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"TIME FOR REVIEW OF POOLING CRITERIA"

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TIME FOR REVIEW
OF POOLING CRITERIA

I. Introduction

When AT&T and NCR agreed to merge last May, the companies sought the Commission's concurrence that the proper accounting method for the business combination was the pooling of interests method rather than the purchase method. As everyone here is aware, pooling would permit retention of the historical cost of assets and liabilities of the two companies and would not result in adjusting any amounts to fair market value.

In order to satisfy Commission requirements for the business combination to receive pooling of interests accounting treatment, AT&T, among other things, agreed to sell 6.3 million shares of new NCR stock. The unusual sale was intended to "undo" NCR's stock repurchases over the last two years, which could have blocked the use of pooling. These repurchases, if left "uncured," arguably would have violated one of the twelve specific requirements, included in APB Opinion No. 16 for the merger to be considered a pooling of interests.

The approximately $7.5 billion AT&T - NCR merger, the largest pooling ever, heightened interest in the pooling method of business combination accountings, and, in my opinion, this heightened interest calls for thoughtful reexamination and reconsideration of the criteria required to qualify a business combination for pooling accounting treatment. Today I wish to discuss the development of the current criteria for a business combination to qualify for the pooling of interests accounting method, what the trend in this area is internationally, and a suggestion for how the method should be applied in the future domestically.

As everyone here is well aware, generally accepted accounting principles for the acquisition of a business are set forth in Accounting Principles Board ("APB") Opinion Nos. 16 and 17. APB Opinion No. 16 specifies two methods of accounting for business combinations. The two methods are not elective alternatives. One of the two methods will be required depending upon the structure of the transaction. If a business combination meets the twelve criteria contained in APB Opinion No. 16, the pooling of interest

accounting method will apply. Otherwise the purchase accounting method applies.

Obviously many parties to a business combination prefer using pooling rather than purchase accounting because pooling avoids the recognition of the goodwill asset, which must be amortized and charged to income. Goodwill is often by far the largest dollar factor in a business combination. For example, the goodwill asset in the AT&T-NCR merger was approximately $5.7 billion, which will amount to an annual charge of approximately $114 million. The amortization of the goodwill asset can often have a significant negative impact on future reported net income and earnings per share. This negative impact can be avoided if pooling of interests accounting is applicable to the business combination.

II. The Development of the Current Pooling Criteria

In 1969 and 1970, the Commission testified before Congress on the abuses occurring in the accounting for business combinations.[1] In his 1969 testimony before the Senate, then

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[1] See Statements of Hammer H. Budge before the Subcommittee (continued...)

Commission Chairman Budge noted that at the encouragement of the Commission, the APB was considering "very severe restrictions" on the use of the pooling method. He also stated that if the APB was unable to resolve the issue, the Commission would consider rulemaking.

Shortly thereafter, the APB issued new accounting rules (Opinion Nos. 16 and 17), which was the culmination of a process that began with research studies in 1963. Due to practice eroding to the point that companies could account for similar transactions using the purchase, pooling, or even "part purchase-part pooling" methods, the APB voted to eliminate the latter method (part purchase - part pooling) and also to restrict the use of pooling generally.

The establishment of these new rules was extremely controversial, as evidenced by the over 800 comment letters

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[1](...continued)
on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, on Pressing Problems Confronting The Commission, February 25, 1969 and before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, February 18, 1970.

received on the exposure draft. The most controversial provisions in the exposure draft were: the requirement that only common stock could be issued in a pooling; the requirement that only companies which met certain size tests could pool (e.g., not more than two or three times larger than one another); and the requirement that under the purchase method, goodwill resulting from an acquisition had to be capitalized and amortized.[2] A number of APB members believed that the pooling method should be eliminated altogether.[3]

Only after a controversial debate among its members was the APB, under close oversight by the Commission, able to issue the final standard, APB Opinion No. 16, by the bare minimum 12 to 6 vote. While APB Opinion No. 16 continued to permit the pooling

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2 Exposure Draft: Proposed APB Opinion: Business Combination and Intangible Assets, February 1970, Accounting Principles Board.

3 APB Opinion No. 16, Business Combinations, August 1970, Accounting Principles Board, dissenting position of Messrs. Davidson, Horngren, and Seidman. ("Messrs. Davidson, Horngren, and Seidman dissent to the Opinion because it seeks to patch up some of the abuses of pooling. The real abuse is pooling itself. . . .")

accounting method, the final standard incorporated complicated criteria which must be satisfied in order to use that method. However, noteworthy among the compromises made during the debate was the elimination of the comparable size test as one of the pooling criteria.

Almost immediately after the issuance of the new standard, practice in the business combination accounting area again appeared to erode; and implementation problems arose. As before APB Opinion No. 16 was issued, companies began to abuse the pooling concept to avoid the goodwill asset amortization, rather than using the pooling method because the business combination represented a uniting of interests. As a result, the APB considered whether to amend Opinion No. 16 to address some of these abuses. The APB chose instead to permit its staff to issue formal interpretations. Between December, 1970, and March, 1973, thirty interpretations were issued, many at the urging of the Commission. Rather than risk the same breakdown in practice that had created

the need for APB Opinion No. 16 in the first place, the Commission also issued several interpretive releases in this area.

Subsequently, in 1976, the Financial Accounting Standards Board ("FASB") issued a Discussion Memorandum on business combinations but never completed the project. It is my understanding that the FASB currently has a project on its agenda addressing when a new basis of accounting is appropriate because a business has been acquired in a situation such as in a leveraged buyout. Some members of the FASB have stated publicly that they expect to have to reconsider APB Opinion Nos. 16 and 17 as a result of this current project, or as another project in the 1990's. I would respectfully urge the FASB to bring to the forefront of its agenda a review and reconsideration of at least the criteria for pooling in APB Opinion No. 16.

APB Opinion No. 16 continues to provide twelve criteria in an attempt to ensure that mergers that were considered to be a pooling could be distinguished adequately from those that were purchases. A strong argument can be made that APB Opinion No.

16, with its twelve conditions, gives little regard to the real substance of a merger. In reality, pooling is a rare combination, and I suspect that the vast majority of business combinations are in fact acquisitions rather than a uniting of interests. While APB Opinion No. 16, with its complexity, has resulted apparently in a decrease in the use of the pooling accounting method, the more preferred approach, in my judgment, would be to revise the criteria so that the substance of the criteria would more accurately identify that rare occasion when the business combination in question should be accounted for as a pooling of interests.[4] The current approach of imposing technical conditions which are difficult to interpret and to apply, and thereby simply discourage attempts to utilize the pooling method, is, in my view, misguided.

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[4] See Davis, Michael, "APB 16: Time to Reconsider," Journal of Accounting, October 1991, at p. 100. ("The complex rules of APB Opinion No. 16 have achieved one desired objective: The use of pooling has decreased steadily. . . . [T]he number of poolings for the 600 companies tracked in Accounting Trends & Techniques declined from 185 in 1969, the last full year before Opinion No. 16 became effective, to 18 in 1969.")

III. Business Combination Accounting Methods in Other Countries

An argument historically used to justify the existence of broader pooling accounting treatment in the U.S. has been that such broader treatment is more compatible with international accounting practices and is necessary for U.S. companies to be competitive internationally in the business combination area. A review of the business combination accounting practices internationally indicates that the international trend is to be more stringent on pooling than under APB Opinion No. 16. The review also indicates that there is mixed usage of the amortization of the goodwill asset concept although, at least in the U.K., goodwill amortization as a part of the purchase business combination accounting method is being considered. Thus, an international accounting practice review provides at best limited support for a broad application in the U.S. of the pooling accounting method.

(A) Pooling Accounting

Pooling accounting is utilized infrequently outside of the United States in any event. French, Japanese and Italian

accounting literature are silent as to the concept; Australian literature explicitly prohibits pooling of interests accounting. Stock for stock transactions do not exist in Japan, thus eliminating a traditional rationale for pooling of interests accounting. Dutch literature is silent on pooling of interests accounting, but pooling accounting has been used to present a "true and fair view" of certain business combinations. In Germany, the U.K., and under International Accounting Standard ("IAS") No. 22, pooling accounting for business combinations is achieved rarely. It is required only when an acquirer cannot be identified.

In addition, it is my understanding that the U.K. Accounting Standards Board has proposed to further restrict poolings to combinations in which the size of the organizations to be united is roughly the same.[5] Thus, even in the U.K., one of the few countries where pooling accounting is permitted, the trend is to be more restrictive in the pooling area.

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[5] See Exposure Draft No. 48: Accounting for Acquisitions and Mergers, February 1990, United Kingdom Accounting Standards Board.

(B) Purchase Accounting

Purchase accounting standards are very similar between the U.S., Australia, Canada, The Netherlands, the U.K. and under IAS No. 22. However, in the U.K., Germany, Italy, The Netherlands and under IAS No. 22, a company may charge the amount of goodwill recorded in a business combination to equity at the consummation of the business combination. This treatment eliminates the reduction of future earnings arising from goodwill amortization and occasionally is cited as allowing companies domiciled in those countries, particularly the U.K., to bid higher than U.S. companies for potential acquisitions.

German standards do limit the allocation of fair values to a ceiling (acquirer's purchase price) and to a floor (historical net book value).

Japanese business combinations are either "legal mergers" or "consolidations." The Japanese Commercial Code requires only that the recorded amount of net assets acquired in a legal merger be

limited to fair value – no specific valuation guidance is provided. Consolidations are similar to U.S. purchase combinations.

As I indicated, it is my understanding that the purchase and pooling accounting methods for business combinations are being reconsidered in the U.K. Under this proposal, which also as I previously mentioned further restricts pooling, goodwill, under the purchase accounting method, could not be charged off to equity but, as in the U.S., would have to be capitalized as an asset acquired in the purchase.[6] Any goodwill recorded from the acquisition would have to be amortized over a period not to exceed twenty years, as opposed to a maximum of forty years which is allowed in the U.S. Thus, as proposed, the U.K accounting treatment for goodwill in a purchase business combination would be more stringent than that of the U.S. The combined restrictive treatment proposed for goodwill under the purchase method, and for the pooling method in general, should eliminate most of the U.K. business combination accounting competitive concerns for the U.S.

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6 See note 5, supra.

Therefore, some competitive concerns, which have in the past supported the continuation of the pooling criteria as set forth in APB Opinion No. 16, may soon no longer exist. Some other competitive concerns, as the above international accounting practice review established, may never have existed in the first place.

IV. International Accounting Standards Committee Developments

On a multilateral level, there is additional evidence of a trend toward restricting, if not eliminating poolings altogether. In July, 1990, the Board of the International Accounting Standards Committee ("IASC") issued a Statement of Intent to reduce the alternative accounting treatments in IASC standards ("Comparability Project"). The changes are to take effect after other improvements to the implementation guidance and disclosure requirements in IASC standards are made ("Improvements Project").

One of the decisions reached by the IASC Board in the Comparability Project was that a "uniting of interests" should be

accounted for using the pooling of interests method.[7] It further was concluded that a uniting of interests should arise only when an acquirer cannot be identified and that the revised standard would include guidance on when this was the case. Thus, proposed IASC standards would effectively limit poolings to those rare circumstances where the parties to the business combination join together in a substantially equal arrangement. The proposal is similar to the present accounting treatment for poolings in Canada and is somewhat similar to that proposed in the U.K., but relative to U.S. accounting, the proposal would be more restrictive.

The Improvements Project has been underway for over a year now, and the IASC Improvements Steering Committee ("Committee") presently is considering the criteria that would be essential for pooling treatment of a business combination. It is difficult to predict at this point what the final conclusions of the Committee and the IASC will be, but various factors essential to a pooling and

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7 See Exposure Draft No. 32: Comparability of Financial Statements, July 1990, Board of the International Accounting Standards Committee.

to identifying an acquirer are being considered. These proposed factors essential to a pooling include criteria that there be principally an exchange of voting common shares and that the whole, or effectively the whole, of the combining enterprises are combined into one entity. Among the specific conditions being considered that may indicate whether the primary criteria essential to a pooling is satisfied (i.e., that no party can be identified as being dominant or subordinate) is one that looks to the relative sizes of the enterprises.

V. Conclusion

In conclusion, APB Opinion No. 16 was intended to curb the abuses of applying the pooling accounting method during a period when virtually any business combination could be accounted for in this manner. Today, it appears that while APB Opinion No. 16 has restricted or discouraged the use of the pooling accounting method for business combinations, it has not successfully limited the method to combinations where a uniting of interests has occurred. Both the U.K and the international accounting community have

begun to acknowledge the fact that today's business environment is far different than when business combination guidelines such as APB Opinion No. 16 were issued (i.e., some 20 plus years have passed since APB Opinion No. 16 was first issued), and both the U.K. and the IASC already are taking steps to further restrict the use of pooling.

If, as intended, the IASC standards result in a more comparable accounting treatment for business combinations and are generally accepted internationally, it may be necessary in the near future for the FASB to reconsider APB Opinion No. 16. I am inclined to believe that the U.S. should follow the IASC's example and should consider limiting pooling treatment to those situations where the parties to the combination are relatively the same size.

Although the IASC has not as yet incorporated a specific size test into its pooling conditions, a comparable size test would, in my view, reflect the reality that a true pooling is a rare occurrence that occurs only when the entities to be combined are roughly the same

size.[8] The U.K. Accounting Standards Board is apparently considering a size test, and there was considerable support for the inclusion of a relative size limitation as one of the criteria for APB Opinion No. 16 when the Opinion was being adopted.[9]

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[8] At least one commentator agrees with this conclusion. See Davis, Michael, "APB 16: Time to Reconsider," supra note 4, at p. 103. In his article, Dr.Davis stated:

> Research studies have found the average relative size of pooled companies, both before and after Opinion No. 16, is about 20% of the acquirer. Rarely do pooled companies approach 50% of the acquirer and many are less than 5%. Except in the most unusual circumstances, it seems inconceivable a true pooling of interests could occur when one merger partner is 5 to 20 times larger than the other.
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> . . . .
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> Poolings are rare indeed. According to my study of a sample of 108 U.S. pooling method mergers during 1971-82 as published in the July 1990 issue of the Accounting Review, a 40% size restriction would have eliminated all but one of them.

[9] APB Opinion No. 16, Business Combinations, August 1970, Accounting Principles Board, dissenting position of Messrs. Broeker, Burger, and Weston. ("Messrs. Broeker, Burger, and Weston dissent to issuance of this Opinion because they believe that it is not a sound or logical solution of the problem of accounting for business combinations. They believe that, except for combinations of companies whose relative size is such as to indicate a significant sharing of ownership risks and benefits, business combinations represent the acquisition or purchase of (continued...)

Most business combinations that meet the current pooling rules are not poolings in substance but acquisitions disguised as poolings. Thus, arguably one result of the application of the present pooling criteria is a financial statement which does not reflect true economic values and is potentially materially misleading. Either the FASB or the Commission should reexamine the appropriateness of the pooling of interests business combination accounting method in the United States to cure what appears to again be an abuse, albeit a more limited one, of a more favorable accounting method.

As I mentioned, any justification for pooling on the basis of international competitiveness concerns is limited at best; and the worldwide trend appears to be more stringent on pooling treatment. In my judgment, the pooling criteria of APB Opinion No. 16 should

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[9](...continued)

one company by another and that accounting should reflect that fact. While they agree that the criteria specified in this Opinion for the pooling of interests method represent, in most cases, an improvement over present criteria in practice, this action does not, in their opinion, represent a substantive response by the Accounting Principles Board to the overall problem.")

at least be reviewed and reconsidered and possibly modified to include a specific size requirement.