Pooling or Purchase: A Merger Mystery

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On September 14, 1998, WorldCom merged with MCI to form MCI WorldCom, a global telecommunications giant. On September 30, NationsBank of Charlotte, North Carolina, and BankAmerica of San Francisco merged to form BankAmerica, one of the largest banks in the United States. While each case involved the combination of two firms, each used a different accounting method. MCI WorldCom's merger announcement noted that the combination would be accounted for as a "purchase"; on the other hand, BankAmerica's merger used a method called "pooling of interests" accounting.

In May 1991, American Telephone and Telegraph (AT&T) acquired computer manufacturer NCR Corporation (formerly National Cash Register) for $110 per share, in what was to that date the largest-ever computer industry merger. Press reports indicated that during negotiations AT&T upped its offer by $5 per share, an increase of about $325 million, to secure NCR's cooperation in accounting for the acquisition as a pooling of interests.[1]

Here is the mystery. AT&T paid the additional $325 million to use pooling accounting rather than the alternative—purchase accounting—a choice that affected accounting numbers but neither added assets, reduced liabilities, nor changed tax treatment. Why then was AT&T willing to expend an additional $325 million? Both anecdotal and empirical evidence indicate that AT&T's preference for pooling is not unusual. Corporate managers frequently go to some expense to employ pooling, though there are no obvious benefits.

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[1] For a detailed discussion of AT&T's acquisition of NCR, see Lys and Vincent (1995). For press reports, see Smith (1991) and Cowan (1991).

These cases raise questions for those not acquainted with the features of merger and acquisition procedure. What are the differences between purchase and pooling of interests accounting? Should the choice of accounting method be of concern to analysts, investors, or others interested in business activity? Why are two different forms of accounting—purchase and pooling—used for otherwise similar acquisitions? What drives the choice between the two methods, and why are acquirers willing to take expensive steps that have only cosmetic consequences? This article addresses these questions.

Despite firms' express preference for pooling, the body responsible for setting U.S. accounting standards, the Financial Accounting Standards Board (FASB), recently proposed eliminating pooling, even though the accounting treatment has been used for years. While the change would bring U.S. merger and acquisition accounting standards more in line with standards used in other countries, acquisitive corporations are likely to oppose it. The change might offer some benefits, but the benefits could be offset by efficiency losses.

1. POOLING AND PURCHASE: THE NUTS AND BOLTS

Accountants attempt to report in balance sheets an accurate valuation of a firm's assets, liabilities, and equity. But how should accountants value a firm arising from the combination of two separate businesses? One approach is to simply sum the dollar amounts of assets, liabilities, and equity of the two firms as they stood before the combination. This is pooling of interests accounting. Or, since business combinations are typically one firm's purchase of another firm, another valid method would value the purchased firm at its purchase price, and add the purchase price to the assets of the acquiring firm, as one would if the acquisition were of a piece of equipment. In broad terms, the latter approach is purchase accounting. The financial statements of a combined firm will vary with the choice between pooling or purchase accounting. While accounting methods for business combinations have changed over time, under today's accounting rules both pooling and purchase are acceptable means of valuing combinations in the United States.

The terms merger, acquisition, consolidation, reorganization, and combination are often used interchangeably (none is particularly associated with either pooling or purchase accounting). While no single term predominates, throughout this article the term *business combination* will be employed to indicate the uniting of two firms, regardless of the features of the unification.

Pooling of Interests Accounting

As already implied, pooling of interests accounting is conceptually quite simple. When a business combination is completed, the balance sheet of the combined firm reflects assets, liabilities, and owners' equity at the sum of these accounts as recorded by the separate companies immediately before the combination was completed. Income statements will show income and expenses for the statement period in which the combination occurs as if the companies had been combined from the beginning of the period (FASB 1992, pp. 213–14).

Purchase Accounting

Purchase accounting is somewhat more complicated. Under purchase accounting the acquiring and acquired firms are treated differently, so the first step is to identify which is which. FASB holds that in a typical combination the acquiring company pays out cash or other assets or issues the stock used in the acquisition and is the larger of the firms (FASB 1992, pp. 213–14).

Once acquirer and acquired are identified, accounting for the acquisition can proceed. The acquirer is to record on its books the acquisition at the price paid to the acquired firm's owners, using a two-step process. First, assets and liabilities from the acquired firm (target) are recorded on the acquirer's books at individual market values. Second, any positive difference between acquisition price and market value of net assets (assets minus liabilities) is recorded as an asset called goodwill. Once recorded, goodwill is depreciated by equal annual charges against the combined firm's earnings for a period of years over which, in the accountant's estimate, the combined firm benefits from the goodwill built by the acquired firm. The amortization period is limited to at most 40 years (FASB 1992, pp. 227–28). If the market values of the acquired assets and liabilities are accurately measured, goodwill is the value of the acquired firm as a going concern. Alternatively, goodwill can represent promising products developed by the target, or the price the acquirer is willing to pay for economic gains, such as economies of scale, expected from the merger (Brealey and Myers 1996, p. 930).

The following example may help illustrate purchase accounting. Assume Honest Auto Maintenance, Inc. (HAM), an auto repair shop management company, agrees to pay $100 million cash to acquire Wally's Import Repair, a regional chain. Following the acquisition, the assets and liabilities purchased in the acquisition are recorded on HAM's books at their current market values as determined by appraisers hired by HAM. The appraisers value the assets at $160 million and the liabilities at $90 million. So HAM has purchased net assets with a market value of $70 million ($160M–$90M). To record the difference between the market value of the net assets and the $100 million purchase price, $30 million of goodwill is recorded on HAM's balance sheet. For the next 40 years (the estimated life of the goodwill according to HAM's accountants) HAM will record on its income statement an after-tax expense of $750,000 ($30M/40 years), decreasing its reported net income each year by this amount.

The Logic Underlying Acquired Goodwill

The same example can be used to illustrate the logic of the purchase accounting treatment of goodwill. Assuming HAM viewed as accurate its appraisers' assessment of the market value of Wally's assets, $70 million of the $100 million it paid for Wally's company was for Wally's tangible assets. The remaining $30 million was to acquire Wally's good name in the community, an intangible asset, but an asset nonetheless. The asset will yield a future return. Following the acquisition, the value of Wally's good name must be recorded as an asset (called goodwill) on HAM's books; if it is not, HAM's worth is understated.

The $30 million expense borne to purchase the good name is *not* realized (charged against earnings) when the purchase is made but over time as the asset produces matching revenues. If the firm does not match expenses with the revenues these expenses produce, outsiders viewing HAM financial statements could be misled. For example, if instead all of the expense were recorded on the date the asset was purchased, profits would appear inappropriately low during the year of the purchase and too high in later years when the revenues generated by Wally's good name are received. So the annual $750,000 charges against earnings must be recorded on HAM's income statements throughout the estimated life of the asset.

The value of the asset must also be depreciated (lowered) over time. The logic here is that like most assets, Wally's good name has a limited life. Over time Wally's customers will move away or die off or, alternatively, learn that Wally is no longer running the operation and shift their business to competitors. Therefore the value of the good name declines over time, and goodwill is depreciated by $750,000 each year.[2]

When to Purchase and When to Pool

How do accountants determine whether to pool or purchase? A set of rules specifies the characteristics of combinations that can receive pooling or, alternatively, purchase treatment. The rules are intended to distinguish between two types of combinations: one represents firms joining forces, and the other represents one firm buying the assets and liabilities of another. Theoretically, in the first instance, the combined firm receives pooling treatment, and in the second, it receives purchase. Regardless of the intent of the rules, in reality firms can often choose their accounting treatment by structuring the combination carefully, though at possible extra cost.

[2] This example assumes straight-line depreciation whereby the asset is depreciated by equal yearly amounts. Other depreciation schedules are allowed under acquisition accounting rules.

The Rules

The rules are part of generally accepted accounting principles (GAAP). Combined firms' financial statements, like those of all firms, must adhere to GAAP, and therefore be in accord with the rules, to be deemed transparent, or not misleading, by the Securities and Exchange Commission (SEC) and for independent auditors to grant an unqualified audit report (Woelfel 1994, pp. 518, 1037).

Today GAAP is established by FASB, a private sector organization funded by contributions from professional accounting associations. The ultimate authority for determining GAAP rests with the SEC, however. The Securities Exchange Act of 1934 gave the SEC authority for establishing accounting and reporting standards for publicly held companies. The SEC delegates the setting of accounting standards to FASB, subject to SEC review.

The rules (called *conditions* by accountants), of which there are 12, were established in 1970 by the Accounting Principles Board (predecessor to FASB). If one or more of the conditions is violated, the combination must be accounted for as a purchase. If all conditions are met, pooling treatment is obligatory. (See the Box on page 44 for a list of the conditions.)

In general terms, the 12 pooling conditions prohibit certain financial transactions for specified periods before and after the acquisition and place restrictions on the terms of the acquisition. For example, one condition requires that the owners of the target be compensated predominantly with acquirer stock (specifically, 90 percent of consideration must be in stock—see condition 4 in the Box). Fundamentally, this condition and several others are intended to prohibit from pooling those combinations in which most target owners do not remain combined firm owners. This intention is based on the idea that to receive pooling treatment the combination must simply be the joining of two firms, with the former owners of the two firms continuing as owners of the combined firm. Other conditions prohibit acquirer and target repurchases of stock for a period before and after the acquisition. In a stock repurchase owners are bought out for cash and therefore relinquish their ownership interest in the combined firm.

Motivation for the Rules

By long-standing accounting convention, assets are recorded in financial statements at their original purchase price and liabilities at the amount of the original debt. The convention is known as historical cost accounting. But when does the original purchase of assets occur, and when are the liabilities assumed? Normally the answer is simple, but not necessarily when firms combine.

If the combination is simply the purchase of all of the assets and liabilities of the target firm, then historical cost accounting implies that the combined firm originally purchased the assets and originally assumed the liabilities on the date the combination occurred. Accordingly, purchase accounting offers the appropriate treatment for such combinations. Operating under the notion that acquirers pay market value for assets and liabilities of targets, purchase accounting demands that each individual acquired asset be recorded at its market value at the time of the combination. As previously noted, the difference between the purchase price and the market value of net assets is recorded in a new asset account, goodwill, to account for the going concern value of the target at the time of the combination.

If, instead, two firms have combined with neither of them buying the other, no assets or liabilities change hands at the time of the combination. In this case, historical cost accounting demands that assets and liabilities be valued at the prices the target firm paid for them when it originally purchased or assumed them, perhaps years before the date of the combination. In other words, here historical cost accounting demands pooling treatment, in which the values as reported on the target's financial statements are carried over to the combined firm's statements.

There is no economic content to the distinction between combinations characterized by a joining of forces and those characterized by one firm buying the assets and liabilities of another. The bottom line is that the assets and liabilities of the two firms are merged together; therefore, the resulting firm is equivalent in either case. Furthermore, in a dynamic stock market, ownership changes hands constantly anyway as shares of stock are traded, so it makes no difference whether the same set of owners remains immediately before and after the combination.

Even if Pooling Rules are Violated, Firms May Still Manage to Pool

A firm that has violated one of the 12 conditions may still be able to pursue remedial steps that would allow it to pool. For example, prior to AT&T's purchase of NCR in 1991, NCR had repurchased several million shares of its own stock, thus violating a condition that seemed to make pooling impossible. So that AT&T could continue to employ the pooling accounting method, NCR agreed to reverse the stock repurchase by placing an equivalent amount of Treasury stock before the acquisition was completed (Gilson and Black 1995, p. 537; Lys and Vincent 1995, p. 367). Afterwards, the private placement was deemed sufficient to mend the violation of the condition.

2. THE MYSTERY: WHY DO ACQUIRERS PREFER POOLING?

The financial press and specialists in mergers and acquisitions maintain that acquirers prefer pooling to purchase accounting. Empirical analysis supports this view as well. It provides evidence that acquirers are willing to pay higher bid prices in acquisitions that are pooled than in those that use purchase accounting. Likewise, even though there can be additional costs of qualifying for pooling, discussed below, the current significant use of pooling argues for the presence of a fairly strong preference. So what benefit underlies this strong preference?

At first blush one might imagine that pooling has some tax advantage. But, as shown later, advantageous tax treatment plays only a peripheral role, so taxes alone cannot explain the preference for pooling. Instead, both observers and acquirers themselves often argue that pooling is advantageous because reported earnings will generally be larger with pooling than with purchase.

For those who believe that markets are efficient whereby stocks are priced accurately based on all available information, the reported earnings explanation is puzzling, however. While accounting numbers are enhanced using the pooling method, firm performance is unaffected by the accounting choice. Moreover, information is available that allows investors to eliminate the effect on reported earnings. What follows will examine the puzzle but can offer no solution.

Acquirers Prefer Pooling

Attorneys and accountants specializing in mergers and acquisitions, as well as the financial press, report a strong preference among acquirers for pooling treatment.[3] To use pooling, all 12 conditions must be met (or violations must be mended). Some conditions severely restrict the structure of combinations and restrain the future actions of acquirers. Under the circumstances, the fact that pooling is chosen at all, much less that it predominates for large combinations, seems strong evidence that the reports are accurate.

AT&T's acquisition of NCR illustrates some of the costs of meeting pooling conditions. AT&T bore the expense of reversing NCR's earlier stock repurchases, an expense estimated to be $50 million (Lys and Vincent 1995, p. 367). Additionally, during negotiations with NCR, AT&T offered to increase its bid by $5 a share to $110 a share, or by $325 million, if NCR would make it possible to use pooling of interests accounting (Lys and Vincent 1995, p. 368). Similarly, acquisitive firms often give up or at least put off stock repurchases to avoid running afoul of pooling conditions.

As noted in a 1997 *Wall Street Journal* article, "[c]learly, companies prefer pooling over . . . purchase accounting. . . . Since 1992, there have been 357 poolings vs. 36 purchase acquisitions in deals valued at over $100 million. . . . So far this year, there have been 41 poolings vs. four purchase acquisitions" (MacDonald 1997).

[3] Attorney and accountant reports of a preference come from the author's interviews of merger and acquisition specialists.

Tax Avoidance Offers Only a Partial Explanation of the Pooling Preference

Does pooling offer a tax advantage not available under purchase accounting? The answer is that while no tax advantage results directly from pooling, one of the conditions that must be met to qualify a combination for certain tax advantages is also a key condition for pooling treatment. Consequently, the desire to attain tax advantages might account for some of the apparent preference for pooling treatment. Still, factors beyond taxes must explain most of the preference.

To What Extent Do Taxes Explain Pooling's Predominance?

In broad terms, under the Internal Revenue Code a combination is treated either as a *tax-free reorganization*, in which no taxes are assessed in response to the combination, or as *taxable,* in which case certain taxes are typically imposed. In a tax-free reorganization, the target's shareholders face no capital gains taxes on their stock as a result of the combination; instead, these taxes are deferred. While target shareholders receive the direct benefit, acquirers can expect to benefit as well, since target shareholders are likely to agree to a lower bid price if they are assured the acquisition will be deemed tax free. Alternatively, if a combination is deemed taxable, the target's shareholders must pay capital gains taxes on the exchange or sale of their stock.

One of the major conditions for a combination to be deemed tax free is that a majority of the consideration paid the target's shareholders be stock of the acquiring firm. In certain types of combinations, all consideration must be stock for the combination to be tax free. The upshot is that a firm wishing its combination to receive tax-free status automatically meets one of the fundamental conditions for pooling treatment—that the consideration be largely in stock. One might imagine, therefore, that the numerical predominance of firms choosing pooling treatment to some degree results from a preference for tax-free status.

The Pooling Preference Goes Beyond Taxes

If the conditions for tax-free treatment equaled those for pooling treatment, then the desire to avoid taxes might completely account for firms predominantly choosing pooling treatment. But the two sets of conditions are not equivalent. Instead, acquirers often choose to structure a combination to meet conditions for tax-free reorganization while stopping short of encumbering themselves with the conditions for pooling, some of which restrict valuable future actions.

A prominent example of a tax-free combination that used purchase rather than pooling accounting was when NationsBank Corporation, a large U.S. banking organization based in Charlotte, North Carolina, acquired Boatmen's

Bancshares of St. Louis in 1997. In this case the acquirer did not wish to pool because it intended to undertake stock repurchases in conjunction with the acquisition (NationsBank 1996, 1997).

Yet other firms are willing to take the extra step of meeting all of the pooling conditions, apparently for some benefit they perceive beyond tax-free status. For example, to qualify for pooling, acquisitive firms often willingly forgo planned stock repurchases, a step necessary for pooling treatment but not required for tax-free status.

Beyond the logical argument, there is empirical evidence that supports the theory that a pooling preference exists apart from any tax incentive. Robinson and Shane (1990) test for an association between accounting treatment and the premium paid for an acquisition, holding tax status constant. A premium is the difference between the bid price paid by the acquirer and the stock market value of a firm before its acquisition. Their hypothesis is that if acquirers prefer pooling to purchase accounting, one would expect acquirers to pay higher premia for such acquisitions. Using a sample of 95 tax-free acquisitions made between 1972 and 1982, including 59 accounted for by pooling of interests and 36 by purchase, Robinson and Shane find that, other things equal, acquirers pay more for pooling acquisitions than for purchase acquisitions. They provide estimates of the premia difference using various procedures. The average premia in pooled acquisitions exceeded the average in purchase acquisitions by between 29 and 66 percent. All the estimated differences were statistically significant. Consequently, the study suggests two conclusions, (1) that there is a measurable preference for pooling, borne out in the higher price paid for pooled acquisitions, and (2) since the study includes only tax-free acquisitions, acquirers prefer pooling for reasons beyond tax considerations.

Improved Reported Earnings as an Explanation for the Pooling Preference

If taxes cannot explain the pooling preference, what other motives remain? One frequently discussed explanation is that pooling allows acquirers to avoid purchase's negative effects on accounting earnings reported in financial statements in the years after the acquisition is completed. When purchase price exceeds book value of the target's equity, pooling accounting will produce higher reported earnings than purchase accounting for two reasons. First, goodwill depreciation lowers earnings but is not present in a pooled combination. Second, future reported earnings are reduced as higher depreciation expenses are recorded for the marked-up (to market value) assets in a purchase, but not pooled, combination. The view is that acquisitive firms are concerned that lower future reported earnings depress post-transaction stock prices.

The financial press often promotes this view (though articles typically focus only on the effect of negative earnings from goodwill depreciation and ignore higher depreciation from marked-up assets). For example, a March 1997 *Institutional Investor* article points to an instance in which a deal failed, in part, over the effect on reported earnings of purchase accounting's goodwill amortization. One reason for the failure of Paramount Communication's 1989 bid for Time, Inc. was the "staggering load [of goodwill amortization that] was expected to depress the earnings of the acquiring company—and its stock price—for years to come" (McGoldrick 1997, p. 145). Likewise, a 1998 *Wall Street Journal* article on SEC efforts to reduce the use of pooling notes that the "drawback to purchase accounting is that it [imposes] an earnings penalty" (MacDonald 1998b).

Concern for reported earnings was apparently a major factor underlying AT&T's willingness to go to considerable additional expense to pool. In their review of AT&T's acquisition of NCR, Lys and Vincent (1995) conclude that a concern for a negative effect of goodwill amortization on future AT&T stock price was responsible for AT&T's willingness to expend at least an additional $375 million (i.e., 5 percent of the total acquisition price) to pool. Specifically, Lys and Vincent report that when they interviewed AT&T spokesmen, the spokesmen indicated that AT&T management believed that "financial analysts would . . . penalize AT&T's stock price for lower earnings [resulting from purchase's goodwill amortization]" (Lys and Vincent 1995, p. 370).

Outside of these reports, a number of empirical studies have investigated earnings maximization as a possible motive in acquirers' accounting choices. The studies find that acquirers act predictably if accounting choice (i.e., the choice between pooling and purchase) was motivated to maximize reported earnings.

When purchase price is higher than the target's book value, acquired asset depreciation and goodwill amortization charges will result. If managers are interested in maximizing *reported* earnings, they will prefer pooling to purchase when purchase price is higher than book value. Moreover, the larger the amount by which purchase price exceeds target book value, the more likely the manager should choose pooling. In research reviewed in Robinson and Shane (1990), a number of analysts found statistical evidence that managers choose to pool when the purchase/book value differential is positive; furthermore, the more positive the differential, the more likely pooling is chosen.

By All Logic, Acquirers Should Not Prefer Pooling to Purchase

The choice between pooling and purchase has no apparent economic consequences. Goodwill amortization charges are not cash flows and only serve to lower reported earnings. These charges have no effect on the current or future income produced by the activities of the firm. As a result, one would expect investors to ignore such changes to reported income and instead focus on changes in financial reports that signal changes in future income or in the health of the firm. While there appears to be abundant evidence of managers' preference for pooling, as previous sections have described, acquisitive managers should be indifferent between pooling and purchase if investors look beyond reported earnings.

Nevertheless, the question arises: Do investors have sufficient information with which to remove the distortion produced by the pooling-purchase choice? The answer is yes. Such information is typically available in proxy statements associated with an acquisition so that interested investors should be able to remove the effects of goodwill on future earnings.

Empirical investigation supports the argument that the differences in reported earnings under pooling and purchase do not sway investors. Hong, Kaplan, and Mandelker (1978) examined empirically the stock price reaction to acquirers' pooling-purchase choice. They did so by using a statistical technique known as event study, which isolates the stock market's reaction to the event in question. In this case the event was business combinations accounted for either by pooling or by purchase methods.

Hong, et al. investigated acquisitions made in the period 1954 through 1964, when rules that limited the choice between the two accounting methods were more lax than those adopted in 1970. All acquisitions in the authors' sample were tax free.[4] They found no evidence that stock prices of acquirers using purchase accounting suffered relative to that of acquirers using pooling accounting. In fact, just the opposite was true—the stock price of acquirers using purchase accounting rose around the time of the acquisition while the stock price of poolers demonstrated no significant change.

Davis (1990) repeated the Hong, et al. study using a somewhat more advanced methodology and sampling business combinations that occurred after rules were tightened in 1970. Davis's sample covered the period between 1971 and 1982, and as with Hong, et al., it included only tax-free combinations. His results were equivalent to those in the earlier study. In other words, there was little evidence of a stock price reaction to pooled mergers but a significantly positive stock price reaction to mergers accounted for as purchases. Nonetheless, the positive reaction for purchases occurred largely in the six months prior to the mergers' announcements, presumably before the market knew the accounting method to be used. In the period after the merger announcements, the stock price reaction was positive for purchase and negative for pooling, but neither reaction was statistically significant. In sum, Davis's results show no stock price benefit from pooling. Therefore, Hong, et al.'s results seem to hold up well across time and across accounting rule regimes.

[4] Typically, combinations in which the acquired firm's shareholders sell their shares for cash are taxable to the acquired firm's shareholders, while those in which the acquired firm's shareholders are paid in stock are not taxable. Hong, et al. include in their sample only combinations in which the compensation was stock.

The Hong, et al. and Davis findings are in line with those of other event studies examining various types of firm choices that alter accounting numbers but have no economic effect (Brealey and Myers 1996, pp. 342–44; Copeland and Weston 1983, pp. 319–27). Such findings indicate that investors make use of information beyond reported earnings to make their stock investment decisions, ignoring accounting numbers that have no real economic significance.

3. FASB MAY ELIMINATE POOLING

Ever since pooling was first officially recognized almost 50 years ago, firms wishing to qualify have had to meet certain conditions. Yet over the years, businesses have attempted to test and expand the limits set on pooling treatment. Accounting rulemakers have consistently viewed this expansion as an abuse of the proper use of pooling and have responded by tightening the conditions. Nevertheless, inventive acquirers have successfully circumvented the stricter conditions. The opportunity for such expansion could end shortly, however. On April 21, 1999, FASB announced a proposal to eliminate pooling before 2001 (FASB 1999). FASB has noted several reasons, but two other factors discussed below seem worthy of consideration.

History of the Two Methods

While there were no official pronouncements before World War II, purchase accounting was apparently the more uniformly accepted method among accountants. For example, according to a 1943 version of the *Accountants' Handbook*, pooling treatment was "questionable," and purchase accounting was the "proper" means.[5] Pooling treatment began to gain favor among accountants in the late 1940s as more acquirers paid target firm owners with shares of stock in the combined company rather than with cash (Wyatt 1963, p. 24). As the means of payment shifted to stock, the outcome in these combinations was that owners from both the target and acquirer remained owners of the combined firm. As such, no sale of the assets had occurred, and there was no reason to revalue assets of the acquired firm.

The first authoritative pronouncement on accounting for business combinations embraced this interpretation. The Committee on Accounting Procedure, a predecessor of FASB and the body responsible for establishing GAAP at the time, issued *Accounting Research Bulletin No. 40* in September 1950, which stated that pooling treatment was allowed if several broadly specified conditions could be met; otherwise, purchase accounting was to be used. The first and pri-

[5] W. A. Paton, editor, *Accountants' Handbook,* third edition, 1943, as cited in Wyatt (1963), p. 21.

mary condition required that "substantially all" of the owners of predecessor corporations be paid with shares of the combined company rather than with cash or other assets. The other conditions were that neither of the combining firms be "minor" in size relative to the other, managers from both firms be retained in the combined firm ("management continuity"), and the activities of the combining firms be "either similar or complementary."[6] (Wyatt 1963, pp. 24–25, 123–26.)

Still, businesses had no strong preference for pooling at first because until 1953 purchase accounting did not necessarily result in charges against future reported earnings. Firms were allowed to charge the excess of purchase price over the acquired firm's book value to a capital account (called surplus). As a result, acquirers avoided the depreciation and amortization charges that lowered reported earnings. This capital account option was an alternative to establishing a goodwill account and recording future charges against earnings as under today's purchase accounting (Wyatt 1963, pp. 34, 38–39, 59). But in 1953, *Accounting Research Bulletin No. 43* eliminated the option of deducting the excess from surplus. With this change, a strong preference for pooling over purchase accounting began to surface apparently because of acquirers' aversion to charges against reported earnings (Wyatt 1963, pp. 38–39, 59–60).

By the late 1950s, accountants were expanding the vaguely specified pooling conditions to include more and more combinations (Wyatt 1963, pp. 61–62). For example, the condition requiring that the target's owners be compensated in stock was effectively relaxed as deals that involved substantial amounts of cash were soon treated as poolings. Likewise, the condition that neither combining firm be minor in size was continually tested so that by the 1960s, deals were handled as poolings even when the seller made up only 1 percent of the combined firm (Scharf, Shea, and Beck 1991, pp. 177–78). As a result, by the second half of the 1960s, pooling became predominant (Hong, Kaplan, and Mandelker 1978, p. 34). Clearly, businesses could and did choose pooling regardless of the features of the transaction.

In 1970 the Accounting Principles Board (APB; descendent of the Committee on Accounting Procedure and predecessor of FASB) issued new rules for business combinations intended to limit the use of pooling (FASB 1997, p. 2). Before the passage of these stricter rules, which are still in effect today, the SEC had itself threatened action to limit poolings. Initially the APB proposal completely prohibited pooling, but because the business community reacted

[6] The wording of *Accounting Research Bulletin No. 40* indicates a willingness to allow some violations of the size, management continuity, and activity similarity conditions without necessarily requiring purchase treatment. In reference to these three conditions, it says: "No one of these factors would necessarily be determinative, but their presence or absence would be cumulative in effect." The *Bulletin* offers no signs of flexibility in the requirement that payment to acquired firm shareholders be in the form of stock of the surviving firm. (*Bulletin No. 40* is reproduced in Wyatt [1963], pp. 123–26.)

negatively, it settled on new rules restricting pooling somewhat (Gilson and Black 1995, p. 517).

Today the tighter conditions make qualification more difficult. Nevertheless, as demonstrated by AT&T in 1991, combinations that might at first appear to be in violation *can* meet the pooling conditions if they follow some creative and at times costly procedures. The recent predominance of pooling for large combinations attests to the ability of firms to arrange their transactions to meet pooling conditions.

FASB's Proposed Change and Its Motivations

In August 1996 FASB once again began to consider changing the rules governing U.S. accounting treatment of business combinations. After reviewing a number of options, on April 21, 1999, FASB announced a proposal to eliminate pooling of interests accounting. FASB plans to release for comment its formal proposal early in the third quarter 1999 (FASB 1999). According to press reports, the international accounting community had encouraged FASB to adopt standards closer to international standards. The SEC likewise had urged FASB changes, and FASB itself had shown interest in aligning its standards more closely with international standards prior to the recent announcement (FASB 1997, p. 3; McGoldrick 1997, p. 147; MacDonald 1998a, pp. A2, A7; FASB 1999). FASB's proposed elimination of pooling would align the standards since most other nations allow pooling only infrequently or not at all.[7] However, U.S. companies are likely to oppose the proposed elimination.

FASB expressed several motives for eliminating pooling both prior to and as part of its April 21 announcement. Given that pooling is infrequently used in other countries, one reason FASB is planning to eliminate it is to simplify international accounting comparisons (FASB 1997, p. 21). FASB also wishes to prevent "abuses" of pooling; presumably, by "abuse" FASB means that firms are constantly stretching the definition of pooling to fit more and more combinations (FASB 1997, p. 2). Recently the SEC penalized just such stretching in some highly publicized cases. Several acquirers were required to revise financial statements to record as purchases combinations that had previously been shown as poolings (McCafferty 1998, p. 23; MacDonald 1998b, pp. C1, C2). Last, FASB wants to make comparison across U.S. firms simpler. Comparison is costly now, involving as it does two very different accounting treatments for business combinations (FASB 1999).

[7] See McGoldrick (1997) and FASB (1997) for a listing of business combination accounting standards in other major countries. For example, Australia allows no poolings at all, while Canada allows them only when an acquirer cannot be identified. In the case of Canada, the merger partner with more than 50 percent of the combined firm is assumed to be the acquirer.

An Additional Rationale for Eliminating Pooling

One can imagine an additional reason for preferring purchase to pooling. Purchase accounting requires acquiring firms to reveal more up-to-date information about the value of the target firm's assets and liabilities than that revealed by pooling, thereby potentially lowering information costs to investors. Specifically, target firm assets and liabilities must be recorded on the combined firm's books at their market values as of the time of the combination. Alternatively, under pooling treatment the target's assets and liabilities are recorded at historical cost, or value at the time they were originally obtained by the target, with no adjustment for price changes occurring since.

The current market values can be useful in the following manner. Imagine first Conceal, Incorporated, a firm arising out of a pooled combination of Conceal, Inc. (the surviving firm) and Target, Inc. An investor considering a purchase of stock in Conceal will wish to determine whether Conceal received a good price on its purchase of Target in order to judge the quality of Conceal's management. Because the Conceal-Target combination was pooled, Conceal's financial statements reveal only the historical asset and liability values (the prices originally paid for the assets and the debts originally contracted for) of Target. Yet the investor is concerned that the true market values may be quite different due to influences or disturbances (shocks) that may have affected prices of some of Target's assets.

The investor believes that analysts who have studied Target's stock make recommendations influencing its price that fail to account for the effect of the shocks on Target's asset values. So the investor is left to make his stock purchase decision based on historical asset values for Target and on his own admittedly rough estimate of how the shock might have affected Target's true asset values.

On the other hand, imagine Divulge, Inc., a new firm resulting from a combination of Divulge, Inc. (the surviving firm) and S. Target and Sons. Suppose this combination received purchase accounting treatment. Here the situation is exactly the same as the Conceal case except the investor has access, from Divulge's financial statements, to the current market values of S. Target's assets and liabilities. In this case, the investor need not estimate the effect of the shocks on various S. Target assets because the figures are provided on Divulge's financial statements.

Are the market values of S. Target's assets and liabilities, as reported on Divulge's financial statement, likely to be accurate, or will Divulge be able to manipulate their values to paint a more positive picture? For assets and liabilities with no secondary market, the estimates of market values will necessarily involve some subjective judgments. Still, there is a fairly well-established body of rules and procedures used to guide the pricing of such assets. These rules, developed by the appraisal industry, have been tested in court cases over the years. If the appraiser hired by Divulge to evaluate S. Target does not abide by the rules, he could be sued. Therefore, while manipulation is certainly possible, the threat of lawsuits brought by disgruntled stockholders tends to encourage reasonable valuations.

Consequently, purchase accounting may provide investors with superior information compared to pooling of interests accounting. At the very least, purchase provides all the information pooling does along with an appraiser's estimate of market values of the target's assets and liabilities.

A Move to Eliminate Pooling Should be Undertaken Cautiously

As shown previously, not only has FASB identified several reasons to eliminate pooling, but also this article has noted that purchase accounting may provide superior information as compared to pooling. Nevertheless, FASB might wish to consider one factor before proceeding with its proposal to eliminate pooling.

Pooling may produce some real cost savings that are not immediately evident, for managers prefer pooling in spite of no apparent stock price benefit and therefore no benefit to owners. Are managers simply acting foolishly? This seems unlikely, since one expects foolish behavior to be punished and eventually extinguished by a reasonably efficient stock market. Yet poolers are not penalized by the stock market, and the pooling preference has continued for years, perhaps because pooling allows some firms cost savings, offsetting the additional costs of meeting conditions to pool.

It is not difficult to imagine, at least in broad terms, how benefits from pooling might arise. For example, perhaps pooling may give the combined firm greater flexibility in its future accounting. Managers may use that flexibility to increase their salaries and bonuses. While such managerial actions may appear to enrich managers at stockholders' expense, they may be necessary to achieve a preferred compensation and incentive arrangement between management and ownership. The benefits of achieving the preferred arrangement might exceed the costs of achieving pooling.

However, if benefits exceed the costs of achieving pooling, would we not then expect empirical tests (e.g., Hong et al.) of stock price reactions to have shown pooling to be rewarded more highly than purchase? Not necessarily. Some firms may not need to allow managers the added flexibility to extract higher compensation. Since these firms may prefer other management compensation arrangements, they are free to use purchase accounting, thereby avoiding the additional costs of meeting the conditions to pool. Any firm, whether it is one that chooses pooling or one that chooses purchase, will be rewarded for choosing its optimal accounting strategy.

The important point here is that unless managers are irrational, and as long as the market is fairly efficient, there is reason to believe that firms' preference for pooling is driven by some real cost savings. Attempting to identify that benefit perhaps should be a prerequisite to eliminating pooling.

4. CONCLUSION

In the post–World War II period, business combinations have received one of two accounting treatments, pooling of interests or purchase accounting. From the start, businesses preferred pooling and are apparently willing to pay for it, by most accounts because it allows them to report higher earnings. Yet that accounting choice neither increases assets, reduces liabilities, nor modifies tax treatment, so in theory it ought to be ignored by investors. The preference for pooling is especially puzzling since empirical research implies that investors are not swayed by whether merged firms employ pooling or purchase accounting.

While the puzzle has yet to be solved analytically, there is a good chance that it will diminish in importance for business decisions. The Financial Accounting Standards Board has indicated that it may well eliminate pooling, bringing U.S. business combination accounting standards in line with those in other industrialized nations. This article suggests that while the elimination of pooling in favor of purchase accounting could produce benefits by requiring more complete disclosures in financial statements, it also might eliminate arrangements that owners and managers find to be cost-saving. Evidence that acquirers are willing to bear additional costs to pool, combined with the lack of a stock price penalty for poolers, at least hints at the presence of some as-yet-undetermined cost savings.

The Twelve Conditions For Pooling

1. Each of the combining companies is autonomous and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

2. Each of the combining companies is independent of the other combining companies, meaning that none of the combining companies have significant equity investments (greater than 10 percent of outstanding voting common stock) in one another.

3. 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.

4. Payment is effected by one corporation offering and issuing only common stock in exchange for substantially all (meaning 90 percent or more) of the voting common stock interest of another company. The common stock issued must have rights that are identical to those of the majority of the issuing company's outstanding voting common stock.

5. None of the combining companies changes the equity interest of its voting common stock for two years before the plan to combine is initiated or between the dates the combination is initiated and consummated. Changes to equity interests may include distributions to stockholders and additional issuances, exchanges, and retirements of securities.

6. None of the combining companies reacquires shares of its voting stock except for purposes other than business combinations. Examples of allowable share repurchases might include shares for stock option and compensation plans and other recurring distributions provided a systematic pattern is established at least two years before the plan of combination is initiated.

7. The ratio of the interest of an individual common stockholder to those of other common stockholders in the combination is unchanged before and after the combination. In other words, each individual common stockholder who exchanges his stock receives a voting common stock interest exactly in proportion to his relative voting common stock interest before the combination is effected.

8. Voting rights in the combined company are exercisable by the stockholders. This condition is not met, however, if shares of common stock issued to effect the combination are transferred to a voting trust, in which case the individual stockholders would lose the ability to vote.

9. The combination is resolved at the date the plan is consummated. In other words, the combined corporation does not agree to issue additional shares of stock or other consideration on any contingency at a later date to former stockholders of the combining companies.

10. The combined corporation does not agree to retire or reacquire any of the common stock issued to effect the combination.

11. The combined corporation does not enter into other financial arrangements—such as a guaranty of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities—for the benefit of former stockholders of a combining company.

12. The combined corporation does not intend to dispose of a significant part of the assets of the combining companies—other than disposals in the normal course of business or to eliminate duplicate facilities or excess capacity—within two years after the combination.

Source: Financial Accounting Standards Board (1992), pp. 209–12.

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