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Accounting for Mergers, Acquisitions and Investments, in a Nutshell: The Interrelationships of, and Criteria for, Purchase or Pooling, the Equity Method, and Parent-Company-Only and Consolidated Statements

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Accounting for Mergers, Acquisitions and Investments, in a Nutshell: The Interrelationships of, and Criteria for, Purchase or Pooling, the Equity Method, and Parent-Company-Only and Consolidated Statements

By TED J. FIFLIS*

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INTRODUCTION

There comes a time in the affairs of a business lawyer in this era of acquisitions when he or she must pause to unravel the often confusing accounting for long term investments in equity securities by one corporation in

Editor's Note: The assistance of William P. Hackney of the Pennsylvania Bar and Larry P. Scriggins of the Maryland Bar, who served as Reviewers for this article, is hereby gratefully acknowledged. Notwithstanding the aid thus provided to the Editor, it should be emphasized that the article in its final form and the views expressed therein should be attributed solely to the author.
another. Even if many lawyers understand in a general way the concepts of "purchase" accounting and "pooling of interests" for "business combinations," precisely how these fit in with the "equity" method, "parent-company-only statements" and "consolidated statements" is not widely understood.\(^1\) Even the professional accounting literature does not contain an explanation of the interrelationships.\(^2\) In addition there is much misunderstanding of the equity method among lawyers. This paper is intended to help explain these matters as an aid to lawyers who must deal with the accounting concepts in various contexts, including planning for corporate takeovers, drafting disclosure statements, legislation, or restrictive covenants for debentures or preferred shares, and in negotiating acquisitions.\(^3\)

---

1. The terms in quotes will be defined as they arise in the course of our discussion.

Because some readers may not be fully conversant with the accounting literature and terminology, a preliminary note on bibliography and terminology may be desirable.

As to the bibliography, a proliferation of accounting pronouncements has added to lawyers' difficulties in this area. In this article, frequent references will be made to statements of the American Institute of Certified Public Accountants ("AICPA"), the Financial Accounting Standards Board ("FASB") and two of the AICPA's committees, the Committee on Accounting Procedure, which published fifty-one Accounting Research Bulletins ("ARB No. _") and the Accounting Principles Board, which published thirty-one Opinions ("APB Op. No. _"), four Statements ("APB St. No. _") and numerous Interpretations. The first 42 ARB's were restated and superseded by ARB No. 43. The four APB statements are merely descriptive of accounting principles, not prescriptive. See Notes to APB St. No. 2, No. 3, and No. 4. The AICPA and FASB pronouncements referred to in this article are collected in CCH, Financial Accounting Standards, Original Pronouncements, an annual publication, and may be found in any of the recent annual issues.

As to terminology, accountants are fond of drawing fine distinctions in the usage of words, as if they contained much more than the "skin of a living thought." Thus, they say that if one firm "acquires" another, there is no question that the accounting must be on a "purchase" basis (to be explained in text following note 11). In discussions they insist on the word, "combination," as a neutral term which may then fall into the category of an "acquisition" accounted for on the "purchase" basis, or, alternatively, the "uniting of ownership interest," accounted for on the "pooling" basis (also explained below). See APB Op. No. 16 n.2 and ¶¶ 1 and 12 (1970). But words are not wholly reliable vehicles and ought not to be loaded with too much freight. The word, "acquisition," will be used therefore to include both types of combinations because the cost of using the accountants' terminology is a great deal of awkwardness, to little avail.

Further, in this paper, the terms "Capital Surplus" and "Earned Surplus" will be used although they are no longer found in accounting statements, because they are used in judicial opinions and statutes and hence are familiar to lawyers. Accountants prefer designations such as "Capital Contributed in Excess of Par," for one type of "Capital Surplus" known to lawyers as "Paid-in Surplus," and "Retained Earnings," in lieu of "Earned Surplus." See AICPA Accounting Terminology Bulletin No. 1 ¶¶ 65-70 (1953).


In addition to correlating purchase or pooling, the equity method, parentcompany-only and consolidated statements, the paper will explain the criteria for fitting transactions into one or another category or a combination of them. One who understands this subject, either before or after studying this explanation, will find a diagrammatic summary of these processes in Figures 1, 2 and 3, infra. These may serve as a useful reference from time to time.

Perhaps the more glamorous subject is that of abuses in the accounting for acquisitions, but that is not covered here, because to do so might hinder the explanation.

First, we shall deal with the accounting for an assets acquisition, i.e., a transaction in which the corporation from which the assets are acquired disappears from the economic entity and some or all of its assets become directly owned and some or all of its liabilities may be assumed by the acquiring corporation through a statutory merger, consolidation or purchase of assets. In this situation, of course, there are no consolidated statements and the fundamentals of purchase or pooling accounting can be most easily understood. Then we shall examine the more complex accounting for acquisition of stock of other enterprises and retention of such stock as an investment or as a subsidiary. The additional complexities of foreign exchange accounting when a foreign company is acquired will not be discussed here, nor will the accounting for investments by specialized industries such as the mutual fund industry be described. Tax considerations, of great importance here, will not be discussed except as they appear pertinent to the accounting.

This paper is divided into three main parts. In Part I, dealing with assets acquisitions, there are two principal categories, acquisitions of isolated assets not a going concern, and acquisitions of going concerns (i.e., "business

---

For a more recent exposition, pointing out that the lesson went unlearned in California, see de Capriles and Brown, Accounting for Business Combinations Under The New California Corporations Code, 29 Hastings L. J. 851 (1978). Presumably in response to this article, the California Code was amended. Cal. Corporations Code § 409(e) (West, 1977) as amended by Stats. 1978 ch. 370, § 4.

4. The acquired corporation need not in fact disappear. E.g., in the sale of assets by B Corp to A, B may continue. What is meant throughout this part when it is said that B disappears as a separate entity is that B is disassociated from the business, which will be owned and operated by A Corp.


Business combinations are to be treated as "poolings of interests" if the requisite degree of continuity of the rights and risks of their original investments exists for shareholders of both the acquiring company and the acquired company. All other acquisitions are treated as "purchases."

In Part II, where both corporations continue as legal entities, we shall note that if one corporation controls the other, both entities' financial statements will be consolidated, on either the purchase or pooling basis, if the further condition is met that consolidation would not be misleading. If that condition is not met, instead of consolidation, the so-called "equity method" of accounting for the unconsolidated subsidiary must be followed, with one treatment for "poolings" and another for "purchases."

Part II also describes the accounting where no control is held by either legal entity over the other. In this case one of three methods of accounting is required, depending on whether certain criteria are met. These methods are:

(a) The "cost" method;
(b) A variation thereof, "cost or market"; or
(c) The equity method (on the "purchase" basis only).

The criteria for the equity method in this case (where there is no control relationship) are: one entity has significant influence over the operating and financial policies of the other, or alternatively, the accounting entity holds a joint venture interest in the other.

Accountants may bridle at the use of the terms "isolated assets not a going concern" and "going concern" because the term "going concern" is used in accounting thought to distinguish viable businesses from nonviable ones. They might prefer to use terms such as "assets not constituting a business" and a "business." A "business" may be in corporate form, a partnership, sole proprietorship, a trust account, an estate, etc. Thus even the purchase of land in the illustration could constitute the entire business of operating a parking lot, a ranch, etc. Or a business could be purchased with a view to its liquidation or the disbursement of its assets among the departments of an acquirer, thereby terminating the acquired business.

The accountant must ascertain whether a "business" or a "nonbusiness" will be operated by the acquirer by addressing numerous questions. He would focus principally on the economic aspects of the assets and liabilities received, including utilization, management, control, benefit, etc. Some of the questions considered would be:

1. Is it a self-sufficient economic entity?
2. Can it be self-sufficient?
3. Is there real economic potential?
4. Does the acquirer intend to operate the consideration received as a business enterprise?
5. Does the acquirer intend to merely use the consideration received to supplement or enhance his existing business enterprise?
6. What changes in operation does the acquirer intend to accomplish?
7. Were any operating personnel concurrently acquired or employed by the acquirer?
8. Does the acquirer intend mere liquidation of the consideration acquired?

There are, of course, many other attributes that would be proper for inclusion in the accountant's thought processes depending upon the circumstance of any particular acquisition.

The term, "consolidate," and its derivatives, like "going concern" and many others, have different meanings in accounting and law. "Consolidated financial statements" have no relationship to the statutory consolidation of two corporations into a third. See text at n. 63, et seq., for a description of consolidation of financial statements.
Parts I and II are concerned with accounting on the financial statements intended to be the primary statements used for reporting to investors.

In Part III, consideration will be given to the accounting statements of the legal entity holding shares of another when the statements are not limited as those primarily for investors. Here we shall see that the accounting is anarchistic.

I. ACCOUNTING FOR ASSETS ACQUISITIONS: I.E., ACQUISITIONS RESULTING IN ONE SURVIVING CORPORATION

The simplest situation, and one for which the accounting is familiar to most business lawyers, is that in which an entity acquires substantially all the assets and liabilities of a second business entity, by merger, consolidation or purchase of assets, and remains as the sole survivor in the economic unit—the so-called assets acquisition. The question in this case is: should the acquisition be accounted for as a “purchase,” or as a “pooling of interests”?

Before examining these two alternatives, we should make certain that the accounting for purchase of an isolated asset and assumption of a liability is clearly in mind.

A. Accounting for the Purchase of Isolated Assets Not a Going Concern

If A Corp. were to buy land from B Corp. (carried by B Corp. on its books at $35,000) at a price of $20,000 in cash plus assumption of an $80,000 note bearing interest at the current market rate, that purchase would be accounted for in A’s journal as follows:

<table>
<thead>
<tr>
<th>Land</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
</tr>
<tr>
<td>Note Payable</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

The important result to notice here is that the acquired asset is shown at its $100,000 cost to A, regardless of the $35,000 book carrying value of the seller, B.

If several individual assets were to be acquired from B for a lump sum in what is often referred to as a “basket purchase,” they also would be carried by A at their cost to A, although a problem would arise concerning allocation of the lump sum among the several items. In this situation, generally accepted accounting principles (“GAAP”) provide that the total price should be allocated among the assets proportionately to their individual fair values. In

9. APB St. No. 4 ¶ 145 (1970). If the interest rate on the note is below the going rate, the assumed liability may be decreased accordingly. See APB St. No. 4 ¶ 181 M-1C and Discussion (1970). And see APB Op. No. 21 (1971) (discount or premium in certain cases). For the case of acquisition of a going concern, see APB Op. No. 16 ¶¶ 72, 88g, h & i (1970), discussed in text at n. 18, infra.

10. The term, "generally accepted accounting principles" is a technical one, not explained here. For an explanation, see APB St. No. 4 ¶¶ 137-42 (1970) and AICPA, Statement on Auditing Standards No. 5 (1975) for the meaning of "present fairly in conformity with generally
B. "Purchase" Accounting for an Assets Acquisition of a Going Concern

What should be the method of accounting when, instead of the purchase of isolated assets, control is acquired over an entire business as a going concern?

1. MEASUREMENT AT CURRENT COST TO ACQUIRING COMPANY

By our hypothesis, control is acquired by A Corp., B Corp. disappears from the economic entity, and B or B's shareholders receive either A Corp. stock or other property. This will result in a "business combination" which, to accountants, means A Corp.'s acquisition of control, in any form, over the business of B Corp.12

Assuming for the moment that the acquisition will be accounted for as a "purchase," this means that the acquired assets will be entered on the acquirer's books at their current cost to it13 and liabilities will be credited at their current values; i.e., the total purchase price will be allocated among the individual assets and liabilities acquired to the extent of their fair market values. This is one of the two most important consequences of accounting for the combination as a purchase, for it means that, in the usual case, where current cost is higher than the seller's book carrying value, the buyer's future income statements will be charged with greater expenses than the seller's statements would have shown as these assets are depreciated or amortized. The result is that the increment in the buyer's income resulting from the acquisition usually will be less than the seller's income would have been without the combination.14

accepted accounting principles" in the independent auditor's report, 140 J. of Accountancy 80 (Sept. 1975).

The term "GAAP" is used in this article to emphasize its technicality.

11. APB Set. No. 4 ¶ 181 M-IA(2) (1970). To illustrate: If A buys three items, with fair values of $300, $400 and $900 respectively, for an aggregate price of $1200, the first asset will be entered on A's books at 300/1600 X $1200, or $225, the second at 400/1600 X $1200, or $300, and the third at 900/1600 X $1200, or $675. If the first item is nondepreciable land, it will not affect subsequent income. If the second item is a depreciable desk, its cost less salvage value will be "depreciated" periodically over the term of its useful life by expense charges in some systematic pattern. Intangibles such as a patent will be treated similarly, although the conventional terminology is that intangibles are "amortized." Otherwise, "depreciation" and "amortization" mean the same. See Figure 2, boxes 3 and 4, infra at text following n. 53 for a diagram of these results.

12. See A. Wyatt, A Critical Study of Accounting for Business Combinations (Accounting Research Study No. 5) 12 (1963) herein sometimes referred to as "ARS No. 5") defining a business combination as "any transaction whereby one economic unit obtains control over the assets and properties of another economic unit, regardless of the legal avenue by which such control is obtained and regardless of the resultant form of the economic unit emerging from the combination transaction."


14. The accounting effects of a "purchase" transaction are only part of those which must be considered. E.g., the tax consequences (including the effects on future cash flow of a currently taxable reorganization) and state law questions such as those concerning effects on the dividend
2. GOODWILL ARISING ON A PURCHASE

If the combination is to be accounted for as a purchase, there may be a second important impact on accounting income after the combination. When the purchase is of a going business enterprise rather than of merely isolated assets, the parties typically will have determined a total price not based on values of individual assets but on the going-concern value, which frequently will be in excess of the fair values attributable to the isolated assets net of liabilities. In these circumstances, instead of allocating the full purchase price among only the assets appearing on B's books, accountants recognize that intangible assets, usually called "goodwill," should appear on the books of A Corp.

Here again a problem arises concerning allocation of the lump sum purchase price among the acquired assets, including the goodwill, but it is resolved by a two-step process different from the one-step technique described for the basket purchase of isolated assets. First the purchase price is allocated among the tangible and identifiable intangible (e.g., patents) assets acquired according to their fair value; then any residue is debited to the new intangible asset account, goodwill.

A myriad of other questions arise in such acquisitions. A routine event in an acquisition is the contest between management, which would like certain results from the acquisition including auditor's judgment—calls its way, and the auditor, who is enjoined to exercise an "independent" judgment. Abuses have frequently occurred.

None of these matters will be dealt with in this paper since it is concerned with the fundamentals of the accounting for these equity investments.

It is unlikely that the individual assets would be worth more in the aggregate than the price for the going concern, since the business in that case presumably could be liquidated for this higher value instead of being sold for the lower price. For the proper accounting if the business nevertheless is valued and sold as a going concern at less than the net value of the individual assets, see n. 17 infra.

The parties often do not in their documentation allocate the purchase price among specific assets. Seller and buyer have competing interests; for example, sellers prefer larger allocations to goodwill so as to obtain capital gain treatment for taxes since goodwill is a capital asset under I.R.C. § 1221 (e.g., Ensley Bank & Trust Co. v. U.S., 61 F. Supp. 317 (D. Ala. 1945), aff'd, 154 F.2d 968 (5th Cir. 1946)) whereas buyers prefer smaller allocations because goodwill is not amortizable for tax purposes. Treas. Reg. § 1.167(a)-(3) (1960). To avoid an additional negotiating problem and because the parties may prefer to argue with the Internal Revenue Service without being tied to the figures determined in an arm's-length negotiation, they often will contract for a lump-sum price.

The accountant and the lawyer for the purchaser then will play a useful role in minimizing future taxes by maximizing allocations in the most favorable way. See the tip on this score in Heath, Property Valuation Problems and the Accountant, 117 J. Accountancy 54, 57-58 (Jan. 1964), substantially reprinted in T. Fiflis & H. Kripke, Accounting for Business Lawyers 210 (2d ed. 1977).

If aggregate fair values of identifiable tangible and intangible assets exceed the purchase price, the value of noncurrent assets (other than marketable securities) to be debited on A's books, is reduced pro rata as necessary. Only after the carrying values of those assets are reduced to zero will an excess of remaining fair value of current assets and marketable securities over the price
To illustrate, assume balance sheets in columnar form for corporations A and B prior to A's acquisition of B, as below:

<table>
<thead>
<tr>
<th></th>
<th>A Corp.</th>
<th>B Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$50,000</td>
<td>$0</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Plant</td>
<td>70,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
</tr>
<tr>
<td><strong>Liabilities and Equity:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$24,000</td>
<td>$15,000</td>
</tr>
<tr>
<td><strong>Equity:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td>$30,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>39,000</td>
<td>4,200</td>
</tr>
<tr>
<td>Earned surplus</td>
<td>47,000</td>
<td>4,800</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Further, assume that A Corp. buys the assets and assumes the liabilities of B for cash paid to B in the amount of $30,000,000 and that no new identifiable assets appear. The form of journal entry for A, omitting all but one of the figures, will be (000's omitted):

```
Inventory  a
Plant      b
Land       c
Goodwill   d
Accounts payable  c
Cash       $30,000
```

The values, a, b and c, to be attributed to the three identifiable assets will be determined as the fair market value of each. Then the accounts payable will be valued at $15,000,000 if there is no reason to decrease or increase them. Any excess of credits over debits will be balanced by a debit to goodwill. Thus, if the inventory has a fair market value of $12,000,000, plant, $18,000,000, and

paid be balanced by a credit, sometimes termed "negative goodwill." APB Op. No. 16 ¶—87, 91 (1970). This negative goodwill, like positive goodwill, will be amortized, but that will result in a credit to revenues, thereby enhancing future income (id. ¶ 91), in contrast to the debit against revenues by amortization expense, required for positive goodwill. Amortized negative goodwill probably is not taxable income but, by the same token, the asset values above their cost are not depreciable for tax purposes since their tax basis is cost. I.R.C. § 1012. See box in Figure 2 infra, in text following n. 53.

18. See APB Op. No. 16 ¶¶ 72, 89g, h & i (1970), describing when liabilities will be revalued.
19. See text at n. 17 supra.
land, $10,000,000, goodwill will be debited in the amount of $5,000,000, assuming accounts payable are valued at $15,000,000.20

On these assumptions the result of accounting for the combination as a "purchase" can be illustrated as follows:

**Balance Sheets (000's omitted)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$50,000</td>
<td>$0</td>
<td>$0</td>
<td>($30,000)</td>
<td>$20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>10,000</td>
<td>12,000</td>
<td>32,000</td>
<td></td>
</tr>
<tr>
<td>Plant</td>
<td>70,000</td>
<td>15,000</td>
<td>18,000</td>
<td>88,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
<td>10,000</td>
<td>5,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>5,000</td>
<td></td>
<td>5,000</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
<td></td>
<td>$155,000</td>
<td></td>
</tr>
</tbody>
</table>

**Liabilities and Equity:**

<table>
<thead>
<tr>
<th>Accounts</th>
<th>A Corp.</th>
<th>B Corp.</th>
<th>A Corp.</th>
<th>B Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable</td>
<td>$24,000</td>
<td>$15,000</td>
<td>$15,000</td>
<td>$39,000</td>
</tr>
<tr>
<td><strong>Equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock</td>
<td>30,000</td>
<td>6,000</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td>39,000</td>
<td>4,200</td>
<td>39,000</td>
<td></td>
</tr>
<tr>
<td>Earned</td>
<td>47,000</td>
<td>4,800</td>
<td>47,000</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
<td></td>
<td>$155,000</td>
</tr>
</tbody>
</table>

20. Valuations may be of extreme importance for income tax purposes. See n. 16, second paragraph.

Throughout this illustration and subsequent illustrations we shall assume no intercorporate dealings had occurred prior to the combination. If there had been intercorporate transactions, our explanation would include additional details. For example, if B previously had purchased goods from A on credit, B's liabilities would include an account payable to A and A's assets would include an account receivable from B. On the balance sheet, the receivable (asset) and liability (payable) would cancel each other and neither would be shown. Similarly if A's income statement for the year of the sale were to be consolidated with B's, the revenue to A and cost to B should be eliminated with the result that the consolidated income should be less than the sum of the separate incomes of A and B by the amount of the profit of the sale. These would present merely routine technical accounting problems to eliminate their effects, which we need not consider here. See any Intermediate or Advanced accounting text for the details.
Manifestly, future periods' income for A will then be chargeable for the aggregate cost of goods sold in the amount debited to inventory and for depreciation of the fair market value of the former B Corp. plant. An accounting rule also requires the amortization of the goodwill account over not more than forty years by periodic charges to expense. Notice that this amortized goodwill has a greater impact on reported net income than do most other expense charges; since amortization of goodwill is not tax deductible, there is no partially offsetting reduction in tax expense on the income statement.

21. This statement must be qualified when other than first in, first out (FIFO) accounting for inventories is used. See T. Fiflis & H. Kripke, Accounting for Business Lawyers ch. VI (2d ed. 1977) for an explanation of the flow of cost factors in inventory accounting.

When FIFO or LIFO (last in, first out) accounting is used for A's inventory reporting, questions are raised by Mr. Hackney, in a letter to the author, as to whether the acquired B inventory will be considered like a current purchase by A Corp. Thus, for example, if treated like a current purchase of goods by A Corp., and where A Corp. accounts for the business combination as a "purchase," the write-up on acquisition of B's inventory may not be charged against income until A's pre-existing inventory is exhausted. Several additional questions may be detailed under either FIFO or LIFO whether accounting is on a purchase or a pooling basis.

I am not aware of GAAP on these questions and presume that practice varies. If so, opportunities for post-combination income manipulation exist for the combined entity.

For purposes of this paper, we will assume that the FIFO method is used, and, further, that the acquired inventory at the acquisition value is charged as expense in the first year after the acquisition, thus avoiding the above problems.

22. APB Op. No. 17 ¶¶ 9, 28-29 (1970). See Figure 2 box 7, infra.

23. Treas. Reg. § 1.167(a)(3)(1960) states that Goodwill is not "depreciable" (sic) for federal income tax purposes.

One must further note, however, that if the corporate combination, although accounted for as a purchase, is a tax-free reorganization, the enhanced depreciation and cost of goods sold expense on the financial statements also will not be partially offset by any income tax saving since there is no related tax deduction for these enhanced values.

Although a taxable reorganization will usually be accounted for as a purchase on the financial statements, the criteria for imposing the tax and for purchase accounting are not identical. Hence, a transaction might be tax-free, yet accounted for as a purchase, or taxable, yet accounted for as a pooling of interests. For example, acquisition of another company's subsidiary solely for voting stock is ineligible for pooling (APB Op. No. 16 ¶ 46a (1970)) but would be tax-free under I.R.C. § 368(a)(1)(B); Treas. Reg. § 1.368-2(c) (1976). On the other hand, acquisition for voting stock of ninety percent or more of the voting stock of another corporation plus "boot" for dissenters could be a pooling (See APB Op. No. 16 ¶ 47(b) (1970) but would not be tax-free under I.R.C. § 368(a)(1)(B), although some dissent from this view of the availability of the (B) reorganization when boot is involved has been expressed and some qualifications to the bald proposition may be required. For the refinements, see Note, The "Soley for Voting Stock" Requirement in a (B) Reorganization After Reeves v. Commissioner and Pierson v. United States, 66 Va. L. Rev. 133 (1980). B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.13 n. 73 (4th ed. 1979) & 1980 Cum. Supp. N. 3).

3. THE CONCEPT OF GOODWILL

Although these mechanics for treating the purchase of a going concern are settled, at least for the time being, the conceptualization of goodwill is by no means the subject of a consensus. Goodwill means different things to different people. Although this primer is not the place to pursue the intricacies of goodwill, it is necessary for attorneys to be conscious of the predominant aspects of its ambiguous nature.

Some view goodwill as a residue of the valuation process—the price paid by A Corp. over the sum of the values assigned to other assets (tangibles and specifically identifiable intangibles such as patents) received from B Corp., net of liabilities assumed. This concept perhaps is no more than a description of the accounting process just described. In this sense, it is more a nonconcept—one that is purposely left undefined.

Others conceptualize goodwill as the value of "superior earning power." Champions of this view, however, are not in agreement on the answer to the question, "Superior to what"—similar businesses, investment of the same amount in risk-free assets, the next best alternative investment, or what have you?

Another view is that goodwill is the value of what it would cost to start up a new business and bring it to the same level as the acquired business, less the fair value of recorded net assets.

Other concepts are also held and all of them may be related or differentiated by anyone who chooses to flesh out the details of each concept as his

24. The compromises worked out in APB Op. No. 16 (1970) and No. 17 (1970) have been the subject of continuing debate, resulting in extensive refinement of APB Op. No. 16 (1970). In addition to 39 formal interpretive statements on Op. No. 16 (1970) by the AICPA and two more by the FASB [all 41 of which are reproduced in CCH, Financial Accounting Standards, Original Pronouncements (1980)], the SEC has issued four Accounting Series Releases [Nos. 130 (1972) and 135 (1973) (concerning retention of shares until publication of financial statements covering a certain post-acquisition period) and Nos. 146 (1973) and 146A (1974) (concerning use of treasury stock in the acquisition)]. And see FASB, Discussion Memorandum, An Analysis of Issues Related to Accounting for Business Combinations and Purchased Intangibles (Aug. 19, 1976).

The FASB has made it clear that it must reconsider purchase or pooling but will do so only after further progress on its project to develop a "conceptual framework" for accounting. FASB, "Status of Technical Projects on the FASB Agenda as of December 31, 1976," Status Report No. 44 at 2 (Jan. 10, 1977).

Those who fear the learning of this article soon may be superseded need not be concerned; the Board in June, 1981, decided to shelve the project for the time being. J. Accountancy 8 (June, 1981).


25. E.g., see Baillie, Goodwill ... a Sacred Cow? 80 Accountant's Mag. 90-92 (Scotland, Mar. 1976).
imagination permits. Suffice it to repeat here that there is no consensus on a single concept of goodwill.  

4. FORM OF PURCHASE

Returning to our illustration, and still assuming purchase accounting, even if the consideration given by A Corp. is other than cash, the acquired assets and liabilities will be entered on A's books at their cost to A, although the consideration paid will be credited to some account other than the cash account. For example, if $10,000,000 par value of A's preferred stock having a current value of $30,000,000, were the consideration in the above illustration, the credit, instead of being to cash account, would be to a capital stock account in the amount of $10,000,000, plus some capital surplus account for $20,000,000, aggregating the net cost of the acquisition. (Of course, the assumption of the $15,000,000 liability is also part of the price paid and will be credited, as well.) The journal entry would be (000's omitted):

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$12,000</td>
</tr>
<tr>
<td>Plant</td>
<td>18,000</td>
</tr>
<tr>
<td>Land</td>
<td>10,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>5,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>15,000</td>
</tr>
<tr>
<td>Capital stock—$10 par preferred stock</td>
<td>10,000</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>20,000</td>
</tr>
</tbody>
</table>

This treatment applies to any acquisition by A Corp. if it is to be accounted for as a purchase, whether the transaction is a merger, consolidation, or purchase of assets and an assumption of liabilities on the one hand, or, on the other hand, is an acquisition of B Corp.'s shares followed by: a statutory merger of A and B; a liquidating dividend by B; or any other set of transactions which would result in A holding the assets and liabilities of B and B disappearing as a separate entity.


Moreover, as we shall see, (text, infra, following n. 55) even if B Corp. remains a separate legal entity, if its financial statements are consolidated with those of A Corp., the consolidated financial statements will be identical with those just described.

As will be seen, the accounting entries may be affected by statutory requirements of the governing corporation code. The entries here set forth assume that there are either no such legal provisions, or that if there are, the attorney addressing a particular problem will be able to consider them with the text descriptions as a starting point.

See text at n.46 et seq. infra.
C. "Pooling of Interests" for an Assets Acquisition of a Going Concern

1. POOLING ACCOUNTING

Accountants purport to find a fundamental difference between a "purchase" of a business by another entity and a combination whereby the shareholders of the acquired business continue in interest by receiving voting common stock in the surviving entity—a "pooling of interests."29 "In accounting theory, a 'pooling' is conceptualized as a flowing together of two continuing separate entities, with a substantial continuity of ownership, properties and management, whereas a 'purchase' of one by the other is thought of as more closely akin to a termination of one enterprise and the acquisition of its component parts by another."30 A classic case for "pooling" would be the statutory merger of two corporations of similar size with the common shareholders of each holding common stock in similar amounts in the surviving entity.

The accounting for such a pooling of interests is radically different from purchase accounting and rests on the notion that when two entities come together, with the interests in rights and rewards of the owners of each continuing, the old basis of accounting for each should continue.31 This means that the book carrying values of the assets and liabilities of each entity are continued on the books of the new or surviving entity and the earned surpluses of the two are combined.32 Subsequent income statements, of course, are

CCH, Financial Accounting Standards Board, Accounting Principles Board and Committee on Accounting Procedure Financial Accounting Standards 245 (1977), describes poolings and purchases as follows:

Pooling of Interests Method

The pooling of interests method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the combined corporation at their recorded amounts. Income of the combined corporation includes income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods is combined and restated as income of the combined corporation.

Purchase Method

The purchase method accounts for a business combination as the acquisition of one company by another. The acquiring corporation records at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill. The reported income of an acquiring corporation includes the operation of the acquired company after acquisition, based on the cost to the acquiring corporation.

31. For a challenge to the view that pooling has a basis in principle, see A. Wyatt, A Critical Study of Accounting for Business Combinations (Accounting Research Study No. 5) (1963).
For limitations on the carryforward of B's Earned Surplus, see n. 37, infra.
charged with depreciation and amortization expenses based on the old recorded amounts. Further, accounting for income under pooling is different from purchase accounting in that, irrespective of when the combination occurs during the year, the income of the two entities for the year of the combination is combined on the income statement of the new or surviving entity. Finally, if any prior years' income statements of A are restated, the incomes of A and B will be combined retroactively on those restated income statements although the two entities were independent at that time.

To illustrate, assume the same data for A and B as before, but that this time, instead of A purchasing B's assets for cash and assumption of the liability, it acquires them for 1,000,000 shares of $10 par value common stock, valued at $30,000,000, plus assumption of the liability. The journal entry, on a pooling basis, on A's books at the time of the acquisition of B's net assets will be (000's omitted):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$10,000</td>
</tr>
<tr>
<td>Plant</td>
<td>15,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$15,000</td>
</tr>
<tr>
<td>Capital stock</td>
<td>10,000</td>
</tr>
<tr>
<td>Earned surplus</td>
<td>4,800</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>200</td>
</tr>
</tbody>
</table>

Note that B's assets, liabilities and earned surplus are simply transferred at the same carrying value as on B's books—as called for by the pooling concept that this is a marriage of two entities with neither one acquiring the other; just as A's old carrying values and earned surplus continue, so do B's. The credit to capital stock is to evidence the issuance of the A shares and is in the amount of the aggregate par (or stated) value of the shares issued. The capital surplus credit is in the amount necessary to balance the other credits with the debits. Also note that if the net assets acquired in excess of capital stock issued were less than B's earned surplus, only an amount of earned surplus equal to that excess would have been credited on A's books.

33. "However, the separate companies may have recorded assets and liabilities under differing methods of accounting and the amounts may be adjusted to the same basis of accounting if the change would otherwise have been appropriate for the separate company." APB Op. No. 16 ¶ 52 (1970).
35. Id. ¶ 57. See Figure 2, boxes 8, 9, infra.
36. See text following n.17, supra, for the data.
37. This could be viewed as the result of the mechanics of double-entry bookkeeping. Many would quarrel, however, with the assertion that these results are mechanically dictated by double-entry bookkeeping requirements. See APB Op. No. 16 ¶ 53 (1970) which describes a principled basis for the bookkeeping. It states that the capital (i.e., stated value or par value plus capital surplus) of A and B are added together as are the earned surplus amounts on the combined corporations' balance sheet; if the new combined capital stock exceeds that of A and B together, the excess first reduces combined capital surplus and then reduces combined earned surplus.
Looking at the separate balance sheets of A and B, infra, pooling calls for combining them as noted without regard to A's current cost of $45,000,000 for the assets of B. Contrast this with our prior accounting (as shown in the last column infra) when stock was issued but the accounting was on a purchase basis.\textsuperscript{38}

**Balance Sheets (000's omitted)**

<table>
<thead>
<tr>
<th></th>
<th>A Corp.</th>
<th>B Corp.</th>
<th>Combined in pooling</th>
<th>Fair market values of B's assets and liabilities and balancing debit to goodwill</th>
<th>Combined in purchase (for preferred stock)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 50,000</td>
<td>$ 0</td>
<td>$ 50,000</td>
<td>$ 0</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>10,000</td>
<td>30,000</td>
<td>12,000</td>
<td>32,000</td>
</tr>
<tr>
<td>Plant</td>
<td>70,000</td>
<td>15,000</td>
<td>85,000</td>
<td>18,000</td>
<td>88,000</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td></td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
<td>$170,000</td>
<td></td>
<td>$185,000</td>
</tr>
<tr>
<td><strong>Liabilities and Equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$ 24,000</td>
<td>$15,000</td>
<td>$ 39,000</td>
<td>$15,000</td>
<td>$39,000</td>
</tr>
<tr>
<td><strong>Equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock (common and preferred)</td>
<td>30,000</td>
<td>6,000</td>
<td>40,000</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>39,000</td>
<td>4,200</td>
<td>39,200</td>
<td></td>
<td>59,000</td>
</tr>
<tr>
<td>Earned surplus</td>
<td>47,000</td>
<td>4,800</td>
<td>51,800</td>
<td></td>
<td>47,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
<td>$170,000</td>
<td></td>
<td>$185,000</td>
</tr>
</tbody>
</table>

As already noted, under pooling a unique accounting for income also appears: for the period in which the combination occurs, the income of B is added to the surviving corporation's income statement and on restatement of any prior period's income, the combined income of both corporations must be set forth. Finally, of course, as a consequence of B's assets being carried at the old book carrying value of B, which is typically lower than the value paid by A, A's future income statements typically will show lesser amounts for costs of goods sold, depreciation, and other deferred costs than they would under

\textsuperscript{38} See text following n. 27 supra.
purchase accounting—and no expense whatsoever for amortization of goodwill, since none arises. Put another way, the increment to A's income on a pooling tends toward being equal to what B's individual income is or would have been for that same period.

2. REASONS FOR POOLING

These accounting results are believed by many to be the major motivation for the invention of pooling and the reason for its continued existence. Thus, many corporate acquirers desire, and perhaps could not succeed without, accounting for acquisitions which result in (a) lower reported depreciation and amortization expenses than would be shown under purchase accounting with the consequential higher income and rate of return, (b) carryover of the acquired firm's earned surplus, and (c) combination of earnings in the income statements for the year of acquisition and for restatements of prior years' earnings.

It should be noted that if pooling were not an available accounting choice, acquirers would make decisions about acquisitions independently of the choice of accounting treatment, and presumably would structure some acquisitions to minimize the actual costs—something which is not always done now because of the corrupting influence of pooling accounting. Perhaps for that reason, resources are being inefficiently allocated today.

One asserted ground for legitimization of pooling treatment has been the tax-free reorganization rules under the Internal Revenue Code. Under the code, many statutory mergers and consolidations, exchanges of shares and sales of assets for shares have been defined as reorganizations which are "tax-free" to investors and the corporations involved. Consistent with the tax-free treatment for the corporate constituents, however, the corporations' tax bases for assets remain and are carried over to the reorganized company, as is the tax area's near-kin to earned surplus, "earnings and profits." Proponents of

39. E.g., see A. Wyatt, A Critical Study of Accounting for Business Combinations (Accounting Research Study No. 5) ch. 6 (1963).

However, there is some empirical support for the view that investors are not affected by the choice of accounting alternatives. E.g., Hong, Kaplan & Mandelker, Pooling vs. Purchase: The Effects of Accounting for Mergers on Stock Prices, 53 Acctg. Rev. 31-47 (1978).
41. It has frequently been pointed out that some corporate managers have sought to maximize reported earnings rather than to maximize true economic gain. E.g., see Staff Report of the SEC to the Special Subcomm. on Investigations, Comm. on Interstate and Foreign Commerce, The Financial Collapse of the Penn Central Company, H.R. 33-83, 92d Cong 1st Sess. (1972). The most dramatic illustration of this might be the acquisition of B Corp. by A Corp. near the end of a poor year for A in order to combine B's reported earnings with A's. This could be done by issuance of A shares for a value less than what the A shares could fetch in cash.
42. IRC §§ 354, 361, 368(a)(1), most importantly.
pooling have urged that this is similar to pooling's treatment of the assets and surplus of both constituents—which retain their old book carrying values. They urge in effect that what is good for Uncle Sam is good for corporate accounting, but the logic of this assertion is not apparent—especially since pooling accounting is not limited to tax-free reorganizations and purchase accounting is not limited to taxable ones.\

Other theoretical underpinnings may exist for pooling accounting, especially when in fact A and B are equally matched; in this situation, it would require some deviation from the historical cost convention to require either or both A and B to reflect new values in their accounts. The battle over pooling rages unabated in the literature.\

3. CRITERIA FOR POOLING

The questionable legitimacy of pooling, based as it is, largely in the attractiveness to managers of its financial statement results and the illogical implication that imperfect parallelism with the Internal Revenue Code is desirable, indicates a weak-principled basis for distinguishing situations where either pooling or purchase accounting should be prescribed. APB Op. No. 16 nevertheless purports to find twelve criteria for a pooling. Figure 1 is a decision chart which provides a guide for determining whether to account for a transaction as a purchase or a pooling by reference to the twelve requirements, each of which must be met for pooling treatment.

---

43. See n.23, supra.
44. For a comprehensive, although ponderous, statement of the considerations, see FASB, Discussion Memorandum, An Analysis of Issues Related to Accounting for Business Combinations and Purchased Intangibles (Aug. 19, 1976), a 178 page treatment with an additional 154 pages of appendices.
Figure 1. Accounting for Business Combinations
A Decision Chart (References are to paragraph numbers of APB Op. No. 16)

Adapted from: Robert E. Hamilton and James W. Pratt, Accounting (Planning) for Business Combinations, J. of Accounting 83 (Jan. 1972).
D. A Note on Accounting Fixed by Law

Without attempting a full-scale analysis of the relationship of law to accounting, it should be noted at this point that corporation code provisions regulating dividends (including the effect of corporate combinations on capital and surplus) may alter, in the view of a small minority of accountants, the above-described presentation of accounting data on financial statements. For example, the governing corporation statute may prescribe that on a merger, the earned surplus of the merging corporation shall be available to the survivor for dividend purposes. Some accountants may believe that under such a statute, even if the merger would not be considered a pooling for any reason, the earned surplus required to be available for dividends should be presented on the audited balance sheet as part of the survivor’s earned surplus. Other accountants disagree.

Notwithstanding, it would seem that dividend law, once a more powerful influence on accounting presentation, now has merely a vestigial effect. At

46. E.g., see Hackney, Accounting Principles in Corporation Law, 30 Law and Contemp. Prob. 791 (1965) for a fine analysis from the law point of view.
47. E.g., see id. at 800. Wyatt, n.12, supra, states at 66:

Some accountants contend that while the pooling of interests is an accounting concept rather than a legal concept, it should not violate the applicable state laws. Others contend that the earned surpluses may be combined even if the state law does not permit this, with the surplus available for dividends being shown parenthetically or disclosed in some other manner in the financial statements.

And see Melcher, Stockholders’ Equity (ARS No. 15) (1973), at 17 (“... corporate statutes often influence the accounting for the issuance of stock”); at 21-22 (“... statutory definitions and designations of components of equity continue to influence, if not control, the accounting for shares of stock ...”). See also, N. Bedford, K. Perry, & A. Wyatt, Advanced Accounting 647 (3d ed. 1973) and G. Catlett & N. Olson, Accounting for Goodwill (ARS No. 10) 65-66 (1968).


49. E.g., if twenty-five percent of the merged corporation’s shareholders were “cashed out,” pooling would not be permitted under APB Op. No. 16 ¶ 47b (1970).

50. See n.47 supra. In actuality, the audited balance sheet would use the caption “retained earnings” or the like, not “earned surplus.” For a case upholding a shareholder’s right to demand and receive financial statements comporting with the governing dividend statute, see Burguieres v. J.M. Burguieres Co., Ltd., 312 So. 2d 179 (La. Ct. App. 1975), for which I am indebted to D. Herwitz, Accounting for Lawyers 170 (1980).

51. See, e.g., n.47 supra.

52. Hackney, Accounting Principles in Corporation Law, 30 Law and Contemp. Prob. 795 n.13 (1965) stated as early as 1965:

In prior years, the law was considered one of the essential sources dictating in part the development of good accounting practice. Dicksee’s pioneering work entitled Goodwill (1900) commenced with an introductory chapter consisting of an “outline of the law relating to good will.” Hatfield’s and May’s writings are sprinkled with case citations and quotations from opinions. Dean spoke in 1949 of the circuitry of reference when a lawyer, “asked to pass upon a legal concept deriving its meaning, in whole or part, from accounting concepts, in the absence of statutory authority or case law, turns to the accountant for help in determining [‘g.a.a.p.’],” while he in turn is met with a request from the accountant for advice as to “the
the present time lawyers must follow accounting for the most part in ascertaining dividend limitations.53

Indeed, the movement in corporation law is away from tying law to GAAP. If the latest revisions of the MBCA's financial provisions become widely adopted, both accounting and dividend law will be divorced and thereby be vastly improved.54

That being so, this paper informs lawyers of accounting practices rather than informing accountants as to dividend law. In any event, to the extent that dividend law may continue to affect balance sheet presentations of corporate equity, lawyers are equipped to explain that law to accountants and need no further aid here.

E. Summary

The skeletal outline, described in Part I, of the accounting for the case of a single survivor after an acquisition, may be simply diagramed as in Figure 2.

---


Figure 2

(1a) **Transaction:** A Corp. either acquires net assets of B Corp. or receives stock and B Corp. is liquidated into A Corp.

(2) **Issue:** Is this a "business combination" under APB Op. No. 16? Apply criteria of whether control over assets has been obtained. Wyatt, ARS No. 5, p. 12.

(3) Carry B's assets on A's books at cost to A, allocated proportionately to their fair market value. (APB Sl. No. 4, ¶ 181 M-1A(2))

(4) Amortize A's cost of the acquired assets over their useful lives.

(5) **Issue:** Is the combination to be accounted for as a "pooling of interests"? (Apply 12 criteria of APB Op. No. 16 ¶ ¶ 46-48.)

If no,

(6) **Purchase accounting:** Carry B's assets at A's cost, allocated proportionately to their fair market value, with excess debited to goodwill. APB Op. No. 16, ¶ ¶ 67-68.

(7) Amortize the cost of the acquired assets at A's cost. Goodwill amortized over not more than 40 years. APB Op. No. 17, ¶ ¶ 9, 28-29.

If yes,

(8) **Pooling accounting:** Carry B's assets at B's book carrying amount. Carry over B's earned surplus to balance sheet. APB Op. No. 16, ¶ ¶ 51,53.)

(9) Income of A and B combined for year of acquisition and on restated income statements. (APB Op. No. 16, ¶ 56.) Amortize the acquired assets at B's carrying value.
II. SHARE ACQUISITIONS; I.E., ACQUISITIONS OF THE SHARES OF COMPANIES WHICH ARE THEREAFTER CONTINUED AS SEPARATE ENTITIES

When, instead of B Corp.'s assets being absorbed by A, A and B remain separate legal entities and B's shares are held by A, a host of additional accounting issues arise. To help isolate the questions to be discussed here, a diagram (Figure 3) correlating the transactions, accounting issues posed, and accounting treatments prescribed by GAAP may be a helpful analytic and mnemonic device if set forth in advance of the explanation instead of at the end as we did in Part I. Experts may find Figure 3 to be a useful summary of GAAP in this area. The explanation follows in the remainder of Part II.
This diagram does not depict accounting for the subsidiary corporation as an entity. It does include parent-company-only statements, but exclusively those which are prepared "for publication to shareholders as the financial statements of the primary reporting entity." (Other parent-company-only statements are considered in Part III.) Also included are consolidated financial statements after a business combination.

Inspection will reveal that the diagram has three main divisions. These result from, first, dividing those acquisitions by A of B Corp. which are required to be accounted for on consolidated statements from those which must be accounted for by parent-company-only statements and, then, further subdividing the parent-company-only category into "business combinations" and other acquisitions.

To begin, consistent with our scheme of treating simpler matters first, we shall consider cases in which consolidated statements are required.

A. Accounting for a Business Combination in Consolidated Statements

Consolidated statements ordinarily are called for by GAAP (although perhaps not required in theory) when two or more separate legal entities constitute a single economic enterprise—i.e., when one of the companies has a "controlling financial interest" in the other or others. As a rule of thumb, accountants consider ownership of a majority voting interest to be a basis for consolidation, but even with such majority interest, consolidation will not be proper in two categories of situations: (a) when there is no real control in A, as

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55. Accounting for the subsidiary company statements presents a fascinating question of whether a new basis of accountability arises when the subsidiary's shares are acquired by A. The FASB has this question under consideration. FASB, Status Report No. 99, at 6 (Feb. 11, 1980). And see letter of John Burton, then Chief Accountant of the SEC [in 1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,093.

56. See text at n. 129 et seq., infra. "Parent-company-only" refers to the financial statements of the parent, A Corp., which will show the investment in the subsidiary, B Corp., as a single asset account. See, Figure 3, boxes 11-22, supra.

57. Id. boxes 23-27.
58. Id. boxes 23-27.
59. Id. boxes 11-22.
60. Id. boxes 18-22.
61. Id. boxes 12-17.
62. Id. boxes 10, 23-27.
63. ARB No. 51 ¶ 1 (1959) speaks of the "presumption that consolidated statements are more meaningful" and "usually necessary for a fair presentation" when there is a "controlling financial interest." Convention calls for consolidation in these circumstances.

64. APB Op. No. 18 ¶ 3c (1970) states: "The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders or by court decree." And see N. Bedford, K. Perry & A. Wyatt, Advanced Accounting 295-96, 587-88 (1973) for further discussion of the accountants' concept of control.

In sum, the accountants' concept of control, like that of the securities law, is basically one of fact, although in practice, accountants feel that majority voting ownership is an overwhelming consideration.

65. ARB No. 51, ¶ 2.
when that control is temporary, does not rest with the majority vote (as when a receivership exists), or when the owner's control over a foreign subsidiary is limited by a foreign government's restrictions; or (b) when the subsidiary's business is so different from the parent's as would make consolidated statements misleading (e.g., the parent is a manufacturer and the subsidiary is an insurance company). Thus, a controlling financial interest is a necessary but not a sufficient condition to consolidation.

When consolidated statements are called for, the books of account of the separate legal entities are not affected merely by virtue of the consolidation, but consolidated statements, including income statements, balance sheets, and statements of changes in financial position are prepared for the entire economic enterprise. In the process, intercompany transactions and intercompany claims are eliminated from the consolidated statements, as is that peculiar intercompany claim, the parent's investment in the subsidiary.

Because of this, the consolidated statements of A and B after a business combination (still assuming no minority shareholders' interest) will appear identical to those of A Corp. when A Corp. acquired the net assets of B, as described, supra, Part I, subparts B and C. That is to say, the acquisition of B Corp. will be treated as a "business combination" to be accounted for on either a "purchase" or a "pooling" basis depending on whether the twelve criteria of APB Op. No. 16, set forth in Figure 1, are met. It is a business combination because, by our hypothesis, A Corp. has control of B Corp. (otherwise their statements would not be consolidated), and this, we have seen, is virtually the criterion for treating an acquisition as a business combination.

66. Id. ¶ 3; ARB 43 ch. 12 ¶¶ 8-9 (1968). Even in this case, some accountants would approve consolidation. It is a "matter of judgment."

67. There are two discrete underlying theories of consolidated statements, based on two different perspectives:

(a) that of the stockholders of the parent company (known as the "proprietary theory"); and

(b) that of the management of the parent company (known as the "entity theory").

Different formats of financial statements will result, depending on which theory is followed, when there is a minority shareholder interest in the consolidated subsidiary.

Under the proprietary theory, those minority shareholders of the consolidated subsidiary are treated as outsiders, like creditors, whereas under the entity theory, they are treated as co-owners. The former, proprietary theory, is predominant in practice. For a description see, n.77, infra. And see e.g., N. Bedford, K. Perry & A. Wyatt, Advanced Accounting 301-03 (3d ed. 1973).

68. See text at n. 20, and n. 38, et seq. supra. Compare Figure 3, boxes 23-27 and Figure 2, boxes 5-9, supra.

69. See text n. 12, supra.

Some may quarrel with this assertion, pointing out the "controlling financial interest" condition for consolidated statements is contained in formal GAAP (ARB No. 51 ¶ 1) whereas the "control over assets" test of ARS 5 for determining whether a business combination exists is not only literally different, but also is not contained in formal GAAP; APB Op. No. 16 ¶ 1 (1970), dealing with business combinations, refers only to "one accounting entity" being formed.
On the other hand, not every business combination will result in consolidated statements because of the exception from the consolidation requirement for incompatibility noted above. We will consider these cases shortly. 70

Parent-company-only statements will generally be considered inappropriate for publication when consolidated statements are required. 71 Hence, only the consolidated statements will be published in either the purchase or pooling mode previously described. 72

To illustrate the consolidation process, let us use the same data as in our prior illustration of purchase and pooling when the net assets of B were acquired. Assume A Corp. buys all of B's outstanding shares for $30,000,000 value in stock plus assumption of the $15,000,000 liability, and the fair market values of B's assets and liabilities and the balance sheet carrying values of A and B appear as follows:

**Balance Sheets (000's omitted)**

<table>
<thead>
<tr>
<th></th>
<th>A Corp.</th>
<th>B Corp.</th>
<th>Fair market values of B's assets and liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 50,000</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>10,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Plant</td>
<td>70,000</td>
<td>15,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
<td></td>
</tr>
<tr>
<td><strong>Liabilities and Equity:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$ 24,000</td>
<td>$ 15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td><strong>Equity:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock (common and preferred)</td>
<td>$ 30,000</td>
<td>$ 6,000</td>
<td></td>
</tr>
<tr>
<td>Capital surplus</td>
<td>39,000</td>
<td>4,200</td>
<td></td>
</tr>
<tr>
<td>Earned surplus</td>
<td>47,000</td>
<td>4,800</td>
<td></td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
<td></td>
</tr>
</tbody>
</table>

70. See part II, subpart B1, infra. There is another case which may be a business combination where consolidated statements are not appropriate. If corporations A and C form a 50/50 joint venture which they operate through B Corp. and they have no other activities, the three are "one economic entity" so as to require treatment as a business combination but consolidated statements would be inappropriate. The "equity method" of accounting would be required for each of A and C. See text at n. 100, infra.

71. See In the Matter of Atlantic Research Corporation, 41 SEC 733 (1963), and APB St. No. 4 ¶ 195, R-5 (1970). See Part III, infra, for the presentation of parent-company-only statements when consolidated statements are published.

72. Note that if another entity, C Corp., is also controlled by A Corp., but C is not consolidated for some reason despite A's control, C Corp., will be accounted for on the consolidated statements by the "equity method," described at text following n. 114, et seq. infra.
1. CONSOLIDATION ON A PURCHASE ACCOUNTING BASIS

If the A stock used in the combination is preferred stock, the accounting must be on the "purchase" basis, recognizing the fair market value of B's assets as well as goodwill on the consolidated balance sheet at the time of acquisition. Even on A's unconsolidated balance sheet, A's investment in B of $10,000,000 par value preferred having a value of $30,000,000, will be carried at A's cost, $30,000,000. The journal entries on A's books will be (000's omitted):

<table>
<thead>
<tr>
<th>Investments</th>
<th>$30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock-preferred</td>
<td>$10,000</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>20,000</td>
</tr>
</tbody>
</table>

A Corp.'s unconsolidated balance sheet will then appear (000's omitted):

<table>
<thead>
<tr>
<th>A Corp.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
<tr>
<td>Investments</td>
</tr>
<tr>
<td>Plant</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock (preferred and common)</td>
</tr>
<tr>
<td>Capital surplus</td>
</tr>
<tr>
<td>Earned surplus</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

Now the problem is, how will A's and B's balance sheets at the date of acquisition be consolidated?

In consolidation, since we have assumed there is no minority shareholder interest in B Corp. and there are no intercompany transactions or accounts between A and B, the only necessary step is to substitute B's assets and liabilities for the "investments" account on A's individual balance sheet. Since the combination with B is to be accounted for as a "purchase," this entails bringing the assets into the consolidated balance sheet at fair market values with any excess carried as goodwill. The result will be just as if A Corp. had

---

73. See Figure 1, box 3.
purchased the net assets of B instead of B's shares of stock. On a worksheet this reallocation process may be set forth as follows:

**Balance Sheets (000's omitted)**

<table>
<thead>
<tr>
<th>Eliminations and adjustments:</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheets</strong></td>
<td><strong>A Corp.</strong></td>
<td><strong>B Corp.</strong></td>
</tr>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$50,000</td>
<td>$0</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Plant</td>
<td>70,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Investments</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$170,000</strong></td>
<td><strong>$30,000</strong></td>
</tr>
</tbody>
</table>

**Liabilities and Equity:**

| Accounts payable | **$24,000** | **$15,000** | **$39,000** |

**Equity:**

| Capital stock (preferred and common) | 40,000 | 6,000 | 46,000 |
| Capital surplus | 59,000 | 4,200 | 63,200 |
| Earned surplus | 47,000 | 4,800 | 51,800 |
| **Total** | **$170,000** | **$30,000** | **$185,000** |

*To allocate the excess of fair market value of identifiable tangible and intangible assets.  
**To enter goodwill.  
***To eliminate the investments account.  
****To eliminate B's equity accounts.

74. If A had purchased B's net assets, as we have seen, the journal entry would have been (000's omitted):

- **Inventory** $12,000
- **Plant** $18,000
- **Land** $10,000
- **Goodwill** $5,000
- **Accounts payable** $15,000
- **Capital stock** $10,000
- **Capital surplus** $20,000

See text at n. 27 supra.
It will be observed that the consolidated balance sheet is identical with the balance sheet resulting after the purchase of net assets, previously set forth in the text following note 38.75

In periods after the purchase, consolidated statements of income will, of course, include charges against income for cost of goods sold, depreciation, and amortization of goodwill and these charges will be greater than the charges on B Corp.'s income statements because the related asset accounts on the consolidated balance sheet are greater (since equal to the higher fair market value paid by A) than they are on B's balance sheet. Therefore, the consolidated income on the purchase basis will be diminished to this extent from the aggregate of the separate incomes of A and B.

To illustrate, assume B's income statement for the first year of operations after the purchase showed $4,000,000 of net income, B paid a $1,000,000 dividend to A, B's plant is being depreciated at a 10 percent rate, goodwill is amortized at the minimum 2.5 percent rate (over forty years) allowed by APB Op. No. 17; and the B inventory is carried on the first-in, first-out basis and has been turned over at least once during the year.

On these assumptions, B's contribution to the consolidated earning statement would not be $4,000,000, but would be diminished by:

(a) $2,000,000 additional expense because of the additional inventory amount which will be charged to cost of goods sold as that inventory is sold off;
(b) Additional plant depreciation expense in the amount of 10 percent of the $3,000,000 write-up in plant on the consolidated balance sheet (or $300,000); and
(c) An amortization charge for the $5,000,000 of goodwill, in the annual amount of $125,000.

The $1,000,000 dividend would be an intercorporate transfer affecting nothing in the consolidated statements, just as if the cash had been transferred from one corporate bank account to another. Hence, the net contribution by B Corp. to consolidated income will be:

\[
\begin{align*}
B \text{ Corp.'s earnings} & \quad $4,000,000 \\
\text{Less adjustments on consolidation:} & \\
\text{Extra cost of goods sold} & \quad (2,000,000) \\
\text{Extra depreciation} & \quad (300,000) \\
\text{Amortization of goodwill} & \quad (125,000) \\
\text{Net contribution to consolidated income} & \quad $1,575,000\footnote{76}
\end{align*}
\]

\footnote{75. This result would be altered had A purchased less than 100\% of B Corp.'s shares. In that event, the B Corp. minority shareholders' interest would appear on the consolidated balance sheet. See n. 77, infra. See Figure 3, box 24, 25, supra.}

\footnote{76. We have ignored accounting for income tax expense or benefits which could entail additional complexity beyond the purposes of this paper.}
2. CONSOLIDATION ON A POOLING OF INTERESTS BASIS

The distinctive features of a pooling of interests, we have seen, are:

(a) No new valuations are accorded the assets and liabilities of B Corp. after the pooling of interests.
(b) No goodwill arises;
(c) The earned surplus of B Corp. usually is carried over to the financial statements of the combined entities;
(d) Income of the two entities for the year of the combination is aggregated; and
(e) If prior years’ income statements are restated, the incomes of A and B will be combined although the two entities were separate at that time.

These attributes apply whether B Corp.’s net assets are acquired by A, as in our Part I, subpart C, or B Corp.’s shares are acquired and B’s statements are consolidated with A’s. If A’s and B’s balance sheets are consolidated at the time of acquisition, they will appear as illustrated in the “combined in pooling” column, at text following note 38, supra. Thereafter, unlike the case of a purchase, the sums of the consolidated entities’ separate charges for depreciation, etc., will be charged on the consolidated income statements.77

77. See Figure 3 box 26, 27, supra. If, contrary to our assumptions, A owns less than 100 percent of B Corp., the consolidated balance sheet will portray the minority interest in the subsidiary as a liability just before net worth in the same amounts whether A’s acquisition is accounted for as a purchase or a pooling. If the minority holds a 10 percent interest, and it is common stock, it would be carried at 10 percent of B’s net worth (capital stock plus all surpluses). If preferred stock of B instead is held by the minority, the amount will be the par value of the preferred held by them, or, the liquidation preference of that holding, if greater, on the theory that the minority preferred does not participate in surplus, which instead redounds to the benefit of the common, except to the extent of any liquidation preference in excess of par.

On a pooling, only A’s proportionate share of B’s earned surplus will appear as such. (The minority’s proportionate share of earned surplus of B will be netted-in as part of the liability for minority interests.)

The capital surplus account of A will be credited to the extent the net worth of B exceeds the aggregate of the amounts credited to the liability for minority interests, earned surplus and capital stock. If the combination is accounted for as a purchase, the capital surplus will be credited for the purchase price paid by A less the amount credited to A’s capital stock account.

To illustrate, let us assume the same data as shown in the balance sheets in the text preceding note 73, except that 10 percent of the common stock of B is held by minority shareholders. It will appear that the 10 percent minority interest will be shown as a liability of $1,500,000 on the consolidated balance sheet, whether the accounting is as a purchase or a pooling (since that 10 percent is neither purchased nor pooled—it has not been acquired by A). However since the minority interest is thus shown as a liability, thereby fully subtracting the minority interest, the consolidated balance sheet will show 100 percent of the other assets and liabilities (at their written-up values if a purchase except for goodwill).

The goodwill, perhaps unexpectedly, will be shown at a value diminished not only by 10 percent of the 100 percent value of goodwill, but also by 10 percent of the written-up value of the other assets. Thus, in our example, where there is no minority interest and the accounting is by purchase, goodwill is shown at $5,000,000. If instead only 90 percent of the common is acquired, the goodwill is diminished by two amounts: 10 percent of the “full value” of goodwill ($500,000) and 10 percent of the write-up in the other assets (10 percent of $2,000,000 write-up in inventory plus $3,000,000 write-up in plant plus $5,000,000 write-up in land) or $1,000,000, for a net goodwill carrying amount of $3,500,000.
B. Accounting by the Investor for an Investee When Consolidated Statements Are Not Appropriate

In comparison with the prior subpart A, where the criteria for consolidated statements were met, the accounting for a second category of situations, those in which the criteria for consolidation are not met, is more complicated. Here, as can be seen from Figure 3, there are two major categories:

1. Business combinations;
2. Other acquisitions.

In either of these two categories, by our hypothesis, B Corp.'s financial statements will not be consolidated with those of A Corp. For business combinations the equity method will apply but for other acquisitions, depending on the facts, one of three types of accounting treatment will be accorded B Corp. on A's published financial statements:

1. The "cost" method;
2. The "cost or market" method; or
3. The "equity" method.

Giving effect to the foregoing:

<table>
<thead>
<tr>
<th>Assets</th>
<th>If purchased:</th>
<th>If pooling:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 50,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>32,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Plant</td>
<td>88,000</td>
<td>85,000</td>
</tr>
<tr>
<td>Land</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>3,500</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$183,500</strong></td>
<td><strong>$170,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$ 39,000</td>
<td>$ 39,000</td>
</tr>
<tr>
<td>Minority interest in subsidiary</td>
<td>1,500</td>
<td>1,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock</td>
<td>39,000</td>
<td>39,000</td>
</tr>
<tr>
<td>Capital surplus</td>
<td>57,000</td>
<td>39,180*</td>
</tr>
<tr>
<td>Earned surplus</td>
<td>47,000</td>
<td>51,320</td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
<td><strong>$183,500</strong></td>
<td><strong>$170,000</strong></td>
</tr>
</tbody>
</table>

*Of the $15,000,000 net worth of B Corp., $1,500,000 is credited to minority interest, $4,320,000 is credited to earned surplus, and $9,000,000 is credited to capital stock, leaving $180,000 to be credited to capital surplus.

78. Where A Corp. has investments in two or more companies, one or more of them may be consolidated and others may not. Thus, in our Figure 3 we might have diagramed the situation where consolidated statements for A Corp. and B Corp. include one or more unconsolidated investees, C, D, and E. Since the accounting for unconsolidated investees on consolidated statements is identical with the accounting for unconsolidated investees on parent-company-only statements, Figure 3 simply includes the former at boxes 15-17 and 19-22. The explanation which follows applies equally to unconsolidated investees whether in consolidated statements or parent-company-only statements.
I shall first explain these and then the two subclasses of the equity method for business combinations.\textsuperscript{79}

1. ACCOUNTING BY THE INVESTOR FOR AN UNCONSOLIDATED INVESTEE WHEN THERE IS NO BUSINESS COMBINATION; I.E., CONTROL IS NOT HELD OVER THE INVESTEE

If A Corp. invests in equity shares of B Corp. without obtaining control, the acquisition will not be considered a "business combination"\textsuperscript{80} and, further, the financial statements will not be consolidated.\textsuperscript{81} The criteria for determining when one of the three methods, cost, cost or market, or equity, will be applied to these published statements, and the description of each, when there is no business combination or consolidation of statements, follows.

a. The Cost Method

At the instant when the B Corp. shares are first acquired, the accounting for a noncontrolling interest under all three methods is identical.\textsuperscript{82} A Corp. will simply debit an investment account for the cost and credit cash or whatever else it uses to pay for the investment. But thereafter the three methods diverge.

The simplest to describe is the "cost" method, which will be applicable if A Corp. is not engaged with another in a joint venture in B Corp., has no "significant influence over operating and financial policies" of B Corp. (the criteria for use of the "equity" method), and the B shares are not "marketable equity securities" (the criterion for use of the "cost or market" method, regulated by FAS No. 12).\textsuperscript{83}

The cost method simply calls for carrying the B shares at cost like any other long-term investment,\textsuperscript{84} with a write-down for a permanent decline in value below cost (although write-downs are not common).\textsuperscript{85} In addition, income is recognized by A Corp. when dividends are declared by B Corp. out of post-

\textsuperscript{79} The accounting on the A Corp. financial statements, when they are not published as "those of the primary reporting entity," is described in Part III infra.
\textsuperscript{80} See text at n. 12 supra. Regarding the meaning of "control," see n. 63, supra. See Figure 3 boxes 12-15, supra.
\textsuperscript{81} See text at n. 64, supra.
\textsuperscript{82} The accounting is also the same under a business combination accounted for as a purchase. But for a pooling of interests, at this point the accounting differs. See text at n. 119, et seq. infra.
\textsuperscript{83} FASB, Statement of Financial Accounting Standards No. 12, Accounting for Certain Marketable Securities (1975).
\textsuperscript{84} APB St. No. 4 ¶¶ 163-64 (1970).
\textsuperscript{85} Id. ¶ 183 S-5E.
acquisition earnings of B,\textsuperscript{86} and other dividends are considered returns of capital and reduce the carrying amount of the investment.\textsuperscript{87}

\textit{b. The "Cost or Market" Method}

If, instead, the \textit{B} shares still are not to be accounted for on the equity method, but do fit the criteria of FAS No. 12 (which covers marketable equity securities whether held for the short or long-term),\textsuperscript{88} they initially will be entered at cost, but on subsequent balance sheets of \textit{A} will be carried at the lower of cost or market at the balance sheet date.\textsuperscript{89} Under FAS No. 12, the income statement of \textit{A} will not be affected by any write-down to market for

\textsuperscript{86} See APB Op. No. 18 ¶¶ 6(a), 7 (1971) and ARB No. 43, ch. 1, ¶ 3 (1953). Although not stated in these authorities, they support the apparent practice assuming a LIFO basis for these dividends; \textit{i.e.}, payment of dividends is deemed to be out of the most recent earnings. See Hackney, Financial Accounting for Parents and Subsidiaries—A New Approach to Consolidated Statements, 25 U. Pitt. L. Rev. 9, 18 n. 19 (1963).

\textsuperscript{87} Ibid.

\textsuperscript{88} This paper is not concerned with short term investments held as a more profitable substitute for cash. Short term investments in securities are carried either at cost, or, if they are within the terms of FAS No. 12 governing marketable equity securities, at "cost or market" as therein described. See notes 89 and 90, infra, regarding such short-term holdings. The equity method is inapplicable to short term investments. Cf. APB Op. No. 18 ¶¶ 2, 14-17 & n.4 (1921); FAS No. 12 ¶ 6 (1971).

\textsuperscript{89} FAS No. 12 ¶ 7 (1971) defines "marketable" as follows:

(b) Marketable, as applied to an equity security, means an equity security as to which sales prices or bid and ask prices are currently available on a national securities exchange \textit{(i.e.,} those registered with the Securities and Exchange Commission) or in the over-the-counter market. In the over-the-counter market, an equity security shall be considered marketable when a quotation is publicly reported by the National Association of Securities Dealers Automatic Quotations System or by the National Quotations Bureau Inc. (provided, in the latter case, that quotations are available from at least three dealers). Equity securities traded in foreign markets shall be considered marketable when such markets are of a breadth and scope comparable to those referred to above. Restricted stock does not meet this definition.

\textsuperscript{89} FAS No. 12 ¶ 8 (1971).

The discussion in the text here is based on the simple case of a long-term investment in only one company.

If two or more companies are investees or two or more companies' stocks are held as short-term substitutes for cash, the accounting is complicated slightly by FAS No. 12's use of the portfolio concept. And the application of that concept will vary depending on whether the investor's balance sheet is "classified" \textit{(i.e.,} divided into current and noncurrent assets and liabilities). At the risk of getting off into a complex tangent, this may be briefly illustrated.

Assuming a classified balance sheet and holdings for the short-term of stocks in three companies, \textit{A}, \textit{B} and \textit{C}, purchased at costs of $10, $12 and $6, respectively, and long-term
long-term investments if it is judged to be an “other than temporary” decline. Consistent with this treatment of temporary declines (not being charged against income), if the market value rebounds at a subsequent balance sheet date, the investment will be written up again (but not above original cost) and the recoupment will not be counted as income. In this latter respect the cost or market method differs from other cases in which the written-down value becomes the new “cost” figure for future purposes and is not written up on recoupment—as in the case of inventory write-downs. Finally, as with the cost method, dividends out of post-acquisition earnings of \( B \) are income to \( A \); other dividends are a return of capital which diminish the carrying value of the investment account.

holdings of \( X \), \( Y \) and \( Z \), purchased respectively at the same costs, further assume that at the end of the accounting period the values have changed as follows:

<table>
<thead>
<tr>
<th>Holding</th>
<th>Cost</th>
<th>End-of-period-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$10</td>
<td>$8</td>
</tr>
<tr>
<td>B</td>
<td>12</td>
<td>14</td>
</tr>
<tr>
<td>C</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Totals</td>
<td>$28</td>
<td>$25</td>
</tr>
<tr>
<td>Long-term:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>X</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Y</td>
<td>12</td>
<td>14</td>
</tr>
<tr>
<td>Z</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Totals</td>
<td>$28</td>
<td>$25</td>
</tr>
</tbody>
</table>

The short-term and long-term holdings each will be treated as a portfolio and the aggregate costs and market values compiled. The lower of the aggregate cost or market value for each portfolio will be carried on the balance sheet. Thus each portfolio above will be shown at $25, the lower of the aggregates of cost or market.

Because FAS No. 12 provides no criteria for distinguishing short-term from long-term holdings, and ARB 43, c3A, ¶ 4 states only that “marketable securities representing the investment of cash available for current operations” should be considered short-term, there is much freedom in constituting the two portfolios. See L. Heath, Financial Reporting and the Evaluation of Solvency 81 (AICPA Accounting Research Monograph 3)(1978).

90. Id. ¶ 11 requires that writedowns of long-term investments by-pass Income accounts. Instead, the debit will be to an equity account and the credit to a “contra-asset” account. If the value later increases and is higher at a subsequent balance sheet date, the contra-asset account will be debited for the increase to the extent of the investments’ original cost and equity will be re-credited.

The term “contra-asset account” refers to an account which is part of the main asset account but is segregated in a separate ledger account for the purpose of preserving the main account intact. Other examples of contra-asset accounts are what lawyers know as reserves for bad debts and reserves for depreciation. (Accountants now eschew the term “reserves” for all but reserves out of surplus. See AICPA, Accounting Terminology Bulletin No. 1 ¶¶ 57-64 (1953).)

For short-term investments, on the other hand, changes in the contra-asset account will be debited (for losses) or credited (for gains) against income.

91. FAS No. 12 ¶ 21.
c. The Equity Method

The equity method is far more complex and is subject to much misunderstanding, even among sophisticated lawyers. One of its features is well-known—that the balance sheet value of the investment account will be written up or down in proportion to A's ownership share as the shareholders' equity of the investee rises or falls, and that the write-up or write-down will be added to or subtracted from A's income. But few are aware that, in other than poolings, a significant adjustment to that write-up or write-down is required. It will be explained shortly.

Although APB Op. No. 18, para. 19 (1971) states the accounting details for the equity method, one who is not already familiar with the practices, like

93. The adjustment is required in all contexts but the pooling one. See text at n.119, et seq. infra.
94. The more significant portions of which are here quoted:

19. Applying the equity method. The difference between consolidation and the equity method lies in the details reported in the financial statements. Thus, an investor's net income for the period and its stockholders' equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated (except as indicated in paragraph 19i). The procedures set forth below should be followed by an investor in applying the equity method of accounting to investments in common stock of unconsolidated subsidiaries, corporate joint ventures, and other investees which qualify for the equity method:

- Intercompany profits and losses should be eliminated until realized by the investor or investee as if a subsidiary, corporate joint venture or investee company were consolidated.
- A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary.
- The investment(s) in common stock should be shown in the balance sheet of an investor as a single amount, and the investor's share of earnings or losses of an investee(s) should ordinarily be shown in the income statement as a single amount except for the extraordinary items as specified in (d) below.
- A transaction of an investee of a capital nature that affects the investor's share of stockholders' equity of the investee should be accounted for as if the investee were a consolidated subsidiary.
- Sales of stock of an investee by an investor should be accounted for as gains or losses equal to the difference at the time of sale between selling price and carrying amount of the stock sold.
- A loss in value of an investment which is other than a temporary decline should be recognized the same as a loss in value of other long-term assets. Evidence of a loss in value might include, but would not necessarily be limited to, absence of an ability to recover the carrying amount of the investment or inability of the investee to sustain an earnings capacity which would justify the carrying amount of the investment. A current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment. However, a decline in the quoted market price below the carrying amount or the existence of operating losses is not necessarily indicative of a loss in value that is other than temporary. All are factors to be evaluated.
- An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. The investor ordinarily should discontinue applying the equity method when the investment (and net advances) is reduced to zero and should not provide for
The reader of Dr. Johnson’s dictionary,96 will find little meaning in these prescripts. Before explaining those mechanical steps in the equity method, we shall determine in subtopic (i), following, when the equity method is required by GAAP. Then in subtopic (ii) we shall consider the mechanics, including the adjustment, which will be illustrated in (iii).

(i.) Criteria for Use of the Equity Method

One key to understanding the equity method is to note that it is a parallel to consolidated statements. Just as financial statements usually will be consolidated if A Corp. controls B Corp., so too, the equity method usually will be applied if the statements are not consolidated but nevertheless, A has at least “significant influence” over operating and financial policies of B Corp.,96 and, moreover, A’s income, net assets, and net worth will be the same under the equity method, with a minor exception, as they would be if consolidated statements were prepared.97 The increment in A’s net assets will be included in the single investment account on A’s balance sheet. Because of these characteristics, the equity method is frequently referred to as “one-line consolidation.”

A Corp. must use the equity method where B is a controlled subsidiary (usually meaning more than 50 percent of B’s voting stock is held by A Corp.) which is not consolidated because B’s business is not compatible with A’s,98 e.g., where A Corp. is an industrial company and B is a bank or insurance company.99 So, too, the equity method is required where B Corp. is a joint venture corporation, such as when A and C each own 50 percent of B and operate it cooperatively.100 And finally, the equity method also applies even if B Corp. is not a controlled subsidiary or joint venture but A Corp. has “significant influence” over B’s operating and financial policies.101 According to Opinion No. 18 there is a rule of thumb presumption that significant influence exists if there is 20 percent or greater ownership by A of B’s voting power.102 However it may be noted that the subjectivity of the “significant influence” standard has enabled several firms to use the equity method when additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended.

95. S. Johnson, Preface to the English Dictionary, reprinted in II The Works of Samuel Johnson, LL.D. 446, 450–51 (1837): “[E]very art is obscure to those that have not learned it; . . . it must be remembered that I am speaking of that which words are insufficient to explain. . . . The solution of all difficulties, and the supply of all defects, must be sought in the examples.”

98. Id. ¶ 14. See Figure 3, boxes 20, 22, supra.
101. Id. ¶ 17.
ownership of shares is at a much lower level but significant influence is claimed because of other factors such as interlocking directorates. On the other hand, the equity method has also been used simply because 20 percent or greater ownership existed although the power to exercise significant influence was possibly absent. The FASB in May, 1981, issued an interpretation addressed to the latter abuse, further explaining the criteria, and the SEC has been reconsidering the criteria in large part because of its subjectivity and potential for abuse.

103. E.g., Leasco Corp., holding about 3 percent of Reliance Group in 1979 used the equity method on the grounds that the two firms were operated by the same officers and directors. See Briloff, Leveraged Leasco, Barron's 10/20/80 at 4.

Curtiss-Wright, Corp., holder of 14.3 percent of Kennecott Copper Corp. in early 1980 determined to use the equity method, although Kennecott was clearly antagonistic, Curtiss-Wright in 1978 had waged an unsuccessful proxy battle for control of Kennecott and in 1980 Kennecott sought to take over control of Curtiss-Wright by a tender offer. Coopers & Lybrand, the Curtiss-Wright auditors, approved.

104. See Briloff, supra n.103, and FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock (May, 1981), emphasizing that "significant influence" is a question of fact although the presumptions in ¶ 17 of APB Op. No. 18 (1971) are intended to provide a reasonable degree of uniformity.

Paragraph 4 of the Interpretation reads:

4. Examples of indications that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include:

a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor's ability to exercise significant influence.

b. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.

c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.

d. The investor needs or wants more financial information to apply the equity method than is available to the investee's other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.

e. The investor tries and fails to obtain representation on the investee's board of directors. (Footnotes omitted.)

In SEC v. McLouth Steel Corporation, [1981 Current Vol.] Fed. Sec. L. Rep. (CCH) ¶ 98,032 (D.D.C. 1981), the Commission announced a consent decree stating that the Complaint in that case alleged use of the equity method by McLouth to account for its holdings in Jewell Coal and Coke Company despite an inability to exercise significant influence, identifying seven supporting factors:

1. McLouth was not represented on the Jewell Board of Directors, despite its request to be represented;
2. McLouth did not participate in Jewell's policy making process;
3. There was no significant interchange of managerial personnel between McLouth and Jewell;
4. The remaining 80.13 percent of Jewell's outstanding common stock was owned or controlled by one family;
5. McLouth was forced to resort to three separate lawsuits against Jewell to exert any influence;
6. McLouth was unable to win shareholder support for a dividend proposal; and
7. The relationship between the managements of McLouth and Jewell was overtly hostile.
There is one especially hazy area in which the accountant must apply a rather vague standard in determining whether to apply the equity method.

As previously discussed, certain subsidiaries' financial statements will not be consolidated with those of A Corp. no matter what portion of voting shares are held by A Corp. (e.g., where the parent is an industrial firm and the subsidiary is a bank). As to such subsidiaries which are not consolidated because their business is incompatible with A's, the equity method, as we have just stated, is required. But an ambiguity arises as to those other unconsolidated subsidiaries which are not consolidated for the different reason that there is no real control in A Corp.

Footnote 4 to APB Op. No. 18 states, with respect to these subsidiaries, that the equity method may not apply to them:

The limitations on consolidation described in paragraph 2 of ARB No. 51 and paragraph 8 of ARB No. 43, Chapter 12 [see footnote 106], should also be applied as limitations to the use of the equity method. . . . The conclusions [that the equity method should be used where subsidiaries are not consolidated] . . . apply to investments in foreign subsidiaries unless those companies are operating under conditions of exchange restrictions, controls or other uncertainties of a type that would affect decisions as to consolidation or application of the equity method; if those conditions exist, the cost method should be followed. [Bracketed matter not in original.]

This means that the equity method may not be used for 50 percent-plus subsidiaries which are not consolidated because control is temporary, or

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**Footnotes:**

105. At text following p.65, supra.
106. ARB No. 51 ¶ 2 (1959) states:

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. For example, a subsidiary should not be consolidated where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy). There may also be situations where the minority interest in the subsidiary is so large, in relation to the equity of the shareholders of the parent in the consolidated net assets, that the presentation of separate financial statements for the two companies would be more meaningful and useful. However, the fact that the subsidiary has relatively large indebtedness to bondholders or others is not in itself a valid argument for exclusion of the subsidiary from consolidation. (Also, see chapter 12 of Accounting Research Bulletin No. 43 for the treatment of foreign subsidiaries.)

ARB No. 43, ch. 12 ¶ 8 (1968) states:

8. In view of the uncertain values and availability of the assets and net income of foreign subsidiaries subject to controls and exchange restrictions and the consequent unrealistic statements of income that may result from the translation of many foreign currencies into dollars, careful consideration should be given to the fundamental question of whether it is proper to consolidate the statements of foreign subsidiaries with the statements of United States companies. Whether consolidation of foreign subsidiaries is decided upon or not, adequate disclosure of foreign operations should be made.
control does not rest with the majority (e.g., because the company is in
receivership), or there is a very large minority interest, or a foreign
government in fact prevents control, viz., because control does not in fact exist. But
“significant influence” nevertheless may exist as to these noncontrolled
subsidiaries and, if it does, it would seem the equity method should be used.
Further, in subsequent footnotes (6 and 7), Opinion No. 18 also states that the
equity method may not be used for joint ventures or less-than-50 percent-
owned companies over which A Corp. has significant influence, “insofar as the
limitations on the use of the equity method outlined in footnote 4 would be
applicable to investments other than those in subsidiaries.” This may mean
simply that the equity method does not apply when in fact A’s “significant
influence” over B is merely temporary or does not exist. But this is not clear.107

(ii.) The Mechanics of the Equity Method When B Corp Is Not Controlled
by A Corp

If the criteria for application of the equity method are met, APB Op. No. 18
spells out in further nearly incomprehensible detail the mechanics.108 We may
translate and summarize these as follows:

(a) On acquisition.
As noted previously, on acquisition of the B Corp. shares, they are
entered at cost on A’s books, by a debit to an account which may be
labelled “Investments,” and a credit to cash or whatever was used to pay
the seller.
(b) During the holding of the B shares. When the B Corp. shares are
accounted for by the equity method, A Corp. must:
(i) Recognize A’s proportionate share of B’s post-acquisition earn-
ings by debiting (on A’s financial statements) “investments” and
crediting a revenue account. Any intercompany transactions must
be eliminated, as for consolidated statements. This will result in A’s
balance sheet assets (and consequently net worth) being increased
for profits of B, or decreased for losses of B, and A’s income
statement being similarly affected.
(ii) Recognize a charge against revenues for certain imputed depre-
ciation, cost of sales, and amortization expense. (This is the little-
known adjustment referred to above which will be explained imme-
diately following this summary.108

107. There is a further ambiguity. APB Op. No. 18 n.4 (1971) says that where the equity
method and consolidation of financial statements are not allowed, the cost method must be
followed. Since FAS No. 12 (1975) postdates APB Op. No. 18 (1971), it is likely that either the
“cost or market” method of FAS No. 12 (1975) or the cost method will apply, depending on
whether or not the B Corp. shares are “marketable equity securities” as defined at ¶ 7(a)-(b) of
FAS No. 12 (1975). See text at n.87, et seq. supra.
109. And see APB Op. No. 18 ¶ 19(b) (1971) quoted at n.94 supra.
(iii) When dividends are received from B, whether or not from post-acquisition earnings, treat as a return of capital by a debit to "cash" and credit to "investments" on A's financial statements, thereby not reflecting dividends in income (since A's proportionate share of B's earnings has already been recognized—at (i) above).

(iv) If there is an "other than a temporary decline" in the value of the B shares, debit a loss account and credit "investments."

(c) On resale:
On resale of the B shares, A Corp. must charge the loss or credit revenue in the ordinary manner as for any asset by crediting investments at the current carrying value and debiting "cash" (or whatever is received) and charging or crediting the difference to loss or gains, as the case may be.

What is the explanation of item (b)(ii), "recognize a charge against revenues for imputed depreciation and amortization expense?" The crux of the matter is this:

When A Corp. purchases a sufficient portion of B Corp. to exert significant influence over B, A often pays more than a proportionate share of the fair market value of identifiable tangible and intangible assets, and an even greater amount more than a proportionate share of the book value of net worth shown on B's books. We have seen that the cost of an isolated asset (presumably equal to fair market value) in excess of the seller's book value is recognized on the buyer's books when purchased, and depreciated or amortized (if a depreciable or amortizable asset), as time passes.\(^1\) We have also seen that when a going concern is acquired in a business combination and the purchase price is in excess of the aggregate fair market values of the identifiable tangible and intangible assets, under the "purchase" mode of accounting, goodwill is required to be recognized and amortized over not more than forty years. Similarly when A acquires significant influence over B Corp. so that the equity method must be used, the excess of purchase price over fair market value of identifiable assets is required by GAAP to be imputed as goodwill and amortized as expense and the excess of fair value of the identifiable depreciable or amortizable assets over B's book carrying values must be depreciated or amortized so as to reduce A's revenues. This debit against revenues is balanced by a credit against the investment account.

(iii.) Illustration

For this purpose, and to permit comparisons, let us assume the same data as in our first illustration of purchase accounting\(^1\) except that instead of

\(^1\) See text following n.6 supra.

\(^1\) See text at n.17 supra.
purchasing 100 percent of the net assets of B Corp. for $30,000,000, A purchases 20 percent of the voting shares of B for $6,000,000.

On these assumptions, the balance sheets of A and B and the market value of B's assets will be as follows:

**Balance Sheets (000's omitted)**

<table>
<thead>
<tr>
<th>Assets:</th>
<th>A Corp.</th>
<th>B Corp.</th>
<th>Fair market value of B's assets and liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 50,000</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
<td>10,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Plant</td>
<td>70,000</td>
<td>15,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td>$140,000</td>
<td>$30,000</td>
<td></td>
</tr>
</tbody>
</table>

| Liabilities and Equity: |         |         |                                               |
|-------------------------|---------|---------|                                               |
| Accounts payable        | $ 24,000 | $15,000 | $15,000                                      |

| Equity:                |         |         |                                               |
|------------------------|---------|---------|                                               |
| Capital stock          | 30,000  | 6,000   |                                               |
| Capital surplus        | 39,000  | 4,200   |                                               |
| Earned surplus         | 47,000  | 4,800   |                                               |
| **Totals**             | $140,000 | $30,000 |                                               |

At this point A's accounting, using the equity method, is simple. Merely add a new asset to the balance sheet, "investment in B Corp., $6,000,000" and diminish A's cash by crediting that account the $6,000,000 paid.

However, the complexities of the equity method, its parallelism to consolidated statements, and its differences from the cost and cost or market methods, arise subsequently as B Corp. operates and pays dividends.

To keep this primer efficient, let us continue to assume no intercorporate transactions have occurred but that during the first year B's operations resulted in earnings of $4,000,000, $1,000,000 in dividends was paid to all shareholders ($200,000 to A Corp.), that the plant is being depreciated at 10 percent, and that any goodwill would be amortized over the maximum forty years allowed by APB Op. No. 17. Further assume that inventory is carried on the first-in, first-out method and that the inventory was turned over at least once during the year so that B's entire opening inventory was sold during the year. On these assumptions, if A had owned 100 percent of B, and A's and B's
financial statements were fully consolidated, as we have seen,\textsuperscript{112} $B$'s contributions to profits would have been less than $B$'s reported $4,000,000 because:

(a) The cost of goods sold on the consolidated statements would have been increased by the $2,000,000 excess of value of the inventory contributed by $B$ over its book carrying value;
(b) Depreciation (at 10 percent) would have been increased by $300,000 for the excess of the plant's $18,000,000 value over its $15,000,000 book carrying value; and
(c) Amortization of the $5,000,000 goodwill at 2.5 percent per year would have increased expenses by $125,000.

Thus, the contribution of $B$ to the consolidated income of $A$ and $B$, as we have seen, would have been calculated (ignoring related tax effects):

\[
\begin{array}{c|c}
\text{B's reported earnings} & \$4,000,000 \\
\text{Less:} & \\
\text{Additional cost of goods sold} & (2,000,000) \\
\text{Additional depreciation} & (300,000) \\
\text{Amortization of goodwill} & (125,000) \\
\hline
\text{Total} & \$1,575,000
\end{array}
\]

Since $A$ does not own 100 percent of $B$'s shares, but owns only 20 percent, $A$'s share of undistributed income (before dividends) therefore is 20 percent of $1,575,000, or $315,000. Since $A$'s receipt of $200,000 cash, as a dividend, is not revenue to $A$, but diminishes $A$'s investment, $A$'s investment account will be written up by the net $115,000, $A$'s cash account will be increased by the $200,000 received, and $A$'s income account will be written up the $315,000 total, consisting of $200,000 realized in cash and the $115,000 increased equity in $B$ Corp.—hence the name, "equity" method.\textsuperscript{113}

\textsuperscript{112} See text at n.76 supra.

\textsuperscript{113} For those who prefer to see the accountant's work, the following may be more readily understandable:

Observing the mechanics outlined in the text above (text at n.108), the following debits and credits would properly reflect the effects on $A$'s financial statements:

(a) On acquisition at January 1:

| Investments | $6,000,000 |
| Cash        | $6,000,000 |

To enter $A$'s purchase of 20 percent voting interest in $B$ Corp.

(b) At end of first year of $A$'s ownership:

| Investments | $800,000 |
| Investment Revenues | $800,000 |

To enter $A$'s 20 percent share of $B$ Corp.'s $4,000,000 net income for year.
2. ACCOUNTING BY THE INVESTOR FOR AN UNCONSOLIDATED INVESTEME WHEN THERE IS A BUSINESS COMBINATION; i.e., CONTROL IS HELD OVER THE INVESTEMEE

a. Purchase or Pooling?

In the few cases where the statements are not to be consolidated solely because the compatibility criteria for consolidation have not been met,114 say A Corp. is an industrial corporation and B is a bank, there nevertheless would

(c) At this point it becomes necessary to pretend that A acquired B Corp. and that purchase accounting would be followed, meaning that 20 percent of the fair market value of B's assets and liabilities would be entered on A's balance sheet with the balance of the purchase price entered as goodwill. The calculation of the amounts to be allocated among the assets and goodwill proceeds thusly:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price paid for 20 percent of B</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>Less—20 percent of B's book value (net assets)</td>
<td>(3,000,000)</td>
</tr>
<tr>
<td>Equals investment excess</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

Allocation of investment excess:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 percent of the $5,000,000 excess in value of Land over its book value on B's books</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>20 percent of the $3,000,000 excess in value of Plant over its book value on B's books</td>
<td>600,000</td>
</tr>
<tr>
<td>20 percent of the $2,000,000 excess in inventory over that shown on B's books</td>
<td>400,000</td>
</tr>
<tr>
<td>Balance to goodwill</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Investment excess</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

All but Land are depreciable or otherwise amortizable to expense as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plant (at 10 percent per annum rate)</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Inventory (all enters into current cost of goods sold)</td>
<td>400,000</td>
</tr>
<tr>
<td>Goodwill (at 2.5 percent per annum for 40 years)</td>
<td>25,000</td>
</tr>
</tbody>
</table>

(d) Resuming the journal entries at year end:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment revenues</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Investments</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>To impute depreciation expense on excess of value of plant over B's book carrying value.</td>
<td></td>
</tr>
<tr>
<td>Investment revenues</td>
<td>$ 400,000</td>
</tr>
<tr>
<td>Investments</td>
<td>$ 400,000</td>
</tr>
<tr>
<td>To impute cost of goods sold expense on excess of value of opening inventory over B's book carrying value.</td>
<td></td>
</tr>
<tr>
<td>Investment revenues</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Investments</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>To impute amortization of goodwill arising from A's purchase of B</td>
<td></td>
</tr>
</tbody>
</table>

On receipt of dividend:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>Investments</td>
<td>$ 200,000</td>
</tr>
<tr>
<td>To reflect receipt of cash and diminution of A's equity in B Corp.</td>
<td></td>
</tr>
</tbody>
</table>

114. See text at n. 65, supra, indicating no consolidation if either no real control is held over B by A Corp., or if the two businesses are not compatible with the consequence that consolidated statements would be misleading. See also, n. 106. If the reason for not consolidating is the lack of real control, then there is also no business combination and the treatment will be as in text following n. 77, supra.
be a business combination if \( A \) controls \( B \)'s assets. In that case, the next issue will be whether the parent-company-only financial statements must be prepared on a purchase or on a pooling basis. To decide this issue the twelve pooling criteria must be applied as before.

b. **Purchase—on the Equity Method**

If application of the pooling criteria results in a determination that pooling would be inappropriate, then at the date of acquisition, \( A \)'s investment will be shown as "investments," at cost, on \( A \)'s balance sheet.

However, for subsequent balance sheets, the issue arises whether the investment in \( B \) Corp. will be carried on the cost, cost or market, or equity bases, with the resultant differences in net assets shown on the \( A \) Corp. balance sheet and with a consequential effect on incomes shown on \( A \)'s income statements. The answer is that in all cases where there is a non-pooling business combination, i.e., \( A \) controls \( B \) but the pooling criteria are not met, the equity method will be required on parent-company-only statements and

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115. Similarly, other cases could be imagined in which the criteria for consolidation are not met, yet a business combination may be thought to exist. For example if \( A \) and \( C \) corporations form a 50/50 joint venture which they put in corporate form as \( B \) Corp., and \( A \) and \( C \) operate no other business, neither \( A \) nor \( C \) may consolidate its statements with \( B \)'s, but the joint venture itself constitutes a classic business combination. Although this case does not seem to fit the criterion of ARS No. 5 at 12, "control over assets" of \( B \) by \( A \), so as to constitute a business combination, it does seem to fit the "one accounting entity" description of APB Op. No. 16 § 1 (1970). But is that so? Can it be said that \( A \) and \( C \) are a single entity?

What does it matter?

Both \( A \) and \( C \) are required to use the equity method. But in doing so, if it is a "business combination" that exists, will not there be an additional need for \( A \) and \( C \) to choose whether to account for the acquisition of \( B \) as a purchase or a pooling? No, since one of the twelve criteria for pooling is that "substantially all of the voting stock" of \( B \) be obtained, and this means at least 90 percent and, in our example, \( A \) owns only 50 percent of \( B \). APB Op. No. 16 § 47. Since this cannot be a "pooling" even if it is a "business combination," "purchase" accounting is required, and this will be dealt with under the equity method described in text following n. 92 supra. See Figure 3, box 17. Thus, except for appropriately locating this case in our chart, there is no special problem here. I would locate this case in either box 17 or box 20; it does not matter.

116. See Figure 1, supra.

117. APB Op. No. 18 § 14 (1971) states:

The Board reaffirms the conclusion that investors should account for investments in common stock of unconsolidated domestic subsidiaries by the equity method in consolidated financial statements, and the Board now extends this conclusion to investments in common stock of all unconsolidated subsidiaries (foreign as well as domestic) in consolidated financial statements. The equity method is not, however, a valid substitute for consolidation and should not be used to justify exclusion of a subsidiary when consolidation is otherwise appropriate. The Board concludes that parent companies should account for investments in the common stock of subsidiaries by the equity method in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity.

The cost or value method is not applicable where the equity method is. Cf. FAS No. 12 § 6 (1975).
the accounting will be as just described for the equity method when there is no business combination.118

c. Pooling—on the Equity Method

If the combination is a pooling, however, and consolidated statements again are not appropriate, the equity method is still required by APB Op. No. 18.119 But the accounting for a pooling under the equity method differs from the accounting for a purchase under the equity method. An "investor's net income for the period and its stockholders' equity at the end of the period are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated,"120 and, as we have seen, consolidated income under pooling differs from consolidated income under purchase accounting.121

Therefore in our example, where A Corp. buys all of the stock of B Corp. but the two firms' statements are not to be consolidated and the combination is a pooling, the investment in B Corp. should be carried on A's balance sheet at B's net asset amount ($15,000,000 in our example)122 and A's equity should be

118. See text at n.92, et seq. supra.
120. Id. ¶ 19.
121. See text at n.63, et seq. supra.
122. This use of the net asset value measure for the debit to Investments account is expressly assumed to be correct in N. Bedford, K. Perry & A. Wyatt, Advanced Accounting 647 (1973).

Hackney, Financial Accounting for Parents and Subsidiaries—a New Approach to Consolidated Statements, 25 U. Pitt. L' Rev. 9, 16 (1963), in addition to the net asset value, notes two potential alternatives, the par value of the A shares issued and their fair value (i.e., the cost of the B shares acquired). He notes that Carman Blough, the AICPA's director of research in 1957, had recommended the use of the par value of the A shares in Blough, Accounting and Auditing Problems, 104 J. Accountancy 71 (Sept. 1957). (Presumably Blough also would espouse stated value where the shares are no-par shares.) Modern writers indicate par is still used by some accountants. See J. Gentry & G. Johnson, Finney and Miller's Principles of Accounting, Advanced 199 (6th ed. 1971); G. Welch, C. Zlatkovich & J. White, Intermediate Accounting 768 (4th ed. 1976). However, all three of these statements seem to be addressed to parent-company-only books when consolidated statements are to be prepared—in which case those consolidated statements will be adjusted to carry the Investee's accounts at net asset value.

The last-cited authority states that some accountants alternatively carry the B shares at A's proportionate share of net contributed capital (i.e., stated value plus capital surplus). Of the four alternatives for carrying the investment in B shares on A's books at:

(1) Par value (of stated value) of the A shares issued;
(2) Cost to A (not endorsed by any of the sources cited in this note);
(3) A's proportionate share of B's contributed capital; or
(4) A's proportionate share of B's net asset value; only the last is reasonable as it is the only one consistent with later balance sheets of A which will be presented in accordance with APB Op. No. 18 (1971).

It is likely that the writers who endorse the other methods have in mind only the books of account of A (as opposed to the A Corp.-only balance sheet at the date of acquisition) or the A Corp.-only balance sheet when consolidated statements are also published. See Part III infra.

Meyer, Accounting for Business Combinations: A Framework for Implementation, 21 Nat'l. Public Accountant 15, 17 (Feb. 1976) says the net asset value is correct and that "a number of textbooks lead their readers to the misleading conclusion that the investment is recorded on the basis of the newly issued shares' aggregate par value."
shown in the same amount, divided between capital stock ($10,000,000) and capital surplus ($5,000,000). As time passes and B Corp. generates profits or losses, unlike the case of purchase accounting, there will be no “extra” charges for amortization of goodwill or depreciation of the excess of fair market value of B’s assets over their carrying value on B’s books. In this way the profits of A Corp. will be the same under the equity method (pooling basis) as under consolidated statements (pooling basis), just as is required by APB Op. No. 18, para. 19. Thus, A’s investment account will be written up or down by the amounts of B’s profits or losses as shown on B’s own books and dividends will diminish the Investments account.

To illustrate, using the same data as in our last example involving the equity method when there is no business combination (except that this time B is 100 percent owned by A Corp.) when B Corp. generates $4,000,000 of income, all of that will be debited to A’s investments account and credited to A’s revenues without further adjustments. The $1,000,000 dividend will be debited to cash and credited to investments. Unlike purchase accounting on the equity method, under pooling accounting on the equity method, there will be no extra depreciation or amortization expense.

III. PARENT-COMPANY-ONLY STATEMENTS (FOR “BUSINESS COMBINATIONS”) NOT PUBLISHED AS THOSE OF THE PRIMARY REPORTING ENTITY

A. The Two Concepts of Parent-Company-Only Statements

To this point, our concern has been with the financial statements published to investors as those of the primary reporting entity. Hence when we discussed consolidated statements, we ignored the statements of A Corp. itself. Yet consolidated statements are not meaningful for every purpose. Consolidated statements, because they ignore the separate legal entities, may be of limited usefulness to minority shareholders of B Corp. and to creditors and financial analysts of A or B. For example a creditor of A is usually subordinated to creditors and even minority shareholders of B with respect to B’s assets, yet

123. Based on anecdotal evidence, apparently some accountants believe that the $5,000,000 should be credited to earned surplus, at least where B’s earned surplus amounts to that much. Hackney, supra n.122 at 16, 18, states that the credit must be to capital surplus, although his opinion concerns what appears to be required of Pennsylvania corporations under Pennsylvania law.

124. See text at n.92, et seq. supra.


The SEC in various parts of its accounting regulations (“Reg. S-X”, 17 CFR Part 210) has required separate statements of certain parents and subsidiaries or investees whose statements are consolidated or for which the equity method has been applied. For a comprehensive current proposal to change these regulations, see, SEC Rel. 33-6316 (May 11, 1981) [Current Vol.] Fed. Sec. L. Rep. (CCH) ¶ 82,870 (1981).
consolidated statements could delude him into thinking all assets were equally available to all creditors.\textsuperscript{126}

Obviously, one additional purpose for which consolidated statements may be useless is in determination of legality of a dividend where the state law or contract being construed is not based in terms of consolidated statements. Since only one state law exists permitting dividends from consolidated surplus, that of California, although the Pennsylvania law allows use of a hybrid test,\textsuperscript{127} consolidated statements are not useful to lawyers concerned with the validity of dividends under other states' laws. Hence, it is the parent-company-only financial data which is of interest to a lawyer who wishes to determine the validity of a dividend distribution by the parent.\textsuperscript{128}

At this point, it becomes necessary to note a subtlety concerning the two different concepts apparently held by accountants concerning parent-company-only statements. Notice that in the prior discussion of the "equity method" of accounting,\textsuperscript{129} we referred to parent-company-only statements "prepared for issuance to stockholders as the financial statements of the primary reporting entity."\textsuperscript{130} This appears to denote a dichotomy, implying another class of parent-company-only statements.

Although these two concepts are not explained in the accounting literature, so far as can be determined, what must be intended is an analogue to the dichotomy between consolidated statements and the parent-company-only statements prepared in conjunction with the consolidated statements. That is to say, consolidated statements are to parent-company-only statements not prepared for publication as "parent-company-only statements prepared for issuance to stockholders as the financial statements of the primary reporting entity" are to parent-company-only statements not prepared for publication.

As noted above, accountants seek to present information as to the economic enterprise in the consolidated statements, recognizing that for many purposes additional parent-company-only statements are necessary for the needs of

\textsuperscript{126} It is not always true that the separate legal entities will be honored in law, and courts will sometimes aggregate the assets and liabilities of corporate affiliates. \textit{E.g.}, see Chemical Bank New York Trust Co. v. Kheel, 369 F. 2d 845 (2d Cir. 1966). \textit{See also}, for some of the more recent esoterica, Landers, \textit{A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy}, 42 U. Chi. L. Rev. 589 (1975); Posner, \textit{The Rights of Creditors of Affiliated Corporations}, 43 U. Chi. L. Rev. 499 (1976); Landers, \textit{Another Word on Parents, Subsidiaries, and Affiliates in Bankruptcy}, 43 U. Chi. L. Rev. 527 (1976); Comment, \textit{Substantive Consolidations in Bankruptcy: A Flow-of-Assets Approach}, 65 Calif. L. Rev. 720 (1977).


\textsuperscript{128} Of course, if the dividend statute is not tied to GAAP in any way, the parent's financial statements will have nothing to say for the lawyer. But many statutes, even if not based on GAAP, at least permit the directors to rely on financial statements prepared by certified public accountants, thus in effect incorporating statements prepared in accordance with GAAP, and most statutes are affected to some extent by GAAP. See Hackney, \textit{Accounting Principles in Corporation Law}, 30 Law & Contemp. Prob. 791, 813–23 (1965).

\textsuperscript{129} Text following n.92, \textit{supra}.

\textsuperscript{130} Quoted from APB Op. No. 18 \S 1 (1971).
creditors and financial analysts of both corporations, and shareholders interested in A Corp.'s dividend potential. Similarly, accountants, in APB Op. No. 18, must recognize that parent-company-only financial statements "prepared for issuance to stockholders as the financial statements of the primary reporting entity" are for the purpose of presenting economic information as to the enterprise, not merely the legal data. Hence APB Op. No. 18 does not purport to regulate the accounting of A Corp. for such purposes as analysis of potential dividends. This, of course, is of major consequence in making dividend determinations. These statements are special purpose statements unregulated by formal, uniform GAAP, as the next subpart will indicate.

B. Accounting in Parent-Company-Only Statements Not Published as Those of the Primary Reporting Entity

The accounting by A Corp. for A's investment in B Corp., in other than the consolidated statements or parent-company-only statements prepared for stockholders as those of the primary reporting entity, is anarchistic. APB Op.'s No. 16, 17 and 18, regulating purchase or pooling, accounting for goodwill, and the equity method, respectively, do not, by their terms apply, but FAS 12, governing accounting for marketable equity securities, and the pervasive principle that assets ordinarily shall be carried at cost, do apply if the statements purport to be in compliance with GAAP. But since the pervasive cost principle is subject to numerous exceptions (such as pooling), it is not a principle as much as it is a normative convention. Hence, as would be expected, practices vary.

1. THE PARENT COMPANY'S BALANCE SHEET AT THE DATE OF ACQUISITION

On acquisition of B Corp. shares as a long-term investment, A Corp. may account, on statements not published for stockholders as those of the primary reporting entity, pretty much as its management pleases, within broad limits —i.e., the historical cost convention, with its exceptions, and FAS 12, since these financial statements are not regulated by APB Op. No. 16.

a. Pooling

Where the pooling criteria are met at the time of acquisition, some firm's will enter the investment in B shares at par (or stated value), some at A's cost, others at A's proportionate share of B's capital stock and capital surplus, and still others at A's share of B's net asset value.

131. FAS No. 12 (1970) seems to be limited to published financial statements but includes all published statements and not just those of the primary reporting entity. See FAS No. 12 ¶¶ 7(g), 8 (1970).
b. Purchase

Where the pooling criteria are not met, and whether or not a "business combination" has occurred, A Corp. will enter its investment at cost at the acquisition date.

2. THE PARENT COMPANY'S ACCOUNTING SUBSEQUENTLY TO ACQUISITION

Subsequently to the acquisition date, regardless of whether a business combination by way of purchase or pooling has occurred, A Corp., on its own books and on statements not published for stockholders as those of the primary reporting entity, probably has the option of following the equity method (at least where A is a joint venturer in B or has "significant influence" and B's shares are not marketable\(^\text{132}\)) or the cost method, although because FAS 12, by its terms, does apply, if the B shares are "marketable," the "cost or market" method may have to be followed.

IV. SUMMARY

A summary of Parts I and II of this paper is fully contained in Figures 1-3. It is suggested that these are the best mnemonic device for fully comprehending that subject matter. A diagram of Part III was not prepared, as it would not appear helpful. The following verbal summary of all three parts may be a helpful supplement.

We have seen that when a single economic entity is formed by two legal entities coming together (i.e., A controls B), accountants ordinarily believe it more informative to present a single set of financial statements. Thus whether net assets of one legal entity are acquired by another legal entity, or instead shares of stock of the first, sufficient to provide control, are acquired by the second, a single set of financial statements usually will cover both. In the assets acquisition, these are statements of the acquiring legal entity whereas in the controlling share acquisition, with one exception, these are the consolidated statements of both legal entities.\(^\text{133}\)

The exception from consolidation is in the case of a controlling share acquisition where consolidation of statements is deemed inappropriate because the two entities are incompatible so that consolidated statements would be misleading. But even here, the equity method is required for the parent company statements which results in the net worth and earnings of the parent

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132. Since no formal GAAP exist for this situation, it would seem that if adequate disclosure is made, A could use the equity method even where the criteria for that method are not met. Whether A Corp. has the option of using the equity method, when marketable equity securities of B are held, is more problematical. FAS No. 12 (1970) literally applies to all A's financial statements and is not limited to those prepared as those of the primary reporting entity.

133. See Parts I and IIA, supra.
being represented in the same amount as if the financial statements had been consolidated.\textsuperscript{134}

In any of these cases in which a single economic entity is formed, whether an assets acquisition or a controlling shares acquisition, one issue is whether a new basis of accountability arises for the acquisition. If so, "purchase accounting" will be required, with a write-up of the acquired company's assets, including goodwill, and amortization of goodwill and the written-up assets thereby diminishing the subsequent net income of the combined entity correspondingly.\textsuperscript{135}

If instead the two sets of owners of the companies making up the single economic entity are envisioned as merely pooling their interests, with each set maintaining a continuing interest in rights and risks, no new basis of accountability arises, and the book carrying values of each will carry over to the balance sheets and be amortized on the income statements of the new entity.\textsuperscript{136}

In cases where there is not a single economic entity formed because $A$ does not control $B$, the financial statements of each will be separately published and the acquiring company will account for its investment on the cost basis\textsuperscript{137} unless (a) the investment consists of marketable equity securities, in which case they will be accounted for on the "cost or market" basis,\textsuperscript{138} or (b) the investor is involved in a joint venture in the investee or holds significant influence over operating and financial policies of the investee. In the latter case, (b), the equity method must be used with a new basis of accountability for the acquired company, and the investor will include in its net worth and income its proportionate share of the investee's income, adjusted to reflect depreciation and amortization of the fair market value of the investee's net assets and goodwill at the date of acquisition.\textsuperscript{139}

For financial statements of $A$ Corp. which are not published as those of the primary reporting entity, APB Op.'s No. 16, 17, and 18, regulating purchase or pooling, goodwill, and the equity method, do not by their terms apply; as a result GAAP are somewhat anarchistic. Only one assertion may be confidently made: at the date of acquisition, where there is no pooling of interests, $A$ must carry its investment account for $B$ Corp. at cost. If there is a pooling, at least four different valuations are defensible: (a) par or stated value of the $A$ shares issued, (b) cost to $A$, i.e., the fair value of these $A$ shares, (c) $A$'s proportionate share of $B$'s contributed capital, or (d) $A$'s proportionate share of $B$'s net assets.

\textsuperscript{134} See Part IIB2, supra.

\textsuperscript{135} See Parts IIB, IIA1, and IIB2(b), supra.

\textsuperscript{136} See Parts IC, IIA2, and IIB2(c), supra.

\textsuperscript{137} See Part IIB1(a), supra.

\textsuperscript{138} See Part IIB1(b), supra.

\textsuperscript{139} See Part IIB1(c), supra.
After acquisition, it may be that if the B shares are marketable, A must use the cost or market method of FAS 12. Otherwise A has the option of recognizing income only from dividends out of post-acquisition earnings, or, as under the equity method, at least where the criteria for that method are met, and perhaps even otherwise.