

THE POOLING OF INTEREST METHOD OF ACCOUNTING- WHAT IS THE PROBLEM?

Dispute over whether or not the pooling of interests method of accounting is theoretically justified is rapidly growing as a result of recent proposals from many accounting bodies throughout the world. This paper examines that the debate and the question as to whether or not the method is appropriate.

Introduction

The pooling of interest method of accounting is rapidly emerging as the accounting debate of the 1990's. Renewed interest in the topic has been generated not only in the United States, but also on the international scene. In October 1998, the Accounting Standards Board of the Canadian Institute of Chartered Accountants (AcSB) issued a press release stating that it was involved in an attempt to harmonize accounting standards for business combinations in North America (Chartered Accountants of Canada, 1999). Then in the fall of 1998, the AcSB, along with other G4+1 members issued a Position Paper that recommended the purchase of accounting for business combinations (Methods of Accounting 1999). (The G4+1 consists of members from Australia, New Zealand, the United Kingdom, Canada and the United States.) On April 21, 1999, The Financial Accounting Standards Board (FASB) in the United States announced a proposal to eliminate the pooling of interest method as a means of accounting for a business combinations (FASB to Eliminate 1999). Springsteel (1997a), credits the renewed interest in the United States to a decision by the Securities Exchange Commission (SEC) concerning First Bank Inc.'s acquisition of First Interstate Bancorp of Los Angeles. This \$10 billion transaction was to be accounted for using the pooling of interest method, however a review by the SEC concluded that the purchase method was appropriate given the circumstances

The purpose of this paper is to examine the current debate surrounding the pooling of interest method. Reactions to the FASB announcement in the U.S. will be examined and an analysis of these responses will be performed. The question to be answered is whether or not pooling of interests accounting is theoretically justified. Canada and the United States have different prerequisites for use of the pooling of interest method. Substantial differences in the incidence of the pooling method of accounting between the two countries has resulted. *Financial Reporting in Canada* reported that only three business combinations out of three hundred sampled, were effected using the pooling of interest method in Canada during the period 1981 to 1990 (Beechy 1994). In the United States in 1998, four of the five largest merger and acquisition deals were accounted for using the pooling of interest method. The mergers were worth \$70 billion (Springsteel, 1999)..

US GAAP vs. Canadian GAAP

Canadian generally accepted accounting principles require four conditions to be met in order for a business combination to be accounted for as a pooling of interest. Firstly, the combination must involve an exchange of shares. Secondly, the voting interests of the parties

after the transaction must be of comparable size. Also, the persons that comprise the talent of the organization, should continue with the merged company. Lastly, there should not be substantial minority interest after the pooling (Beechy, 1994). These rules result in the application of the pooling of interest method in Canada only when an acquirer cannot be identified in the transaction. This will be the case, only in rare cases where the ownership of the combining companies is widely held and where the companies are comparable in size prior to the merger.

The US requires that the SEC approve the application of the pooling of interest method by public companies prior to its use in financial statement preparation (Springsteel 1999). It is actually the SEC that has indirectly created a renewed interest in pooling of interest accounting through demanding greater justification for its use than in previous years (Deger 1998). As stated by Richard Dieter in an article for CPA Journal in 1989, “the pooling method remains one of the few areas of major consequence where the SEC and its accounting staff remain the defacto standard setter.”(1989 2).

Accounting Principles Bulletin (APB) 16 identifies twelve conditions, which must be met in order for a US company to use the pooling method. The three major categories include the attributes of the combining companies, the manner of combining the interests and the absence of planned transactions (Williams 1998). In order to meet the pooling requirements in the US, the companies that are to be combined, must not have been subsidiaries of another company within the two years prior to the transaction date. Common shares only must be issued on the exchange and as a result of the transaction, shareholders of one of the merging companies must receive shares of the other company that is party to the transaction. In order to meet the requirements set out in APB 16, the companies must agree that no transactions are contemplated after the pooling which would indicate that an actual purchase has occurred. This would include transactions that would reacquire or retire shares that had been issued in the pooling (Ibid.). APB 16 also requires that at the time of the transaction, there is no evidence of “expressed intent” to dispose of substantial amounts of assets within two years from the date of the transaction. The only exceptions permitted are the sale of assets to reduce excess capacity or a sale that is in the ordinary course of business of the entity.

In Canada, a comparable voting interest is required in order to account for a combination using the pooling of interest method. There is no such requirement in the US. If, for example, a large company merges with a much smaller company through an exchange of shares, in Canada an acquirer (the larger) company can be identified and therefore, the purchase method would be appropriate for the transaction. In the US however, this same case could be accounted for using the pooling method. While it would appear to be more difficult to meet the twelve requirements of pooling under APB 16 in the US, this is not the case. The widespread use of pooling in the US attests to the fact that it has actually easier for companies to structure their deals to ensure the application of the pooling method. (Springsteel 1999; Gibbins 1995). Sophisticated managers a competitive takeover world, will be cognizant of the financial implications of a transaction before a deal is finalized. Many deals are actually contingent upon the use of the pooling of interest method (Springsteel 1997a).

Financial Statement Impact

The recording of a transaction using the pooling of interest method of accounting is the same in Canada and the US. The merging companies combine their businesses at historic cost. The transaction is recorded in the records of the company as if the companies have always been combined. The current fair market value of identifiable assets, and the value of intangibles such as goodwill, is ignored in the application of the pooling of interest method (Byrd & Chen 1999).

The growth in the incidence of mergers throughout the world, precipitated the review of the pooling of interest by both the G4+1 member organizations and FASB due to increased concern over reported abuses of the standard. (Briloff 1992; Dieter 1989). The inability to

compare two mergers recorded using different accounting methods also became evident. The globalization of business has resulted in a renewed interest in international standards in accounting for business combinations. Pooling of interest accounting is so rare in other countries that it is often perceived that US companies gain a competitive advantage over their competitors when bidding on takeover targets (Springsteel 1999). The International Accounting Standards Committee published a discussion paper in December 1998, inviting comments on the G4+1 paper that recommended the use of the purchase method for all business combinations (IASC Publishes 1999). To date, no official guidance has been given by the IASC concerning the issue.

With two different accounting treatments currently permitted for business combinations in most countries, the difference in the rules with respect to the application of a particular method has produced results that question the ability for comparison of cross-border business combinations. Todd Johnson, senior project manager at FASB stated “what makes financial statements useful is the ability to compare them, but if they account for things differently you can’t compare them that easily” (Deger 1999 2). The difficulty with the ability to compare results that fundamentally arise due to very similar economic events may very well be “intentional absurdity” (Briloff 1992 4).

Investor Sophistication

FASB Chairman Edmund L. Jenkins stated that “The Board decided that it is hard for investors to make sound decisions about combining companies when two different accounting treatments exist for what is essentially the same transaction. We believe that the purchase method of accounting gives investors a better idea of the initial cost of a transaction and the investment’s performance over time than does the pooling of interests method” (FASB To Eliminate 1999 1). Because no recognition is given to the value of goodwill or the increase in the value of other assets on the balance sheet when pooling is applied, no future charges to the income statement result from the transaction. Are investors sophisticated enough to factor into their analysis, premiums paid for companies with large amounts of value inherent in intangible and tangible assets that are not recorded on the consolidated financial statements after the merger?

Rodney Jacobs, CFO of Wells Fargo thinks that “share values in the market are driven by the smart money, and the smart money understands the economics of cash flow” (Springsteel, 1997b 2). While the efficient market hypothesis suggests that the logic expressed by Jacobs is true, many investors require a simple measure of a company’s performance. This measure has traditionally been earnings per share (EPS). EPS is based on net income, which includes the deduction for amortization of any goodwill booked on a business combination. Therefore, the requirement to record goodwill on the balance sheet under the purchase method of accounting, affects EPS which in turn affects investor reaction to market information (Condon 1999). If the pooling method is used, the impact of amortization is avoided, as the value of the intangible asset remains off the balance sheet.

The impact of the purchase method of accounting on EPS, can be demonstrated by examining some significant deals which have occurred in recent years. In 1995, The Walt Disney Company purchased ABC Inc. for \$18.9 billion, which included \$18.3 billion of goodwill (Springsteel 1997b). The net income of Disney is reduced each year as a result of the \$450,000 in amortization associated with the transaction. Disney stated in its annual report that the most meaningful measure for investors was EPS adjusted to remove the amortization of goodwill (Ibid.). The amortization of goodwill resulted in a drop of pro forma EPS from \$2.89 to \$2.33 (19%) which could have been avoided had the pooling of interests method of accounting been used for the transaction (Ibid.).

To assume that the investor can analyze billion dollar deals with limited information, and project the difference due to the use of one particular accounting method over another, is myopic.

The accounting rules are very complicated and to expect an investor to be able to decipher the impact of one method of accounting over another is nonsensical.

Amortization of Goodwill

To a great extent, the difficulty with the acceptance of the purchase method in the US has been a result of the effect of amortization of goodwill and other intangibles recorded on the balance sheet of those companies who use the purchase method of accounting (Wettlaufer 1998). It can even be said that the main problem to be solved relates to the treatment of goodwill. Both American and Canadian accounting bodies have identified the treatment of goodwill as part of the problem. Edmund Jenkins, FASB Chairman stated that “The Board intends to reconsider its prior tentative decisions about goodwill before issuing its proposal on business combination issues” (FASB to Eliminate 1999 1). In Canada, a review by the AcSB of the method for accounting for business combinations is currently ongoing, with an objective to issue an exposure draft simultaneously with the US, harmonizing the method of accounting for business combinations between the two countries (Chartered Accountants of Canada 1999). The final standard is expected to be implemented by the fourth quarter of 2000 (Ibid.). In conjunction with this project, the AcSB issued an Invitation to Comment on the accounting treatment of goodwill and intangibles (Methods of Accounting 1999).

Jack Ciesielski, an outside advisor to the FASB stated that “pooling leaves the surviving management teams less accountable to shareholders for earning a return from the acquired operations, because shareholders never get to see what was paid for which asset, and never see the amortization of those purchased assets over time” (Springsteel 1999 2). The matching principle is paramount to any accounting system. Amortization of amounts expended to acquire an asset is required to ensure that the revenue and expense effects of a given event are recognized in the same accounting period. The cost principle, which underlies the preparation of financial statements, requires that all transactions be recorded at the “historical cost” amount. This has traditionally been the purchase price of the asset. Should intangibles, which are often the most expensive part of a takeover, be recorded on a company’s balance sheet? The amounts spent on goodwill have enduring value to the acquirer, can and have been valued, and should therefore be recognized. Use of the purchase method will result in true economic representation of the enterprise as all assets are recognized. An article in CFO magazine in 1997 stated that Republic Industries Limited, tripled revenues in 1996 by making approximately \$1.6 billion worth of acquisitions, including the purchase of Alamo Rent-A-Car. The company however, recorded less than \$100 million of goodwill because of the application of the pooling of interest method to record the transaction (Springsteel 1997). The time has come to reflect reality on corporate balance sheets.

Shadow Pooling

Merging companies in the US which have large value associated with in-process research and development (R&D), are permitted to write-off the value of the R&D as an expense of the business combination in accordance with APB-16 and FASB Interpretation 4, pars.4 and 5 (Miller 1998). The excess of the purchase price over the fair market value of the net identifiable assets at the date of combination is first allocated to this in process R&D. Any amount remaining is attributed to goodwill. Allocating in-process R&D is referred to as “shadow pooling”. High value in-process research and development written off as part of the cost of the acquisition, results in a reduction in the amount allocated to goodwill. This therefore reduces the amount of amortization to be charged to income annually. EPS statistics suffer less as a result.

A study by Baruch Lev of New York University’s Stern School of Business reported that on average, 72% of the purchase price was written off as the value of in-process R&D in four hundred transactions examined between 1980 and 1996 (Barr 1998). This removed from the

balance sheets, 72% of an amount that would otherwise been identified as goodwill. Lev postulates that this approach has resulted in inflated share values that are sometimes even five times book value (Springsteel 1997b). The subjective determination of the value of R&D is problematic. Shadow pooling in the US has become part of the game that is played to avoid charges to the income statement, which affect EPS and ultimately shareholder decisions.

The US is currently the only country that allows in process research and development to be applied to reduce the value of goodwill. If globalized accounting standards are perceived as the optimum, the issue of in-process R&D and its valuation is an important part of the equation that is required to be resolved. FASB has recommended that in-process research and development be recognized as an asset and amortized over the asset's estimated useful life (Summary of Tentative 1999). The Invitation to Comment issued by the Canadian AcSB concerning goodwill in February 1999, requested comments regarding the issue of in-process R&D. Two options suggested by the AcSB include an immediate deduction for the value of research and development or the capitalization of the amount with subsequent amortization (Methods of Accounting 1999). Again, a harmonized accounting treatment would be optimal.

What Are the Ramifications in the U.S. if Pooling is Eliminated?

Many Wall Street advisors predict a decrease in the number of acquisitions if the pooling of interest method of accounting is abolished. (Deger 1999; ITAA Seeks 1999). A reduction in the purchase price of target companies may also result. Research has indicated that acquirers who use the pooling of interest method have generally paid higher premiums for their targets than buyers who use the purchase method (Deger, 1999).

Some corporate managers in the US, perceive the pooling of interest method of accounting to be a prerequisite to the consummation of a deal. However, academic research has provided evidence that evading the recognition of goodwill through the application of the pooling of interests method has a negative effect on share prices (Springsteel 1997a). While capital market reaction to the FASB proposal is beyond the scope of this paper, research by Michael Davis, associate professor of accounting at Lehigh University, revealed some interesting facts. His research discovered that shares in companies using the purchase method to account for the business combination showed better aggregate performance in the short term (six months) and no difference in the longer term (one to three years) from their pooling counterparts (Ibid.). Davis also detected that pooling of interest acquirers often paid a premium- up to 200 percent higher for their acquisitions, than those who accounted for their acquisition by the purchase method (Ibid.). If the research by Davis is accurate, the elimination of the pooling method in the US may slow merger activity but in all likelihood will not eliminate it. There should also be no change in share values.

What Is The Heart Of The Issue?

Fundamentally, accounting information should be useful in a number of ways. Information presented in financial statements should be relevant to the decisions being made by the users. The principle of relevancy with respect to information provided through accounting for business combinations is worthy of examination. Many critics of conventional accounting believe that some accounting principles which have been standardized, actually distort reality (Condon 1999). The pooling of interests method may in fact be considered in this category as it ignores the actual cost of the acquisition by failing to recognize goodwill.

In order for financial statements to objectively depict an enterprise's financial position at a particular point in time, the information should be representationally faithful (Gibbins 1998). This requires that the information presented should "tell the entire story", without being influenced by the interests of any party involved, who might want things different. The objectives

of financial reporting cannot be met when accounting principles ignore the value of goodwill and other intangibles paid for in a business combination. The objective of financial reporting is to provide information about the entity's economic resources, obligations and equity/net assets, changes in these amounts and the economic performance of an entity (Canadian Institute 1000.15 1999). Should pooling of interest accounting be allowed? Does the failure to recognize goodwill actually distort the value of the assets recorded or the measurement of financial performance? Is the real story told when amounts are "buried" because of an accounting principle which allows a company to ignore the value of goodwill? Does excluding goodwill reduce the reliability of financial information?

Some argue that goodwill is not an asset as it is not a useful balance sheet account when assessing the capital strength of a company (Wettlaufer 1998). This opinion has actually been codified in the UK where Financial Reporting Standard (FRS) 10, states that "goodwill arising on an acquisition is neither an asset like other assets nor an immediate loss in value" (FRS 10 1998). However, the standard requires purchased goodwill to be capitalized and to be amortized systematically over a period not to exceed twenty years. The rationale used is worthy of review. The UK has not viewed goodwill itself as an asset, but instead considers it to be part of a larger asset- the investment in a particular company (Ibid.). It is clear, that an investment in another company is an asset that is to be recognized in the financial statements. Goodwill is intrinsically part of the value of this purchased asset. To record purchases using the pooling of interest method, fails to give recognition to part of the actual cost of the investment. This, in turn, essentially relieves the pressure on management to be accountable for their decision to make the acquisition in the first place.

Goodwill arises due to the excess of the purchase price paid for an investment over the fair market value of the net identifiable assets acquired. In theory however, goodwill represents an intrinsic value that has evolved due to good management, name identification, customer loyalty etc. If a purchase price is negotiated between an arms length buyer and seller in an unrestricted market place, it is something that is "real". Some proponents of the pooling of interests method state that goodwill is too difficult to value and therefore should not be recognized (Condon, 1998). Accounting standards all over the world require the recognition of some estimated amounts in the financial statements. Goodwill is an asset that can be valued – perhaps more easily than some assets that recorded in accordance with GAAP. Although goodwill is not an asset that can be seen, it can and is valued as part of a negotiation process. Valuation and measurement therefore, should not be a concern.

Is Change Necessary?

As stated earlier in this paper, many analysts and corporate managers in the US do not wish to see any change in the rules with respect to accounting for business combinations. They feel that most investors understand the impact of amortization of goodwill, and are sophisticated enough to be able to factor this into their analysis. Gabrielle Napolitano, a Goldman Sachs vice-president and chair for the financial accounting policy committee at the Association for Investment Management and Research, supports the pooling method. She states " the disclosures are complete at this point. Analysts focus on EBITDA (meaning earnings before income taxes, depreciation and amortization). Those numbers are comparable in pooling and we're happy to have FASB stay the course" (FASB Told 1998).

Not all agree with the opinion of Ms. Napolitano. In a letter written by the Financial Policy Committee of the Association for Investment Management and Research to FASB, Peter Knutson, Chair stated that " in the case of business combinations, financial reports have been distorted by the use of the pooling of interests accounting method in which fair values are not recognized even when they are validated by an exchange. Therefore we recommend the Board focus its attention on proposing a standard that provides one method of accounting for business

combinations, a method based on recording the fair values of identifiable assets and liabilities acquired in a transaction” (Issues Associated 1997 3).

Standard setting in the US has been dictated from the corporate boardroom in general and the Securities Exchange Commission in particular. The time has come to ensure that all standard setters are independent bodies who make decisions without influence from self-interest groups. Accounting standard setters must uphold the standards that have been entrenched in the generally accepted accounting principles that they have developed. Inconsistency among the application of these principles must also be abolished. Ensuring the integrity of financial information is key.

The Future

There is no doubt that the FASB recommendation to eliminate pooling of interests by the year 2000 will be an interesting struggle. Already, industries in the US are implementing letter writing campaigns to express their outrage at FASB’s recommendation. The Information Technology Association of America (ITTA) which has 11,000 members in the United States is vehemently opposed to the proposal. In a press release Harriss Miller stated that “...eliminating the pooling of interests method could slow the pace of M&A (mergers and acquisitions) transactions, hamper growth of the IT industry, and reduce the number of high-paying, skilled jobs the IT industry creates” (ITTA Seeks 1999 1). It is absolutely remarkable, how a change in the accounting for a transaction can yield such dire predictions. The substance and the reality of the transaction are not dependent upon the accounting method chosen! In the three-year period ending December 31, 1998, there were 210 business combinations completed in the IT industry with price tags greater than \$100 million. The total value of these 210 transactions was a staggering \$163 billion. The amount accounted for through the use of the pooling of interests method was \$108 billion (Ibid.). Opposition from this group is anticipated to be quite strong.

The National Venture Capital Association has also embarked on a mammoth letter writing campaign to FASB in support of maintaining the pooling of interest method of accounting. In a letter to their members dated January 25, 1999, members were encouraged to discuss certain “realities”. The NVCA credits the application of the pooling of interest method with actually supporting the growth of some of their companies (Pooling Under 1999). The letter states in part that “the view that the U.S. needs to harmonize its accounting rules with the rest of the world is out of step with reality. The fact is the U.S. is the leader in establishing the most thorough and complete accounting standards. The rest of the world should follow the U.S., not the other way around” (Ibid. 1).

The attitude of the NVCA, especially concerning its belief that all other countries should follow the U.S., is troublesome. International accounting standards are those that are ratified by all countries involved. To expect other countries to “do as they say” is absurd. The job of FASB in this particular issue is not an easy one. Some opponents of FASB are already warning that they will seek congressional intervention as they did in the case of accounting for stock options and derivatives, should pooling be abolished (Springsteel 1999). It is clear that corporations and self-interest groups in the United States perceive their role as an active one in the standard setting process. To anticipate congressional intervention, seriously undermines the private standard setting process, which is the cornerstone of the financial reporting process in most countries.

Canada also has to ensure the maintenance of the high standards that have been evolved over the years. In recent months, one large merger in Canada was announced that is to be accounted for as a pooling of interest. On March 22, 1999, Bruncor Inc., Island Telecom Inc., Maritime Telegraph and Telephone and NewTel Enterprises Limited, owners of major IT and provincial telecommunications companies in Atlantic Canada, announced a merger (Atlantic Merger 1999). The merger created a \$3 billion dollar company that is now the third largest Canadian owned telecommunications company and one of the largest mobile satellite services companies in North America (Ibid.). The pooling of interest method is to be applied to the

transaction, which involved a share for share exchange of all shareholders. Given the rarity of the pooling method in Canada, it was interesting to see such a large merger being accounted for using pooling of interest accounting.

Implications For Future Research

Further research will be needed before the debate over the issue of pooling of interest method is finalized. If possible, empirical research needs to be undertaken to determine whether or not there is any relationship between amortization expenses and stock performance. This will enable a decision to be made as to whether or not the amortization of goodwill impacts investor's decision making-processes.

Given the earlier intervention by corporations, self-interest groups and even Congress in standard setting in the US, research is needed to determine the degree of influence exhibited by these stakeholders. US. Standard setting should not be subject to intervention by self interest groups or government. To expect anything less, is to undermine the entire standard setting process in particular and the accounting profession in general.

If the pooling of interest method is to be abolished, research needs to be conducted to determine how to deal with situations where an acquirer cannot be identified. If an acquirer cannot be identified, how does the accountant determine which company's balance sheet is to be re-valued? Research is required to determine the appropriate way in which to deal with this dilemma. If the purchase method is the only method to be sanctioned, guidelines are necessary to assist accountants in identifying an acquirer in those rare circumstances where it is not evident.

Given the globalization of the marketplace and the removal of barriers due to the advancement of technology, mergers of companies all over the world is now a reality. To ensure comparability, one standard of accounting for business combinations is needed. The International Accounting Standards Committee also needs to attempt to reach an agreement on one standard for all. Globalization of accounting standards under the IASC may be optimistic as it is quite a challenge to expect over 120 accounting bodies in 90 different countries to reach a consensus (Gibbins 1998). However, the G4+1 countries have evolved as a standard setting body as recently evidenced through its first standard on the elimination of the pooling method (Adopting Global 1999). It would appear to be easier to reach a consensus on standard setting in this forum than in the IASC.

Change is on the tide and only time will tell how it will turn. Einstein once said that "the secret of creativity is knowing how to hide your sources" (Drip Portfolio 1999 1). If this is true, accountants have become artists of disguise in hiding significant amounts of value from corporate balance sheets. The time has come to eliminate pooling of interest accounting and return to what accountants do best- providing information that useful, reliable, relevant and verifiable.

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