Pooling-of-Interests Method

When one firm acquires all, or substantially all, of another firm, there are two ways that firm can account for that acquisition: the purchase method or the pooling-of-interest method.

Under the purchase method, the firm records the acquisition at the amount of cash or market value of property given in exchange for the purchase. The purchase method is the simpler of the two methods, and it is consistent with the way the firm usually accounts for other transactions (at cost).

Under the pooling-of-interest method, the firm simply adds the book value of the assets and liabilities of the two firms together. The final consolidated financial statements of the two firms do not represent the market value of the firm and they do not reflect what the first firm paid for the second firm.

Under the pooling-of-interest method, assets and equities are usually less than under the purchase method. And because depreciation expense will be less, profits (and ratios like ROE and ROA) will be higher over time than under the purchase method.

Pooling-of-interest method, in a sense, views the two companies as merging into one. It does not view the transaction as one buying out the other.

Whether a firm uses the purchase method or the pooling-of-interests method is determined by GAAP. However, critics of the pooling-of-interest method contend that it allows acquiring firms to report artificially high profits and to manipulate those profits. Proponents contend that the combined firm has no more opportunity to mislead than did the original company, and the pooling-of-interest method is consistent with the historical cost basis of accounting.