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In This Issue...

Battle Over Pooling

Managing Earnings

What Directors Need to Know

Still Thinking of an IPO?

Japan's High Tech Failures

Conversation

The LOOP

Arcade

The Battle Over Pooling Mergers

Proposed FASB Rule Unlikely to Halt Activity

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Application: Despite proposed pooling rule, firms urged to pursue mergers that make economic sense.

Maybe you've never taken an accounting class, or maybe you took one years ago and don't remember much. However, if your firm is in the acquisition mode, one issue in accounting should be of interest to you. This issue is whether or not pooling of interests accounting should be allowed, and it is creating a firestorm in the merger and acquisition arena.

In essence, when two firms combine, there are two methods that can be used to account for the combined value of the firm. They are the purchase method and the pooling of interests method. In most cases, they yield radically different outcomes - with pooling resulting in a much better looking income statement for years to come. Yet, the Financial Accounting Standards Board (FASB), the primary accounting rule-making body in the U.S., has preliminarily decided to eliminate this method by the end of the year.

Should you be concerned? More importantly, if you are thinking of acquiring another company or are in the market to be acquired, should you be trying to wrap it up by the end of this year? If you take literally some of the comments reported recently in the business press, it would surely seem that you should be. For example, in a report entitled *Valuing the New Economy: How New Accounting Standards will Inhibit Economically Sound Mergers and Hinder the Efficiency and Innovation of U.S. Business*, Merrill Lynch states that "the (purchase) accounting method itself would prove an obstacle to a merger that both parties want to consummate. As a result, the wave of consolidations that has enhanced productivity, encouraged innovation, and stimulated dynamism in the U.S. economy may notably decline."

In a report titled entitled *The Furor Over Purchase/Pooling*, Daniel Donoghue and others with the investment banking firm U.S. Bancorp Piper Jaffray make the following alarming statement right after summarizing the proposed new rules: "These changes could potentially have a chilling impact on

the mergers and acquisitions market." Yet listen to the very next, virtually contradictory, statement: "The new rules have no real economic consequences since corporate cash flows are not impacted." In other words, the proposed new rules don't change cash flows one iota.

So, how can such toothless rules that do not affect real value possibly have a "chilling" impact on the M&A marketplace? The authors provide a partial answer to this question when they write, "**The proposed accounting only affects reported earnings**" (emphasis added). Therein lies the real issue: Is the market fooled by cosmetic accounting differences?

To help you separate the wheat from the chaff and provide evidence to answer this question for yourself (and for your company if you're feeling the "urge to merge"), this article will first provide a simple example to illustrate the financial statement differences between the two methods so you can see what the big deal is all about. Then, a brief summary of research findings on this issue will be presented, some of which are fairly startling. Finally, there is a prediction about the final outcome of this battle that may help you decide whether or not you need to be concerned.

The Two Methods of Merger Accounting

In the simplest of terms, the issue can be illustrated by the following scenario. If two companies merge, each one having only one asset, say a truck, the combined balance sheet would consist of two trucks and the combined income statement would consist of the total combined revenues. The controversial issue is: What value should be used for the two trucks? Should they be combined using their existing recorded values? Or should both be restated to their current market value? Or should the truck of the company being "acquired" be restated to the price actually paid by the acquiring company? Current rules say that if the merger is a pooling, the assets are combined at their book values. If one company is "purchasing" the other company, the purchased asset is recorded at its purchase price.

There are actually twelve rules, all of which must be met, that determine if the new company can use the pooling method of accounting. The main rule is that stock must be used for the payment instead of cash. The implication is that there is a continuity of ownership and that nothing has really changed for the two companies. In other words, if the company being "acquired" is given stock in the acquiring company, the two ownership groups have simply combined to own a larger basket of assets. There is no sale and there are no tax implications. If cash is used, however, the owners of the acquired company are viewed as having sold the assets so

that they have a taxable gain (or loss), and the buyer records the assets at the price paid for them.

A more helpful example would be as follows: Company A pays \$650 in stock to acquire Company B. The book value of Company B is \$50, composed of \$150 in assets minus \$100 in liabilities. The \$600 excess over book value is allocable \$100 to undervalued plant, property and equipment and \$500 to goodwill due largely to intellectual property. If the combination is treated as a pooling, the combined balance sheet and income statement look as follows:

Balance Sheet

	A	B	A+B "Pooling"
Current Assets	200	100	300
PP&E	500	50	550
Intangibles			
Total	700	150	850
Current Liabilities	100	50	150
Long Term Liabilities	200	50	250
Stockholder's Equity	400	50	450
Total	700	150	850

Income Statement

	A	B	A+B Pooling
Revenues	1000	600	1600
Expenses	-400	-200	-600
Net Income	600	400	1000

If, however, the combination is treated as a purchase, the combined financial statements will look as follows (pooling totals shaded for comparison):

Balance Sheet

	A	B	A+B Pooling	Purchase Adjustments	A+B Purchase
Current Assets	200	100	30		300
PP&E	500	50	55	+100	650
Intangibles				+500	500
Total	700	150	85		1450
Current Liabilities	100	50	15		150
Long term Liabilities	200	50	25		250
Stockholder's Equity	400	50	45	+600	1050
Total	700	150	85		1450

Income Statement

	A	B	A+B Pooling	Purchase Adjustments	A+B "Purchase"
Revenues	1000	600	1600		1600
Expenses	-400	-200	-600		-600
Net Income	600	400	1000		1000
Extra Depreciation (10 year life)					-10
Amortization of goodwill (20 year life)					-25
Net Income after extra depreciation and amortization of goodwill					965

Note that the balance sheet looks stronger under the purchase method due to a higher asset base. The income statement looks worse, however, due to the extra depreciation and amortization of goodwill. In many of today's mega mergers, the income statement differences are far greater because goodwill can comprise 80-90% of the purchase price resulting in huge amortization charges that can even cause the combined entity to report operating losses for years to come.

To put the difference between the two methods into the simplest terms, the previously cited Merrill Lynch report states it this way: "The premium paid for the intangible goods - the goodwill - is never recorded (in a pooling)." Yet, if you think about it, this is an amazing statement that actually highlights the fatal flaw of the pooling method - **The premium paid is never recorded.** Although financial accounting may be deficient in myriad ways, there is no other instance in which it is proper and legal to avoid recognizing a payment for something - especially something that can run into the billions of dollars.

Research Findings

A question that has been directed to the FASB is whether an acquisition paid for with stock is fundamentally different from an acquisition paid for with cash. The FASB has been asked to consider this. Harvey Golub, chairman and CEO of American Express, put it this way in a recent article in the *Wall Street Journal*: "...a merger with stock isn't the same as a purchase for cash. Different business combinations require different accounting treatment. One company buying another for cash is decidedly different than an exchange of stock, which consolidates the ownership of the two entities."

The problem with this argument is two-fold. First, in negotiating the exchange ratio of the stocks, the current market value of both companies' stock, and not book value, is the primary determinant of the ratio. In a very real sense, the acquiring firm estimates what the target firm is worth in total, divides that by the acquiring firm's current share price to determine the number of shares to be offered, and then breaks that down into a share-for-share ratio. In other words, a company's stock is a negotiable type of currency - just one step away from cash.

Second, the continuity of interests only lasts for a moment in time. In fact, there may be a large number of shares trading hands all the way up to the date of the formal exchange. Moreover, most shareholders in the target firm receiving shares of the acquiring firm are free to sell them immediately after receiving the shares.

A more convincing argument, however, is what has occurred in the marketplace. In an article published in the *Journal of Finance*, Tim Loughran and Arnand Vijh examine benefits accruing to target shareholders in the five-year period after the combination. Those that received cash and immediately invested that cash into the acquirer's stock realized substantial returns by holding that stock for five years. In contrast, target shareholders who received stock in the acquiring company and held that for five years realized essentially no gain as any premium received at the time of the acquisition tended to dissipate.

These results are consistent with the popular theory that a firm issues stock when insiders believe the stock is overvalued. Adding fuel to the pooling fire, consider the results from two other streams of research. First, there have been about ten academic studies using different methodologies and time periods that have consistently demonstrated that, in spite of the higher reported earnings, the stock performance is not better for pooling method firms after the combination. In fact, two studies, including one by this author, found that the stock of firms that used the

purchase method performed significantly better than that of firms using the pooling method. In other words, the market is not fooled by the higher cosmetic earnings reported by pooling method firms, and it appears to reward firms using the more conservative purchase method.

Yet, in spite of these consistent research results, some firms are willing to pay extra to be able to pool. One example is the well-documented 1991 AT&T-NCR pooling method merger. A conservative estimate is that AT&T paid \$50 million to be able to pool but, depending on how stock price changes during the negotiation period are interpreted, the additional cost may have been as high as \$500 million for a merger that was ultimately disastrous. Two additional academic studies examined large samples of pooling method mergers and found that, in general, not only does the likelihood of using the pooling method increase with the size of the potential goodwill to be recorded, but the premiums paid for similar sized target firms are higher if the pooling method is used.

Where Do We Go From Here?

The Financial Accounting Standards Board held public hearings on the proposed new rules in February, 2000. Not only did they hear the same "sky is falling" arguments described earlier, but not a single person who testified was able to present a workable alternative to the FASB's proposed new rules. Even if convincing evidence had been presented indicating that the new rules would have a significant negative impact, the FASB's mandate is to advocate rules that present the economic reality of a transaction and not to be swayed by the potential "economic consequences" of those rules.

Adding to the FASB's resolve on this issue is the fact that most major industrialized countries do not allow poolings or allow them only in very rare circumstances. Only Canada has rules similar to ours, and they are also proposing to eliminate poolings. All of this has not stopped those who want to maintain the availability of pooling from urging members of Congress to pressure the FASB into not changing the rules. However, it appears likely that the FASB will stick to its guns and eliminate poolings by the end of this year.

What the business press has not reported is that the elimination of pooling does not eliminate the possibility of using stock to acquire another firm. Stock exchanges will still be possible - they even can still be tax-free - but companies won't be able to use the pooling method of combining both firms at book value. In other words, mergers that make economic sense will continue to make economic sense. Due to the growing size of goodwill, more and more firms are highlighting either earnings before goodwill amortization (as

the FASB's proposed rules require) or cash earnings since goodwill amortization is not tax deductible in most cases.

So, firms need not stifle the urge to merge. Instead, they must redouble efforts to identify firms that fit strategically with their growth plans, and use cash or stock - whichever makes the most sense in a particular situation.

Although Mr. Golub made several questionable statements in his *WSJ* article, he clearly got one thing right at the end when he writes, "Several recent studies ...show that the market does not give higher valuations to companies that combine via pooling rather than purchase accounting. The market doesn't seem to care which accounting method merging companies use."

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