ACCOUNTING ASPECTS OF BUSINESS COMBINATION

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When your president invited me to speak on the subject "Accounting Aspects of Mergers and Combinations" he said that he understood from mutual friends that I had some excellent material on this subject which would be of considerable interest to members of the Association. Since the S.E.C.'s public files do contain many examples of business combinations that should be of interest to teachers as well as to public and private practitioners of accounting, I am pleased to have this opportunity to share our experience in this area of accounting with you.[1]

The title given to me I interpret as an invitation to discuss the evolution of the idea of that is generally referred to in professional accounting circles as "pooling of interests" accounting in contrast to "purchase" or "acquisition" accounting in business combinations. Mr. Kohler's A Dictionary for Accountants has a definition which brings together the old and new terms used in discussions of this subject. His definition of a business combination is "The bringing together of two or more business entities, usually corporations, into one, accomplished by transferring the net assets of one or more entities to another of them (a merger) or to a new one created for that purpose (a consolidation). Either action may, in effect, be a purchase, with one or more groups of stockholders retiring, or a pooling of interests may occur in which the stockholders of all the participants share."

Although this subject has been an active one for discussion in recent years, it is not a new problem. "The Urge to Merge" was the title of a FORTUNE article in 1954.[2] This article

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

[2] Reprinted in American Management Association, Mergers and Acquisitions, Conference Handbook, 1956, pp. 25-38.

recognizes three great merger movements: The first from 1890 to 1904 characterized by vertical integration of industries put together by bankers in which the securities "offered were so thoroughly watered that it took a generation of industrial growth and the inflation of a world war to dry them out." By contrast the article notes that in today's mergers (the third round) the securities are "bone dry when offered." The second round recognized was from the end of World War I to the end of the twenties. Since 1945 seven thousand five hundred mergers important enough to be noted by financial journals or services were reported.

The Commission's experience with mergers is indicated in our proxy statistics. For the fiscal year ended June 30, 1958, 107 proxy statements contained an item relating to mergers, consolidations, acquisition of businesses, purchase and sale of property. This is typical of the experience during the last five years. The securities issued in most merger plans are exempt from registration because no sale is involved as that term is interpreted under the Securities Act.[3]

Before proceeding with a discussion of the subject perhaps I should mention that the Administrative Procedure Act requires that most

This resulted not only in inflated book values, but also in a lack of a basis for proper depreciation charges."

The effect of this practice was still evident in financial statements of many corporations at the time the securities law were enacted by Congress.

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[3] See Byron D. Woodside, "Particular S.E.C. Merger Considerations," an address presented before the Finance Orientation Seminar No. 121-91, American Management Association, New York, N. Y., November 1957, and published in condensed form in TAXES, February 1958, pp. 136-144. Mr. Woodside is Director, Division of Corporation Finance of the S.E.C.

Two of the rules formally adopted by the American Institute of Accountants in 1934 dealt with charges to capital surplus and the treatment of earned surplus of a subsidiary prior to acquisition. Similarly, Accounting Series Release No. 1 of the S.E.C. states the opinion of its first chief accountant (Carman G. Blough) that losses resulting from revaluation of assets should be charged to earned surplus rather than to capital surplus, and Accounting Series Release No. 3 described the treatment of investments in subsidiaries in preparing consolidated statements. Some registrants had not eliminated earned surplus of subsidiaries at date of acquisition. However, at the same time, in some cases involving statutory mergers under state laws permitting the carrying forward of earned surplus of the merged company such accounting was accepted as having authoritative support.[5]

During this period, too, the Institute's and the Commission's releases on charges to capital surplus were supplemented and expanded by releases dealing with quasi-reorganizations.[6] It is important to note here that these releases from both sources dealt with the writing off of losses and the elimination of debit balances in the earned surplus account. After World War II some accountants began to urge strongly that a net write-up of assets, as well as a net write-down, could be accomplished by means of a quasi-reorganization. This idea is found in the report of October 20, 1945, from the Institute's Committee on Accounting Procedure to the Executive Committee. (This report also contains the earliest use of the term "pooling of interest"

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[5] R. H. Montgomery, Auditing Theory and Practice, 5th ed., 1934, p. 416; W. A. Paton, editor, Accountants' Handbook, 2d ed., 1932, p. 950.

[6] Accounting Research Bulletin No. 3, September 1939; Accounting Series Releases Nos. 15 and 16, March 16, 1940, and No. 25, May 29, 1941.

that has come to my attention.) The Commission has never been convinced that adequate safeguards against abuse of the write-up have been established[7].

Since the question of the recognition of goodwill in business combinations is a matter of critical importance, comment on the Institute's and the Commission's releases on the subject is pertinent. Accounting Research Bulletin No. 24, published in December 1944, recognized that in the past it had been acceptable practice to eliminate goodwill by a write-off against any existing surplus -- capital or earned. Since this practice was so common the committee did not recommend prohibition of it but did say that charges to capital surplus should be discouraged. The Commission's Accounting Series Release No. 50 expressed the view that a write-off of purchased goodwill to capital surplus was contrary to sound accounting principles. The release stated that it was preferable to make the write-off "through timely charges to income" but in no event to capital surplus. The revision of Bulletin 24 now found in Chapter 5 of Bulletin 43 prohibits charges to capital surplus and lump sum write-offs in any case immediately after acquisition. Some critics say that failure to recognize goodwill in a pooling of interests transaction is the same as a write-off against capital surplus and hence a violation of the

[7] See In the Matter of Great Sweet Grass Oils Limited and Kroy Oils Limited, Sec. Ex. Act Rel. No. 5483, April 8, 1957; In the Matter of The Fall River Power Company, Sec. Act Rel. No. 3932, June 4, 1958.

principles set out in the goodwill releases. If you accept the pooling of interests concept as a continuation of the combined enterprises and not a new start, no accounting basis for recognition of goodwill is established even though the earnings of the parties may indicate its existence. We have permitted a write-off of goodwill against capital surplus when a review of the transaction in which it originated indicated no goodwill should have been recorded at the time.

The stage is now set for the events leading to the Institute's Accounting Research Bulletin No. 40 on Business Combinations published in September 1950. In the October 20, 1945, report of the Committee on Accounting Procedure mentioned earlier in referring to a pooling of interests, it is stated that "the committee assumes that the term 'pooling' as here used refers to a situation in which two or more interests of comparable size are combined and would not include a transaction by which the interests of a small company are combined with those of a company that is substantially larger." Whether this influenced the thinking of the S.E.C. staff at the time I don't know, but it is clear from the cases that at this time the pooling of interests accounting which avoids the booking of goodwill by using the accounting basis of the constituent companies and permits the carrying forward of their earned surpluses was deemed appropriate when the companies to be combined were of about equal size and were engaged in similar or complementary businesses. No detailed guide lines had been established at this time, but the legal and accounting professions were actively concerned with the problems involved.[8]

In 1945 the Commission considered a merger proposal in which all factors other than size clearly supported a pooling of interests solution. The result was that goodwill was not recorded

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[8] See The New York Certified Public Accountant, July 1945, for two papers entitled "Corporate Consolidations, Reorganizations and Mergers" presented by J. Arthur Marvin, C.P.A., and William W. Werntz, Chief Accountant, S.E.C., for the Course on Current Problems in Accounting for Lawyers given by the Practicing Law Institute in cooperation with the American Institute of Accountants and the New York Society of Certified Public Accountants.

and the earned surplus of both companies was carried forward. In this case the assets and common stock equity of the smaller company were less than one-fifth and one-third, respectively, of the larger company.[9] From this point on, relative size was considered to be less important than other factors in considering whether a business combination met the test for pooling of interests accounting.

Publication of Accounting Research Bulletin No. 40 in September 1950 did not solve all of our problems, but the practicing public accountant did have a guide with respect to business combinations which identified factors to be taken into consideration.[10] Four tests emerged -- a continuity of substantially the same proportionate equity interests, relative size, continuity of management, and similar or complementary activities. As the trend toward diversification developed, this last test declined in importance and was not repeated in the new Bulletin No. 48 published in January 1957.

It is significant that Bulletin 40 was unanimously adopted but with Messrs. Andrews, Paton and Wellington assenting with a qualification. These gentlemen believed that the bulletin did not make it clear that any adjustments of asset values or of retained income which would be in conformity with generally accepted accounting principles in the absence of a combination would be equally so if effected in connection with a pooling of interests. This provision was included in the revision at chapter 7(C) of Bulletin No. 43 with no dissenters. Is this intended to keep the door open for an upward restatement of assets if such accounting gains acceptance?

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[9] For a detailed discussion of this case see William M. Black, "Certain Phases of Merger Accounting," The Journal of Accountancy, March 1947, p. 214.

[10] For preliminary exposure of the subject see Edward B. Wilcox, "Business Combinations: An Analysis of Mergers, Purchases, and Related Accounting Procedure," The Journal of Accountancy, February 1950, pp. 102-107. Also, see letters to the editor after publication, The Journal of Accountancy, April 1951, pp. 532-533.

An example of a situation in which a registrant urged that a write-up of the assets was proper took the form of the purchase of assets from five predecessor companies under varying degrees of common control in exchange for stock of a new company. The allocation of the shares was based upon a valuation of estimated oil reserves, leaseholds, mineral interests and other assets and the use of a price per share approximating that at which a public offering was to be made. This price was in excess of the recent market quotations of predecessors' shares. On this basis the assets of the new company would have totalled about $15,000,000 as compared to $10,000,000 on the combined balance sheets of the predecessors. Upon a consideration of all the facts the Commission concluded that pooling of interests accounting was appropriate and no write-up of assets should be made.

In a more recent case involving a merger of two substantial companies in the oil business, the stockholders of the one whose assets were to be acquired by the other in exchange for stock desired to sell their holdings. This situation we agreed was a purchase transaction and a registration statement was filed to cover the stock to be issued in the merger. Preparation of comparable financial statements resulted in a revision of previously published figures for the acquired company because of revised estimates of oil and gas reserves. The effect of changes in depletion and depreciation charges was disclosed in a note to the summary of earnings. In addition a pro forma statement of combined earnings of the constituent companies for the most recent year was included in the prospectus. This statement disclosed the increased depletion charge based on the excess of the purchase price over the values on the merged company's books. A reclassification of operating items deferred by the merged company to accord with the survivor's accounting procedures was also necessary.

The next significant step in the case-by-case consideration of this general problem by the Commission was raised in a proposed merger involving the possibility that a minority interest would remain after an exchange offer and the smaller company would continue as a subsidiary. It was concluded that in these circumstances it would be inappropriate to treat the transaction as a pooling of interests, and therefore the earned surplus of the acquired company could not be combined with that of the registrant. On a purchase basis goodwill would have been negligible.

Even without the complication of a minority interest, Bulletin 40 and Chapter 7(C) of Bulletin 43 had been interpreted consistently as requiring the dissolution of the merged corporation into a surviving corporation. This seemed to emphasize a legal technicality and to ignore the economic aspects of the situation. Reexamination of the problem resulted in Bulletin No. 48, published in January 1957. This revision omits the requirement of similar or complementary businesses and permits a pooling of interests when substantially all of the ownership interests in the constituent corporations continue, and permits a subsidiary relationship to survive "if no significant minority interest remains outstanding, and if there are important tax, legal, or economic reasons for maintaining the subsidiary relationship such as the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases or licenses." The revision retains the tests of continuity of ownership and of management or power to control the management and introduces a more specific test of relative size. Although relative size may not necessarily be determinative, the bulletin says that "where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90% to 95% or more of the voting interest in the combined

enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests.

As you would suspect, the first questions raised under Bulletin 48 were with regard to the size test and minority interests. The first cases involved combinations in which the smaller company fell in the range of five per cent to ten per cent of the combined equity. No objection was raised to pooling of interests accounting in these cases when it appeared that a strong case had been made under the other tests. As a general proposition we have objected to pooling of interests when the equity of the smaller company would be less than five per cent. However, in some situations pooling of interests accounting has been accepted when the acquiring company's interest has exceeded 95 per cent, when, for example, the other factors involved were persuasive and the size and position of the companies were such that any other view would, for all practical purposes, have the effect of excluding certain industry leaders from the pooling of interests doctrine entirely.

It is not always possible for the public reader to determine from published material whether all of the criteria for a pooling have been met. However, these are the subject of discussion between the S.E.C. accounting staff and representatives of the registrants and the certifying accountants. We are particularly concerned with evidence of intent on the part of all the parties, other than for normal trading in listed shares, to retain shares issued to them in the exchange or in dissolution of corporations which have transferred assets to the surviving corporation. Registration under the Securities Act of 1933 of shares received in the transaction or other evidence of intent to dispose of them is ordinarily fatal to a pooling of interests solution.

Plans for the integration of top management personnel we think are significant evidence as to the good faith of representations that the plan is a pooling and not a purchase. Token

representation on a big board of directors may not be very convincing, whereas a merger involving a small progressive company and a very large company needing the particular talents of the officers of the smaller company may satisfy the requirement.[11]

Much time of our accounting staff is devoted to conferences with representatives of registrants and certifying accountants in discussing the facts surrounding business combinations where registrants recognize that there could be a difference of opinion as to the accounting to be followed. Now and then preliminary proxy material is submitted or a registration statement for an exchange offer is filed in which an accounting solution is offered which we find it necessary to challenge. The solution is then usually worked out in a conference at which pertinent facts are developed and judged in light of the criteria laid down in the bulletins I have discussed.

An interesting example is found in a recent registration statement in which an exchange offer was described. As originally filed, purchase accounting was applied to the combination of two companies of which the proposed parent company was one-fifth the size of the company being acquired. The smaller company, which had some 400,000 shares of stock outstanding, was to issue 1,600,000 shares of its $.25 par value common stock for the entire outstanding stock of the larger company, assigning to its shares a value of $2 per share. The prospectus also carried a public offering of 250,000 shares at a price to net the company $2.10 per share. As originally proposed in the registration statement, $2,600,000 of the excess of the ascribed value of the new shares was to be assigned to certain undeveloped real estate owned by the larger company.

After reviewing the terms of the proposed combination our staff objected to the use of

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[11] For a practicing accountant's discussion of this subject see William W. Werntz, "Intangibles in Business Combinations," The Journal of Accountancy, May 1957, pp. 46-55.

purchase accounting and the resulting substantial write-up in the value of the land. Prior to the exchange offer the registrant's then outstanding common shares were redesignated as Class A Convertible stock. This class was convertible into debentures until a specified date after which, if not converted, Class A automatically became common shares. Class A stock and the debentures together had voting rights for the election of five directors, and the new common issued under the plan of exchange was limited to representation by five directors, making a total of ten directors. However, two members of this new group in the organization were to become president and secretary of the parent company.

After discussions, an amended registration statement was filed in which the pooling of interests concept was applied to the combination and the investment in the subsidiary was recorded on the books of the parent at the underlying book value based on cost.

The prospectus in this example included the usual financial statements for an exchange offer and in addition some unusual features. Proxy statements seeking stockholder approval of a plan for a business combination as well as prospectuses for exchange offers must include balance sheets, income and surplus statements, and summaries of earnings for all parties to the plan. In addition a pro forma balance sheet is required to show the result to be obtained. Likewise, a summary of earnings on a combined basis is necessary. The problem of cross holdings among the parties is not unusual and must be dealt with particularly in developing proper comparisons of earnings per share in the summaries of earnings.

An element in the case I have been using as an example was a "spin-off" in the year prior to the exchange offer of a substantial part of the smaller company's income producing assets. The income and expenses attributable to these assets for the period prior to the spin-off were eliminated from the income statements and earnings summaries and were shown separately in a

footnote. In addition, certain “Special items” of a non-recurring nature were omitted from the combined summary of earnings, and earnings per share in this case were shown only in this combination for the benefit of the public investors -- the exchange offer having been a privately negotiated contract. The per share figures here ware based upon the total of the class A and common shares to be outstanding after the exchange. The fact that the class A shares were convertible into interest-bearing debentures was recognized in a footnote to the summary which stated the amount of interest charges assuming full conversion. Another footnote disclosed that the taxation for land sales might be changed from a capital gains basis, which had been challenged by the Internal Revenue Service, to an ordinary income basis.

This case demonstrates some of the disclosure problems facing the accountant in the preparation of financial statements for public use in connection with a business combination. Another common problem is the recasting of income statements of different fiscal years to a common fiscal year if practicable for the purpose of showing combined operations of the constituent companies. Service and finance companies usually adjust to a common basis. Companies with large inventories and inadequate accounting controls may not be able to recast to a common basis. In such cases combining of income statements for different fiscal years has been accepted with appropriate explanation of the circumstances. Discussions on this subject demonstrate the need of better accounting procedures in many businesses. Poor inventory control is still one of the principal sore spots in business operations.

I have attempted to show that our accounting problems in the area of business combinations are of two kinds: the determination of whether pooling of interests or purchase

accounting is applicable and the presentation of the financial statements and notes so that suitable disclosure for the purpose at hand is accomplished.

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