University of Mississippi
eGrove

Haskins and Sells Publications | Deloitte Collection

1958

Some accounting problems in business combinatons

John S. Schumann

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Selected Papers, 1958, p. 192-197

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Some Accounting Problems In Business Combinations

By John S. Schumann
Partner, Los Angeles Office

Presented before the Los Angeles Chapter downtown group of The California Society of Certified Public Accountants—October 1958

There have been an unusually large number of mergers in the United States during the last ten years and an accompanying sharp interest has been taken by management in the related accounting problems. Certainly management of a surviving enterprise has an understandable interest in the method of recording this important transaction and in its effect on the reporting of future operations.

One accounting problem—in many cases the very basic problem—revolves around whether one of the combining corporations is looked upon as the very senior member of the constituent organizations, the others being, in effect, purchased by that dominant member, or whether all constituents are considered important to a joining of forces—a pooling of interests—in continuing businesses. The method of recording the combination will depend upon which of the two views—purchase or pooling—is adopted.

The conventional textbook approach to accounting for a combination of corporations has been to consider that the properties of each are received by the survivor in a transaction we speak of as a *purchase*. In that type of transaction—a purchase—the accounting is based upon the fair values of the properties, whether cash, surviving corporation's capital stock, or other property is exchanged. And, the transaction being a purchase, previously accumulated details of the source of net assets of the purchased companies become unimportant. Inventories, operating properties, and all other assets, including troublesome goodwill, are recorded at the amount computed as having been paid for them by the survivor—just as in any other purchase—and if issue of the survivor's capital stock is the consideration, net asset values at the computed *fair value* or *cost* figure are reflected entirely as paid-in capital.

However, if the merger transaction is made not as a purchase but as a pooling of interests the accounting is different. Here the carrying values of the properties of the old companies are carried forward in the accounts of the survivor, and the previously maintained distinction between paid-in capital and retained earnings is continued. True, it might be necessary to transfer amounts between

paid-in capital and earned surplus, but to no greater extent than would have been the case had the old corporation changed the aggregate par or stated value of its own stock without a merger's taking place.

In many situations—I would guess in most—the pooling-of-interests approach is the one management would favor. Earned surplus of the various companies is frozen as part of paid-in capital of the survivor under a purchase concept, but is carried forward to the greatest extent possible under the pooling concept. Then, too, operating properties are so often carried at amounts below current appraisal values, resulting in smaller charges to operations under a pooling concept than would be the case if the merger were handled as a purchase transaction. When there exists the possibility of combining all earned surplus accounts without increasing charges for depreciation of physical properties and amortization of goodwill, and when it is recognized that these factors have at least some influence on investors and credit grantors, management understandably can become intensely interested in the approach to be adopted.

In 1950 the Accounting Procedures Committee of the American Institute of Certified Public Accountants issued its Bulletin 40, which recognized the pooling concept in situations where the survivor issues its capital stock to the owners of the constituents and where the owners intend to maintain their interests. However, the application of pooling accounting was limited under the Bulletin by a few factors that seemed too restrictive.

For instance, pooling treatment under Bulletin 40 might be entirely appropriate in a situation except for the fact that one of the companies is to continue as a subsidiary of another. The properties and activities might be indirectly those of the parent and operations might continue in the same manner as though actually those of the parent, but Bulletin 40 ruled against pooling treatment just because more than one corporate entity survived. The obvious result was the presentation of consolidated statements in such cases prepared on bases differing from those that would have been employed had but one corporation survived—assuming, when we call this illogical, that all other factors of a pooling approach were present.

Again, Bulletin 40 took the position that, other things being equal, the presumption that a pooling of interests occurred would be strengthened if the activities of the various companies were similar or complementary. The general trend to diversification in industry probably made managements more vocal in objecting to this factor

than they otherwise would have been, but, in all fairness, it does not seem that the type of business should so drastically influence recorded results. After all, many types of businesses may be found in any corporate organization and the significance of *type of business* was hard to see.

Recognizing the merits of these complaints, the Committee in January of 1957 published its Bulletin 48, which completely eliminates the *similar or complementary business* factor and makes it unimportant whether the businesses are continued in one corporation or continued in more than one. In addition, Bulletin 48 attempts to be more specific than Bulletin 40 as to the *relative size* factor, indicated in both bulletins as a consideration in deciding between pooling and purchase.

The purchase concept, with its fair-values and frozen-earnings approach, is the familiar textbook approach. Today, let us give attention to the pooling approach.

POOLING-OF-INTERESTS APPROACH

Bulletin 48 describes a pooling of interests as *a business combination of two or more corporations in which the holders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors . . . are present.*

In accepting more than one surviving corporation, Bulletin 48 attempts the same practical result as in the case of a single survivor in calling for no significant minority interest in any one of the subsidiaries. In addition, true continuation of the individual ownership and business is expected, with no important disposition of either planned by the owners or the corporation shortly before or after the date of combination. Another consideration is whether management of each enterprise is continued in the new set-up. If some management is eliminated or its influence becomes very small, a pooling of interests is not indicated. Just as continued ownership of securities is expected for a pooling approach, so the management factor is expected to continue.

Another factor expected to influence any decision as to the type of combination for accounting purposes is the relative size of each of the corporations to be combined. As mentioned earlier, Bulletin 40 was thought to be not specific enough in this respect when stating: *A purchase may be indicated when one corporate party to a combination*

is quite minor in size in relation to the others. The new Bulletin attempts to be more specific in this, holding that—as an example—a purchase is presumed where 90 per cent to 95 per cent of the voting interest in the combined enterprise is obtained by stockholders of one of the constituent corporations.

It should be made clear at this point that no one of the several factors to be considered in deciding between purchase accounting and pooling accounting is determinative on its own. Instead, all factors are to be considered in the process of deciding whether, on a broad basis, the transaction represents a real joining of forces, with the survivor continuing with the resources and management direction of the predecessors. In the words of the Bulletin, a determination should be made *in the light of all such attendant circumstances.*

Bulletin 48 is not difficult reading and most of the factors to be considered seem to be logical requirements. But I suppose that most of us have pains in making the necessary decision between purchase and pooling in the individual transactions entered into by our clients.

EXAMPLE OF A PROBLEM

In 1956 one of our clients acquired 98 per cent of the outstanding capital stock of another corporation through an exchange of shares. While the relative voting ownership in the parent and relative management influences indicated a pooling, the combination was a purchase transaction by Bulletin 40 definition since one of the companies continued as a subsidiary.

In this case, millions of dollars of earned surplus of the subsidiary would have to be reflected as paid-in capital under usual consolidation accounting procedures, and I imagine that no one would be too happy with that type of accounting. Fortunately, Bulletin 48 was issued before the company's published reports were issued so most of these retained earnings could be treated as part of consolidated earned surplus under a pooling approach. I am not sure what the eventual accounting would have been in the 1957 report had Bulletin 48 been issued later in 1957. We did not have to decide that one.

The 2 per cent minority interest in this situation presented something under Bulletin 48 that could not exist under Bulletin 40, for under the latter there was no such thing as a *pooled* subsidiary. As of the date of the original exchange of shares, all earned surplus was carried forward as such in consolidation, except that allocable to the 2 per cent minority interest. The 2 per cent was treated in the same

manner that it would have been in a purchase transaction—shown separately as a so-called liability item and, in this case, just above the stockholders' equity section.

From time to time in 1957 and so far in 1958, some of the minority shares have been acquired by the parent, thus increasing the original 98 per cent ownership to around 99½ per cent as of today. Now as earned surplus applicable to the 98 per cent originally acquired was considered as part of consolidated earned surplus, the natural question arises as to whether that allocable to the additional 1½ per cent acquired should be similarly treated.

Considering the fact that all transfers of management had been accomplished in 1956 and viewing the 1½ per cent merely as an additional investment, it was felt that any pooling approach to the 1½ per cent would be inappropriate. At that point, there was no additional joining of forces—merely an acquisition which would bring a greater portion of future earnings of the subsidiary into consolidated net income. The bit-by-bit acquisitions were viewed as purchase transactions and were accounted for as such.

Recently management of the same parent company went to stockholders, and caused the subsidiary to go to the minority stockholders, with a proposal to merge the two companies, the parent to be the survivor, and to merge other companies as well.

With this merger of the parent and subsidiary, note that we now will have exactly the same result as though the companies had been merged in 1956. Yet, had the Bulletin 40 requirement of but one survivor not been eliminated in Bulletin 48, we still would have to consider the prior earnings as frozen, for the transaction first giving control would have been interpreted as a purchase transaction. And the fact that the later merger cures the defect in the 1956 transaction does not affect accounting in 1958. The Bulletin specifically provides for this by holding *if . . . prior to the . . . combination one party . . . acquired by another . . . as a subsidiary in circumstances which precluded . . . a pooling of interests, the parent's share of the earned surplus of the subsidiary prior to such acquisition should not be included in the earned surplus of the pooled corporations.* This seems to be a sound approach, for all factors determinative of purchase or pooling accounting were present at the time of the original acquisition in 1956. And nothing is about to change in 1958 except the legal form of parts of the combined enterprise.

In asking stockholders for approval of the merger, which included the subsidiary and other companies, it was necessary to comply with

the Proxy Rules of the Securities and Exchange Commission, calling for, among other things, the publication of pro-forma combined earnings statistics for the last five years. It might interest you to note that in preparing such statistics, as corroborated in recent discussions with the SEC, previously reported charges against income for the minority interest in earnings of those years are eliminated, for the minority is expected to disappear through exchanges of stock. But while the disappearing income charges increase pro-forma earnings for all prior years, there is no effect on earned surplus in 1958, since the minority interest acquisition is viewed—and consistently has been viewed—as a purchase transaction. The present liability for minority interest will merely be reclassified to become part of the parent's paid-in capital.

I have mentioned just a few accounting problems that occur to me related to mergers and other business combinations. Undoubtedly you have your own special problems in this area which you now might want to discuss.