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Analysis of the Exposure Draft to Eliminate the Pooling-of-Interests Method

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ABSTRACT

This paper analyzes and discusses the major issues, benefits, and problems with the recent Exposure Draft, which deals with accounting regulations for business combinations. This Exposure Draft makes several significant changes to Generally Accepted Accounting Principles (GAAP) including the elimination of the pooling-of-interests method and a reduction in the goodwill amortization premium to a maximum of twenty years. Utilized methods include researching the Exposure Draft and several pertinent, outside sources. The majority of sources used for this paper confirm the need to make such changes. Several articles also provide quality arguments against the Exposure Draft, leading the author to agree with the Financial Accounting Standards Board's (FASB) proposal. The Exposure Draft is likely to be passed in its entirety, and with it, disclosure and comparability of financial statements will be enhanced.

Accounting standard boards tried for decades to curtail the pooling-of-interests method to account for business combinations. Recently, the Financial Accounting Standards Board (FASB) took strides to achieve this goal by issuing an Exposure Draft to eliminate this method. On April 21, 1999, this proposal was opened to public comment before the Board presents their final ruling (Sclafane, 1999, p.34). If the Exposure Draft is accepted in its entirety, the purchase method will remain the only accounting method to record business transactions.

The international community has also taken strides to remove the use of poolings. The majority of the G4+1 members have implemented international accounting standards to eliminate the use of poolings. According to Todd Johnson, a FASB member, Australia has already adopted a purchase only standard; New Zealand and Canada are working on similar proposals. Currently, Canada and Britain limit the poolings use specifically to instances where business combinations are equal (Johnson, 1999, p.80).

The pooling-of-interests method is one of two accounting procedures to account for a business combination. In a pooling transaction, two entities merge without the legal dissolution of either entity by adding the book values of the two entities to create one. Today, combining companies must meet twelve criteria established in APB 16 to use this method. The two most significant rules require the entire purchase must be in stock, and one company must hold at least a ninety-percent interest in the other company.

If combining companies can not meet the twelve requirements or the companies choose to not utilize the pooling method, the companies must use the purchase method. The purchase method establishes one company as the acquirer. The acquired company is legally dissolved; thus its assets and liabilities are recorded in the acquirer's balance sheet at fair value. The difference between the purchase price and the fair value of the acquired company (fair value of the acquiree's assets minus the fair value of their liabilities) is recorded as goodwill[1].

This paper discusses major issues dealing with the pooling-of-interests method and the recent Exposure Draft. First, the history of the pooling method will provide the historical context of how businesses use this method. Next, Exposure Draft explains the expected changes for business combinations. The remaining sections explain the benefits and problems with the Exposure Draft and its effects.

HISTORY OF POOLINGS

The pooling-of-interests method has been around for almost a century. However, during the majority of this time, accounting standard setting bodies have a bias against pooling for a variety of reasons. Many bodies have enacted on this bias by trying to limit or eliminate this method. This section will showcase this bias and discuss the attempts to hamper the use of poolings.

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1 APB 16 requires goodwill to be recorded on the balance sheet as a long-term asset, and goodwill should be amortized over a period greater than one year but less than forty years.

The use of poolings originated in the 1920's. Although its use was limited pooling was used to merge two subsidiaries of the parent company. Recording combinations at book value was consistent with accounting principles because both subsidiaries remained the legal property of the parent company. Since the combination did not require a legal dissolution, regulatory bodies accepted the use of poolings.

The amount of pooling transactions increased drastically during the 1940's. The Federal Power Commission accepted the use of poolings for public utility rate-base situations because owners were closely related, which increased the use of poolings (Fioriti, 1994, p.21). For the next couple decades, the use of poolings was expanded as many companies cited this precedent to combine their newly purchased businesses.

This ruling also changed the nature of pooling transactions. Previously, pooling were limited to situations were legal dissolution was not required because one owner owned both combining companies. Afterwards, pooling was allowed in situations where companies were not dissolved legally. However, the accounting records did not reflect this because new assets and liabilities were recorded at book value instead of fair value.

Accounting regulatory bodies recognized this flaw and made several attempts to control the use of poolings. In 1950, The American Institute of Certified Public Accountants (AICPA) issued the Accounting Research Bulletin No. 40, "Business Combinations," and seven years later, issued Accounting Research Bulletin No. 48, "Business Combinations." According to Andrew

Fioriti: "Neither did much to alleviate the many discrepancies and misinterpretations inherent in the pooling treatment," (Fioriti, 1994, p.24).

In 1970, new attempts were made to alleviate the problems of the pooling-of-interests method. APB 16 listed twelve criteria that companies must meet before they use the pooling method. This ruling prevented many companies from using poolings, but it failed to resolve the inconsistencies of having two methods for the same transaction. APB 16 also failed to correct the accounting inconsistencies of this method.

SUMMARY OF THE PRELIMINARY RULING

Because of previous failures, the FASB plans to issue a ruling to eliminate the use of poolings. Currently, an Exposure Draft has been issued and comments requested. This section will discuss significant accounting issues involved with the Exposure Draft. Although some changes may be made before the final ruling is issued, the major issues, including the removal of the pooling-of-interests method, discussed below are unlikely to change.

The final ruling will amend APB 16, "Business Combinations," and will supersede APB 17, "Intangible Assets." This will occur as soon as the final ruling is implemented.

First and foremost, this ruling prohibits the use of the pooling method. This applies to all business combinations following the implementation date, and applies to all areas of business excluding not-for-profit businesses and excluding any transfer of assets or stock between two enterprises under common control.

Part I modifies the rules to record negative goodwill.[2] Under the proposed method, negative goodwill is first applied to the combined intangible assets, then the tangible long-term assets, except for marketable securities.

Part II of the Exposure Draft changes the goodwill amortization period. Companies will only be able to amortize goodwill over twenty years instead of the current forty-year maximum, and goodwill will be amortized exclusively on a straight-line basis. To remain consistent, the Board limited the amortization of all intangibles to twenty years, unless the company can prove that the intangible assets can generate cash flows that extend beyond the twenty-year time frame. The Board also established impairment reviews and tests of goodwill that must be performed annually. The Board proposes that goodwill amortization is recorded separately on the income statement and net of tax, which makes the effects of the goodwill charges more transparent to users. Disclosure rules will be increased to provide more information to financial statement users.

ADVOCATES OF THE PURCHASE METHOD

Most companies in the United States and international communities have adopted the purchase method as the primary method for business combinations. Those countries that have not adopted the purchase method have proposals to do so similar to the one before the FASB now. These companies use the purchase

[2] APB 17 mandates a company record negative goodwill when the fair value of the company acquired exceeds the purchase price. Negative goodwill occurs when the fair value of assets received is greater than the purchase price. Negative goodwill is allocated to all long-term assets, except marketable securities, based upon the percentage of that assets value. If all long-term assets are subsequently reduced to zero, and negative goodwill remains, then a credit is stated on the balance sheet and is amortized on the income statement yearly.

method because it results in better financial disclosure and comparability for users of their statements.

FINANCIAL COMPARABILITY

The FASB strives to make financial statements relevant to users. Using the accounting concept of comparability, the FASB can achieve this goal. Comparable financial statements allow users to make better investment decisions, which remains the purpose of these statements.

Eliminating all but one way to measure and record business combinations enhances comparability. Currently, analysts have difficulty comparing companies that use separate methods because the pooling-of-interests method does not record goodwill, purchase values are often different between methods, and pooling does not state assets at fair value. By eliminating the use of poolings, all these dissimilarities disappear allowing users to compare financial statements and evaluate management's performance on business deals.

Ratio analysis will also benefit from the elimination of the pooling-of-interests method. Since recording assets at fair value only occurs with the purchase method, analysts can not compare asset ratios because fair value is often significantly different than historical value (used when implementing the pooling-of-interests method). Earnings ratios are hard to compare, because the amortization of goodwill means that the purchase method creates a lower net income (or a greater net loss) than the pooling-of-interests method. These methods create significant differences in the ratios they produce, which is enough to affect comparability (Ayers, 1999).[3]

Internationally, the Exposure Draft enhances financial comparison. International accounting boards advocate the use of the purchase method. This preference places the United States as one of the only remaining countries that still allows pooling combinations.

FINANCIAL DISCLOSURE

Another benefit of the purchase method is better disclosure within financial statements. These benefits include better information concerning the purchase price, subsidiary's performance, and subsidiary's fair value. These disclosures allow users to make more informed decisions about companies.

The purchase method provides users with much more important and complete information about the purchase price of a company. As required, companies disclose the purchase price in monetary terms, and through the recording of goodwill, they allow users to determine the acquired company's fair value. Lucent's 10-K for the fiscal year ending September 30, 1998 provides a terrific example of the disclosure for the purchase method (Lucent, 1999). Shown in table form within the footnotes, all material acquisitions using the purchase method provide information on the acquisition date, the purchase price, the form of consideration given, goodwill, the goodwill amortization period, and a

[3] Although the study found varying results for different industries, Ayers and others found that, on average, return-on-equity was 13.6% higher when using the pooling-of-interests method. Similarly, earnings per share for pooling transactions were 2.2 to 15.7% higher than if the purchase method was used. Other ratios, similar to these, suffer similar differences.

description of the acquired company. This required information is more significant and relevant than required when using the pooling-of-interests method.

It is difficult to identify the real price paid for acquisitions when using the pooling-of-interests method. Requirements for disclosure only include a footnote detailing the description and number of shares issued. Even more confusing for financial statement users is the way stockholder's equity accounts are combined. The amount recorded in the additional paid-in-capital account does not reflect the excess of the market price over the par value, the amount is determined by the acquired company's stockholder's equity section of the balance sheet.[4] This makes it impossible for users to know the stock's worth on the day it was traded or the amount paid for the acquired company's stock.[5]

Acquisition costs are fully disclosed under both methods. This information shows costs incurred while pursuing, negotiating, and combining the two companies. Viewing Quadramed Corporation's financials for fiscal year 1999, the statements display all acquisition expenses both on the consolidated statements and in the footnotes (Quadramed, 2000). These costs are fully disclosed with the purchase method as well.

The purchase method provides more information to users about a subsidiary's performance and contribution to the consolidating entity. The purchase method requires that a parent company record only the net income

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[4] When a company issues stock, the par value of the issued stock is recorded in the corresponding stock account. The difference between the proceeds received and the par value account gets recorded in the additional-paid-in-capital account. Knowing the par value of the issued stock and the additional paid-in-capital account amount allows users to determine the market price of stock issued for the acquired company.

[5] Knowing the market price on the date of exchange provides users with minimal information to determine the amount paid for the company. However, users never know the company's worth.

earned following the acquisition date. Net income can be recorded two ways. Either the consolidated entity includes all sales and expenses for the year and the portion of net income relating to the reacquisition time period is excluded or only the sales and expenses occurring following the acquisition are recorded. The former allows for better comparability and could become a future Generally Accepted Accounting Principle (GAAP) requirement. Unfortunately, companies like Omnicare uses the latter method in their fiscal year 1997 10-K

The pooling-of-interests method fails to provide adequate disclosure rules dealing with the subsidiary's performance or contribution to the acquiree's financial performance. This method assumes companies have always been combined; therefore, previously issued financial statements must be restated to include the acquisition (Baker, 1999, p.27). Even if companies combine in the final period of the fiscal year, the financial statements of the parent will include the entire year's revenues, expenses, and net income of the subsidiary. For example, Tyco acquired Kendall September 30, 1994 using the pooling method. As a result, the company reported all of Kendall's sales, expenses, etc. as their own. During fiscal year 1996, Tyco describes what portion of revenue belongs to which company, but the company does not make separate disclosures for expenses (Tyco, 1996). This failure makes judging the performance of acquisitions complicated, as well as the parent's performance.

ARGUMENTS FOR THE POOLINGS METHOD

Despite the benefits of the Exposure Draft, there are those who oppose its implementation. Several accounting professionals and others in the business profession have provided several arguments for the retention of the pooling-of-interests method. Unfortunately, some groups are against the Exposure Draft for biased reasons, and they ignore the benefits that the draft may bring. Three arguments for the retention of the use of poolings are a negative economic impact to accepting the proposed ruling, the difficulty in determining an acquirer for pooling transactions because the combination resembles a "true merger", and the recording of goodwill.

RECORDING OF GOODWILL

The main argument against the Exposure Draft is the mandate for companies to record goodwill. The FASB notes that the majority of the people who disagree with the purchase method, especially those with economic concerns, disagree with the recording of goodwill (FASB, 1999, paragraph 105). Making the issue even more contentious is the section that reduces the goodwill amortization period to a twenty-year maximum. Recording goodwill becomes a significant earnings drag to companies planning to combine following the FASB ruling.[6]

[6] For example, NationsBank acquired both the Barnett Banks and BankAmerica for a total of $55 billion in stock. Had they used the purchase method, the company would record $30 billion worth of goodwill. Accounting consultant Jack Ciesielski noted that had they amortized goodwill, earnings for the year would drop 11% (from $4.65 to $4.16) and return on equity would drop from 17% to 9.1% (Tully, 1999, p.207). Had the goodwill period been reduced to a maximum of twenty years, earnings would drop by approximately another $0.49 to $3.67 for year- end 1999.

Some argue that goodwill fails to meet the definition of an asset[7], therefore, goodwill should not be recorded on the consolidated balance sheet. There are two arguments against recording goodwill as an asset. One, goodwill is more similar to an expense than an asset because goodwill can be seen as a cost of acquisition without a future benefit. Second, goodwill is not an asset because it is inseparable from the business and sold.

The FASB concludes that goodwill meets the definition of an asset, thus companies should record goodwill on the consolidated balance sheet. Although goodwill is not separable like some assets, the Board concludes that this does not necessarily have to be true (FASB, 1999, paragraph 182). The requirements below determine the essential characteristics of an asset. Other similar characteristics are mere coincidences.

The definition of an asset requires an asset to have a probable future benefit. As commented in Concepts Statement #6, the market price paid for an asset determines the future benefit of that asset. This applies to the definition of goodwill, which is the amount paid in excess of the acquired company's fair value. This premium demonstrates the future benefits deriving from possible

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The use of the purchase method would lower earnings by 21% for 1999 when compared with the pooling method.

[7] The FASB provides the most current and acceptable definition of an asset. Concept Statements #6: *Elements of Financial Statements* states:

> "An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. [paragraph 26]"

[This has been quoted from the Exposure Draft 121, paragraph 179.]

synergies of the combined company or assets, which translates into greater cash flows.[8]

The Board also determined that the combined company obtains the benefit and controls access to goodwill, which meets the second asset criteria. Management makes decisions regarding the assets purchased in conjunction with goodwill and stockholders own any cash flows generated by these assets; therefore, the company controls the access to goodwill. Also, company growth and profits are derived from the synergies mentioned above, proving the company further benefits from goodwill.

The third requirement of an asset dictates that the transaction for the transfer of rights must have already occurred. Since companies purchase goodwill along with any other assets and liabilities, the company owns the rights to the goodwill[9]. This means that as soon as the consideration is given or promised to the acquired company, goodwill should be recorded as an asset.

IGNORE GOODWILL. People against forcing companies to record goodwill have proposed several alternatives to the Board's exposure draft. One alternative is to ignore goodwill by not recording it on the consolidated balance sheet or income statement.

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[8] Sometimes a company can not provide superior performance to justify the use of goodwill, or oftentimes the company may sell assets following the combination that were deemed to provide certain synergies as a whole, then the current Exposure Draft requires the company to test for the impairment of goodwill. The impairment test must be performed yearly, and goodwill must be further amortized if necessary.

[9] This assumes that the acquirer purchases 100% of the acquired company. If the company only purchases a portion (greater than 50% and less than 100%) then the company would record the outstanding portion in an account called "Non-Controlling Interest." The Non-Controlling Interest title rightfully implies that outsiders do not make any decisions regarding the assets, including goodwill, they only receive their share of net income, as would any other stockholder. However, control still remains with the parent company.

Several problems arise with this suggestion. Ignoring goodwill under the purchase method is not feasible for all options (Johnson, Nov 17, 1999). For example, if consideration is rendered in cash, then it is impossible to fairly state either the acquisition cost or the assets due to a difference between debits and credits. Another problem is that the "nature of the consideration tendered should not dictate the accounting for the net assets acquired," (Johnson, Nov 17, 1999). For example, companies should not ignore goodwill when the acquirer pays with stock, yet force the acquirer to record goodwill on cash purchases.

EXPENSE GOODWILL. Another alternative is to expense goodwill in the acquisition year. Advocates justify this approach on measurability problems of goodwill cash flows. This situation leads to accounting inconsistencies, which the FASB is trying to prevent. Since future cash flows can not be determined or separated from other assets, goodwill should be expensed immediately.

This method also has its setbacks. First, FASB identifies goodwill as an asset, which means goodwill has several years of revenue potential. Expensing all of goodwill in the first year would violate accounting's revenue matching concept[10]. Although amortization over several years is somewhat arbitrary, this method at least recognizes that a future benefit exists. Furthermore, the goodwill impairment tests provide a minor check on this arbitrary amortization because if goodwill loses value it must be expensed. Second, this method is consistent with other intangible assets. Other intangibles often do not have recognizable revenue streams, yet they are still classified as an asset and amortized over a forty-years.

[10] This concept states that all revenues must be matched with their appropriate expenses on the income statement (or year incurred).

Amortize to Equity. Another proposal is to record goodwill directly to equity. Currently, goodwill is recorded on the income statement as an expense. Proponents argue that goodwill is confusing to users because goodwill is not a true operating cost, thus it should be deducted directly from equity.

The FASB disagrees with this method. First, recording expenses in equity decreases the transparency for investors, because investors rarely read this section in the financial statements (Johnson, Jun 1999). Another reason is that equity would be affected equally whether a company expenses goodwill on the income statement or deducts goodwill from equity. Finally, the amortization of goodwill is similar to several depreciation methods to depreciate assets. Consistency requires the amortization expense to be recorded on the income statement.

DETERMINING AN ACQUIRER

Another argument for the use of poolings is that pooling should occur where an acquirer can not be determined. Advocates state that the combined company is similar in both structure and function to the two separate companies. These similarities include ownership structure, no new capital is issued, united or combined strategies, and similar risk factors. Due to the similarities, some argue that this constitutes a true merger, or a merger of equals. Since one entity does not dominate or control the combined entity, an acquirer can not be determined.

However, most conditions are either limited in nature or significant differences exist.

Risk and other business strategies and goals change after a combination occurs. Combined companies often enter new business fields, new markets, etc., which modifies the combined company's risk when compared with the companies' risk before combination. Strategies also change. These changes occur because companies grow in size, and management pursues new products or regions to pursue. Strategies also change to incorporate the company restructuring plans, something managers would not focus on if companies remained unconsolidated.

The use of poolings can not be viewed as a combination of related parties because the combinations follow the pattern of a purchase (FASB, 1999, paragraph 146). The acquirer often issues stock with a higher market value than the other company's value, which creates a premium for the shareholders of the acquired company. This results in a profit for the stockholders of acquired company, which closely resembles the profit a seller earns on a sale to a customer. Both situations indicate the acquirer, who purchases the asset, from the acquiree, who receives the premium.

There may be instances where combined businesses are similar to a true merger. This situation could occur if the combining businesses were of similar size, type, management control, and asset structure. Management must continue to operate their respective divisions and control of the combined company would be shared equally. The Board of Directors and Chief Executive Officers would be combined and their duties shared. However, the possibility of these similarities occurring concurrently is extremely rare.

Even if all these similarities were to exist, the FASB believes the combined entity should choose an acquirer so everyone can use the purchase method. The FASB labels the larger company the acquirer (FASB, 1999, paragraph 100). However, the FASB has yet to choose what statistic needs to be larger to determine the acquirer. If a larger company does not exist, the Board allows the separate companies to appoint the acquirer (FASB, 1999, paragraph 101). Although appointment of one or the other as acquirer creates a modest accounting difference, the Board believes that this is an insignificant difference because of the vast similarities.

The FASB could also determine the acquired company as the one who receives the premium to their current stock price. This can be determined by examining the per share market value both before and after the consolidation. If one receives a premium to their current stock price on the date of the combination announcement, they can be considered acquired by the other.

There are two reasons that this method is logical. First, the premium paid is similar to earning a profit on goods. This means the company receiving the premium is being paid extra to forfeit their interest in that entity. Second, a seller would rarely make a sale for below fair value. This demonstrates that the company paying the premium should not be considered the acquired company.

ECONOMIC IMPLICATIONS

Although the pooling-of-interests method is used in less than five percent of combinations, it is possible that pooling will increase significantly because of the current, highly valued stocks. Advocates claim the FASB should reject the Exposure Draft because the draft may slow mergers and acquisitions and prevent certain industries from gaining investment capital.

The technology, biotechnology, and Internet sectors complain about the loss of the pooling-of-interests method (Tully, 1999, p.206). Currently, these industries have high stock valuations and few companies have enough cash to use for mergers. This situation makes combinations difficult, especially in a crowded industry with fierce competition. The lack of cash and high acquisition costs force companies to use stock for combinations.

Shawn Tully notes that financial companies also complain about the Exposure Draft (Tully, 1999, p.206). First, financial companies, especially the big investment banks like Merrill Lynch, earn billions of dollars structuring combinations in the technology, biotechnology, and Internet sectors. Financial companies lose money when merger activity slows. Second, this is one of the biggest users of the pooling-of-interests method (Ayers, 1999). It is likely that they would disagree with a ruling that prevents them from combining and making money.

These industries may suffer further hardships. If predictions are correct and mergers slow, then investors would be skeptical of these industries. The negative outlook prevents these companies from obtaining new investment capital, further impacting the industry. Several authors identified other industries, such as the property and casualty insurance industry and the bank industry, which also suffers from these problems.

The FASB responds to this economic concern by declaring them irrelevant (FASB, 1999). The FASB strives to ensure businesses record transactions fair and accurately. They ensure that outside stakeholders[11] can rely on financial statements to be useful and materially correct in all aspects. By eliminating the use of poolings, the FASB assists comparability and improves financial disclosure. The Exposure Draft also increases accuracy and consistency by recording assets and liabilities at fair value and recording the true cost of the combination via goodwill.

Others have responded to the economic implications directly. Some argue that mergers will not slow. They believe that companies who want to combine using the pooling-of-interests method will do so before the FASB issues the final ruling (Greenwald, 1999, p.2). Due to unresolved issues with the Exposure Draft, the final ruling may take another year or more to complete. This timeframe allows most companies ample time to start their business combination progress.

Others indicate the Exposure Draft does not affect the numerous combinations because of industry overcrowding. This overcrowding forces companies to merge regardless of the draft, and acquirers continue to pay premiums as long as quality assets are received (Greenwald, 1999, p.2).

Additionally, most companies use the purchase method regardless of stock valuations. For example, Berkshire Hathaway purchased General Re Corporation using the purchase method during June of 1998. This was the largest deal in the

[11] Stakeholders can be defined as anyone that has an interest in the business. Outside stakeholders include any banks loaning money to the company, bond holders, stockholders, etc.

property and casualty industry and one of the industries believed to be unable to merge using the purchase method.

Even if the Exposure Draft eliminates the pooling-of-interests method, it is likely to create a more efficient system of allocating resources (Johnson, Jun 1999). Eliminating the pooling method prevents those combinations from reporting higher earnings than the purchase method[12] and allows for a more efficient allocation of capital.

CONCLUSION

Although concerns exist about the Exposure Draft, the benefits of better financial statements make it hard to disagree with its acceptance. Furthermore, the opposition's arguments are of either little concern to accounting goals (such as the economic implications' argument) or have serious conceptual flaws (as in the opposition to goodwill).

Accounting standards and standard setting bodies strive to provide useful financial statements. This Exposure Draft provides a critical step to make financial statements more comparable and make more information available to users. Not only will this be a benefit to the United States standard setting bodies, but benefits to the international community occur as well. After all these years, the FASB has finally accomplished what they intended to do with APB 16.

[12] The pooling-of-interests method does not record goodwill at either the date of combination or any other time. This practice is different than the purchase method, which records goodwill. Since goodwill must be amortized yearly and presented as an expense on the income statement using the purchase method, then the use of poolings allows companies to report higher earnings (holding all other amounts equal).

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