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Purchase versus pooling in stock-for-stock acquisitions: Why do firms care?☆

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Abstract

We investigate firms' choices between the purchase and pooling methods in stock-for-stock acquisitions. We find that in acquisitions with large step-ups to targets' net assets, CEOs with earnings-based compensation are more likely to choose pooling and avoid the earnings 'penalty' associated with purchases. We find no association between stock-based compensation and the purchase–pooling choice, suggesting that managers are not concerned about implications of large step-ups for firms' equity values. We also find that the likelihood of purchase increases with debt contracting costs, consistent with its favorable balance sheet effects, and with costs of qualifying for pooling, particularly the restriction of share repurchases.

JEL classification: M41; G34

Keywords: Business combinations; Pooling of interests; Executive compensation

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1. Introduction

Accounting for business combinations has long been one of the most controversial financial reporting issues, generating numerous opinions and interpretations by accounting standard setters and capital market regulators. At the center of the controversy is the principle established in 1970 by Accounting Principles Board Opinion (APBO) No. 16 that both the purchase method and the pooling-of-interests method are acceptable in accounting for business combinations. The distinction between purchase and pooling relates mainly to how the difference between the acquisition price and the book value of the acquired firm's net assets (herein referred to as the 'step-up') is accounted for in the consolidated financial statements. Under the pooling method, the step-up is not recognized and the net assets of the acquired company are combined with those of the acquiring company at their book values. Under the purchase method, the acquiring company recognizes the differential by restating all identifiable assets and liabilities of the acquired company to their fair values, and recording the remaining balance as goodwill. The objective of our paper is to investigate the determinants of firms' choice between the purchase and pooling-of-interests methods.

Conventional wisdom holds that managers favor pooling over purchase because it allows them to avoid the additional depreciation and amortization expense arising from the asset write-up under the purchase method.[1] Consistent with this conjecture, evidence from the prior literature reveals an association between the likelihood of pooling and the magnitude of the step-up, suggesting that managers select the accounting method that leads to higher post-merger earnings.[2] However, the extant literature provides little insight into possible economic explanations for managers' preference for pooling. In particular, studies find no support for the perception that share prices are favorably affected by the application of the pooling method, suggesting that investors see through the 'window-dressing' effect of pooling.

Unlike most prior studies on the purchase–pooling choice, we examine non-capital-market explanations for managers' preference for pooling, particularly

[1] The business press provides numerous examples of mergers that were either not completed because pooling could not be secured or would not have completed in the absence of a pooling treatment. For example, the February 1999 issue of CFO Magazine quotes Mark McDade, a partner in the corporate finance group at Price Waterhouse LLP, as saying: 'It's becoming more frequent that combinations are contingent on [applying] pooling. Companies walk away from deals all the time if they can't pool, because of the fear of dilution caused by goodwill'.

[2] The effects of the accounting treatment on the post-merger consolidated income statement can be substantial. For example, the $19 billion Walt Disney-Capital Cities/ABC 1995 merger resulted in a $16 billion asset write-up, adversely affecting Disney's net income by more than $400 million per year.