Viewpoints

Why Eliminate the Pooling Method?

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As has been widely reported in the business and financial media, the Board has proposed that all business combinations should be accounted for by one method, the purchase method, and that the pooling-of-interests method (pooling method) should be eliminated. That proposal would have significant ramifications for how future mergers and acquisitions would be accounted for. Why did Board members unanimously conclude that the pooling method should be eliminated?

Provides Less Useful Information

The pooling method produces dramatically different results than the purchase method and was not intended as an alternative to that method. However, in practice, the transactions to which the pooling method is applied are similar to those that are accounted for by the purchase method. As a result, investors are provided with less information—and less-relevant information—than provided by the purchase method. That is because the pooling method ignores the values exchanged in a business combination transaction whereas the purchase method records those values. As a result, the pooling method does not provide users of financial statements with information about how much was invested in the combination. It also does not provide them with the information they need to assess the subsequent performance of that investment and compare it with the performance of other companies.

The information that the pooling method provides about individual assets and liabilities also is less complete and less comparable than that provided by the purchase method. It is less complete because the pooling method does not record any acquired assets or liabilities that were not previously recorded and thus masks their presence, whereas the purchase method reveals those hidden assets and liabilities by recording them. Moreover, the acquired assets and liabilities that the pooling method does record are not measured on a basis that is comparable with how acquisitions generally are measured (that is, at the values exchanged in those transactions), as does the purchase method. Because the values exchanged are not recorded, management is not held accountable for either the investment made in the business combination or the subsequent performance of that investment. Moreover, subsequent rate-of-return measures are artificially inflated because the numerator (earnings) is higher and the denominator (investment) is lower.

Imposes Added Costs

The Board observed that, as a second method of accounting for business combinations, the pooling method imposes additional costs on those involved in financial reporting. The Board acknowledged that the costs of actually applying the pooling method are usually less than those of applying the purchase method because applying the pooling method primarily involves adding together the book values in the financial statements of the companies being combined. No effort is made to identify all of the assets and liabilities acquired or to measure their fair values, as is the case with the purchase method. However, the costs of applying the pooling method do not reflect the full picture—there are other costs associated with it that also must be considered.

Costs to Users of Financial Statements

Because most business combinations are accounted for by the purchase method, the Board noted that investors and others who use financial statements must bear added costs of analysis in trying to compare the financial statements of companies that have used the pooling method with those of companies that have used the purchase method. Users of financial statements also must bear added costs of analysis in trying to compare financial statements of companies that employ the pooling method with those of companies that acquire their assets and liabilities individually or in groups rather than in business combinations.

Furthermore, investors increasingly are seeking investment opportunities globally. Because the pooling method is employed far less often outside of the United States (being either prohibited or limited to combinations such as so-called mergers of equals), investors face difficulties in comparing domestic and foreign investment alternatives if the US companies being considered have used the pooling method and the foreign companies have used the purchase method. Indeed, the growing use of the pooling method in the United States has exacerbated differences in financial statements of US and foreign companies.

The matter of financial statement comparability was the focus of one of the issues raised in the FASB Invitation to Comment, *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*. Respondents were asked whether the differences in the methods of accounting for business combinations make it difficult to compare the financial statements of companies that apply different methods. Most of those who responded to that question agreed that it did make comparison more difficult.

Costs to Companies

The Board observed that companies also bear significant costs related to the pooling method. The availability of the pooling method often puts companies under pressure to employ that method because it typically produces higher reported earnings and rates of return subsequent to the combination than the purchase method. Moreover, because the pooling method is applied *retroactively,* the comparative earnings reported for periods *preceding* the combination are also higher than under the purchase method—even before the companies were in fact combined.

As a result of those pressures, companies often must bear significant costs, both monetary and nonmonetary, in seeking to use the pooling method. In positioning themselves to try to meet the 12 criteria for applying that method, companies may refrain from engaging in appropriate economic actions that they might otherwise undertake, such as asset dispositions or share reacquisitions. They also may incur substantial fees to auditors and consultants in seeking to meet those criteria. The efforts to meet those criteria also may lead to conflicts between companies, auditors, and regulators with respect to judgments about whether the criteria have been met, thereby adding uncertainties and their attendant costs to the process, and raising questions about the operationality of those criteria.

Adversely Affects the Allocation of Economic Resources

Another issue raised in the Invitation to Comment focused on whether the markets for mergers and acquisitions are affected by the use of the pooling method compared to the use of the purchase method for accounting for business combinations. Most of those who responded to that issue agreed that the pooling method creates an unlevel playing field for companies that compete for mergers and acquisitions because the ability—or inability—to use that method affects whether they enter into those transactions and the prices that they negotiate for those transactions.

Companies that cannot use the pooling method because they cannot meet the criteria required for its use often conclude that they cannot compete for targets with those that can meet the criteria. Companies that can use the pooling method often are willing to pay higher prices for targets than they would if they had to use the purchase method because they do not have to account for the full cost of the resulting investment and the subsequent performance of that investment. Thus, by using the pooling method, they can avoid the "earnings penalty" associated with the purchase method that they believe would penalize their share prices.

Although the consideration paid in a business combination accounted for using the pooling method is in the form of shares rather than cash or other assets, the higher prices that companies making takeover offers are often willing to pay—provided that they can use the pooling method—are nonetheless real prices. Those prices must be borne by the shareholders of those companies in the form of greater dilution of their equity interests because a higher price conveys more of the equity interests in the resulting combined company to the shareholders of the target company.

Moreover, even though using the pooling method rather than the purchase method might result in being able to report higher per-share earnings following the combination, the fundamental economics are not different because the actual cash flows generated following the combination will be the same regardless of which method is used. As a result, the added earnings reported under the pooling method reflect artificial accounting differences rather than real economic differences.

To the extent that the markets respond to artificial differences, they direct capital to companies whose financial reporting benefits from those differences and away from companies whose financial reporting do not. As a result, markets allocate capital inefficiently rather than efficiently. While inefficient allocation of capital may benefit some companies and even some industries, it imposes added costs on a great many others, depriving them of capital that they need and could employ more productively. That outcome is detrimental to those companies—but more importantly, to the economy as a whole.

"Public Policy" Considerations

Many of the respondents to the Invitation to Comment urged that the pooling method be retained primarily because of what some have termed public policy considerations. Some, for example, argued that eliminating the pooling method would discourage the desirable consolidation that is now occurring in certain industries and reduce the flow of capital into certain industries, thereby stifling the entrepreneurial culture, impeding the development of new products, and impairing job growth.

The Board has from time to time heard similar arguments that accounting standards should assist in achieving certain public policy goals. However, it observed that there would have to be agreement on what those goals should be. Moreover, since those goals often change with changes in government or for other reasons, there would be questions about whether accounting standards should change every time public policy changes. Perhaps most important, if accounting standards were to become a tool for facilitating or implementing public policy, their ability to help guide policy and measure its results would be impaired.

For those reasons, the Board concluded long ago that the only public policy position that can be sustained is to maintain and enhance the integrity of accounting information so that capital market participants are on an equal footing. Indeed, one of the precepts that the Board follows in the conduct of its activities, as stated in the Board's mission statement, is as follows:

> To be objective in its decision making *and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.* [FASB *Rules of Procedure,* page 3]

In the context of business combinations, that means that accounting standards should not themselves seek to encourage or discourage combinations. Instead, those standards should portray the results of those combinations fairly and evenhandedly so that investors and others can form judgments about those combinations and their subsequent performance, and so that capital can be allocated efficiently in the capital markets. Those standards should not tilt the playing field to favor certain companies competing in the markets for mergers and acquisitions.

The Board concluded that those who argued that the pooling method should be retained for public policy purposes do not in fact favor neutrality and evenhandedness in financial reporting. Instead, they view accounting standards as a means for tilting the playing field and diverting capital to particular companies and industries and away from those to which that capital might otherwise flow, thereby disrupting the efficient allocation of capital in the markets.

Has a Flawed Conceptual Basis

Because the rationale that underpins the pooling method has been widely criticized, the Board considered various aspects of that rationale in reaching its decision.

Nature of Consideration

The use of the pooling method is predicated on the use of a particular form of consideration and it can only be used when the consideration is substantially in the form of stock. That is in contrast to the purchase method, which can be—and is—used regardless of the nature of the consideration tendered, whether it is in the form of cash, other assets, debt, or stock.

The Board observed that the nature of what is given up in consideration does not alter what is received in exchange for that consideration, namely, the net assets of the target company, and that the values of the assets acquired and the liabilities assumed are not dependent on the nature of the consideration tendered for them. Thus, regardless of the form of the consideration if $5 million is paid to acquire the target company and its net assets, those net assets should be recorded at that amount, even if their previous book value was $3 million.

Moreover, the consideration paid for a target company can be interchangeable. For example, new shares could be issued for cash and the cash then used to acquire the target company. Alternatively, cash could be used to purchase treasury shares and those shares then used to acquire the target company. The net result would be that the consideration can be viewed as either cash or stock. However, if the pooling method is used in the second scenario (the purchase method would have to be used in the first), the net assets would be recorded at different amounts, depending on the sequence of the transactions.

Furthermore, if the net assets are recorded at the book value in the records of the acquired enterprise rather than at the values actually exchanged, a hidden reserve would be created in the amount of that difference. That hidden reserve would ultimately inflate future earnings, either gradually over time by means of lower reported expenses or when those net assets were sold by increasing the reported gain on sale. In either case, the combined company would report earnings that it did not earn but, rather, obtained from the hidden reserve. For example, if A acquired B (whose net assets have a book value of $10 million) for $100 million, use of the pooling method would result in creating a hidden reserve of $90 million. Assuming no other changes, if A later sold B for $100 million, A would report a $90 million gain that it did not earn. Alternatively, if A later sold B for $60 million, A would report a $50 million gain, even though economically it would have suffered a $40 million loss.

Owner Involvement

The pooling method is based on the assumption that the business combination is a transaction between the owners of the combining companies and that the companies themselves and their managements are essentially little more than interested bystanders. The Board observed that that assumption is contrary to fact because corporate mergers and acquisitions are negotiated between the managements of the companies themselves. Shareholders rarely have any role at all in those negotiations and frequently first hear of the deal when it is announced to the general public, at which time it is presented to them for their approval as a *fait accompli.*

Continuity of Ownership Interests

The pooling method is also based on the assumption that ownership interests are continued following the combination. That is, the owners of the combining companies decide to cast their lots with each other and go forward together. The Board observed, however, that holdings can and often do change following business combinations (often soon afterward) and that owners may sell their interests in the combined company for a variety of reasons. Owners of target companies, for example, may seize the opportunity to cash in their gains, and owners of both the acquiring and target companies may decide that the resulting combined company does not fit the needs of their investment portfolios and sell their interests.

The Board further observed that even if predecessor ownership interests are continued following a business combination, they are no longer the *same* interests. That is because the owners of the predecessor companies were exposed to risks and rewards that are likely to have been quite different from those associated with the combined company. Moreover, the ownership interests themselves change following the combination, as the owners of the target company own a smaller share of a larger company following the combination.

"Mergers of Equals"

Some have argued that the pooling method is appropriate only for what are variously described as "true mergers," "mergers of equals," or combinations in which the acquirer cannot be identified and therefore its application should be limited to those combinations. The Board further noted that, to the extent that the pooling method is permitted in jurisdictions outside of the United States, it commonly is used only on that basis (although what constitutes "equals" is interpreted differently in different jurisdictions).

The Board therefore considered limiting the use of the pooling method to such transactions. However, it concluded that mergers of true equals are so rare that they may never occur. Instead, one of the predecessor companies can be seen as surviving the combination and thus can be viewed as the acquiring company. Thus, business combinations are acquisitions and should be accounted for as such.

The Board also concluded that even in a merger of equals, it does not necessarily follow that the book values of the predecessor companies should be carried forward into the combined company. Instead, a method under which the net assets of all combining companies are recorded at their fair values might more appropriately reflect the consequences of the transaction. That is because a merger of equals can be viewed as one in which a new economic and accounting entity has been created and none of the predecessor companies has survived the combination.

Changing Applications of the Method

Transactions that the pooling method is used to account for today are quite different than those for which it originally was conceived. Those transactions typically were where the principal change was that of legal form rather than of economic substance, such as when a parent company combined two of its wholly owned subsidiaries. Today, however, the pooling method is routinely used to account for transactions in which the economic substance has changed. Indeed, those transactions are among the most significant economic events that occur in the histories of the combining companies, if not *the* most significant event in their histories. Such sharply disparate applications of the method raise doubts about the soundness of its underlying rationale.

In view of that, together with its assessments of other aspects of the rationale that underlies the pooling method, the Board concluded that the conceptual basis of that method is flawed. That basis essentially is a means of rationalizing a desired end result, which is to report higher earnings without having to earn them, rather than a sound basis that distinguishes between real economic differences that are relevant in making investment and credit decisions.

The Board's Decision

Based on its conclusions that the pooling method (1) provides information that is less useful than that provided by the purchase method, (2) imposes added costs on users of financial statements and the companies that prepare those statements, (3) adversely affects the allocation of economic resources, and (4) has a flawed conceptual basis, the Board decided that the pooling method should be eliminated. In the final analysis, acquisitions—whether they are of individual assets, groups of assets, or entire businesses—should be recorded in the same way, based on the value of what is given up in exchange for them, regardless of whether that is cash, other assets, debt, or equity shares. The pooling method does not do that, but the purchase method does.

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Why Eliminate Pooling?

- The pooling method provides investors with less information—and less-relevant information—than that provided by the purchase method.
- The pooling method ignores the values exchanged in a business combination, while the purchase method reflects them.
- Under the pooling method, financial statement readers cannot tell how much was invested in the transaction, nor can they track the subsequent performance of the investment.
- Having two methods of accounting makes it difficult for investors to compare companies when they have used different methods to account for their business combinations.
- Because future cash flows are the same whether the pooling or purchase method is used, the boost in earnings under the pooling method reflects artificial accounting differences rather than real economic differences.
- Business combinations are acquisitions and should be accounted for as such, based on the value of what is given up in exchange, regardless of whether it is cash, other assets, debt, or equity shares.