BUSINESS COMBINATIONS
AND OTHER
FINANCIAL REPORTING PROBLEMS

by

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In the invitation to speak before you, the Chairman of your Program Committee suggested that any current topics in the area of financial reporting or accounting treatment with respect to registration statements or other reports would be of interest to your membership and that information with respect to mergers, acquisitions, etc. would be of particular interest as there have been so many such events frequently involving difficult and important problems.[1]

This is a welcome opportunity for me to bring up to date a paper which was written for the annual meeting of the American Accounting Association in August 1958 and published in The Accounting Review of April 1959. Since this is quoted to me from time to time and I cite it as a fair statement of the development of SEC practice in accounting for business combinations, certain aspects in which it no longer reflects the practice today should be reviewed.

The importance of this problem is well recognized and hardly needs statistical support. However, it way be noted that The Conference Board Business Record for September 1961[2] reported listings of mergers and acquisitions for the preceding calendar years in this manner:

	1958	1959	1960
Separate acquiring companies	812	985	1111
Acquired units	1116	1480	1720

The annual reports of the Securities and Exchange Commission list the number of proxy solicitations for mergers, consolidation, acquisitions of businesses, purchases and sales of property and dissolutions of companies for the fiscal years ended June 30, 1958, 1959 and 1960 as 107, 103 and 170, respectively, and for 1961 as 197.

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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] At p. 50.

In addition to our examination of proxy material, business combinations may come to our attention in filings for the offering of securities under the Securities Act of 1933, listing applications, and annual and other periodic reports under the Securities Exchange Act of 1934 and to a lesser extent under other Acts administered by the Commission. In the preparation of this paper and for other purposes I have had a review made of the files for 126 companies involving 312 recent business combinations. Others interested in the subject, the New York Stock Exchange, some public accounting firms, and particularly a task force appointed by the Accounting Principles Board of the American Institute of Certified Public Accountants, may have completed more thorough surveys.

Since The Accounting Review is readily available and I am sure many of you are aware of the paper to which I have referred, I shall note here that prior to 1950 accounting for business combinations had been developed at the Commission on a case-by-case basis in reliance upon available accounting authority which was not always in agreement. Since September 1950 the American Institute of Certified Public Accountants' bulletins on the subject have been recognized guides but difficult to apply uniformly to all cases. The first of these says:

> "Whenever two or more corporations are brought together, or combined, for the purpose of carrying on in a single corporation the previously conducted businesses, the accounting to give effect to the combination will vary depending upon whether there is a continuance of the former ownership or a new ownership."[3]

This basic test of the transaction as a purchase or a pooling of interests, although modified in some respects, has survived and is more briefly referred to as continuity of interests.

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[3] American Institute of Accountants, Accounting Research Bulletin No. 40, September 1950.

In the August 1958 paper I said that "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." At that time securities issued in most merger plans were exempt from registration because no sale was deemed to be involved as that term was interpreted under the Securities Act.[4] With the amendment of Rule 133 in 1959[5] and the adoption of Form S-14 (by which a proxy statement may be converted into a 1933 Act prospectus), registration of securities issued in a merger transaction is not conclusive as to intent of all parties involved.[6]

A pooling solution under the current Institute bulletin requires that substantially all of the equity interests continue or, put the other way around, that no important part of the former ownership is eliminated. It is impossible to catalogue all of the situations requiring a decision under this head. The need to meet pressing financial obligations, provide for settlement of estates, reasonable diversification of investments, retirement of elderly members of family enterprises, and the capacity of continuing members to contribute to the enterprise are factors to be considered.

Continuity of management has been deprecated by some critics as a poor test for an accounting policy. However, especially in closely held companies, this is associated with an intent to retain the equity interest and may be added evidence of continuity. Such intent is often bolstered by management contracts running for several years. Elimination soon after the merger

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[4] See Byron D. Woodside, "Particular SEC 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.

[5] 25th Annual Report, Securities and Exchange Commission, pp. 15 and 20.

[6] See Manuel F. Cohen, "Rule 133 of the Securities and Exchange Commission," The Record of the Association of the Bar of the City of New York, April 1959, p. 162.

is effected of parties represented as essential to the operation is not the best way to demonstrate good faith.

Relative size as a test for qualification as a pooling has been eroding for many years. For ten years prior to the publication of Accounting Research Bulletin No. 48 in January 1957, relative size had been considered a minor factor in judging whether a combination was a pooling or a purchase. The inclusion in paragraph 6 of Accounting Research Bulletin No. 48 of the 90% to 95% or more of the voting interest in the combined enterprise as a test was expected to screen out marginal cases. However, the arguments brought to bear under the provisions of paragraph 7 have practically eliminated size as a factor. Paragraph 7 states:

> "No one of the factors discussed in paragraphs 5 and 6 would necessarily be determinative and any one factor might have varying degrees of significance in different cases. However, their presence or absence would be cumulative in effect. Since the conclusions to be drawn from consideration of these different relevant circumstances may be in conflict or partially so, determination as to whether a particular combination is a purchase or a pooling of interests should be made in the light of all such attendant circumstances."

Some figures may be interesting here. The 126 companies for which files were reviewed reported a total of 312 combinations, 271 of which were reported in the last three years. Of the 312 combinations 159 were recorded as purchases and 153 (including three retroactively) as poolings. All but one of the latter involved equity interests only and 108 of the purchases were of this type. In the poolings involving equity interest only we find 127 were for common stock only; 12 involved common with preferred with varying voting rights; 4 were for common stock, a portion being contingent on subsequent events; and 9 were for convertible preferred stock with voting rights.

On the size question we find that of the 153 poolings the owners of the acquired unit in 63 cases held less than five percent of the voting power after the combination. Thirty-nine held from 5% to 10% of the voting power; 41 from 10% to 40%, and 10 more than 40%. Of the 108 stock transactions recorded as purchases, 90 were in the below 5% class, 12 were in the 5% to 10% group, and 6 in the 10% to 40% group.

The figures I have quoted suggest that the criteria for a decision as to pooling or purchase are not exact enough to conclude that one or the other solution is mandatory in a particular case. We have seen cases in which we felt that only one treatment could be accepted, but in many cases that either solution could be accepted. This suggests that there may be a basic fallacy in the current "pooling of interests" concept.

It is no secret that a small number of combinations recorded as purchases have been changed to pooling of interests accounting. An article in the June 1961 issue of The Journal of Accountancy has given fairly wide publicity to this fact, but not all of the circumstances which led to our acceptance of the change in the cases were known and reported. Among the circumstances not reported was that in four of the six cases cited the accounting was changed within the same fiscal year before an annual report to stockholders was issued. The change from purchase accounting to pooling of interests accounting troubles us particularly when purchase accounting was appropriate in the circumstances, it was adopted by the directors, and it included the allocation of excess payments to fixed assets subject to depreciation and depletion or intangibles subject to amortization. When reports have been published in which a purchase transaction has become so firmly embedded in the accounts, it seems unwise to make a retroactive change to the pooling basis of accounting. Such a change not only goes against the conventions of consistency and conservatism but also brings into question the integrity of the financial reporting. Therefore, I must agree with those who believe that this entire subject can bear reexamination and clarification.

Mr. George O. May at the time Accounting Research Bulletin No. 48 was published expressed a strong dissent in which he took the position that the transactions described in the bulletin really involved an exchange of interests rather than a pooling which he said “has a long established usage to describe an arrangement by which the profits from the use of property are pooled without change in the ownership of property itself.”[7] Since serious studies are now underway, I have no intention of attempting a solution of the problem today. I do want to share a few gleanings from accounting literature of thirty to forty years ago which may shed some light on the subject.

In accounting textbooks prior to 1930 we find discussion of the problem connected with the then current trend to expand by means of merger, consolidation, and the creation of holding companies. Some attempt was made to distinguish between mergers and consolidations with a view to the determination of whether assets should be carried at predecessor’s cost or at new values. Consideration was given to the determination and recordation of good will, both in an acquisition with respect to the excess of the purchase price over net equity and in a combination as to good will of all constituent companies.

The consensus of the authorities, however, was that in mergers, consolidations and reorganizations, the predecessor’s costs, appropriately adjusted, should be used except where there was an outright and complete change in ownership, in which case new costs were

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[7] George O. May, “Business Combinations: An Alternative View,” The Journal of Accountancy, April 1957, p. 33.

established.[8] Most of the earlier authorities consulted eliminated earned surplus of subsidiaries at date of acquisition in the case of holding companies and either eliminated earned surplus or avoided the problem in the case of mergers and consolidation.

The membership of the American Institute of Accountants in 1934 adopted a rule prohibiting the inclusion of earned surplus of a subsidiary at acquisition in consolidated earned surplus.[9]

However, there seems to have been some disparity between theory and practice in those days. The pressure which caused this disparity was generated perhaps from the fact that when two or more going concerns, each with established earnings and dividend records, are combined into one unit, there is a basic economic need for the dividend policies to be continued; and it is to be expected that the earnings and dividends of the combined operations will be at least as much as the combined amounts of the predecessor companies.

These economic considerations embody two major accounting problems connected with the acquisition of a company by issuance of stock. These are (1) whether the carrying value of the assets of the constituent companies are to be used by the continuing company or whether they

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[8] Accountants' Handbook, 2d ed. (1932) p. 648. See also p. 949 where, following a series of illustrations, this paragraph appears: "SIGNIFICANCE OF ILLUSTRATIONS.--If the accounting principles which should underlie reorganization could be definitely formulated, the income tax rules could be greatly simplified, and questions which the above illustrations raise could be easily answered. Little has been said thus far by the accountant concerning the principles to be followed in the recording of the various types of business organizations and reorganizations. His labors have proceeded on the theory that assets acquired by issues or exchanges of stock should appear on the books and in financial statements as reflected on the records of the predecessor business, or as shown in a bill of sale or formal appraisal, or in an amount equal to the par value of the stock, or at values determined by the board of directors. Where two or more of these values are present, he is inclined to prefer them in ascending order as named; ad it is not unusual for him to adopt a number of them at once."

[9] Accounting Research Bulletin No. 43, Ch. 1.

are to be recorded at the fair value of the stock issued, and (2) whether the earned surplus of the constituent companies may be carried forward as earned surplus of the continuing company.

By the close of the twenties there came to be some recognition by accounting authorities of pressure to carry forward earned surplus of companies in a combination in which there was no substantial change in stock ownership other than the brining together of independent groups of stockholders.[10] The term “true merger” appears in the literature of about this time.

Mr. J. M. B. Hoxsey of the New York Stock Exchange, in an address before the American Institute of Accountants in 1930,[11] defined a “true merger” as distinguished from purchase or acquisitions either of stock or of property as one where the identity of the merged corporations continues, though in difference form, and where the earned surplus of the merged

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[10] Accountants’ Handbook, 2d ed. (1932), p. 950. Following an example of a purchase of a subsidiary for cash, the stock transaction is discussed as follows: “The above argument is based on the premise that there has been a change in the effective ownership of the underlying net assets. Where there has been no change of beneficial interests, as where stock in the holding company is exchanged for a controlling interest in the stock of the subsidiary or where two companies are merged and a new unit has grown out of the two previously existing identities, there is no absorption of surplus unless an intention exists to do so, in which event the equivalent of a stock dividend has been paid. Wildman and Powell (in ‘Capital Stock without Par Value’) express the matter concisely as follows:

> ‘Recognition should be given, it seems, to the fact that a new corporation is organized merely as a legal convenience. The value of assets prior to consolidation [merger] is not changed necessarily by the legal formality of transferring them to a new owner [i.e., successor corporation]. The liabilities of constituents are neither increased nor decreased by the process of combination. Under such circumstances it would appear that any excess of assets over liabilities remains the same both before and after consolidation. Finally, if the excess represented surplus available for dividends before consolidation, it must necessarily represent the same thing after consolidation.’

“A change in stockholders, generally evidenced by a consolidation, leads to the elimination of earned surplus, while a brining together of the interests of previously independent groups of stockholders leads to the retention of earned surplus unless eliminated by specific action.

[11] “Accounting for Investors,” The Journal of Accountancy, October 1930, pp. 251, 262 and 263.

corporations may be properly continued as such by the merging company. This position was supported by Montgomery[12] where the state law permits the "emerging" corporation to be a continuance but not if the merger results in a new corporate entity.

This was about the state of affairs when the SEC came on the scene. The Commission found it necessary to issue Accounting Series Release No. 3 to require the elimination of acquisition surplus in consolidation.

With the emphasis of the time on security market values it is natural that emphasis would come to be placed on the market value of the stock issued in exchange for companies acquired by acquisition, merger, or consolidation. This was in conflict with the theory of the "true merger" and the carrying forward of earned surplus and entailed accounting for the excess of the purchase price over net equity with some view to increasing depreciation and amortization charges to income.

This emphasis on the acquisition concept, with new values for the acquired companies, not only continued the problem of having adequate earned surplus available to maintain the dividend policy of the predecessors but also resulted in a reduction of combined earnings as a result of additional depreciation and amortization charges. As a new solution to the problem the concept of continuity through a continuance of pooled interests[13] was reactivated and refurbished and presented as the "pooling of interests" concepts. To date the development of this concept has not yet satisfactorily solved the conflicts in the situation where the corporation acquires another corporation in exchange for its stock based on the fair market value thereof and records the acquisition at the book value of the acquired corporation, which is often much less than the

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[12] Auditing Theory and Practice, 5th ed. (1934), p. 416.

[13] Corporate Accounting, Sunley & Pinkerton, 1931, pp. 497-499.

fair value of the stock issued. The concern over establishing that fair value was received for the stock issued is the same consideration which in the early twenties gave rise to the practice of revaluing assets including good will of all companies in a combination.

In order to emphasize the difference of opinion that exists today I want to use a recent acquisition only slightly disguised. With appropriate corporate action A company acquired all of the assets, properties and business and assumed all the liabilities of B corporation in exchange for common stock in the ratio of one share of A for three shares of B. A shares are distributed to B stockholders, putting them in possession of 8% of A's voting stock. B continues as a division of A under B's administrative and operating management. B's president becomes a vice president and director of A. This situation clearly meets the pooling of interests tests of Accounting Research Bulletin No. 48 and the accounting on that basis is used in pro forma financial statements in proxy material.

As is fairly common in these situations, the financial press reported this as a $25,000,000 transaction. If A had recorded this as a purchase, an excess purchase price over underlying net assets of $20,000,000 would have resulted. Assuming a ten-year amortization consistent with previous purchase transactions on the books of A, this would mean a charge to earnings of $2,000,000 probably not deductible for tax purposes. This would be 12% of the pro forma combined earnings and 250% of the earnings of B.

Suppose for some good reason B were to be the surviving corporation and the same exchange ratio applied. Such an assumption would produce something like $200,000,000 in excess valuation or $20,000,000 a year amortization which would be 120% of combined earnings and 125% of the earnings of A.

Some of the earlier accounting texts examined seem to say that current fair value should be applied to both A and B in this situation. This treatment would result in $220,000,000 excess valuation which in a ten-year amortization would require 130% of combined pro forma earnings.

A very common application of the pooling concept today is found in the combining into one company of a group of corporations under common ownership immediately prior to a public offering of securities. Although Accounting Research Bulletin 48 speaks only of corporations, these combinations may include single proprietorships, partnership and subchapter S corporations. Accumulated earnings of these elements in a combination may not be reported as earned surplus under the pooling theory.

A good example of a pooling prior to going public is a filing which became effective last month. The company's main plant and executive offices are in Champaign, Illinois. After combining four companies, redeeming or exchanging all the outstanding preferred and old common, two families owned all of the Class A and B common stock and after the public offering would continue to own 37% of Class A and 100% of Class B for a combined voting power of 73.5%. A note to the financial statements described the reorganization and merger and stated that it constituted a pooling of interests and the earned and capital surplus balances of the parties to the merger were carried forward in the accounts of the surviving company. Two typical disclosures appear in this prospectus. After the merger the book value of the Class A was $4.44 per share and would increase to $6.30 after the public offering of which the proceeds from 125,500 shares at $15.45 would go to the company. Based on the public offering price the 600,000 shares outstanding would amount to in excess of $9,000,000 compared to a book equity of $2,700,000. The company also announced its intention to furnish annual reports to stockholders which reports will contain audited financial statements. The Commission believes that after going public the stockholders are entitled to reports from the company's management supported by an opinion of independent public accountants.

Another example of the dilution disclosure is expressed in a paragraph in a recent prospectus:

> "Prior to this offering, the book value per share amounted to $1.22; upon completion of the offering such book value will amount to $2.30 per share, the difference between the book value after the offering and the offering price of $5 per share representing an immediate dilution of the public stockholders' interest. Upon completion of the offering of 110,000 shares, present stockholders will own 48% of the outstanding voting securities at an average cost o $1.20 per share, the public will own 48% of such securities at a cost of $5 per share, and the Underwriters and a finder will own 4% of such securities at an average cost of $.14 per share."

Accounting for business combinations is only one of a number of problems facing corporate and public accountants and the Commission today. I can only mention a few of the others. Accounting for research and development is a troublesome matter especially in new companies. A recent example is the company which showed four items on its balance sheet under deferred charges totally $250,000 and a deficit of $350,000 for a net equity of $20,000. A note disclosed that at one time amortization of research and development was based on an expectation of selling 75 units but the accounting had been changed to a four year basis. The text of the prospectus stated that 13 units had been sold, none recently, and there were no orders at the balance sheet date. As you might expect, the accountant's certificate discussed the situation and the opinion was subject to the ultimate recovery of the deferred charges. In another case effective last month the registrant reported a substantial deficit and in addition disclosed that it had a one-third interest in and substantial advances to a company in the promotional stage with uncertain prospects. These examples pose the basic question of when is a going concern not a going concern, or, if not that drastic, when do you give up hope on a new idea? Or, in cases like the Cuban situation, when do you take your losses?

Allocation of taxes and disclosure when deferred tax accounting is involved is far from uniform. Our accountants must spend considerable time in attempts to unravel some of the accounting presented to us. Some of the difficulty arises from the practice of netting the tax effect without disclosure of the amounts involved or of combining deferred tax charges and deferred tax credits with other tax accruals. While our view, as stated in Accounting Series Release No. 85, permits the charge equivalent to the tax reduction to be treated as additional depreciation or as a tax item, it requires that in either case there be an appropriate explanation with disclosure of the amounts involved.

If you attended the American Institute of Certified Public Accountants meeting here last fall, you may have heard reports on studies of the long term lease and pension projects. Both have stirred up considerable debate in recent years. Within the last month I have received a copy of a University of California study of corporate reporting carried out by questionnaire, interview and analysis of over 500 reports to stockholders. Some of you may have participated. This report recommends further study of the price level problem but reports a lack of enthusiasm by financial analyst for this adjustment of the statements.

The study also recommends that a statement of sources and application of funds be included in all reports as a regular supplement to the conventional statements. This also has been a project of the American Institute of Certified Public Accountants and one on which I would be quite interested in the reaction of the Controllers Institute. As you may know, your Institute and the CPAs as well as the Financial Analysts have standing committees which cooperate with the Commission. Their assistance is most helpful and much appreciated.

I have been interested in the funds statement as a possible solution to what seems to be a misleading use of the term “cash flow” Almond R. Coleman of the University of Virginia

Graduate School of Business challenges the common practice of calling net income plus depreciation charges a proper determination of cash flow. [14] Similarly the November-December 1961 Financial Analysts Journal carried a discussion under the title "The Fallacy of 'Cash Flow' and 'Funds Generated by Depreciation.'" The "add back" of depreciation can be misleading and tends to undermine the validity of net income derived by accrual accounting. A recent prospectus for a stock option plan incorporated the financial statements in the report to stockholders which was attached. On a double page spread a seven-year summary of the customary vital statistics, including a line showing Net Earnings, plus Depreciation, was partially surrounded by bar charts showing earnings in millions, stockholders' equity in millions, cash flow in millions, cash flow per share, and earnings as a percent of average equity before and after taxes. Cash flow in the millions and per share charts was depicted as a combination of net earnings in one color with depreciation extending the bars in another color. The amounts expended each year on equipment and leasehold improvement does not appear anywhere. The comparative balance sheet, however, reveals a net increase in this item of $1,000,000 compared with the current year's depreciation and amortization charge of $700,000.

Controllers hardly need reminding that they are a vital part of the process of furnishing the investor with reliable financial statements. The Commission has noted that you have considered and dealt with the serious problem of conflicts of interests. Your committee has concluded that the key role in dealing with conflicts of interest belongs to management and that the Controller's part is in terms of his responsibility for assuring the fiscal protection of the business through adequate internal control.[15] Sixty years ago a book on auditing included an

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[14] The Controller, December 1961, p. 592.

[15] The Controller, April 1961, p. 193.

audit program of an accountant with fifty years' practical experience. One item advised the auditor to "ascertain and take note of the general system upon which the books are constructed, and the plan of checking the correctness of the accounts paid."

A paragraph from an address by Commissioner Robert E. Healy before your Mid-Western Conference in Cleveland on May 15, 1939, is as appropriate now as it was then:

> "What we need, it seems to me, is a return to the recognition that the primary responsibility for proper accounting rests on the corporate management in the person of the controller. Whether the books are audited or not, the stockholder has a right to look to the corporation's own accounting system for an adequate, intelligible and honest reporting of its affairs. Unless in its daily bookkeeping the corporation recognizes a responsibility to stockholders and investors, the most conscientious audits lose much of their meanings."

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