

Biography of Pooling of Interest Method in accounting for Amalgamations¹

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Abstract

'Pooling of interest method' of accounting for amalgamations is a unique concept among accounting practices. Its uniqueness is in ignoring the historical cost concept, a fundamental concept for recording transactions in accounting. In this practice the evidence of cost provided by the transaction of amalgamation is ignored in accounting for the amalgamation. Defined in Indian Accounting Standard 14 para 10 as "Under pooling of interest method, the assets, liabilities and reserves of the transferrer company are recorded by the transferee company at their existing carrying amounts"

This article attempts to find the logic that could have given birth to the 'pooling of interest method' in accounting for Amalgamations. In tracing the logic, the following five steps are taken. To start with, identify the first transaction of business combinations. Second, examine how these early business combinations could have been accounted for. Third, analyze how 'pooling of interest method' accounting for business combinations evolved in United States. Fourth, trace how 'pooling of interest method' of accounting reached India. Finally conclude by the evaluating the reasons for the demise of 'pooling of interest method' in accounting for amalgamations and examine in what form could 'pooling of interest method' survive going forward.

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Introduction

'Accounting is a pragmatic trade'

– J Kitchen

India was ranked the third largest market in the Asia Pacific region, after Japan and Australia for mergers and acquisitions (M&A) in the first half of calendar year 2006². Growth of M&A in the India has been phenomenal. Grant Thornton, investment bankers engaged in M&A tracked 740 deals valued at \$26 billion in 2006³. This was an increase in value by 44% from \$18 billion in 2005. Measured by the number of deals, the growth in 2006 was 58% from 467 deals in 2005.

While mergers and acquisitions activity on the one hand is growing phenomenally, the debate on the effectiveness of merger and acquisition transactions in creating shareholder value on the other hand continues to be hotly contested. Meta research on measuring effectiveness of mergers and acquisitions have not provided conclusive evidence on value creation to the shareholders of acquiring companies⁴ (*Illustration 1*).

Proponents of the M&A-value-creation view argue that a rational buyer exploiting stock market irrationality reflected in valuations can create value for shareholders. Some also believe that one need not depend on stock market irrationality as reflected in valuation for M&A transactions to create value. Rational buyer by themselves seeking to build competitive business advantage can create value for shareholders by creating synergy. Synergy is when one business plus one business, totals more than the two businesses individually. Source of synergy is from

¹ Amalgamation is the term used in UK and India for "merger of two or more companies whose shareholders are issued with appropriate number of shares in the new company".

² Asia-Pacific M&A Bulletin: Setting the pace for an outstanding year, Mid year 2006 review of Price Waterhouse Coopers.

³ Reported in Deccan Herald page 15 on December 25, 2006.

Illustration 1



Created by J. Shankar

sharing resources and creating economies of scale and economies of scope or complementing each other strengths and negating weaknesses.

The logic of the people who believe that M&A destroys value arises from their view that markets are rational and businesses are valued fairly. They believe that it is the irrational buyer blinded by 'hubris' meaning pride, and belief in their own superior managerial ability to the incumbent management that induce them to buy fairly valued businesses at a premium. The origin for rational market-irrational buyer is in the 'hubris hypothesis of corporate takeover' forwarded by Roll⁵. In this hypothesis, a single decision maker overwhelmed by his self confidence and pride thinks he can do better than the existing management and buys the businesses, contributing to M&A deals.

The second reason for the belief that pursuing M&A strategies destroy value is in the assumption that both the market and the buyer are irrational. Empirical evidence for this is advanced by the waves of mergers and acquisitions that are

seen mainly during the bull runs in the stock markets. The popular practice of studying M&A by analyzing merger waves provide some support to this view.

The rational buyer-irrational market view is based on the premise that markets do behave irrationally

by undervaluing some businesses and overvaluing some others. This provides opportunity for the overvalued businesses to buy undervalued businesses and create shareholder value.

The rational-buyer-rational-market view is what triggers most of the companies to pursue M&A transactions. The acquirer intends to create competitive advantage by pursuing M&A strategies. Opportunity for creating value arises as flux in socio-political environment like deregulation, trade liberalization, geo-political changes and demographic changes; economic changes like, dramatic changes in demand and supply situations, changes in capital markets and innovations in technology and financial markets provide an agile management with the opening.

Business rationale apart, accounting and financial reporting methods have also influenced the growth of mergers and acquisitions. Among the exogenous factors influencing mergers, accounting was seen as a prime driver. Accounting and financial reporting methods have been more

of an accelerator rather than ignite M&A deals. Pooling of interest method occupies the prime position as an accounting and financial reporting accelerator of M&A deals. "Pooling avoided dilution of earning brought about by the recognition and mandatory amortization of goodwill, when a merger was accounted for as purchase" states the prominent US M&A lawyer Martin Lipton in his Davies Lecture of 2006 in Osgoode Hall Law School, York University.

'Pooling of interest' a term which for the first time was used in the US Federal Power Commission case in 1943⁶ ruled the M&A world till June 2001, when it was finally discarded in US, its birth place. Pooling of interest method of accounting, starting from its birth in United States spread to other parts of the world reasonably quickly. It had a shorter life in most other parts of the world, compared to its birthplace.

A. Tracing origin of business combinations

Tracing the origin of any event historically, is at best a point of view that is highly subjective dependent on the capability of the individual searching, their frame of reference, diligent application, resources available and the extent of work done earlier by others in this area. Given this fact, the first transaction in business combination identified herein needs to be assessed in the context of circumstantial evidence.

Indian Accounting Standard 14 deals with Accounting for Amalgamations. It came into effect from April 1, 1995. In Para 1 the standard states "This statement is directed principally to companies although some of its

⁴ Does M&A Pay? A survey of evidence for decision makers, by Robert F Bruner.

⁵ Roll, R (1986) 'The hubris hypothesis of Corporate Takeovers' Journal of Business 59; 197-216

⁶ Frank R Rayburn and Ollie S Powers, "A history of Pooling of Interest Accounting for business combinations in the United States," Accounting Historians Journal, December 1991, page 155-192

requirements also apply to financial statements of other enterprises.” Given this strong link between companies and accounting for amalgamations, the search is for the first combination of two companies.

Adam Smith in his *Wealth of Nations* first published in 1776 distinguished a joint stock company from private co-partneries, or partnership as we know them now, on three counts⁷. First, in a joint stock company, “no member can demand payment of his share from the company; but each member can without their consent, transfer his share to another person, thereby introducing a new member.” Second, “each partner is bound only to the extent of his share” and finally “the trade of a joint stock company is always managed by a court of directors.” He further recognizes two forms in which a company can come into existence: by royal charter or by act of parliament.

Satisfying the three conditions of transferability of shares, limited liability of members and separation of management from owners, the first company to exist with these distinctive features is Muscovy Company that was granted its charter in 1555⁸. The famous French historian Fernand Braudel commenting on the first recorded English joint stock company writes “...one could say that Europe had some very early examples of the joint stock company, well before the creation in 1553-5 of the Muscovy Company, the first recorded English joint stock company, though other may have preceded it by a few years⁹.”

The first merger of two corporate entities that I have been able to identify was in Amsterdam on March 20, 1602, within fifty years of the first company formation. *Compagnie van Verre* (Company of Distant Lands) merged with *Verenigde Oostindische Compagnie* (VOC) into a single body. The united company had a Dutch monopoly for all trade with Asia¹⁰. This merged company remained in existence for 198 years till 1799, when it was dissolved on December 31, with the Dutch government taking over the company¹¹.

The spread of company as a form of business organization was quite slow in the initial years. Before 1690, there were only some fifteen joint-stock-companies with a total capitalization of £0.9 million in England; by 1695 there were about 140, with a capital of £4.5 million....¹². It was only in the eighteenth century that companies and stock markets that traded company shares came into their own.

The first acquisition of one corporate entity by another that I have been able to find is on May 23, 1719 in Paris¹³. In August 1717, the French Monarch had approved the statute that formed the Company of the West with the right to all trade between France and its Louisiana colony for twenty five years. This company was given the authority to maintain its own army and navy and to mine and to farm. This company was popularly known as the Mississippi Company.

On May 23, 1719, a Sunday, Mississippi Company acquired the

French East India and China Company, to establish an enterprise with global trading rights. The new company was named the Company of the Indies. This acquisition was paid for by issue of 50,000 shares priced at 500 livers each, issued at par.

In U.S., the largest economy for M&A, economists and historians have classified mergers and acquisitions into M&A waves¹⁴. Four waves are recognized in the 20th century and one wave each in the nineteenth and twentieth century, which is tabulated in *Illustration 2*.

Co-relating the merger waves with stock market booms, a clear pattern emerges (*See Illustration 3*). Five distinct market peaks are visible in the twentieth century. The peaks were in 1901, 1929, 1966, 1987 and 2000¹⁶. The period of merger waves also coincides with the periods of stock market booms, giving a reasonable assurance that the first acquisition could have occurred in first stock market boom.

One of the earliest books dealing with stock market booms was published in 1841 written by Charles Mackay, titled “Extraordinary Popular Delusions and the Madness of Crowds”. This book deals with two stock market booms, the ‘Mississippi madness’ of 1719 and 1720 in France and the South Seas bubble of 1720 in England.

The other two prominent books on financial speculations and financial crises are the book written by Edward Chancellor, ‘Devil take the hindmost: A history of financial speculation’

⁷ Page 940-941, *Wealth of Nations*, by Adam Smith, published by Bantam Classics, Edition March 2003

⁸ Page 26, *The Company*, A short history of a revolutionary idea, by John Micklethwait and Adrian Wooldridge published by Weidenfeld & Nicolson, 2003

⁹ Page 439, *The Wheels of Commerce: Civilization & Capitalism, 15th -18th Century Volume 2*, by Fernand Braudel, Phonex Press, edition 2002

¹⁰ Page 39, *The Corporation that Changed the World*

¹¹ Refer website www.oldest-share.htm referred on December 5, 2006

¹² Page 7,

¹³ Page 135, *Millionaire, The Philanderer, Gambler, and Duelist who invented modern Finance* by Janet Gleeson, Published by Simon & Schuster

¹⁴ Martin Lipton, *Merger Waves in the 19th, 20th and 21st Century*, in the Davies Lecture, Osgoode Hall Law School, York University, September 14, 2006

Illustration 2

Merger waves of the 19th, 20th and 21st century ¹⁵			
Wave	Period	Driver	Prominent Companies
First	1893 to 1904	Horizontal mergers in basic manufacturing and transportation industries like steel, oil, mining, railroad	US Steel Corporation, Standard Oil & Erie Railroad
Second	1919 to 1929	Vertical integration in industries like automobile, power utilities	General Motors Ford
Third	1955 to 1967-73	Diversification to leverage common management resources	International Telephone and Telegraphs (IT&T)
Fourth	1974-80 to 1989	Hostile takeover and Leveraged Buyouts (LBO)	RJR Nabisco
Fifth	1993 to 2000	Global view of markets and high stock valuation leading to use of stock as acquisition currency	Time Warner & AOL
Sixth	2002 onwards	Emergence of strong national and global companies supported by low rate interest financing	Mittal Steel & Arcelor

Illustration 3



and 'Manias, Panics and Crashes: A history of financial crises' by Charles P. Kindleberger. Both the authors

Considering the above, there is reasonable justification to believe that the first merger could have

occurred in and around 1602 and the first acquisition in and around 1719. It is also reasonable to believe that the first merger was of the two Dutch companies. If not the first, then this was among the first few mergers and likewise, the first acquisition if not among the first few acquisition was in France involving the Mississippi Company.

B. Early Accounting methods for business combinations

One can only speculate on how early mergers and acquisitions were accounted for, in my search there was no document available on this issue. Therefore it is logical to work back from where we are today, to as far as we can dig into the yesteryears.

Today, accounting for mergers and acquisitions are mandated by accounting standards. The two dominant schools of accounting today are U S Generally Accepted Accounting Policies (US GAAP) and International Generally Accepted Accounting Policies (IGAAP). The first standard on accounting for business combinations in United States was Accounting Research Bulletin 40 issued in 1950. International Accounting Standards Committee issued its first standard on accounting for business combinations in 1983.

Accounting standards do not emerge in a vacuum. They are a product of experts deliberating on alternative contemporary accounting practices. The trigger for formulating accounting standards in UK and US were divergent practices followed by leading businesses. Both the divergent practices were endorsed by leading audit firms creating confusion among the investors and public.

identified Mississippi scheme and South Seas bubble. Charles P Kindleberger points to the peak of these two financial excesses as December 1719 for Mississippi scheme and April 1720 for the South Seas bubble¹⁷.

¹⁵ Tabulated from Martin Lipton's The Davies Lecture, Osgoode Hall Law School

¹⁶ Page 8, Irrational exuberance, by Robert J Shiller, Broadway Books, 2000 edition

¹⁷ Page 224, Manias, Panics, and Crashes: A history of financial crises by Charles P Kindleberger, fourth edition

Accounting standards in US was triggered by the divergence in the accounting treatment followed by joint venture partners General Motors and Standard Oil when they sold their interests in Ethyl Corporation for a profit of \$40 million each. General Motors accounted for the proceeds as part of its trading income for the year, while Standard Oil took the surplus directly to the reserves without impacting profit and loss account. These two large industrial organizations were audited by two of the most highly respected international firms of accountants¹⁸.

In UK the trigger for formulating accounting standards was a controversy following the hostile takeover of Associated Electrical Industries (AEI) by General Electric Company (GEC). While resisting the takeover, ten months into the year, incumbent management had forecast a profit of £10 million for AEI for that year. Following the takeover by GEC, financial statements of AEI published under GEC management reported a loss of £4.5 million. The former joint auditors of AEI attributed the difference of £14.5 million to 'matters substantially of fact' £5 million and the balance £9.5 million to 'matters substantially of judgment' arising from variations in accounting policies¹⁹.

Accounting standards are also preceded by eminent experts writing on the subject holding forth their point of view. Given this, writings on accounting practices provide a logical point of search for early accounting of business combinations.

The book 'Methods of Amalgamation' written by A E Cutforth and published in England in 1926 is recognized as one of the earliest writings on this subject²⁰. Writing in the preface, the author remarked "no book on the subject of amalgamation appears to have been published in this country, although many amalgamations of industrial and other concerns have taken place within the recent years."

In this book, three methods of amalgamation, as mergers in England were called, are described; Profit pooling schemes, a temporary method and two permanent methods of holding company schemes and direct amalgamation.

1. Profit pooling schemes

The most enduring forms of profit pooling schemes found today are found in Anglo-Dutch firms represented by marquee companies like Royal Dutch/Shell, Unilever and Corus the company currently in news as the target of Tata Steel's acquisition plan.

This structure is best illustrated by Royal Dutch/Shell. 'Royal Dutch/ Shell were a merger of operations only; the group is still 60% owned by Dutch parent, 40% by its distinct British one²¹.' Detailing this structure further of Unilever, Datamonitor Plc, describes "Unilever NV and Unilever PLC are the twin parent companies of Unilever group. They have separate legal entities and separate stock exchange listing for their shares, but operate as a single entity; the Unilever group or Unilever. Also Unilever NV, Unilever PLC and their group companies constitute a single reporting entity for presenting consolidated accounts"

2. Holding company schemes

Prevailing practices of accounting for holding company is comprehensively captured in the 1922 lecture given by Gilbert Garnsey to the members of Institute of Chartered Accountants of England and Wales in London. Garnsey a partner in Price Waterhouse & Co. was speaking on "Holding Companies and their published accounts". His lecture was reproduced in The Accountant of January 1923.

In his lecture he describes four methods of accounting for holding company:

1. Reflect investments made in subsidiaries as investment, and account for dividends received in their profit and loss account. In India this method of accounting was practiced prior to the passing of the Companies Act of 1956.
2. Present holding company accounts as in 1 above and in addition present the accounts of the subsidiary companies. This method of accounting was introduced in India with the passing of the Companies Act of 1956.
3. Present holding company accounts as in 1 above and in addition present a statement of the assets and liabilities of all the subsidiary companies taken together. This method of accounting was introduced in India with the passing of the Companies Act 1956.
4. Present holding company accounts as in 1 above and a consolidated balance sheet of the whole undertaking combining the assets and liabilities of all the subsidiaries with those of holding company along with a consolidated profit and

¹⁸ Page 385, an extract from Accounting Standards by John Blake, reproduced in Mergers et al: Issues, implications and case laws in corporate restructuring, by S Ramanujam,

¹⁹ Page 202, Chronology: The Development of Company Financial Reporting in Great Britain 1844-1977 by C W Nobles and R H Parker, in the book, The Evolution of Corporate Financial Reporting by Lee and Parker

²⁰ Page 100, The Acc

²¹ From rivalry to mergers., ' Economist December 2, 2005

loss account combining the profits and losses of all the companies. This method of accounting was introduced in India for companies listed on stock exchanges from April 2001.

In England, one of the earliest companies to publish consolidated accounts was Nobel Industries Limited for the year ended December 1920, in their annual general meeting held in 1922 along with their 1921 accounts²². The practice in England was to a large extent influenced by the practice in U S, which was leading the way in presentation of consolidated accounts. United States Steel Corporation which stated business on April 1, 1901 reported from its very first year in 1902 consolidated undivided surplus of the company and its subsidiaries²³.

3. Direct amalgamation

The method of accounting for direct amalgamation or mergers has a more interesting history. Distillers Company Limited, the 27th largest company in UK by turnover for 1972-73 contributed its annual reports from 1881 to 1973 in response to an appeal made by Scottish Committee on Accounting History, a committee of the Institute of Chartered Accountants of Scotland.

In analysis of these reports, it was noticed that in 1908, an existing subsidiary was put into voluntary liquidation and its assets and liabilities were absorbed into the holding company²⁴. English Electric Co Ltd also followed an identical method of absorbing subsidiary companies, indicating that liquidating acquired companies to amalgamate them was not a unique event.

English Electric Co Ltd was formed in 1918 to acquire controlling interest in five businesses, The Phoenix Dynamo Manufacturing Co Ltd, Dick, Kerr & Co Ltd, the United Electric Car Co Ltd, the Coventry Ordnance Works and Willans and Robinson. The company announced in its 1924 accounts that it would present consolidated accounts from the year 1925 as 'arrangements having been made to liquidate ... (or)... to complete the liquidation of' the companies²⁵.

Looking at the above practices it is quite possible that early acquisitions could have been accounted for using similar methods of liquidating the acquired companies. For example, the Mississippi Company after acquiring the French East India and China Company could have liquidated the acquired company and absorbed their assets and liabilities.

In the case of the first merger in 1602 involving the Dutch companies, it is probable that the two companies were liquidated and the merged entity was created by the royal charter. Support for this view can be drawn from the writing of Edward Chancellor "In 1602, the united East India Company, the first joint stock company to receive an official government charter, was established with a monopoly over Eastern trade"²⁶ highlighting the fact that it was the first joint stock company to receive an official Dutch government charter.

C. Evolution of 'pooling of interest method' of accounting for business combinations in United States

Today, two alternative methods of accounting for business combinations

are available; the purchase method and the pooling method. The contrast between the two methods is best illustrated by the two acquisitions in the Telecom industry with similar financial profiles that took place within a short span of time, i.e. Northern Telecom (Nortel) acquiring Bay Networks and Lucent acquiring Ascend Communications²⁷.

Nortel acquired Bay Networks on August 31, 1998. The acquisition was valued at \$6.9 billion based on shares of Nortel issued at their prevailing market price. For this consideration, Nortel acquired \$1,881 million of tangible assets and took over liabilities of \$475 million.

Lucent acquired Ascend Communication on June 25, 1999. This acquisition was valued at \$20 billion based on shares of Lucent issued at the prevailing market price. Lucent acquired \$2.8 billion of tangible assets and took over liabilities of \$0.5 billion.

Nortel as a Canadian company had to account for the acquisition using purchase method and Lucent the US Company used the pooling of interest method of accounting. The salient aspects of accounting in the two transactions are tabulated in *Illustration 4*.

Using the pooling of interest method of accounting gave Lucent an accounting advantage of reporting better performance at two levels. First by not accounting for intangible assets, prospective return on investments were exaggerated, second by not accounting for intangible assets, amortization or impairment of these assets were also

²² Page 101, The Acc

²³ Page 58,

²⁴ Page 24, Company Financial Statements by T A Lee, in the book The Evolution of Corporate Financial Reporting by Lee and Parker

²⁵ Page 101,

²⁶ Page 9, Devil take the hindmost: A history of financial speculation by Edward Chancellor, published by Penguin Group, June 2000 edition

²⁷ The End of pooling envy by Claude P Lanfrancon and Darroch A Robertson, in Ivey Business Journal, July/August 2000

Illustration 4

\$US billion

Description	Nortel	Lucent
Consideration paid valued at market price of shares	6.90	20.00
Liabilities taken over	0.48	0.50#
Gross consideration paid	7.48	20.50
Tangible assets taken over	1.88	2.80#
Consideration paid for intangibles	5.60	17.70
Intangibles accounted for by acquirer	5.60	0.00
Market value of shares issued & not accounted for	-	17.70

as of March 31, 1999 and not the date of acquisition, to that extent not comparable

not charged to the profits thereby inflating the profits reported.

What could have led to the emergence of this method of accounting that moves away from the basic concept of historical cost in recording transactions?

While companies as a form of business organization emerged first in Great Britain, regulating accounting practices for the companies developed earlier in United States. Regulation of accounting practices in Great Britain was through legal decisions in general and for specific industries, through legislative enactments. Among the first few regulations in England was mandating 'Double Account system' of accounting for Railways by the Regulation of Railways Act 1868²⁸. It was only in 1942 that Institute of Chartered Accountants of England and Wales issued its first two Recommendations on Accounting Principles. It took another twenty eight years before Accounting Standards Steering Committee was formed in England²⁹.

1. Fair price for general public

In United States, regulation of accounting practices began by prescribing the accounting methods and practices to regulate fair prices. It started first for interstate transport companies, who were regulated by the Interstate Commerce Commission, established in 1887. The next significant regulation was the enactment of the Securities Exchange Act 1934. A year later, SEC appointed a chief accountant, who initiated the drive to narrow the range of diversity in accounting practices³⁰.

The birth of 'pooling of interest method' of accounting for acquisitions goes back to 1887. The lineage can be traced to Interstate Commerce Commission and Accounting for Earned Surplus. US Federal Power Commission acted as the midwife delivering this concept³¹.

Interstate Commerce Commission (ICC) was set up in 1887 to regulate price by fixing fair rates for interstate transport. ICC was given the power to prescribe the system of accounting

that the carriers had to maintain. Not only did they prescribe the system of accounts to be maintained, they prohibited any other system of records to be kept. "The Commission may in its discretion prescribe the forms of all accounts, records, and memoranda to be kept by the common carriers, to which accounts the commission shall have access. And the act makes it unlawful for the carriers to keep any accounts, records, or memoranda other than those prescribed by the commission."³²

Fair price was maintained by the commission by fixing fares based on 'rate base' on the principle of 'rate parity'. Rate base was the capital employed in the business and 'rate parity' was achieved by fixing a rate of return on the capital employed by the common carrier.

The principle of maintaining a fair price in United States by capping the return on capital employed was well etched in industries where general public were the consumers.

2. Capital preservation to protect creditors

Limited liability is the feature that distinguished the advent of company as a form of business organization, from the earlier forms of business organizations. For Companies to survive and flourish, it was critical that the interest of creditors be protected. The primary form of protection offered to creditors was capital preservation.

In the Exchange Banking Co. case in 1882, Jessel MR, clearly summed up this principle "The creditor has no debtor but that impalpable thing that

²⁷ The End of pooling envy by Claude P Lanfrancon and Darroch A Robertson, in Ivey Business Journal, July/August 2000

²⁸ The origin and emergence of double account system: an example of accounting innovation, by J R Edwards, in Abacus, Volume 21, Number 1, 1985

²⁹ Page 197, Chronology: The development of Company Financial Reporting in Great Britain 1844-1977, in the book Evolution of Corporate Financial Reporting, by Lee and Parker

³⁰ Page 209, Chronology: Developments in the Establishment of Accounting Principles in the United States, 1926-1978, in the book Evolution of Corporate Financial Reporting, by Lee and Parker

³¹ Inferenc

³² Extract from the US Supreme Court judgment in Interstate Commerce Commission vs. Goodrich Transit Company, 224 US 194, (1912)

corporation, which has no property except the assets of the business. The creditor, therefore, I may say, gives credit to that capital, gives credit to that company on the faith of the representation that the capital shall be applied only for the purposes of the business and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders. . . .³³

The need for creditor protection had resulted in classifying the surplus in business into Paid-In surplus, i.e. paid in by the shareholders and Earned-Surplus, a result of the decision to retain profits in the company and not declare it as dividends. In subsequent years, dividend could not be declared out of Paid-In surplus, while Earned-Surplus was available for dividend declaration.

This clarity between Paid-In Surplus and Earned-Surplus began to blur on merger between two existing companies. When two existing companies A and B came together and both had Paid-In Surplus and Earned-Surplus, the question arose on how to consider the two surpluses on merger.

Two schools of thought emerged, as is the case in matters involving judgment, when the same issue is viewed from opposing angles. Those who viewed the merger as only a change in form favored carrying forward earned surplus and wanted to retain the Earned-Surplus after merger. Others viewed the resultant entity as a new company and held that a new company could not start with Earned-Surplus.

Both these views had sound logic and two forms of business combinations

began to be recognized; one that resulted in a 'new economic enterprise' and the other that was 'continuation of the old business.'³⁴ Four criteria were identified to distinguish the two forms:

1. The relative size of the predecessors –if significant, earned surplus of the surviving company should be carried forward
2. The degree of affiliations –if wholly owned subsidiaries were being combined or subsidiary combined with holding company, earned surplus could not exceed the combined earned surpluses
3. The extent to which there was change in ownership
4. The nature and extent of prior business relationships between the two companies

In mergers involving, holding company with their wholly owned subsidiary or merger of two or more wholly owned subsidiaries, earned surpluses were being carried forward on the basis that it was continuation of old business, and the change was in form only and not in substance. This gave rise to the accounting practice of recording the assets and liabilities of the merging company at the cost at which they were being recorded in the company prior to merger. This practice can be seen as the seed that germinated into the 'pooling of interest method' of accounting for amalgamations.

3.The birth of pooling of interest method

In 1935, Federal Power Commission was given powers to "regulate electricity utilities wholesale rates and transactions" by the Federal Power Act, 1935³⁵. They followed the

method of regulation based on the precedent set by Interstate Commerce Commission of rate parity and rate base.

Holding companies controlled large segments of the utility, railroad, and entertainment business in United States³⁶. With introduction of rate regulation, the holding companies saw a way of enhancing their rate base by merging wholly owned subsidiary companies with the holding company or merging two subsidiary companies at values higher than their book values by exchange of shares.

Federal Power Commission saw through design, that resulted in asset write up increasing the capital employed and termed the merger of closely affiliated companies as 'pooling of interest method' and held that valuation on the basis of securities exchanged was improper and no new value should be attached to the assets since no change in substance had occurred³⁷.

The first accounting standard on business combinations Accounting Research Bulletin 40 issued in 1950 differentiated between two accounting methods and described them as 'pooling of interest' and 'purchase'. The conditions prescribed for a transaction to qualify for pooling method was similar to the conditions prescribed for carrying forward Earned-surplus. It also stated that using pooling method required that the retained earnings of the acquired corporation be carried forward to the acquiring firm.

Thus 'pooling of interest method' of accounting for business combinations was born. While the conditions to be met to qualify for 'pooling of interest

³³ Page 867, Guide to the Companies Act, A Ramaiya fourteenth edition, 1998

³⁴ Speech of SEC Chief Accountant William W Wernitz reported in The history of pooling-of-interests method in the jurisdictions of G4+1 member organizations

³⁵ Regulation: the fight which saved the nation by Richard Freeman and Marsha Freeman published in American Almanac, February 2001

³⁶ Page 183, The Great Crash 1929, by John Kenneth Galbraith

³⁷ Page 22, Accounti

method' varied over the period, the concept in itself flourished for the rest of the century.

D. Tracing how 'pooling of interest method' of accounting for business combination reached India

Indian accounting practices in the last three hundred years and the Indian Company law from birth have shadowed developments in United Kingdom. In fact, early company law in India is legislation for British India³⁸. The Indian Statute could be mapped section by section to the British Companies Act. The Companies Act, 1956, was enacted by Independent India, but placed considerable reliance on the UK Act of 1948³⁹. Therefore pre-independence history of accounting in Corporate India would be a shadow of the accounting practices in United Kingdom.

Looking at the post independence period, it is only since 1972-73, that mergers and acquisitions concluded during the year have been reported⁴⁰. The year 1972-73 is also seen as a logical point for reporting, as the three key triggers to monitor and regulate business control in the hands of few were activated. The managing agency system was abolished from April 3, 1970⁴¹, the enforcement of Monopolies and Restrictive Trade Practices Act of 1969 from July 1, 1970 and the nationalization of banks in 1969.

In my view prior to this the need for mergers and amalgamations was not felt as managing agency system provided an adequate mechanism for managing multiple companies under common control.

The only exception to the reporting of mergers and acquisitions prior to 1972-73 is of bank mergers under the direction of Reserve Bank of India in 1960's. This initiative saw the number of commercial banks reduced from 566 in 1951, to 292 at the end of 1961, to 100 at the end of 1966 and 85 by the end of 1969. Correspondingly during the same period non-scheduled banks also declined from 474 to 210 to 27 to 14⁴².

The first merger and acquisition transaction that I have been able to trace in the post independent India is in the birth of Hindustan Lever Limited. In November 1956, Hindustan Vanaspati Manufacturing Company private Limited, the first subsidiary of Unilever Company set up in 1931, merged with Lever Brother India Limited established in 1933 and United Traders Limited established in 1935 to become the Hindustan Lever Limited⁴³.

Incidentally, the history of Hindustan Lever is rich in mergers and acquisitions. Starting with its birth in a merger, the company has sought mergers as a way of growth too. In 1993, HLL merged with TOMCO. This was followed by a series of merges within the group companies. In July 1993, Broke Bond India Limited merged with Lipton India Limited to form Broke Bond Lipton India Limited. Three years later on January 1, 1996, Broke Bond Lipton India was merged into HLL. In 1998 Pond's (India) Limited was merged into HLL. In January 2000, HLL acquired 74% stake from Government of India in Modern Foods Limited, a public sector unit.

Earlier Broke Bond India Limited in 1992 had acquired Kothari General Foods and in 1993 acquired Kissan from UB Group and Dollops Ice cream from Cadbury India.

But our interest is in the birth of Hindustan Lever in November 1956 and more specifically in how this merger was accounted for.

In October 1994, the Institute of Chartered Accountants of India announced the Accounting Standard 14: Accounting for Amalgamations, prescribing it as a mandatory standard and stated that the standard should be followed in respect of accounting periods commencing after April 1, 1995⁴⁴.

The standard prescribes two methods of accounting for amalgamations, namely the pooling of interest method and the purchase method. The use of pooling of interest method is restricted to amalgamations that meet the five criteria specified in the standard:

- i. All assets and liabilities of the transferrer company are part of amalgamation
- ii. Shareholders holding not less than 90% of the face value of equity shares become equity share holders of the amalgamated company
- iii. The consideration of amalgamation is equity shares of the transferee company
- iv. The business of the transferrer company is carried on by the transferee company

³⁸ Para 1 of the Indian Companies Act, 1882,

³⁹ Page 8, Guide to Companies Act, A Ramaiya, fourteenth edition, 1998

⁴⁰ Page 11, An analy

⁴¹ Page 2370, Guide to the companies Act, A Ramaiya, fourteenth edition, 1998

⁴² Bank M&A: Stability and Synergy, by A Vasudevan, Business Line November 11, 2004

⁴³ Website www.hll.com; in the section heritage, subsection milestones

⁴⁴ Page 384, Mergers et al: Issues, implications and Case laws in Corporate Restructuring, by S Ramanujam

- v. No adjustment is intended to be made to the book value of the assets and liabilities of the transferrer company when they are incorporated in the books of the transferee company

Amalgamation of Tata Oil Mills Company Limited (TOMCO) with Hindustan Lever in 1995 and in the same year amalgamation of Wipro Infotech Limited and Wipro Systems Limited with Wipro Limited are two prominent instances of accounting for amalgamation using 'pooling of interest' method.

Prior to April 1, 1995, accounting for amalgamation was based on the Guidance note on Accounting Treatment of Reserves in Amalgamations issued by the Institute of Chartered Accountants in 1983⁴⁵.

It was also in 1983, that International Accounting Standards Committee issued its first accounting standard on business combinations. This standard was a result of the Steering Committee appointed in 1978⁴⁶. This committee prepared a discussion outline, in which they evaluated three potential methods of accounting:

- i. The purchase method, in which acquirer recognizes the difference between the cost incurred and the fair value of net assets acquired,
- ii. The pooling method, in which the acquirer does not recognize the difference between the cost incurred and the fair value of net assets acquired,
- iii. The new entity method, in this method, both the acquirer and the acquired restate their assets and liabilities to fair value on the date of acquisition.

The third identified concept, of new entity method of accounting was discarded as it went against the historical cost convention. Purchase method was recommended in situations where a buyer and seller could be distinguished.

Pooling method was identified for those rare transactions of amalgamations, where a buyer and seller could not be distinguished. The objective of pooling method was described as being to consolidate the pooled companies with minimal changes to their individual financial statements, on the basis that the separate businesses continue as before, though now owned and operated as a single unit.

The second draft issued in 1980, identified three categories; Uniting of interest, Uniting of equal interest and Acquisition. Shares exchanged to combine enterprises of similar market worth were recognized as uniting of interest. Uniting of equal interests was when none of the combining entities individually had controlling interest in the new entity. Acquisition was recognized as a business combination that was not uniting of interest.

In my view this classification seems logical considering the three methods of accounting for acquisition identified. Acquisition would require purchase accounting, uniting of interest would require pooling of interest method and uniting of equal interest would require new-entity method.

However, when the accounting standard IAS 22: Accounting for Business Combination was issued,

it had only two methods; purchase and pooling. Pooling method was to be used only in rare circumstances of uniting of interest, in all other cases purchase method was to be accounted. Not defining uniting of interest precisely was the loop hole that gave a lease of life to Pooling. Since uniting of interest was not defined precisely, it permitted amalgamations which were basically acquisitions with purchase consideration in the form of shares to be considered for pooling.

Prior to these discussions and deliberations, what was the thinking on accounting for merger and acquisition? How was the merger of three companies that gave birth to Hindustan Lever Limited accounted for? The options:

1. Did it follow the traditional English practice of liquidating the companies being merged, or
2. Was the new-entity method followed with assets and liabilities accounted for at their fair values, since along with the merger 10% of shares were being offered to the Indian public by Unilever Limited, London, or
3. Was purchase method used, with one company buying out the other two companies by issue of shares or
4. Was pooling of interest method adopted, of accounting for the assets and liabilities of the merging companies at the value at which they were carried in the merging company

From the scrutiny of the Annual report of Hindustan Lever Limited, 1956,

⁴⁵ Page 2560, Guide to the Companies Act, A Ramaiya, fourteenth edition 1998

⁴⁶ Page 31, The History of the Pooling of interests methods in the Jurisdictions of G4 +1 member organizations

which was titled Report and Accounts, 1956, we can gather the following information from the directors' report:

- i. Was converted into a public company on October 27, 1956
- ii. Changed its name from Lever Brothers (India) Limited to Hindustan Lever Limited on November 1, 1956
- iii. By Bombay High Court order on October 8th, 1956, but with effect from the close of business on December 31, 1955, the three companies were amalgamated under section 391 and 394 of the Companies Act, 1956. The three fully owned subsidiaries of Unilever London, Limited that were merged are:
 - 1) The Hindustan Vanaspati Manufacturing Company Private Limited
 - 2) William Gossage & Sons (India) Limited
 - 3) Joseph Crosfield & Sons (India) Limited
- iv. Two wholly owned subsidiaries of Lever Brothers (India) Limited were voluntarily liquidated
 - 1) The North West Soap Company Private Limited
 - 2) The Premier Soap Company of India Private Limited
- v. The company took over the soaps and toilet preparation business of its wholly owned subsidiary company United Traders Private Limited and United Traders ceased to carry on any business for the time being.
- vi. 2 million equity shares of Rs.10 each was allotted to Unilever in consideration of the vesting of assets of the merged company
- vii. 1.57 million Equity shares of Rs.10 each was allotted as bonus shares by capitalizing Rs.15.7 million profits.

viii. Unilever Limited sold by an Offer of Sale to public in India 557,000 shares of Rs.10 each

ix. The figures reported for the previous year in Balance Sheet and Profit and Loss account are of Lever Brothers (India) Limited and are not of the combined merged entity

The following inferences can be drawn based on information listed above and other information available in the Annual reports:

1. The amalgamation under section 391 and 394 of the Companies Act, 1956 resulting from the court order was effective close of business hours, December 31, 1955, a full three months before the Companies Act, 1956 came into force. The Companies Act, 1956, was notified vide Notification No.SRO 612, dated March 8th 1956 in the Gazette of India, Extraordinary, 1956, to come into force effective April 1, 1956⁴⁷.
2. Three distinct types of transactions can be observed, as tabulated in Illustration 5:
3. Taking over the business of United Traders, the fully owned subsidiary did not require any accounting, as no consideration was paid for it. United Traders appears to be the selling agent of Lever Brothers (India), since the profit and loss account of United traders reflected only finished goods inventory and trading profits are transferred to the holding company in 1955 accounts.
4. The liquidation of the two subsidiaries of Lever Brothers (India), The North West Soap Company Private Limited and The Premier Soap Company of India Private Limited seem to be accounted as a pure sale of assets with the profit on sale of Rs.300 thousands being reported separately.

5. On a scrutiny of the balance sheet and comparison with figures of the previous years which are for the standalone company prior to the merger, the consideration of Rs.20 million appears to be for the net assets taken over on merger, as reflected by increase in assets of Rs.25 million detailed below all of which are not accounted for by the increase in operations of the combined entity (*Illustration 6*).

6. The balance sheet of Lever Brothers (India) for 1955 had Trade Marks & Goodwill of Rs.0.3 million. With the merger of three companies, there is an addition to Trade Marks & Goodwill of Rs.0.323 million in the year 1956. This could be the existing value of Trademark and Goodwill in the books of the three companies.

7. The above mentioned factors indicate that this merger could have been accounted for as a pooling of interest method of accounting for amalgamations. In hindsight this looks a fair decision as the companies being merged were all fully owned subsidiaries of Unilever Limited, London. The merger was only a change in form and there was no new business that was being created.

Therefore it is possible if not probable, that the first merger approved by the courts under the Companies Act, 1956 was accounted under the pooling of interest method of accounting.

E. Demise of 'pooling of interest method' of accounting for business combination

Almost with the birth of this concept, discomfort with using 'pooling of interest method' of accounting for business combinations began. American Accounting Association published "A statement of Basic Accounting Theory" in 1966. In this document, it called for discontinuance of pooling, reasoning "it is more than

⁴⁷ Page 1, Guide to the Companies Act, 1956, A Ramaiya, fourteenth edition, 1998

Illustration 5

Sl. No.	Transaction type	Consideration
1	Three wholly owned subsidiaries of Unilever merged with Lever Brother (India) Limited	2 million equity shares of Rs.10 each; the three companies merging into Lever Brothers (India) Limited were valued on par with Lever Brothers (India). The paid up equity capital increased from Rs.20 million, pre-merger level to Rs.40 million post-merger
2	Liquidation of two wholly owned subsidiaries of Lever Brothers (India) Limited	A profit on liquidation of subsidiary companies of Rs.0.307 million is reflected in the profit and loss account. Cost of investment in these two companies was reflected in 1955 balance sheet at Rs.3.199 million.
3	Lever Brothers (India) Limited taking over the business of its wholly owned subsidiary United Traders Private Limited, which ceased to carry on any business, for the time being (emphasis in italics by the author of this report)	No consideration was paid.

Illustration 6

Balance Sheet classification	December 31		Rs.Million	
	1955	1956	Increase	% of 1955
Net Fixed Assets	27.918	35.193	7.275	26%
Loans and Advances	2.497	6.521	4.024	161%
Current Assets	26.82	58.133	31.313	117%
Cash and Bank balances	5.811	9.718	3.907	67%
Unsecured loans	0.000	1.388	-1.3877	N.A
Current liabilities and Provision	12.849	32.77	-19.921	-155%
Total	50.197	75.407	25.210	

questionable that such a treatment which essentially ignores the new exchange values created by a significant market transaction such as combination of two companies can be said to be relevant for investment decision.⁴⁸

Objection to 'pooling of interest method' of accounting for business combinations arose due to the following consequences:

i. Creditors' interest adversely affected as it can lead to reduction of capital: On sale of assets acquired on merger, subsequent to merging separate balance sheets at book value,

accounting profits can be shown although no profit would have been reported if the fair value of transaction had been used for accounting.

ii. Prospective Shareholders' adversely affected as there would be overstatement of profits: As the assets after merger are accounted at the historical cost to the acquired company, depreciation and amortization is under provided resulting in overstatement of profits.

iii. Regulators and investing public interest affected as the performance between similar companies rendered incomparable due to differing

yardsticks used for recording capital employed.

Today pooling of interest method of accounting for amalgamations is withdrawn under both the dominant schools of accounting, the US GAAP and the International Accounting Standards.

In fact, FASB when they concluded that only the purchase method, should be used to account for all transactions that meet the definition of business combination, listed the advantages as enhanced relevance, reliability and comparability⁴⁹, well illustrated in the Nortel and Lucent acquisitions.

Similarly, International Financial Accounting Standard 3 on Business Combinations explained the reason for issuing this standard as "...analyst and other users of financial statement indicated that permitting two methods of accounting for substantially similar transactions impaired the comparability of financial statements."⁵⁰

In India, Indian accounting standards 14: Accounting for Amalgamations is what prevails. In para 42 dealing with treatment of reserves specified

⁴⁸ Page 12, The history of the pooling of interest method in the Jurisdictions of G4+1 Member organizations

⁴⁹ Page 1, of Earnest & Young's, guidance note for Clients and Friends on FASB 141 and 142 dt, February 2004

in a scheme of amalgamation states “where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferrer company after amalgamation, the same should be followed.” The only additional requirement is specified by the general clarification 4/2002 issued by the Accounting Standards Board of the Institute of Chartered Accountants of India. This requires that the treatment given to reserves be described and highlight the deviation from the treatment required under Accounting Standards 14.

Conclusion

Evolution of the ‘pooling of interest method’ of accounting for amalgamations clearly demonstrated, that when accounting practices and accounting standards depart from basic accounting concepts, like in this case historical cost convention, they have a limited shelf life. Life span in these cases is directly proportional to who is benefited by this practice and how much are they benefited. The power of the beneficiaries and the extent of benefit derived by them is demonstrated in the how vociferous and vigorous their involvement is in its defense.

This aspect was reflected in accounting for stock options too, where costs were not recognized on the principle that it could not be precisely quantified. However changes of these magnitudes were made consequent to crashes following the stock market booms. These stock market booms were fueled to a significant extent by these accounting policies.

In fact it is appropriately remarked that in bull markets people talk of business and valuation models and in bear markets people talk of accounting policies and accounting principles.

