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A CURRENT ACCOUNTING CONTROVERSY:
PURCHASE VERSUS POOLING OF INTERESTS
IN BUSINESS COMBINATIONS

By
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B. S., University of Montana, 1969

Presented in partial fulfillment of the
requirements for the degree of

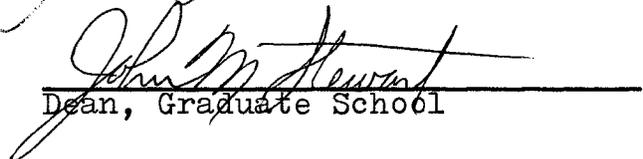
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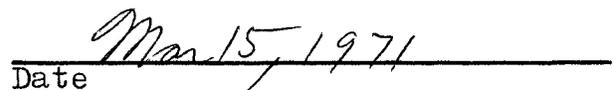
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CHAPTER I

INTRODUCTION

Opinion 16, Business Combinations, seeks to realign accounting practice with pronouncements of the Institute and to eliminate abuses and confusion on the pooling of interests concept. This was one of the greatest contemporary accounting problems facing the public accounting profession. The large number of business combinations taking place during the current merger period and the effect accounting treatment had on net profit and earnings per share divided the ranks of the profession.

This paper will relate the major conceptual argument for the purchase and the pooling of interests method. The criteria for pooling will be explained as set forth by the American Institute of Certified Public Accountants (AICPA) in Accounting Research Bulletin No. 48. Following the criteria, pooling as used in practice will be elaborated upon showing abuses and the widening of the gap between official pronouncements and the practitioner.

The power of the AICPA to enforce its pronouncements will be discussed as it relates to the practitioner and the business world. Some dilemmas of the Institute that are similar to pooling will be mentioned. The criteria

necessary for pooling as set forth by Opinion 16 will be discussed. Emphasis will be placed on comparing pooling as practiced with the changes resulting in elimination of abuses by the adoption of Opinion 16 by the Accounting Principles Board.

For purposes of this paper, a business combination, a purchase, and a pooling of interest will be defined respectively as follows:

A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises.¹

The purchase method accounts for a business combination as the 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.²

The pooling of interests method accounts for a business combination as 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

¹American Institute of Certified Public Accountants, Opinions of the Accounting Principles Board 16: Business Combinations, New York: AICPA, August, 1965, par. 1.

²Ibid., par. 11.

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.³

The business combination phenomenon is not new to the American scene, as it has been occurring ever since the corporate form of business organization came into existence.⁴ A highly episodic pattern emerges when the data on combinations are examined over an extended period of time. The cyclical patterns have given rise to three different, distinct periods of increased merger activity: 1890-1904, the late 1920's, and the current merger movement beginning in the 1950's⁵ and ending in 1970. A visual presentation of the merger pattern is presented in the chart on page four.

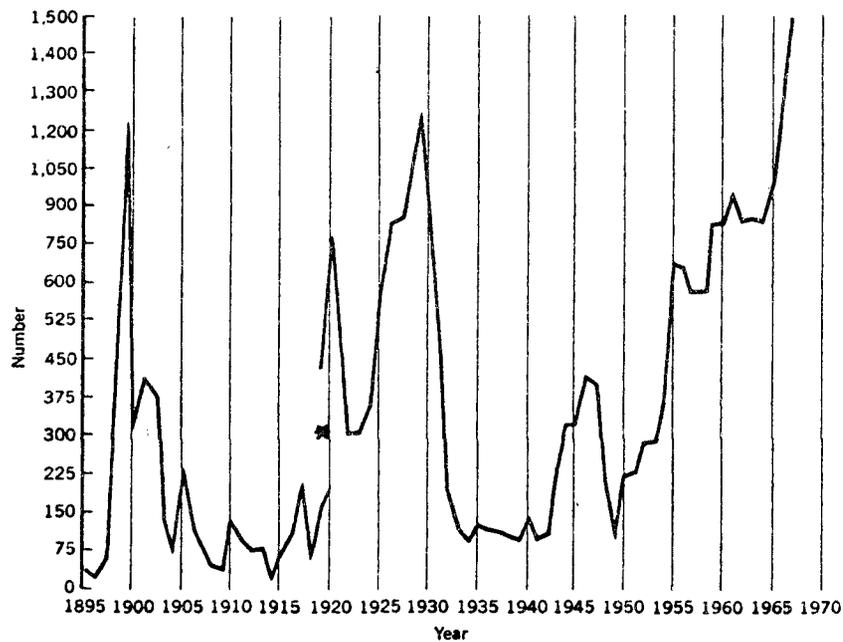
During the current merger period, the principal promoters were the managers of the combining corporations. This period is different from the earlier periods in that mergers resulted in organizing conglomerates such as

³Ibid., par. 12.

⁴Arthur R. Wyatt, A Critical Study of Accounting for Business Combinations: Accounting Research Study No. 5, New York: AICPA, 1963, p. 1.

⁵Samuel Richardson Reid, Mergers, Management and the Economy, New York: McGraw-Hill, Inc., 1968, p. 14.

FIRM DISAPPEARANCES BY MERGER IN
MANUFACTURING AND MINING INDUSTRIES,
1895-1967



*The two series are not directly comparable.

Source: Samuel Richardson Reid, Merger, Management and the Economy, New York: McGraw-Hill, Inc., 1968, p. 14.

International Telephone and Telegraph and Ling-Temco-Vought.⁶ The securities laws of the 1930's had dampened exuberant promoters to the extent that the mergers were effected without the allegation that watered stock or overstated asset values were used. The two methods used to effect a business combination during the period, purchase and pooling of interests, were far more conservative than those of prior periods.⁷

The end product of a business combination will be such that either a consolidated statement of separate corporate entities or a combined statement of several organizations forming the surviving corporate entities will be made. For purposes of illustrating the differences between the purchase and pooling method, only two corporations will be used, although several could be involved.⁸ It must be emphasized that generally accepted accounting principles dictate that a given combination must be accounted for either as a purchase or as a pooling of interests, depending on the criteria in the given situations. Assume Company A and Company B decide to combine.

⁶Ibid., pp. 75, 86.

⁷Wyatt, Op. Cit., pp. 5-6.

⁸Example used was taken from S. R. Sapienza, "Pooling Theory and Practice in Business Combinations," Accounting Review XXXII (April, 1962), 265-268.

The statements of financial position of the two firms are presented below:

A COMPANY

Statement of Financial Position

December 31, 19--

Assets	\$1,000,000	Liabilities	\$ 300,000
		Capital Stock	200,000
		Retained Earnings ..	500,000
	<u>\$1,000,000</u>		<u>\$1,000,000</u>

B COMPANY

Statement of Financial Position

December 31, 19--

Assets	\$500,000	Liabilities	\$150,000
		Capital Stock	100,000
		Retained Earnings	250,000
	<u>\$500,000</u>		<u>\$500,000</u>

To effect the purchase transaction which is assumed to have been duly negotiated, 100,000 shares of A's authorized stock, par value \$10, are to be issued to B's stockholders in return for all of B's stock. The present market price of A, \$40, will be the basis for recording the issuance of A's stock. After the two companies were effectively combined, a consolidated statement of financial position will show:

"A"

Consolidated Statement of
Financial Position

December 31, 19--

Assets	\$1,500,000	Liabilities	\$ 450,000
Excess Cost		Capital Stock	300,000
over Book		Paid-in Capital	300,000
Value	50,000	Retained Earnings ..	500,000
	<hr/>		<hr/>
	<u>\$1,550,000</u>		<u>\$1,550,000</u>

The excess on the asset side of the financial position is due to the cross-addition of the net assets of Company B with those of Company A, and the elimination of A's investment account in B, leaving this amount as an asset in A's consolidated statement of financial position. This can be proven as follows:

Price A paid B (10,000 shares of A stock at \$40)	\$400,000
Net asset of B at the time of purchase of A	<u>350,000</u>
Excess of cost over book value	<u><u>\$ 50,000</u></u>

The excess of cost over book value, if it cannot be assigned to specific intangible or other assets, is often called goodwill. This excess may also be allocated between goodwill, intangibles, and other assets that appropriately reflect their cost.

Assume now, under nearly the same circumstances, that the transaction is to be considered a pooling of interests. The exception to the circumstance will be that

the shares of A's authorized stock are to be recorded at par instead of present market value. The two corporations were effectively pooled and a combined statement of financial position follows:

"A"

Consolidated Statement of
Financial Position
December 31, 19--

Assets	\$1,500,000	Liabilities	\$ 450,000
		Capital Stock	300,000
		Retained Earnings ..	750,000
	<u>\$1,500,000</u>		<u>\$1,500,000</u>

In this illustration, all accounts are cross-added including retained earnings to effect a pooling. A comparison of the two statements of financial position, one of purchase and one for pooling will reveal these important differences. Under purchasing treatment, the assets are \$50,000 greater, paid-in capital is \$300,000, and retained earnings consist of only the parent's \$500,000. The pooling of interests treatment results in assets that are \$50,000 less than under a purchase, no paid-in capital appears, and the retained earnings is the sum of the two companies. How did it occur that two accounting treatments could result in such significant differences? The answer lies in the development of the two methods of combining merging firms.

The purchase method of accounting is based upon the cost principle, which states that cost is the appropriate basis for recording the assets. The purchase method has been used as an acceptable method for a long time; whereas, its counterpart, pooling, is a relatively new accounting development.

Pooling of interests emerged in practice in the 1920's, and was well established by 1932. As first used, the term pooling of interests applied only to a combination between a parent and its subsidiary, where no real change in substance for the corporate entity occurred. The major problem at this time was that prior to pooling it had been generally unacceptable to add together the retained earnings of the combining companies.⁹

The Institute gave no official recognition to the pooling of interests treatment until issuance of Accounting Research Bulletin No. 40 (ARB No. 40) in 1950. This bulletin described those combinations which resulted in a continuance of the former ownership interests as poolings of interests and those resulting in new ownership as purchases. The accounting procedure for each situation was indicated, and the criteria to determine the classification was given.¹⁰

⁹Wyatt, Op. Cit., pp. 19-22.

¹⁰Ibid., p. 25.

When ARB No. 40 was first issued, the accounting practitioner adhered to the procedure stated therein rather closely. As the merger movement gained momentum, adherence began to deteriorate. To realign the practitioner with its official pronouncement, the Committee on Accounting Procedures issued Accounting Research Bulletin No. 48 (ARB No. 48) in 1957. Some said this was a liberalization of ARB No. 40; however, the practitioner had exceeded the criteria required for a pooling at the time of issuance.

The attendant circumstances that identify a business combination as a pooling of interests may be designated as a primary criterion of ownership continuity, and three secondary criteria, that of business continuity, management continuity, and relative size.¹¹

The salient features of Bulletin 48 have been condensed in Table 1 as a frame of reference for the reader.

Most of the theoretical justification for pooling has come from the recognition given to the method by the Accounting Research Bulletins. This was not a substantial problem until pooling became widely used and then the profession began to question the theoretical soundness of the concept.

¹¹Jack H. Fisch and Martin Mellman, "Pooling of Interests: The Status of the Criteria," Journal of Accountancy, CXVI (August, 1968), 43.

TABLE 1

**COMPARISON OF CRITERIA FOR PURCHASING AND
POOLING TYPES OF BUSINESS COMBINATIONS**

<i>Factor</i>	<i>Criteria</i>	
	<i>Purchasing</i>	<i>Pooling</i>
Consideration Exchanged	Stock or cash for all or part of the stock of the acquired company. Stock or cash for all or part of the net assets.	Stock, impliedly common, for all or virtually all the stock of the pooled company. Stock, impliedly common, for all or virtually all of the net assets of the pooled company.
Assets Contributed by the Constituent Companies	Possible abandonment or sale of a large part of the assets of the acquired corporation.	Substantially all the assets of the joined company are brought forward to the joining company.
Size of Constituent Companies Net Assets	Not determinative, although if one company is minor, relatively, a purchase may be indicated.	Not determinative, in itself, although the larger the companies, relatively, the stronger the case for a pooling.
Stock Ownership	Possible elimination of an important part of the stock ownership of the acquired corporation.	Continuance of substantially all of the ownership interest of the pooled company in the stock of the pooling company. Bulletin 48 sets a limit of at least five to ten per cent of the voting interest in the combined enterprise to be given to the pooled company.
Management of the Combined Enterprise	No requisite to bring forward any of the management of the acquired company, although this may be done.	Continuance of management, and maintenance of desired personnel.
Post-combination Corporate Form	Any corporate structure dictated by the circumstances.	Any corporate form dictated by the circumstances.

Source: S. R. Sapienza, "Pooling Theory and Practice in Business Combinations," Accounting Review, XXXVII (April, 1962), 264.

CHAPTER II

CONCEPTUAL ARGUMENTS FOR PURCHASE
AND POOLING OF INTERESTS

The conceptual merits of the purchase method exceed those of the pooling method. The title of this chapter implies that it will relate the arguments for both methods. The most relevant conceptual argument will be presented. However, there is more justification for the purchase method, as favored by the AICPA in its official pronouncements. The Institute's position is supported as deviation from official pronouncements is shown.

The purchase method of accounting for a business combination is unchallenged as an acceptable method for the accounting of a business combination; however, over the years a substantive controversy has developed over the use of the pooling of interests method. Accounting Research Study No. 5 appears to get at the crux of the major conceptual problem: Has an exchange transaction of substance taken place when common stock is used in a business combination?¹² Members of the accounting profession have argued that such a business combination: (1) is an exchange,

¹²Wyatt, Op. Cit., p. 68.

(2) is not an exchange, (3) that relative economic interests of the constituents have been altered, or, (4) that they have not been altered.¹³

Those who favor purchase accounting are convinced that a stock exchange results in an exchange transaction no different from any other exchange. The assets acquired by the new entity should be given a new basis of accountability. This exchange of stock is the same as cash and it should be treated as an ordinary purchase, assigning value for the consideration based on the fair market value of the stock or the assets exchanged, whichever is more clearly identifiable.¹⁴

Those who favor pooling contend that the exchange of stock in a business combination results in no exchange transaction in the normal sense of the word. They point out that the assets are not changed and that the ownership interests of the firms involved continue in the surviving entity; thus, the assets should retain their former basis of accountability. The proponents of pooling of interests say that the exchange of stock should not be accounted for as a purchase because no exchange of substance has occurred.¹⁵

¹³Ibid., p. 69.

¹⁴George R. Catlett and Norman O. Olson, Accounting Research Study No. 10: Accounting for Goodwill, New York: AICPA, 1969, p. 169.

¹⁵Ibid.

Accounting Research Study No. 5 stated that a business combination is an economic event of importance, which is basically an exchange transaction bargained between two economic interests for assets or equities. It was concluded, therefore, that no basis exists for the continuation of what is presently known as pooling of interests if the business combination involves an exchange of assets or equities between independent parties.¹⁶

In agreement, Accounting Research Study No. 10 concluded that there was no theoretical justification for pooling, and it should be eliminated except in rare cases. Opinion 16 will curtail wide use of pooling of interests. It seems quite conclusive that pooling is not a sound method and should be eliminated or highly restricted in usage.

In the past, generally accepted accounting practices have developed through pragmatic application. It is questionable how far the profession has moved from this procedure when one examines what has happened to the criteria required for pooling in ARB No. 48. However, there does appear to be evidence that the pronouncement of the Institute did not clarify sufficiently the difference between a purchase and a pooling.¹⁷ Nonetheless, this

¹⁶Wyatt, Op. Cit., p. 60.

¹⁷Ibid., pp. 41-42.

confusion led to an apparent widening of the differences between official pronouncements of the American Institute of Certified Public Accountants and the practicing CPAs. Whatever the causes, many of the practices prior to Opinion 16 were abuses of the treatment prescribed by the Institute.

Ownership Continuity

ARB No. 48 required ownership continuity whereby substantially all of the equity interest should be continued in a pooling of interests; and if the relative voting rights between the constituents are materially altered by the issuance of senior equity or debt securities having limited or no voting rights, a purchase may be indicated. The interpretation of ownership continuity requirements of ARB No. 48 had become so liberal that the practices followed were abusive.

Cash

It is impractical to argue that large cash payments do not destroy continuity of ownership.¹⁸ Some practitioners have accepted the use of large amounts of cash by corporate parties when consummating a pooling of interests.

¹⁸Some cash will be necessary in the exchange to pay fractional and dissenting shareholders. Dissident stockholders have the right of appraisal in certain states and can secure payment in line with state corporate law.

This could only be interpreted as a breach of the requirements of ARB No. 48.

Possibly the pooling of interests involving the greatest use of cash was the merger of U. S. Business Forms, a partnership, into Comptometer Corporation, in which half of the consideration was paid in cash and half in shares of Comptometer's common stock. The cash portion was treated as a purchase and the stock portion as a pooling. Of the three partners of Business Forms, one was to receive all cash, one all stock, and the third to get half cash and half stock. This treatment was accepted by the auditor, the Securities and Exchange Commission, and the New York Stock Exchange.¹⁹

Current practice shows relatively few instances where the amount of cash was greater than 25 per cent when a complete (that is, 100 per cent) pooling of interests was effected. These cases were rare and were exceptions to what was ordinarily practiced.²⁰ It requires some stretching of the imagination to argue that the use of up to 25 per cent cash would preserve ownership continuity in a pooling, as called for by ARB No. 48. Other abuses related to ownership

¹⁹Henry R. Jaenicke, "Ownership Continuity and ARB No. 48," Journal of Accountancy, CXIV (December, 1962), 58.

²⁰Fisch and Mellman, Op. Cit., 44.

continuity have also occurred; one was the use of treasury stock as the medium of exchange to effect a pooling.

Treasury Stock

In recent years, an increasing number of poolings were consummated when the sole or partial consideration was treasury stock acquired specifically for the purpose of acquiring another corporation. The effect was the same as paying cash in the exchange. The consideration given to acquire the treasury stock results in changing the form of the asset held by the firm. When this treasury stock was given to the pooled firm, the pooling firm's net assets were reduced, affecting the combined financial statement in the same manner as the payment of cash in the exchange. The acquisition of treasury stock for this purpose has proven almost impossible to verify as the answer hinges upon the motivation and intent of the parties involved.²¹ Disregard for the criterion of ownership continuity of ARB No. 48 has occurred when it has been more obvious and verifiable.

Preferred Stock

A conclusion has been reached that "neither the issuance of preferred stock in whole or in part, nor any feature of the preferred issue, will prevent a pooling..."²²

²¹Robert C. Holsen, "Another Look at Business Combination," cited by Wyatt, Op. Cit., p. 113.

²²Jaenicke, Op. Cit., 59.

Even when preferred stock has characteristics that are similar to common stock, such as voting rights and convertibility, it approaches common stock in ownership continuity but is not quite equal to it. When these characteristics are absent and others are incorporated, such as sinking fund and redeemability, the preferred stock departs from the ownership continuity of common stock, as required by ARB No. 48. To some extent, ownership continuity is precluded by the issuance of preferred stock in a business combination. The extent depends upon the characteristics of the issue. Yet, this has not prevented the accounting practitioner from using preferred stock in whole or in part to effect a pooling of interests.²³

Changes in Ownership

Under ownership continuity, ARB No. 48 stated there should be no substantial changes in ownership either shortly before or after a pooling. Accounting Research Study No. 5 stated that there is a strong assumption that this criterion is virtually impossible to evaluate. It imposed on old stockholders the new requirement that they not terminate ownership when they agree to a pooling of interests. The measurement of this criterion depended upon the intent of the stockholders and the

²³Ibid.

negotiability of shares of stock, which hindered determination of whether the intent did in fact occur.²⁴

Others have developed a more concrete measurement of termination of ownership. In the merger of Material Service Corporation into General Dynamics Corporation, 40 per cent of the total stockholders' equity of Material Service Corporation was redeemed for cash immediately prior to the transaction. In another case, Day-Brite Lighting, Inc. was pooled by Emerson Electric Manufacturing Company, and two officers and directors received 17 per cent of the shares issued to Day-Brite. When the listing application was filed, 63 per cent of the stock of officers and directors was registered for sale. The conclusion that can be apparently drawn from these instances is that they were abuses of the requirements of ARB No. 48 and it would have taken the disposition of a very sizeable block of shares for a pooling to be struck down on this basis.²⁵

Current usage gave little recognition to what was required by ARB No. 48. As a rule of thumb, if the planned sale did not exceed 25 per cent of the shares received by the stockholders of the merged corporation, the transaction was normally regarded as a pooling of interests.²⁶ The

²⁴Wyatt, Op. Cit., p. 36.

²⁵Jaenicke, Op. Cit., 60.

²⁶Fisch and Mellman, Op. Cit., 46.

criterion of ownership continuity was strengthened further by the requirement that the overall assets of the constituents should be combined.

Business Continuity

ARB No. 48 stated: "... abandonment or sale of a large part of the business of one or more of the constituents militates against considering the contribution as a pooling of interests." The idea of asset contribution was not one of amount but whether substantially all of the assets of the constituents were combined. A purchase was indicated, if, just prior to a combination, a sizeable portion of the assets were sold or discarded from the combining corporation. Once again, the pooling of Material Services Corporation and General Dynamics can be used to illustrate deviant accounting practice from those required by a pronouncement of the Institute. In the combination, 37 per cent of Material Service Corporation's assets were not transferred, but used to redeem 19,011 shares of Material Services' common stock owned by dissident stockholders. The significant proportion of the assets not transferred did not prevent this combination from being treated as a pooling of interests.²⁷

²⁷R. S. Sapienza, "Distinguishing Between Purchases and Pooling," Journal of Accountancy, CXI (June, 1951), 36.

Management Continuity

ARB No. 48 attributed one of the following characteristics to a pooling. There should be a continuity of management, or the power to control management should be transferred to the combined entity. This trait of a business was rather nebulous and carried with it an implication that the combination would be examined in the future to see if this requirement was met.

Abuse of the management continuity requirement was not as overtly perceivable as with other criteria of ARB No. 48. This criterion was defined in many ways. Did management mean directors only; directors and officers; directors, officers, and certain key personnel; or, a combination of these groups? Did this apply to one or both of the parties involved in the pooling? If a particular segment of management was chosen, how long must it be retained?²⁸

The abuse increased over time as the interpretation evolved and degenerated in importance. When ARB No. 48 was first issued, it was interpreted that continuity would require that management of the merged company be represented on the new board of directors.²⁹

²⁸Sapienza, "Pooling Theory and Practice in Business Combinations," Op. Cit., 274.

²⁹Fisch and Mellman, Op. Cit., 47.

The tendency to look for positions on the board of directors or top management positions declined, except where substantive components were involved. The rule was softened as small firms were included because it would be inappropriate or awkward for a smaller company to be represented directly in top management. The question was change to: Has the operating management been carried forward on a continuing basis?³⁰

Size Requirement

To qualify as a pooling of interests, ARB No. 48 required that one of the combining corporations should not be clearly dominant. An example was used where the stockholders of one of the constituent corporations received 5 to 10 per cent of the stock issued to effect the combination, indicating a purchase had occurred. This requirement of ARB No. 48 has been subjected to gross abuse. Accounting Research Study No. 5 reported that there were a large number of poolings involving constituents of relative disproportionate size in the 1958-60 period. Many poolings have occurred, even though the smaller firm was less than 5 per cent of the larger--ignoring the limitation suggested by ARB No. 48. The most disproportionate example reported

³⁰Ibid.

involved a ratio of 99.7 to .03.³¹ The standard of size has withered away to a point where, in fact, it could be said it was no more.

Part-Purchase Part-Pooling

The accounting procedure of part-purchase part-pooling (cash for the part purchased, stock for the part pooled) developed in practice, though nothing was mentioned of the procedure in ARB No. 48. This treatment resulted in the elimination on the combined balance sheet of that part of the retained earnings of the merged company attributable to the cash payment and the preservation of that segment of accumulated earnings considered pooled. Allocation was made to assets--tangible and intangible--to the extent cash exceeds the percentage of the net assets purchased.

When cash was used in a separate transaction taking place either before or after the exchange of shares (even though the cash portion was small), the transaction was generally treated as a part-purchase and a part-pooling. In one case, there was an interval of six months between the acquisition of a 5 per cent interest for cash and an exchange of common shares for the remaining 95 per cent. The combination was treated as a 5 per cent purchase and a 95 per cent pooling.³²

³¹Wyatt, Op. Cit., p. 28.

³²Fisch and Mellman, Op. Cit., 44.

It has been common, even when minor amounts of cash are used in a simultaneous transaction, to treat the transaction as a part-purchase part-pooling. This method has more recently been used when the purchased part is larger than the pooled. Current practice indicated that the pooled part may be as small as 30 per cent in a simultaneous cash-stock transaction.³³

Some have hailed this innovative ability of the profession to give meaning to a combination when both cash and stock were used, while others have been distressed by the fact that the profession would move so far from the procedure stated in ARB No. 48. Conceptually, this has been attacked most vigorously. An example is in Accounting for Goodwill: Accounting Research Study No. 10, by George R. Catlett and Norman O. Olson, which stated:

When some of the assets, such as a property, are partially revalued and a portion of the goodwill is recognized, the accounting leads to a hybrid result that can be characterized only as "ridiculous."³⁴

Accounting Research Study No. 5 took the position that a combining transaction should either be treated as a

³³Ibid.

³⁴George R. Catlett and Norman O. Olson, Accounting for Goodwill: Accounting Research Study No. 10, New York: AICPA, 1968, p. 56.

pooling or a purchase. It was felt that the division of the transaction into two parts could not be justified.³⁵

Contingent Pay-Outs

One type of business combination has been particularly popular--that of paying the selling shareholders the maximum price, which is in whole or in part contingent upon future earnings of the acquired firm. This type of arrangement was prevalent when the acquired company was closely held and may have inadequate accounting records, unaudited financial statements, or a short history of operations.³⁶

Such contingent pay-outs in stock or cash are not incompatible with pooling of interests as practiced before Opinion 16. Usually an additional pay-out would take the form of voting stock issued when the contingency was met, accounted for by debiting paid-in capital in excess of par and crediting par or stated value. If paid-in capital was exhausted by issuance of shares, retained earnings must be debited.

³⁵Wyatt, Op. Cit., p. 100.

³⁶Samuel P. Gunther, "Contingent Pay-Outs in Mergers and Acquisitions," Journal of Accountancy, CXV (June, 1968), 33.

The use of contingent shares adds immensely to complications of conceptualizing poolings (and also purchases). Contingent shares also have been used in conjunction with part-purchase part-pooling combinations and involved escrow arrangements,³⁷ which raises a complex set of questions that would appear almost too difficult to answer. After all, the accounting profession has been unable with any acceptability to answer satisfactorily the conceptual question arising about a simple pooling of interests. As has been illustrated, the accounting practitioner was pressured to move far from the procedures and tests expounded in ARB No. 48.

The pressure, the urge to merge, made the tests laid out for pooling of interests by the American Institute of Certified Public Accountants in ARB No. 48 basically inoperative, as indicated by Table 2 (page 27). It was the overall feeling by some in the profession that it was obvious that, in treatment and determination of a pooling, almost anything was allowed.

³⁷Ibid., 35-36.

TABLE 2

**COMPARISON OF POOLING CRITERIA WITH POOLING
PRACTICE IN BUSINESS COMBINATIONS**

<i>Factor</i>	<i>Pooling Criteria</i>	<i>Pooling Practice</i>
Consideration Exchanged	Stock, impliedly common, for all or virtually all the stock of the pooled company. Stock, impliedly common, for all virtually all of the net assets of the pooled company.	Poolings occur with practically any combination of different classes of stock, for stock or net assets.
Assets Contributed by the Constituent Companies	Substantially all the assets of the joined company are brought forward to the joining company.	Generally speaking, all of assets are contributed, although cases can be shown where disinvestment in the pooled company appeared significant.
Size of Constituent Companies Net Assets	Not determinative, in itself, although the larger the companies, relatively, the stronger the case for a pooling.	Illustrations have been offered where the company pooled is absolutely and relatively small. As a test, this is fading in importance.
Stock Ownership	Continuance of substantially all of the ownership interest of the pooled company in the stock of the pooling company. Bulletin 48 sets a limit of at least five to ten per cent of the voting interest in the combined enterprise to be given to the pooled company.	Continuity of ownership interest cannot be proved in fact, except for major stockholders who agree not to sell. The force of the tax law militates against transfer so as to undercut this as a test. The test of five to ten per cent of the stock, at a minimum, to go to the pooled company has been breached to the point that as a test it is unimportant.
Management of the Combined Enterprise	Continuance of management, and maintenance of desired personnel.	As defined in this paper, this test seems to have been adhered to, generally, and management continued in force.
Post-combination Corporate Form	Any corporate structure dictated by the circumstances.	The post-combination corporate form has varied from division to subsidiary.

Source: S. R. Sapienza, "Pooling Theory and Practice in Business Combinations," Accounting Review, XXVII (April, 1962), 278.

As the profession moved further from the pronouncements of ARB No. 48, the Accounting Principles Board followed, after the fact, by issuing Opinion 6 which stated that ARB No. 48:

... should be considered as an expression of the general philosophy for differentiating business combinations that are purchases that the criteria set forth... in ARB No. 48 are illustrative guides and not necessarily literal requirements.³⁸

This Opinion is considered by some as the professional acknowledgement that in actual practice the coup de grace had been rendered with respect to pooling standards.³⁹

During the most recent period of mergers, management had its choice whether to effect the transaction by a purchase or a pooling. Naturally, given this choice, they would take the most advantageous treatment to their position which was usually pooling of interests.

One important impetus during the period to encourage the use of pooling was goodwill. Although the accounting profession and the Securities Exchange Commission did not require amortization, most managers were reluctant to carry

³⁸American Institute of Certified Public Accountants, Opinions of the Accounting Principles Board: Status of Accounting Research Bulletins, New York: AICPA, October, 1965, par. 22, p. 44.

³⁹Robert Beyer, "Goodwill and Pooling of Interests: A Re-assessment," Managerial Accounting, L (February, 1969), 11.

forward large amounts of goodwill. The result was that the charge from amortization would reduce net income and earnings per share. Most purchases during this period would result in substantial goodwill, as the asset would be highly appreciated. The amortization would have a double impact of reducing net income but lacking deductibility for income tax purposes.⁴⁰

The criticism of the accounting practice increased as the standards of ARB No. 48 were weakened. Two essential combinations could end up with wholly, often dramatically different results in terms of earnings and earning per share simply because of accounting treatment. After all, there was no real difference in criteria between a pooling and a purchase, except that a pooling requires some stock be issued to effect the transaction.

⁴⁰Wyatt, Op. Cit., p. 60.

CHAPTER III

AMERICAN INSTITUTE OF CERTIFIED
PUBLIC ACCOUNTANTS AND
OPINION 16

Rather than being a time for the Accounting Principles Board to be apologetic about the status of accounting for business combinations, this is the time for the APB to act responsibly and to take direct action to alter the drift of accounting practice in this area. The accounting profession and the business community are not expecting either deeply profound or unusually imaginative pronouncements from the APB. What they are expecting are responsible statements which will move accounting practice away from financial misrepresentations in areas where practice today is weak and forward financial disclosures that are aimed at giving effect to the real substance of business transactions.⁴¹

This was written by Arthur R. Wyatt, author of A Critical Study of Accounting for Business Combinations: Accounting Research Study No. 5, in 1965. His message was especially timely because accounting practices had drifted far from the procedures prescribed by official AICPA pronouncements on business combinations and because there were a large number of business combinations being consummated during this period. If the allegation were true that

⁴¹Arthur R. Wyatt, "Accounting for Business Combinations: What Next?" Accounting Review, XL (July, 1965), 535.

combination reporting was not giving effect to the real substance of the business transaction and a large number of combined business entities were to fail, this would cause substantive damage to the accounting profession and the economy. The institutions that are most responsible for the formulation of accounting principles--American Institute of Certified Public Accountants, American Accounting Association, Securities and Exchange Commission, and security exchanges--were well aware of the problem and its implications. Why then has it taken the Institute of Certified Public Accountants so long to issue an opinion to clarify treatment of business combinations?

The long delay in issuing an opinion may have been caused by a judgment of the AICPA that their solution was impractical because it would not be acceptable to the business community. Originally, the Accounting Principles Board, rule-making body of the AICPA, wanted total elimination of the pooling of interests method. Later, the Accounting Principles Board (APB) was dominated by a consensus that pooling was not a sound method of accounting for a business combination, except in very limited circumstances. When pooling was a highly popular method, during the current merger movement period, such a ruling by the AICPA would have brought strong resistance from the business community. Acceptance by the business community is necessary for effective implementation of AICPA pronouncements.

A basic weakness of the AICPA is enforcement of its pronouncements. Probably most important is the support of the practicing CPA. The rule-making role of the Institute has been gradually and somewhat reluctantly accepted. However, there are still some CPAs who deny the Institute occupies or should occupy this rule-making role.⁴² To make and to enforce a pronouncement on pooling of interests in the business community, the Institute must have the required support of its professional ranks.

In October, 1964, the authority of the APB Opinions was greatly strengthened when the governing council of the AICPA adopted a resolution calling for disclosure of departures from Opinions of the APB, therefore assuring a pronouncement on pooling of interests greater acceptability.

The independent accountant relies upon the Securities and Exchange Commission and the stock exchanges' authority to support his opinions on clients' financial statements when shares of stock are traded publicly. A finely tuned balance must be achieved among government regulatory agencies, stock exchanges, and the independent accountant to enforce accounting principles.

⁴²Leonard M. Savoie, "Controversy Over Accounting Principles Board Opinions," Journal of Accountancy, (January, 1968), 37.

During the past few years, some AICPA pronouncements have not achieved the necessary acceptance from the business community. The criteria required for a pooling by ARB No. 48 was not followed. Two other instances have been the seven per cent investment tax credit and reporting of profits by banks.

Accounting for the "Investment Credit," Opinion No. 2, December, 1962, achieved limited acceptability in practice largely because of the lack of support from the Securities and Exchange Commission and certain large accounting firms.⁴³ The pronouncement was widely disregarded and the flow-through method so dominated practice that the APB recognized this situation in a March, 1964 Opinion. Thus, two alternative accounting methods could be used for the investment tax credit: deferred and flow-through.⁴⁴

Banks were reporting figures on bad debt expenses and on securities gains and losses, but not as part of a figure labeled net profit.⁴⁵ In 1966, the APB proposed that banks should be included under Opinion No. 9,

⁴³Ibid., 39.

⁴⁴Ibid.

⁴⁵David C. Cates, "Bank Financial Statements--A Management Perspective," Bankers Monthly, VXC (May 5, 1968), 20.

Reporting the Results of Operations, making the banks report net income in the same manner as required of other industries. The American Bankers Association went beyond criticizing such a ruling: "In effect, it dared the AICPA to try to make the ruling stick."⁴⁶ After extensive consultation between the banking industry and the AICPA that lasted for years, agreement was finally reached. In a March, 1969 amendment to Opinion 9, banks were required to report net income in the same manner as other industries. Having faced these past dilemmas, the APB proceeded very cautiously and slowly in its development of an opinion on pooling of interests.

It was generally assumed by the accounting profession that an opinion would follow a research study. An opinion was expected after publication of Arthur Wyatt's A Critical Study of Accounting for Business Combinations: Accounting Research Study No. 5, in 1965 but none was forthcoming. The reason that was eventually given was the APB would wait until George R. Catlett and Norman O. Olson finished Accounting for Goodwill: Accounting Research Study No. 10 so that its contents could be considered. It was completed in 1968, but the APB did not take any positive action.

⁴⁶Lee Berton, "Frustrated CPAs: Accounting Body Fails in Attempts to Change Some Firm's Reporting," Wall Street Journal, January 8, 1969, p. 1.

This problem had been given a high priority by the Accounting Principles Board, as evidenced by the two related research studies. By 1969, it was given top priority by the Board.

To insure that the Board would have an opportunity to hear all viewpoints as it developed its own, several invitational symposiums were held. Representatives of business and professional organizations were invited to submit their views on the problem of business combinations at these symposiums.⁴⁷

The Board started the difficult process of synthesizing all the information that had been collected. Two research studies with inclusive comments, information from the symposiums, and other literature on business combinations had been gathered for evaluation.

After much deliberation, the APB finally issued its view in an "EXPOSURE DRAFT, Proposed APB Opinion: Business Combinations and Intangible Assets" on February 23, 1970. (An exposure draft is a proposed opinion that is widely disseminated to interested parties to secure their view before the draft is made into an official pronouncement.)

⁴⁷Joe R. Fritzemeyer and Paul A. Pacter, eds., "Accounting and Auditing Problems, Accounting for Business Combinations: The Evolution of an APB Opinion," Journal of Accountancy, CXVIII (August, 1969), 64.

When the Exposure Draft was released, it sparked a bitter controversy among accountants and corporate financial officers. Arthur Andersen and Company, one of the major public accounting firms, in May of 1970 circulated a stinging denouncement of the February Exposure Draft, charging it would cause great injury and damage to public investors, leading to chaos in the preparation of financial statements.⁴⁸

The Financial Executive Institute charged that the APB contradicted itself by endorsing the popular form of pooling of interests and then attaching restrictions that would eliminate more than 95 per cent of all pooling.⁴⁹

Originally, the Accounting Principles Board considered the total elimination of the pooling of interests method. Later, in the 1970 Exposure Draft, the APB proposed that pooling be limited to mergers in which one company was no more than three times the size of its merger partner. When the Exposure Draft was evaluated in June, 1970, the Board relaxed the "size test" to a nine-to-one ratio.⁵⁰

⁴⁸"Financial Officers Group Fires New Salvo at Proposed Shift in Merger Accounting," Wall Street Journal, June 15, 1970, p. 12.

⁴⁹Ibid.

⁵⁰"Accountants' Top Rule-Making Body Drops Plan to Limit Pooling-of-Interest Mergers," Wall Street Journal, August 3, 1970, p. 1.

During the last week of July, a further concession to opponents of the new rule governing poolings was necessary. The APB rejected the size test completely in order to secure a two-thirds majority vote by the Board for acceptance of an opinion. As a result, in place of one opinion as originally proposed by the Exposure Draft, the APB on July 13, 1970 adopted two new opinions: Business Combinations, Opinion 16 and Intangible Assets, Opinion 17.⁵¹

Opinion No. 16 will be effective in establishing the requirements before a business combination can be treated as a pooling of interests. It will succeed because of the 1964 resolution calling for disclosure of departures from Opinions of the APB. The American and New York Stock Exchanges have required strict compliance with the Opinion when processing listing applications involving poolings.⁵² The position adopted by the APB was a compromise, making the new Opinion more palatable to the business community. Acceptance of the Opinion by the business community will certainly assure compliance with its requirements, as it has incorporated provisions to prevent the past abuses that occurred under ARB No. 48.

⁵¹Ibid.

⁵²"Two Major Exchanges Demand Assurance Firms Use New Merger-Accounting Rules," Wall Street Journal, October 23, 1970, p. 11.

APB Opinion 16

Business Combinations, Opinions of the Accounting Principles Board, 16, states that some business combinations should be accounted for by the purchase method, and others should be accounted for by the pooling of interests method. It stresses the fact that these two accounting methods are no longer alternatives for the same combination. In other words, if a combination qualifies as a pooling of interests, it must be treated as such. The same is applicable to a purchase.⁵³

A business combination which meets all of the conditions specified should be accounted for by the pooling of interests method. The conditions are classified as: (1) manner of combining interests, (2) absence of planned transactions, and, (3) attributes of the combining companies.

Manner of Combining Interests

Opinion 16, Business Combinations lists seven conditions that must be complied with under the classification of combining interests:

⁵³American Institute of Certified Public Accountants, Opinion of the Accounting Principles Board, 16: Business Combinations, Op. Cit., par. 42.

- a. The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.
- b. A corporation offers and issues only common stock with rights identical to those of the majority of its outstanding voting common stock in exchange for substantially all of the voting common stock interest of another company at the date the plan of combination is consummated.
- c. None of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuances, exchanges, and retirements of securities.
- d. Each of the combining companies reacquires shares of voting common stock only for purposes other than business combinations, and no company reacquires more than a normal number of shares between the date the plan of combination is initiated and consummated.
- e. The ratio of the interest of an individual common stockholder to those of other common stockholders remains the same as a result of the exchange of stock to effect the combination.
- f. The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither deprived of nor restricted in exercising those rights for a period.
- g. The combination is resolved at the date the plan is consummated and no provisions of the plan relating to the

issue of securities or other consideration are pending.⁵⁴

These can be compared to the key tests of ownership continuity as set forth in ARB No. 48. Part "b" of Opinion 16 requires the use of voting common stock to be exchanged for substantially all of the other constituent stock. This is not very different than the requirement of ARB No. 48, but this time it is backed up with details of what is required for a pooling.

Substantially all of the voting stock means that 90 per cent or more of the outstanding stock of a combining company is exchanged. The 90 per cent or more of the outstanding common stock of the combining companies is calculated by a somewhat elaborate set of rules. The number of combining company's shares exchanged is reduced by common stock:

(1) Acquired before and held by the issuing corporation and its subsidiaries at the date the plan of combination is initiated, regardless of the form of consideration,

(2) acquired by the issuing corporation and its subsidiaries after the date the plan of combination is initiated other than by issuing its own voting common stock, and

(3) outstanding after the date the combination is consummated.⁵⁵

⁵⁴Ibid., par. 47.

⁵⁵Ibid.

The number of shares of stock of the combining company in the three categories is restated as the equivalent number of shares of the issuing company determined by the ratio of exchange of stock, and the total is deducted from the number of shares of stock of the combining company which is exchanged. Condition "b" of Opinion 16 (quoted on page 39) is not met unless the number of shares of stock exchanged is greater than 90 per cent of the outstanding common stock interest of the combining company.

Further, detailed instructions are given on how an investment in stock of the issuing corporation, a combination of more than two companies, a new corporation formed to issue its stock, etc. satisfies the requirements of "b." Most important is that these requirements do exist in sufficient detail to render abuses of this Opinion unlikely. Less specific requirements, without arbitrary tests, in ARB No. 48 proved to be ineffective in shaping accounting practice.

Cash and other considerations such as preferred stock can no longer be used in large quantities on a pro rata basis to effect a pooling of interests. Thus, a past abuse of practice has been eliminated.

Part "d" of Opinion 16 (quoted on page 39) will also terminate another past abuse. Treasury stock cannot be acquired for the specific purpose of effecting a pooling.

Opinion 16 states specifically in "d" that the combining corporation shall not agree to receive contingently any further consideration, other than that of the initial transaction. Additional consideration may not be issued to an escrow agent for a later transfer to the stockholders or returned to the corporation at the time a contingency is resolved.

This one classification of manner of effecting the transaction would eliminate the following practices which were not intended to develop from ARB No. 48: Use of substantial amount of cash, use of preferred stock, use of treasury stock, and use of contingent shares to effect a pooling of interests.

Absence of a Planned Transaction

Under the classification of absence of a planned transaction, two conditions appear specifically to eradicate failure of past pronouncements:

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

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c. The combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate

companies and to eliminate duplicate facilities or excess capacity.⁵⁶

The first paragraph would once again tend to guaranty ownership continuity. The second would insure business continuity in that large portions should not be sold or separated from the combining companies within two years after the combination. Elsewhere in the Opinion it is provided that all net assets be transferred to the combining entity at the date the plan is consummated.

To insure compliance with paragraph "c" the proposal requires special disclosure of profit and loss resulting from disposal of a significant part of the assets if it occurs within two years after the combination. In practice, large segments of the combining companies have been sold shortly before or after a combination was consummated. Thus, variation in practice from that prescribed by ARB No. 48 has been eliminated.

The procedure of part-pooling part-purchase is abolished. Only the two distinct methods, purchase or pooling, may be used to effect a business combination.

In the new Opinion, the requirement of ARB No. 48 for the management continuity and size test is not included. The reason for the absence of the size test was explained in Chapter II of this paper. Wyatt's research study

⁵⁶Ibid.

determined that the management continuity requirement eluded evaluation. Perhaps this is the reason why it is not included in the Opinion as a condition for pooling.

Attributes of the Combining Companies

The classification of attributes of the combining companies requires that the companies must have been independent for at least two years. This is an especially interesting requirement because it shows how far pooling of interests has evolved since its conception in about 1929. As first used, pooling of interests required a dependence between the firms--in other words, a parent--subsidiary relationship. Now, however, forty years later, the exact opposite circumstances must be present for qualification of pooling under the new Opinion.

CHAPTER IV

CONCLUDING NOTES

Two distinct methods of accounting for a business combination have developed. One, the purchase method, unchallenged as an acceptable method, is based upon the traditional cost concept, where the acquired assets are given a new basis of accountability. The other, a relative newcomer in accounting, pooling of interests, developed in the late 1920's. This method gives no recognition to appreciation of assets or goodwill. Book values of the assets are carried forward to the combined financial statement of the pooled companies. It developed in practice, receiving its first official recognition from the AICPA in ARB No. 48. This bulletin intended to restrict the use of pooling to a few mergers where specific conditions were present.

As the current merger movement gained momentum, the pooling method gained in popularity because it had some advantages for management over the purchase method. Pooling did not recognize appreciation on assets and goodwill; therefore, there were no increased depreciation or amortization charges to reduce earnings per share. When ARB No. 48 was first issued, it was given a relatively strict

interpretation; later the interpretation was weakened and the requirements for pooling became less stringent. In fact, they can be described as abusive.

The criteria of ownership continuity by the bulletin was not followed. Cash, treasury stock, and preferred stock were used in substantial quantities when effecting a pooling. Other criteria such as business and management continuity were weakened. The size criterion deteriorated to a point where it could be said that it did not exist any more. To the chagrin of the Institute, management had its choice of whether to pool or purchase when common stock was exchanged in a business combination.

Originally, the APB considered totally eliminating or highly restricting the use of the pooling of interests method. The two accounting research studies reinforced such a viewpoint as they stated that pooling was not sound conceptually for accounting of business combinations. Indeed, the purchase method is superior conceptually to the pooling method. An Opinion to clarify the use of pooling was needed during this early part of the current merger period. However, the APB did not make a ruling because it would not have been acceptable to the ranks of the profession and the rest of the business community. Acceptance is required by the business community as the APB depends upon the practicing CPA, the stock exchanges, and the Securities and Exchange Commission for the support of its pronouncements.

Previously, the APB had experienced such lack of support in other instances--the seven per cent investment tax credit and the reporting of net income by banks. In the investment tax credit, it was forced to change one of its Opinions to correspond with current practice. In the latter case, the APB retreated temporarily while negotiating with the banking industry. The APB finally did succeed and the industry agreed to conform but only after lengthy negotiations.

With this past experience of problems, the APB moved cautiously before creating a new Opinion for business combinations. It held several symposiums to give the business community a chance to voice their opinions. A compromise was finally reached when the size restriction was dropped.

Opinion 16, Business Combinations, was issued on July 31, 1970. This Opinion will eliminate the abuses that occurred under ARB No. 48. Cloaked in new terms, ownership continuity and business continuity are presented in the Opinion. This time there are certain precise specifications that must be met before a combination can be deemed a pooling of interests. The Institute has included requirements to prohibit practices that have developed in the past. The failings of past pronouncements were considered when making the new Opinion as use was made of specific formulas to test compliance with the conditions set forth.

Cash, treasury stock, and preferred stock could not be used in large quantities when consummating a pooling. The asset of the business must be transferred intact. The size requirement and management continuity were absent from the new Opinion.

Opinion 16 will realign the practitioner with the pronouncements of the AICPA because it will have the support of the business community. The practicing CPAs must adhere to the pronouncements because of the 1964 resolution requiring disclosure of departures from APB opinions. The two major stock exchanges have instructed the management of their listed companies to comply with the requirement of the Opinion. In the future, it is expected that the Securities and Exchange Commission will also endorse Opinion 16.

Why was it necessary for the APB to realign the practitioner with its pronouncements? The requirements of ARB No. 48 were general guides to what should be required before using pooling treatments. These general guides were effective until the pressure to pool mounted as the merger movement gained momentum. The forces were so great from within the profession and from management favoring the use of pooling that the requirements gradually crumbled. A general rule as in ARB No. 48 is preferable to stricter, inflexible specifications, but the general rule has not worked when economic and financial forces of the business

world are brought to bear upon the practitioner. The APB has been forced to abandon the general rule for pooling for more implicit specifications resulting in a pronouncement which is more procedural in nature.

The weakness of the APB was revealed when it compromised by eliminating the size criterion in Opinion 16. It is more conceptually sound that the size criterion be included in the new Opinion. If it had been included, most pooling would have been eliminated.

The Opinion is about twenty years too late. It comes at a time when it is virtually not needed, at least until the next merger movement. The current merger movement came to a close when the stock market declined to its low in the spring of 1970. If the pooling method does not give economic substance to business combinations, then it is too late to help the combined companies and conglomerates which are now in financial trouble. Researchers on this stock market decline may find that unrestricted use of pooling was a contributing factor to the market crash.

Opinion 16 will be effective during the next merger movement because it will be well established by that time. Its requirements are specific enough that interpretation cannot alter their effectiveness when the pressure to pool becomes great. It can be expected that the business community will endorse this Opinion. Opinion 16, Business

Combinations, will realign accounting practice with pronouncements of the Institute and will eliminate abuses and confusion on the pooling of interests concept.

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