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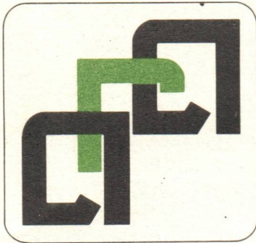

Accounting Research Association
newsletter

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, 666 FIFTH AVE., NEW YORK, N.Y. 10019

Vol. III, No. 3 June 29, 1970

(Editor's Note: The following is the text of the news release issued on the APB decision on business combinations. Formal ballot will be held at next Board meeting, July 30-31.)

NEW RULES ON MERGERS TO BE ISSUED BY CPAS

NEW YORK, June 27 -- In a move to make it harder for a company to show profit increases merely by accounting maneuvers, the Accounting Principles Board of the American Institute of Certified Public Accountants decided today to tighten the rules on accounting for corporate mergers.

The new rules follow those proposed by the Board in a draft previously circulated for comment, except for relaxation of the controversial "size test" from the three-to-one test in the exposure draft to a nine-to-one test. That is, to qualify for the pooling method of accounting for a merger, the smaller company must be at least 10 percent of the sum of the two companies measured by voting common stock interest.

All other mergers will have to be accounted for by the purchase method of accounting, with goodwill being amortized against future earnings.

The new Opinion, as pronouncements of the Accounting Principles Board are known, is expected to be issued later this summer after technical details have been worked out. It will apply to all merger transactions entered into after August 31, 1970.

Reform of merger accounting has been called the most important and controversial subject in the history of financial reporting. Criticism has arisen from the fact that corporations could account for business combinations by different methods -- pooling of interests, purchase, or a combination of the two. Skillful use of these options could produce what were sometimes described as "instant earnings."

Under the new rules, both the pooling and purchase methods are retained but not as optional alternatives, and use of a combination of the two is eliminated.

Under the pooling method, an acquiring company takes the assets of a merged company onto its own books at their original cost. In the past this has occasionally permitted a company to issue stock worth far more than the original cost of acquired assets, then sell the assets at present value and take the difference as profit.

Under the new rules, a business combination will not qualify for pooling accounting if the merger plan calls for disposing of a substantial part of the acquired assets within two years. However, should such a disposal occur in this period following a merger accounted for as a pooling, separate disclosure of the nature of the profit must be made.

(continued)

Also, under poolings it has been possible to include the profits of an acquired company in an annual report to stockholders even though the pooling took place after the end of the year reported on. This will now be prohibited.

The rules will permit mergers to be accounted for by the pooling method only if the combination is effected by an exchange of common stock, thus preventing this accounting method through issuance of "packages" of securities such as convertible stocks and warrants.

Other criteria are established for the pooling method, and all mergers not meeting all the criteria will have to be accounted for by the purchase method.

In purchase accounting, when the value of stock issued by one company for another's assets is higher than the value of the assets, the excess is designated as goodwill. Criticism of present purchase accounting has been that cost usually has not been allocated to the acquired assets based on their fair value, and the cost of goodwill often has not been charged against the surviving company's earnings.

The new rules require the total cost of a business to be allocated to all tangible and identifiable intangible assets, with the remaining cost, if any, allocated to goodwill. The goodwill must be charged against earnings over a period not to exceed 40 years. This feature of the rules was opposed by many corporate managements, but the Board considered amortization of goodwill as essential to proper accounting for the actual cost of an acquisition.

According to Leonard M. Savoie, executive vice president of the American Institute of Certified Public Accountants, the "size test" for poolings was changed after study by the Board members of the several hundred letters received in comment on the exposure draft of the Opinion which was distributed to businessmen, accountants, and government and stock exchange officials last March.

It was felt that the pooling method, which was accepted in the exposure draft as a valid concept for acquisitions made through issuance of common stock, could be justified for companies of greater size disparity than one to three, and that other criteria for qualifying a transaction for pooling accounting were sufficiently restrictive to curb known abuses of the method.

Furthermore, it was felt that use of the pooling method, under the restrictive conditions, would appropriately avoid large write-ups of goodwill and capital based on stock market quotations which are sometimes not indicative of the real value of the business acquired.

"While the Opinion which will now be printed and formally issued will not, and could not, satisfy all points of view on the complex question of merger accounting," Mr. Savoie said, "it represents a major step in the continuing effort to improve financial reporting and disclosure of information to the investing public."

Proposed Opinion on Accounting Changes:

The alternate proposal for reporting Changes in Accounting Methods and Estimates (ARA Newsletter, May 14, 1970), which calls for cumulative "extraordinary item" treatment, rather than retroactive restatement, was discussed at the APB meeting. Certain revisions are to be considered at the July meeting, with the expectation of a ballot in October.