple answer is that amortized negative goodwill can never represent "income." There is no way to rationalize, in this cold world, that a "bargain purchase" — that is, a purchase below book value — results from anything other than a bookkeeping error on the part of the acquired company. Just as goodwill results principally from a failure to record existing intangible assets, negative goodwill results from a failure to write down book values of assets to reflect their actually lowered earning power. To view the amortization of this bookkeeping error as a "profit" is clearly not logical.

However, in some circumstances amortized negative goodwill can be viewed in terms of its origin, that is, as *the correction of an error*. If the assets of the acquired company which are recorded at more than purchase price are themselves being amortized to expense, through depreciation or cost of goods sold, then the expenses of the company are overstated and profits unduly reduced. In this case, the amortization of the negative goodwill serves as a crude bookkeeping device to even up the situation.

On the other hand, if the "excess" depreciation on the overstated assets is less than the amortization of the negative goodwill, then the illwill clearly represents profit inflation. Similarly, if the potential losses resulting from the overvalued assets are realized quickly, as would be the case if inventory were involved, then long-term amortization of the illwill represents a long-term inflation of profits.

The only reasonable solution, given the accountants' failure to adjust the asset values at the time of purchase, is to attempt the difficult and uncertain task of ascertaining the source of the illwill. In recent years, the SEC has occasionally raised objections to this type of accounting, and thus has reduced the number of glaring examples; nevertheless, as noted below, some rather absurd examples are still occurring.

Hidden Treasures in Small Companies

Small, nonpublic companies usually maintain their accounting solely for tax purposes. Since the goal in tax accounting is to minimize income, most companies accounting on a tax basis sharply understate their income, compared with the figures which would be presented in accordance with "generally accepted accounting principles." The understatement is accomplished by providing generous allowances for bad debts, minimizing inventory with LIFO (and sometimes through overlooking some of it), using accelerated depreciation for book *and* tax purposes, charging personal expenses to the corporation, etc. When such a company is merged into a corporation that takes the trouble not only to minimize taxes but also to utilize less conservative methods for book and reporting purposes (which is permissible in virtually every area except the LIFO inventory method), net income of the acquired company can be rather nicely raised, often without sacrificing tax savings.

When such accounting changes are made "in order to bring the accounting practices of the pooled company into conformity with those of the parent," there is a "requirement" that the previous years' statements used for comparison also be restated. However, as a practical matter, the information necessary for such restatements is often impossible to obtain, and the restatement of comparative figures is not performed. The failure to restate, of course, provides for a more favorable comparison with the prior year.

How To Gain One Year's Growth With a Pooling

From Avnet, Inc. Annual Reports:

As Reported In:	Per Share Income		
	1967	1966	1965
June 30, 1966 Annual Report		\$1.58	\$1.03
June 30, 1967 Annual Report	\$2.33	\$1.87	

During the year ended June 30, 1967 the company acquired the net assets of [several companies named]. Subsequent to June 30, 1967, the company acquired the net assets of Channel Master Corporation and the outstanding stock of five affiliated corporations for 319,501 shares of \$3 cumulative convertible preferred stock plus a maximum 146,000 of such additional shares contingent on future earnings. These acquisitions have been accounted for as poolings of interests and accordingly the accompanying statements of income reflect the operating results of these companies for the entire fiscal year. The financial statements for the year ended June 30, 1966, which are included for comparative purposes, have been restated to include the accounts of the pooled companies.¹²

Avnet, with a fiscal year ending on June 30, 1967, agreed on July 11, 1967, to merge with Channel Master Corporation. The merger was accomplished by the exchange of a convertible preferred, plus a contingent issuance of about 50 percent more of the same convertible, for the assets of

¹² AVNET, INC. 1967 ANNUAL REPORT, at Note 1.

Channel Master. According to "generally accepted accounting principles," when a merger is treated as a pooling of interests, in any financial statements presented, the two companies should be shown as if they had always been merged.

Thus, in the normal case of a pooling anytime during a year, *the earnings of the pooled companies are combined for the entire year of the statements*. It is normal accounting practice, however, to reflect in financial statements for a given period, certain "subsequent events." Generally, when an event occurs after the year ends, but before the financial statements for that year have actually been prepared, which had it been known by the end of the year would have modified the statements at the time, the event is retroactively reflected in the statements. Thus, if it is discovered after the year ends that the inventory thought to be saleable at the end of the year actually was not saleable, the year-end inventory would be retroactively written down, if the financial statements had not yet been prepared.

Using the same logic, if a pooling occurs after the year ends, but before the statements have been prepared, it is retroactively reflected in the financial statements for the previous year.

Thus, Avnet reflected the earnings of Channel Master in both years presented in the 1967 Annual Report, even though the merger took place subsequent to the end of the 1967 year. The net result of this "conformity" with accounting theory is to report a year's growth about a year earlier.

Raising Per Share Earnings Through a Pooling

An interesting point about the Avnet figures is that the pooling produced a significant *increase in per share earnings*. It is logical to expect that pooling with a profitable company will increase total earnings. However, assuming that when stock is given to buy earnings, the earning rates of the stock exchanged by both parties should be comparable to each other, *per share earnings* of the joined or pooled enterprise *should not be significantly affected*.

Note that Avnet gave convertible preferred, not common stock. The total annual dividend requirement of the preferred actually given was 319,051 times \$3.00 or about \$960,000. The earnings of Channel Master in 1966 were about \$1,990,000. Since no additional common shares became actually outstanding,¹³ per share income benefited from the \$1 million of additional applicable income.

Fully diluted earnings were required to be shown in the 1967 Listing Application¹⁴ and, interestingly, they are \$1.58 per share for 1966, *precisely the same figure originally presented in Avnet's 1966 Annual Report*.¹⁵ This

¹³ This was prior to the requirement that common stock equivalents be considered in computations of primary earnings per share.

¹⁴ Avnet, Inc. Listing Application to New York Stock Exchange, No. A-25659, Feb. 5, 1968.

¹⁵ See note 12 *supra* and accompanying text.

suggests some increased attention to the fully diluted figure when mergers are consummated with convertibles.

The Ultimate Example: A Part-Pooling, Part-Purchase of a Part of a Partnership

In preparing these discussions on merger accounting, a number of examples of interesting financial presentations were reviewed. The following case is herewith presented as a candidate for the best job of completely destroying any illusions anyone might still retain that there are any basic principles in merger accounting.

In February 1968, Servomation Corporation filed a Listing Application¹⁶ describing the details of its merger with a part of the Kaset Mobile Coffee Service, a partnership with 41 employees engaged in the "mobile catering business" in Chattanooga, Tennessee. Servomation issued 15,300 shares of its stock (constituting 0.334 percent of the combined equity of the merged enterprises) and gave \$240,213 in cash in return for the merchandise inventory and one-half of the net fixed assets of Kaset, all of which had a net book value of \$102,213. The partners of Kaset retained its cash, a parking lot, a building, and \$33,641 of other investments.

The Listing Application notes:

This acquisition will be treated as a partial pooling of interests-partial purchase for accounting purposes. . . . Servomation's independent public accountants have reviewed and approved this treatment and found it to be in accordance with generally accepted accounting principles.¹⁷

Adding it up, we have the merger of a large corporation with some miscellaneous assets of a tiny partnership being treated as a partial pooling-partial purchase. Was it really worth the trouble?

Why Such Chaos?

In recent years a good deal of criticism has been directed at the results of current merger accounting. But, none of this gleeful pin pricking has dealt with the causes of the problem.

Obviously, one problem is the apparently insatiable desire of some American business enterprises to merge with other American business enterprises. If this description has vague sexual connotations, it is accurate at least insofar as it implies the strength of the business impulses with which we are dealing. Similarly, without stretching the analogy too far, the accounting profession is, to some considerable extent, the guardian of public morals. While accountants are not in a position to encourage or discourage mergers, they do have a responsibility to see that accounting for mergers is performed

¹⁶ Servomation Corp. Listing Application to New York Stock Exchange, No. A-25389, Feb. 1, 1968.

¹⁷ *Id.* at 1.

in a reasonable manner. It is difficult to conclude that the profession has been anything other than derelict in its duties in this respect.

A Dozen Years of Inaction

In almost every year of the 1960's the number of business combinations has increased over that of the previous year. The diversity of the mergers — in terms of differing sizes of enterprises, varying types of businesses and forms which mergers have taken — has been staggering. A whole new type of corporation has emerged. With this merger activity has come a vast increase in the demands on merger accounting, both its theory and practice. What has the American Institute of Certified Public Accountants done in response? Until recently, virtually nothing.

In September 1950, the AICPA issued ARB No. 40, which briefly and generally set forth the theoretical characteristics of the pooling and purchase treatment. In January 1957, the Institute published ARB No. 48, which discussed the two treatments in somewhat more specific terms. By 1957 the seductive appeal of the pooling treatment had become apparent and *ARB No. 48* was oriented more toward setting some limits on the use of the pooling treatment. It, too, was written in general terms, except, unfortunately, in the case of the size criterion, which was much too specific. *Since then, for more than 12 years, through the greatest burst of merger activity in American history, there has been no pronouncement from the AICPA on merger accounting.* Companies and their "independent" accountants have been left virtually free to devise whatever methods and mechanisms served their purposes. Only the SEC has served as a control, but it does not appear to have been a match for the combined onslaught of managements and professional accountants. Interestingly, while accountants generally remain rather strongly independent of their clients, in merger cases they clearly appear to have joined forces with the companies.

During 1969, the Accounting Principles Board (Board) of the AICPA finally addressed itself to the problem of merger accounting. From the outset, it became apparent that deep disagreements within the Board, based on a variety of factors, would delay the ultimate issuance of a definitive Opinion. At the time of this writing (December 1969) the Board had indicated that it would issue an exposure draft of a new Opinion. The draft appears to be nothing more than a papering over the disagreements among its members, providing for a limited use of the pooling of interest under supposed safeguards. The draft does not address itself to the basic problem of merger accounting, noted below.

THE REAL PROBLEM

The question can be raised as to whether there will ever be any solution directly centered in mergers.

Consider the basic difficulties of the presently accepted methods of ac-

counting for business combinations. Traditional purchase accounting with the amortization of goodwill results, all other things being equal, in the merged enterprise recording a lower profit than the total of the profits of the previously uncombined units. This result has obviously, with possible justification, been unacceptable to many managements. If the pooling treatment is accorded to a merger, the comparison of profits is unaffected, but only partial recognition is given to the amount of the investment that has been made by the acquiring company. New managements are placed in control of assets which have essentially been bought and paid for, but for which they are not held accountable. The possibility of concealing profit declines, for example, becomes quite real.

A few other methods have been proposed for dealing with mergers. In ARS No. 5 it was suggested that the assets of *both* companies in a merger be revalued to some "fair" or "current" value at the time of the merger and that these values be recorded.¹⁸ In most cases this would produce an even lower profit than purchase accounting with amortization of goodwill. In ARS No. 10, a one-sided polemic mislabelled a research study, the authors suggested that goodwill be recognized at the time of a merger and then be immediately charged off against capital.¹⁹ This would produce the same result as the pooling, but in a less honest fashion. The new Board exposure draft offers yet another variation.

The cataclysmic effect on profits of the "fair value" pooling concept advocated in ARS No. 5 suggests the dimensions of the problem. Why should the revaluation of both companies in a merger to current values or the recognition of the market value of the acquired company through goodwill result in lower profits thereafter? There is only one possible reason: *the companies were valued on their books prior to the merger at less than their real value.* Under current accounting principles, companies do not record all valuable assets, such as internally generated intangibles, and they often understate others, such as fixed assets on accelerated depreciation or LIFO inventories. The costs of using these unrecorded assets do not show as expenses, and profits are thus overstated.

This situation produces no specific problem, *until a merger occurs.* Then a comparison *must* be made between the unrealistic book values and the very real market price being paid for them. *This difference must be disposed of one way or another in accounting for the merger. Merger accounting becomes burdened with all the past inaccuracies of the accounting system.* Under present accounting we either choose to ignore the differences which are clearly seen to exist and use pooling, or we recognize them suddenly and try to compensate for past overstatements by amortizing goodwill. Neither is a particularly attractive solution. Recently, some companies, *e.g.*, Litton Industries, have chosen a third expedient: to record an acquisition as a pur-

¹⁸ Wyatt, *supra* note 1, at 81-86.

¹⁹ Catlett & Olson, *supra* note 2, at ch. 10, especially 105-06.

chase, *without amortizing the resulting goodwill*. This treatment, while "acceptable" under a strict interpretation of existing accounting rules, does some violence to the sensibilities of many accounting theorists. Nevertheless, it does at least place all the assets which have been purchased on the financial statements, albeit in an amorphous blob called goodwill, which does not disturb comparisons of profit before and after the merger. At best, this is a weak attempt at a solution; it simply continues most of the inaccuracies.

Given the nature of the problem, it appears that the only feasible solution must be found outside the specifics of merger accounting, in a major change in general accounting. Unless we dispense with the fiction of stylized balance sheets prepared in accordance with so-called generally accepted accounting principles, which bear no resemblance to reality, there will be no solution to the merger problem. On the other hand, if balance sheets can be brought into some reasonable relation to reality, merger accounting problems will virtually evaporate, just as problems of accounting for bond discount and premium almost disappeared when bonds began to be issued at coupon rates approximating going interest rates.

The Accounting Principles Board has given no indication that it intends to view the solution to merger accounting in this broad context. Instead, they are plainly returning to another compromise within the framework of so-called generally accepted accounting principles. It is difficult to be optimistic that any such shortsighted solution will offer any significant change from the present situation.