BUSINESS COMBINATIONS AND CONSOLIDATIONS

[A Reading to Supplement the Text]

Business combinations in the United States economy have been a common occurrence for over a century. Combinations of unrelated business units are commonly effected through mergers, consolidations, or acquisitions. However, only two methods of accounting for business combinations are found in practice. These methods are not elective, as in inventory valuation or in depreciation accounting, and the appropriate method must be used in a given set of conditions. The resulting combined financial statements may be radically different, depending on the method of accounting used. One method, **purchase accounting**, assumes that one company purchased another company and that a new basis of accountability exists. This new basis requires that the fair market value of the consideration given (the price paid for the acquired company) be the measure for recording the net assets acquired in the business combination.

The other method, **pooling of interests accounting**, often shortened to pooling accounting, assumes that the stockholders of the two constituent companies have merely exchanged common stock and that the separate businesses have been combined into one business. The constituent companies to a pooling of interests are often referred to as a combinor and combinee. A **combinor** is a company that uses pooling accounting to record a business combination and issues its shares of common stock in exchange for at least 90 percent of the outstanding shares of common stock of the other party to the business combination, the combinee. A **combinee** is a company that is a party to a business combination that qualifies for pooling of interests accounting treatment and whose stockholders surrender at least 90 percent of their outstanding common shares in exchange for the common shares of the combinor. When pooling accounting is used, the combinor normally issues its previously unissued common stock (treasury shares of common stock may be used under very limited circumstances, as discussed later) for the outstanding common shares of the combinee. Under pooling accounting, a new basis of accountability is not present. Therefore, pooling accounting requires that the book values of the two companies' net assets be the measure for recording the business combination, and the fair market value of the consideration exchanged is ignored.

REASONS FOR BUSINESS COMBINATIONS

There are, of course, many legitimate reasons for **external business expansion**, that is, expansion through business combinations that bring two or more entities under common control. These reasons include (1) acquiring sources of new materials, productive facilities, production know-how, marketing organizations, and established shares of a market; (2) acquiring financial resources; (3) obtaining competent management; (4) the saving of time by entering a new market through the acquisition of a company already in the market instead of having to develop resources needed to enter the market; (5) the achievement of economies of scale; and (6) the acquisition of tax advantages such as those relating to tax-loss carryovers. On the other hand, **internal business expansion** is based on the use of the resources of an existing business to achieve a growth in business activity by increasing sales, entering new markets, and achieving economies of scale without acquiring another business. Generally, internal business expansion may be slower and riskier than external

business expansion. In addition, the acquisition of scarce raw materials can often be accomplished only by external business expansion.

LEGAL FORMS OF BUSINESS COMBINATIONS

Although the terms *statutory merger, statutory consolidation,* and *stock acquisition* are often used interchangeably, they have precise meanings. It is best to use the precise term to refer to a particular kind of business combination.

Statutory Merger

A **statutory merger** is one where two (or more) companies merge into one surviving company. Although the requirements vary among the different states, in many states it is necessary for two thirds of the stockholders of each constituent corporation to approve the merger.

Statutory Consolidation

A **statutory consolidation** is similar to a statutory merger except that instead of one of the constituent corporations surviving, a new corporation is formed to conduct the combined businesses of the constituents, who dissolve and cease to exist.

Stock Acquisition

Although the term **stock acquisition** is sometimes used in an imprecise manner, the term is generally used to mean that one corporation acquires a majority of the shares of another corporation, and both companies continue to exist as separate legal entities in a parent-subsidiary relationship.

The information above can be summarized as follows:

	Constituents	**Survivors**
Statutory merger	A and B	A or B
Statutory consolidation	A and B	C
Stock acquisition	A and B	A and B

METHODS OF ACCOUNTING FOR BUSINESS COMBINATIONS

Presently, two methods of accounting for business combinations are sanctioned by generally accepted accounting principles (GAAP). One method, called purchase accounting, involves a new basis of accountability (the book values of the seller are ignored in recording the combination). Thus, the new accountability requires that the transaction be recorded at its fair value. This method is generally used where cash, debt, and/or securities, other than common stock, are used, or they may be used in conjunction with common stock in effecting the acquisition.

The second method of accounting for a business combination, the pooling of interests method, is used where at least 90 percent in common stock is used to effect the combination and 11 other criteria (discussed later) are met. When pooling accounting is used, a new basis for accountability does not arise. In pooling, the book values of the assets and liabilities of the parties to the combination are combined for reporting purposes, and this contrasts with the fair market values used in purchase accounting. A discussion of both accounting methods follows.

PURCHASE ACCOUNTING

The treatment of a business combination as a purchase is compatible with the treatment of the acquisition of any asset by a business entity; the **fair value** of the transaction is the basis of recording the exchange. When purchase accounting is used:

1. The parties have bargained in good faith using fair values rather than book values in determining the acquisition price.
2. The transaction is recorded at the **fair value of the price paid** (cash, debt, preferred stock, and so forth, or combinations of these with common stock) *or* the **value of the net assets acquired**, whichever is more clearly evident.
3. The components of the net assets acquired will be recorded at their respective **fair values**. Any excess of cost over the fair values of total identifiable net assets will be assigned to **goodwill**.
4. The retained earnings of the former owners shown on the balance sheet of the acquired company is *not* carried forward to the books of the acquiring corporation.
5. Expired costs, using the fair values assigned to the net assets rather than the book values of the selling corporation, are matched with the revenues generated subsequent to the acquisition from using the acquired net assets.
6. When purchase accounting is used to account for a business combination, only the **income earned *subsequent* to the date of the combination** is combined with the acquirer's income. If the combination occurs at a date other than the end of the acquirer's fiscal year, only the income earned for the portion of the year subsequent to the combination is combined with the income of the acquirer, and a full year's income is combined thereafter.

POOLING ACCOUNTING

The accounting for a business combination by the pooling method represents a special case of accounting. This treatment must be used when the attributes of the business combination meet certain specified criteria, which are discussed later. A major attribute is that the business combination be effectuated by an **exchange of common stock** (*90 percent or more* of the voting common stock of one of the constituents to the combination must be exchanged for voting common stock of the other constituent). When common stock is exchanged for common stock, arguments have been advanced to support the pooling concept. Proponents of pooling maintain that:

1. A pooling of interests is a transaction taking place between the stockholder groups of the parties to the combination. The entities have not changed; the stockholder interests have merely been realigned.
2. The stockholders have pooled their risks and resources so that each stockholder group now shares the risks of the other while continuing to share a part of its former risks and resources.
3. No assets or liabilities of the firms are altered. Common stock is not an asset, and consequently, no assets have been disbursed.

The principal differences between pooling and purchase accounting are that for **pooling** accounting:

1. The retained earnings of the combinee is usually carried forward and becomes part of the retained earnings of the surviving combined or consolidated entity.
2. Restatement of the financial statements is required. Regardless of the date of acquisition, earnings prior to the date of a pooling are combined with the survivor's earnings *as if the constituents were always combined*. In the case of purchase accounting, only the post-acquisition earnings of the acquired entity are combined with the surviving entity's earnings.
3. Market values of individual assets and liabilities are ignored, and only the **book values** of the combinee are used in recording the combination. Consequently, **no goodwill** ever arises in a pooling regardless of the number of shares issued to effect the combination.
4. The aggregate dollar amount at which the combination is recorded is the same regardless of how many shares are exchanged to effect the combination. The same does not apply to purchase accounting. In the latter case, the greater the number of shares exchanged, the greater the dollar value at which the combination is recorded.
5. When pooling accounting is used to account for a business combination, the *full year's* income earned by the combinee in the year of the combination is combined with the income of the combinor so that the income reported for that year is the full years' incomes of the separate companies. This is true even if the combination occurs on the *last day* of the combinor's fiscal year. In addition, when comparative income statements are presented for prior years, the combinor's income statement must be restated to include the income of the combinee for each of the comparative years presented.

REVISED OPINIONS ON ACCOUNTING FOR BUSINESS COMBINATIONS

Presently, *APB Opinion No. 16* enumerates 12 specific criteria for pooling of interests accounting. If a business combination meets the 12 specific criteria, the combination must be accounted for as a pooling of interests—otherwise, the combination must be accounted for as a purchase.

Conditions for the Pooling of Interests Method

Under the provision of *APB Opinion No. 16*, 12 conditions must be met before a business combination may be accounted for as a pooling of interests. These conditions can be grouped under three main categories as listed below:

I. Attributes of the combining companies.
II. Manner of combining interests.
III. Absence of planned transactions.

I. Attributes of the combining companies:

A. Each of the combining companies should be autonomous and not have operated as a subsidiary or division of another company within two years before the plan of combination is initiated. An exception to this condition concerns the divestiture of assets that was ordered by a governmental or judicial body. A subsidiary that is divested under an order or a new company that acquires assets disposed of under such an order is considered autonomous for this condition.

B. Each of the combining companies must be independent of each other. That means that no combining company or group of combining companies can hold as an intercompany investment more than 10 percent of the outstanding voting common stock of any other combining company. To illustrate the 10 percent requirement, let us assume that company A plans to issue its voting common stock to acquire the voting common stock of companies B and C. If companies A and B each own 7 percent of company C's outstanding common stock, A can pool with B, but the combined entity cannot subsequently pool with C since more than 10 percent of company C's outstanding stock would have been held by the other combining companies.

II. Manner of combining interests:

C. The combination should be effected in a single transaction or should be completed in accordance with a specific plan within one year after the plan is initiated. The *Opinion* provides an exception to this one-year rule when the delay is beyond the control of the combining companies because of proceedings of a governmental authority or pending litigation.

D. The combination should involve the issuance of voting common stock only in exchange for substantially all of the voting common stock interest of the company being combined. "Substantially all" in this context means at least 90 percent of the voting common stock interest of the company being combined. Thus, the issuer may purchase for cash or other nonvoting common stock consideration up to 10 percent of the voting common shares of the company to be pooled. Such a cash outlay may be necessary to eliminate fractional shares or to pay dissenting stockholders. The rationale of this criterion is that substantially all of the voting common stock interest in each party to a pooling should be carried forward as a voting common stock interest in the issuer in the pooling. The payment of cash, debt, or an equity instrument that does not satisfy this test destroys the most fundamental basis of a pooling. If the company being combined has securities other than voting stock, such securities may be exchanged for common stock of the issuing corporation or may be exchanged for substantially identical securities of the issuing corporation.

E. None of the combining companies should change the equity interest of their voting common stock in contemplation of effecting the combination. This restriction applies during the period from two years preceding the date the plan is initiated through the date the plan is consummated. Changes in the equity interest of the voting common stock that may violate this condition include distributions to shareholders, additional issuance or exchange of securities, and the retirement of securities. The purpose of this rule is to disallow changes in equity interests prior to a combination because such changes indicate a sale rather than a combining and sharing of risks.

F. Each combining company may reacquire shares of voting common stock only for purposes other than business combinations, and no company may reacquire more than a normal number of shares between the dates the plan of combination is initiated and consummated.

G. The ratio of the interest of an individual common stockholder to those of other common shareholders in a combining company should remain the same as a result of the exchange of stock to effect the combination. This condition ensures that no common stockholder is denied his or her potential share of a voting common stock interest in a combined corporation.

H. The stockholders of the resulting combined corporation cannot be deprived of, nor restricted in, their ability to exercise their voting rights on common stock of the combined corporation. For example, establishing a voting trust to hold some of the shares issued in the combination disqualifies the combination as a pooling of interests.

I. The combination must be resolved at the date the plan is consummated, and there must be no contingent arrangements for the issuance of additional securities or other consideration. All consideration to be given to effect the combination of the companies must be determinable as of the date the plan of combination is consummated. The only exception to this would be a provision to adjust the exchange ratio as a result of a subsequent settlement of a contingency such as an existing lawsuit.

III. Absence of planned transactions:

J. The combined corporation should not agree directly or indirectly to retire or reacquire any of the common stock issued to effect the combination.

K. The combined corporation cannot enter into other financial arrangements for the benefit of the former stockholders of a combining company, such as a guarantee of loans secured by stock issued in the combination. This financial arrangement may require the payment of cash in the future that would negate the exchange of equity securities, and thus, the combination would not qualify for pooling of interests treatment.

L. The combined corporation may not intend to dispose of a significant part of the assets of the combining companies within two years after the combination. Some disposal of assets may be effected within the two-year period provided the disposals would have been in the ordinary course of business of the formerly separate companies or if the disposals were to eliminate duplicate facilities or excess capacity.

If a combining company remains a subsidiary of the issuing corporation after the combination is consummated, the combination could still be accounted for as a pooling of interests as long as all the conditions for a pooling are met. Any business combination that meets all the above conditions must be accounted for under the pooling of interests method.

APB Opinion No. 16 was intended to decrease abuses of the pooling of interests method of accounting. As desired, it was successful in eliminating many abuses but the fact that pooling of interests accounting is permitted at all still allows some interesting outcomes to occur. An example of its impact in relation to purchase accounting is easily observed in AT&T's acquisition of McCaw Cellular Communications Inc. in August of 1993. In this acquisition approximately $12 billion of goodwill was involved. However, by accounting for the combination as a pooling, the assets of McCaw were combined with those of AT&T at their book

values and thus the goodwill inherent in the deal was not recorded in consolidated statements.

For a high technology company like McCaw Cellular, SEC guidelines for amortization of goodwill are 10 to 15 years. Had the combination been recorded as a purchase and the goodwill amortized over 10 years, AT&T would have had approximately $1 billion less in reported net income each year than under pooling. Also, purchase accounting would have caused AT&T's assets in the consolidated balance sheet to be about $12 billion higher than under pooling. For a combined result, AT&T's consolidated financial statements will show higher income, lower total assets and thus a much better return on equity and invested assets than would have been the case under purchase accounting.[1]

Application of the Purchase Method

Under purchase accounting, the business combination is viewed as the acquisition of one entity by another as shown in the foregoing discussion.

Guidelines for Valuation of Assets and Liabilities. *APB Opinion No. 16* established general guides for assigning amounts to individual assets and liabilities assumed, except goodwill, as follows:

1. Marketable securities should be recorded at current net realizable values.
2. Receivables should be recorded at the present values of amounts to be received, determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.
3. Inventories:
   a. Finished goods should be recorded at selling prices less cost of disposal and reasonable profit allowance.
   b. Work in process inventories should be stated at estimated selling prices of finished goods less the sum of the costs to complete, costs of disposal, and a reasonable profit allowance for the completing and selling effort of the acquired corporation.
   c. Raw materials should be recorded at current replacement costs.
4. Plant and equipment to be used in the business should be stated at current replacement costs for similar capacity unless the expected future use of the assets indicates a lower value to the acquirer. Replacement cost may be determined directly if a used asset market exists for the assets acquired. Otherwise, replacement cost should be approximated from replacement cost new, less estimated accumulated depreciation.
5. Identifiable intangible assets should be valued at appraised values.
6. Other assets, such as land, natural resources, and nonmarketable securities, should be recorded at appraised values.
7. Accounts and notes payable, long-term debt, and other claims payable should be stated at present values of amounts to be paid, determined at appropriate current interest rates.

An acquiring corporation should not record goodwill previously recorded by an acquired company as a separate asset. The acquiring corporation should not record deferred income taxes previously recorded by an acquired company. Amounts assigned to the value of identifiable assets and liabilities may be less if part or all of the assigned value is not deductible for income taxes. The acquiring corporation

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[1]Norris, Floyd. "McCaw's Impact on AT& T? A Tale of 2 Accounting Methods," New York Times, August 18, 1993.

should record deferred tax accounts for the tax effect of these differences at the date of acquisition.

Treatment of Goodwill. *APB Opinion No. 17* provides that for the intangible assets acquired in a business combination, the method of allocating the total cost of the acquired company depends on whether or not the asset is identifiable, such as a patent, or unidentifiable, such as goodwill. The cost of an identifiable intangible asset should be based on the fair value of the asset. The cost of an unidentifiable intangible asset is measured by the difference between total cost and the amount assigned to all other assets acquired less liabilities assumed.

The cost of an intangible asset should be amortized based on the estimated life of that specific asset; the period of amortization, however, should not exceed 40 years. The straight-line method of amortization should be used unless the company can demonstrate that another systematic method is more appropriate. The method and period of amortization should be disclosed in the financial statements.

OPERATING RESULTS

As noted previously, when **purchase** accounting is used, only the acquiree's operating results following the date of the business combination would appear on the acquirer's books. Thus, revenue and expense balances of the acquiree prior to the effective date of the business combination would be transferred to the *acquiree's* Retained Earnings account, and this amount of retained earnings would be used to calculate the amount of goodwill, if any, purchased by the acquirer. *Only the revenues and expenses subsequent to the date of the business combination are reported in the acquirer's income statement.* In effect, the acquiree's books as of the date of the business combination are treated as if it were the end of its fiscal year, even though it may not be.

For **pooling** accounting, however, the *combinee's results of operations prior to the date of acquisition are included in the combinor's results of operations* as if the combination took place at the beginning of the year.

SUMMARY

External business expansion, a business combination under which two or more entities are brought under common control, is a common phenomenon on the business scene. The reasons for business combinations are varied and include the need for new sources of raw materials, market shares, productive facilities, managerial talent, and the savings of time to enter new markets.

A business combination may take one of three legal forms. A **statutory merger** is the combination of two or more corporations into one of the corporations, which survives. A **statutory consolidation** is the combination of two or more corporations into a newly formed corporation with a concomitant dissolution of the combinees. The third possibility is a **stock acquisition**, which is a business combination where both the acquirer and acquiree continue to exist in a parent-subsidiary relationship.

Purchase accounting is a method of recording a business combination that assumes that one company purchased another company and that a new basis of accountability exists. This new basis requires that the fair market value of the consideration given (the price paid for the acquired company) be the measure for recording the business combination. **Pooling of interests accounting** is a method of recording a business combination that assumes that the stockholders of the two constituent companies—a **combinor** and a **combinee**—have merely exchanged common stock and that the separate businesses have been combined into one business. Under pooling accounting, a new basis of accountability is not present.

Therefore, pooling accounting requires that the book values of the two companies' net assets be the measure for recording the business combination, and the fair market value of the consideration exchanged is ignored.

The accounting entries used to record a statutory merger or a statutory consolidation consist of recording all of the assets and liabilities of the combinee(s) on the books of the combinor. If purchase accounting is used, the assets and liabilities are recorded at the fair market values for each item. If pooling accounting is used, the book values of each asset and liability are used to record the combination. If a stock acquisition occurs, the parent company merely debits an Investment account using the fair market value of the consideration given if purchase accounting is used and the book value of the net assets of the combinee(s) if pooling accounting is used.