Exhibit No.:
Issue: Purchase Accounting & Deferred Taxes
Witness: Robert C. Kehm
Sponsoring Party: UtiliCorp United Inc.
Case No.: EM-2000-292
Date Prepared: June 26, 2000

MISSOURI PUBLIC SERVICE COMMISSION
Case No. EM-2000-292

Surrebuttal Testimony

of

Robert C. Kehm

Jefferson City, Missouri

Exhibit No. 26
Date 7-14-00 Case No. EM-2000-292
Reporter DURREN

SURREBUTTAL TESTIMONY
ROBERT C. KEHM

UTILICORP UNITED INC.
CASE NO. EM-2000-292

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF ROBERT C. KEHM
ON BEHALF OF UTILICORP UNITED INC.
CASE NO. EM-2000-292

Q. What is your name?

A. Robert C. Kehm

Q What is your business address?

A. My business address is 2301 McGee Street, Suite 400 Kansas City, Missouri 64108.

Q. What is your present occupation and work experience?

A. I am a Certified Public Accountant and a partner with Arthur Andersen LLP ("Arthur Andersen"). I joined Arthur Andersen in December 1972. I became a partner in 1984. I have served a number of investor-owned utilities, including UtiliCorp United Inc. ("UtiliCorp") and St. Joseph Light & Power Company ("SJLP"). I am a member of the American Institute of Certified Public Accountants and the state CPA societies of Missouri, Kansas, and Nebraska. I am licensed to practice in the states of Missouri, Kansas, Nebraska, Minnesota, and North Dakota.

Q. What is your educational background?

A. I graduated from the University of Nebraska – Lincoln with an undergraduate degree in business and a Masters degree in accounting.

Q. Do you have experience with mergers and acquisitions?

A. Yes, I have worked on numerous mergers and acquisitions, including several for UtiliCorp. This work has included, among other matters, due diligence assignments,

transaction structuring and determination of the appropriate accounting treatment for business combinations.

Q. Are you familiar with the proposed UtiliCorp acquisition of SJLP?

A. Yes, I am familiar with the transaction. I previously served as the audit engagement partner for UtiliCorp and SJLP when the acquisition was announced. Currently I serve as the audit engagement partner for SJLP.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my testimony is to address certain accounting matters raised by Mr. Charles R. Hyneman for the Missouri Public Service Commission Staff ("Staff") in his rebuttal testimony, with a specific focus on the question of "pooling" versus "purchase" as it relates to the acquisition adjustment issue.

ECONOMICS OF BUSINESS COMBINATION ACCOUNTING

Q. What methods can be used by a company to account for a business combination?

A. Accounting Principles Board Opinion No. 16 (APB 16), entitled *Business Combinations* provides two methods to account for a business combination. These are the purchase method and the pooling-of-interests ("pooling") method.

Q. Please explain the primary differences between the two methods.

A. The pooling method is intended to present as a single interest two or more common stockholder interests that were previously independent. A pooling is a stock-for-stock transaction, meaning the acquiror must use its stock to acquire the stock of the acquiree. The combined entity values the assets and liabilities of the combining enterprises at historical cost. Goodwill is not recorded as an asset in business combinations accounted

for using this method. In order to apply the pooling method, a business combination must meet a very specific and restrictive set of criteria. Business combinations that do not meet all of the pooling criteria are required to use the purchase method.

In the purchase method, the acquiror can use cash or stock to effect the combination. The assets acquired and liabilities assumed of the acquiree company are recorded at their fair values, rather than historical cost. Goodwill is recorded for the difference between the consideration paid and the fair value ascribed to the assets and liabilities. Similar to a pooling, a purchase can be a stock-for-stock transaction.

Q. How does a purchase transaction differ economically from a pooling transaction?

A. Assuming all things are equal, with the exception of not meeting all the pooling criteria, a purchase transaction will have the exact same economics as a pooling transaction. In other words, it will not differ economically.

Q. What do you mean by the "same economics?"

A. The economics of a business combination equal the amount a willing buyer is willing to pay a willing seller for its business. If this amount is in excess of the fair value of the net assets of the business, goodwill is created. This is true in all acquisitions, whether accounted for as a purchase or pooling. The fact that purchase accounting gives financial statement recognition to the goodwill does not impact the economics of the transaction. Similarly, the fact that pooling does not recognize goodwill does not change the economics of the transaction.

Q. Can you illustrate this point?

A. Yes. To illustrate this point, I refer to the proposed acquisition of SJLP as follows:

	December 31, 1999 (Amounts in thousands, except per share amounts)	
	Pooling	Purchase
Consideration per share of SJLP	$ 23.00	$ 23.00
Shares of SJLP outstanding	8,268	8,268
Total consideration	$190,164	$190,164
Less: Estimated fair value of SJLP (1)	96,188	96,188
Estimated goodwill acquired	$ 93,976	$ 93,976

(1) Assumes the net book value and fair market value of SJLP's net assets are the same.

The above example demonstrates the following:

1. The economics of the transaction are the same: UtiliCorp is paying the same for SJLP, whether or not it is accounted for as a pooling or a purchase.
2. Goodwill is created in both a pooling and a purchase. However, if pooling is used, the goodwill is ignored in the future financial statements of UtiliCorp. This creates an optical illusion. Pooling appears to be a less expensive transaction – no goodwill is shown in the financial statements. However, as the example indicates, that is not the case. The pooling method created the same amount of goodwill as the purchase method.

Q. On page 10, lines 3-7 of Mr. Hyneman's rebuttal testimony, he concludes that the pooling-of-interests method is the preferable method of accounting for a business combination. How do you respond?

A. I do not agree.

Q. Why not?

A. I do not know what criteria Mr. Hyneman is using to conclude that pooling is "preferable." There is considerable discussion regarding whether or not pooling is even appropriate, let alone preferable. This debate is a continuation of arguments raised in

1970 when APB 16 was issued. In issuing APB 16, the Accounting Principles Board did not conclude that pooling was "preferable". In fact, that document outlined the defects of pooling. The most serious defect identified was that the pooling method did not recognize the economic substance of the transaction. It also ignores the current market value of the assets underlying the transaction.

The APB also identified the fact that the pooling method was restrictive – it limited actions companies could take for the betterment of the businesses prior to or after the transaction. In the current era of change, I do not believe any accounting method which restricts a company's current and future flexibility to make business decisions could be deemed to be "preferable".

Q. How does pooling restrict a company's flexibility?

A. The pooling criteria limit the actions a company can take for a period of two years before and after the transaction. I will address this in more detail later in my testimony.

Q. Are the reported results of operations different if the transaction is a pooling compared to a purchase transaction?

A. Yes. Pooling produces a more favorable book accounting answer than does a purchase because it ignores the increased depreciation caused by reporting assets at their higher fair value and the amortization of goodwill. Goodwill is the amount a company is willing to pay to acquire another company over the fair value of its assets and liabilities. In a purchase transaction, goodwill is recorded and amortized over a future period. In a pooling transaction, goodwill is not recorded.

Conventional wisdom has held that the equity market for companies whose mergers were accounted for as poolings was stronger than for those who used the purchase method. A more significant analysis may conclude otherwise. For example, Mr. Hyneman references an article "Say Goodbye to Pooling", *CFO Magazine*, February, 1997 in his testimony on page 13, line 12 to support the prefer ability of pooling. This same article states the following:

> According to a growing body of academic research, however, avoiding goodwill through poolings actually has no positive effect on share prices. In fact, in some cases, the opposite is true. A recent paper by Michael Davis, associate professor of accounting at Lehigh University, for example, points out that the stocks of companies that use purchase accounting show better aggregate performance in the short term (six months) and no difference in the longer term (one to three years) than companies that have combined through the pooling method. In addition, the study, which was published in the *Journal of Applied Corporate Finance,* showed that poolers frequently bend over backwards, often incurring extra costs, to meet the 12 pooling conditions. *Even worse, poolers as a group pay much larger premiums over current market valuations--in one study by Davis, up to 200 percent higher-- than do purchase-method buyers, as the lack of goodwill amortization and the rising value of their stock allows them to pay more for the marginally better reported earnings per share. (emphasis added)*

COULD UTILICORP HAVE USED POOLING?

Q. What types of assistance has Arthur Andersen provided to UtiliCorp related to this transaction?

A. I and others in my firm have had discussions with UtiliCorp personnel concerning the structure of this transaction.

Q. Has Arthur Andersen provided any written advice to UtiliCorp specifically as it relates to pooling criteria?

A. No. UtiliCorp did not request and we did not provide any written advice regarding the application of the pooling criteria to this transaction. We did, however, review and

provide comments on a document prepared by Mr. Streek and shown on Schedule DJS-2 to his direct testimony.

Q. Is it unusual for a client to not request a formal pooling study when a pooling is initially contemplated?

A. No, it is not unusual at all. Given the complexities of the pooling rules, it is time consuming and expensive for a company to have a study performed. When a company determines it is unlikely that one of the criteria will not be met, it is not necessarily prudent to expend additional resources and time to evaluate all the criteria, since failure to meet any of the criteria will preclude pooling.

Q. Are you familiar with the criteria required to be met in order to apply the pooling method to a business combination?

A. Yes. I have been involved in numerous proposed transactions for a variety of companies that intended to apply the pooling method. I am also familiar with the process of pre-clearing pooling issues with the SEC. I have had the opportunity to pre-clear issues with them and in some instances, our clients were successful with their arguments.

Q. Could you please provide some background regarding the complexities of the pooling method?

A. In 1970, the Accounting Principles Board issued *APB 16: Business Combinations.* This accounting standard provided two acceptable methods for accounting for a business combination. In general, the pooling method was designed to address the unique "merger of equals" business combination, in which theoretically the companies acquire each other. If the transaction met an extensive set of criteria, they could apply the pooling method.

If these criteria were not met, a company would need to apply the purchase method. The acceptance of two methods of accounting for business combinations was a compromise solution. Both methods had their proponents and detractors. The APB goes so far as to identify the "defects" of each method.

Q. You stated that pooling requires a company to meet an extensive set of criteria. How many general criteria are there?

A. There are twelve general criteria as defined in APB No. 16, paragraphs 46-48. The twelve general criteria address three broad principles. First of all, the combining companies must be independent prior to the transaction. Secondly, a pooling must be a stock-for-stock transaction. Lastly, there must be an absence of future planned transactions that would alter the character of the combining businesses. APB 16 was a compromise of differing views, and, as a result, some of the requirements are arbitrary. Consequently, the rules have a great deal of room for interpretation that has subsequently developed through practice.

Q. Does the Securities and Exchange Commission ("SEC") have a role in regards to these pooling criteria?

A. Yes. The SEC has taken upon itself the responsibility of developing interpretations to these rules. SEC opinions regarding pooling matters tend to govern the application of pooling rules to mergers of SEC registrants. In recent years, the SEC has continued to narrow its interpretations of the pooling rules. This has resulted in a complex set of SEC interpretations serving as the authoritative basis for multi-billion dollar transactions.

These narrow interpretations have made the ability to pool much more difficult and constraining.

I believe the current SEC view on poolings is that every merger is a purchase unless proven otherwise. Therefore, companies expecting to complete a pooling can expect conclusions for all the criteria to be subject to significant challenge. Failure to apply the pooling rules based on the SEC's interpretation could result in financial hardship if the SEC ultimately rejects a company's proposed pooling and forces a subsequent restatement.

Q. In order to qualify for pooling, how many of the criteria must be met?

A. All of the criteria must be met in order to apply the pooling method.

Q. Do some of these criteria restrict the flexibility of a company?

A. Many of the criteria are restrictive. As a general rule, a company that wishes to pool must refrain from certain actions that may result in an alteration of equity or a disposition of assets for a period of two years before initiation until two years after the consummation of a pooling transaction. In essence, a company is handcuffed during this time period. In the current business environment, this four-year period is a significant amount of time. During this period, it is not unreasonable to conclude that a company may be restricted from taking actions to improve the financial health of the organization in order to preserve a pooling transaction and avoid the financial hardship of restating previously issued financial statements.

Q. Did UtiliCorp take any action that precluded it from using the pooling-of-interests method of accounting?

A. Yes. As Mr. Streek reported in his direct testimony (page 3 lines 21-22), UtiliCorp issued stock options to employees in November, 1998. This represented an "alteration of equity" under APB 16, paragraph 47, which is prohibited. Paragraph 47c states:

> None of the combining enterprises changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated; changes in contemplation of effecting the combination may include distributions to stockholders and additional issuances, exchanges, and retirements of securities.

Q. In regards to paragraph 47c above, what does "in contemplation" mean?

A. In the literal sense, "in contemplation" would indicate a lack of independence between two or more events. One action is made with the intent of impacting another. In apb 16, "in contemplation" suggests that a company might act to improve its position or the relative position of its owners. This would be contrary to pooling because the concept of pooling is the combining of economic interests as though the two companies had always been together.

Q. Has the sec indicated its position regarding "in contemplation"?

A. Yes. Subjective concepts, such as "in contemplation of", naturally generate differences in practice. The SEC appears to be attempting to maximize uniformity in the application of the pooling rules. The SEC has indicated it spends a significant amount of time addressing this issue as it relates to the alteration of equity interests. Given the subjective nature of "in contemplation," the SEC relies extensively on the timing of an event characterized as an alteration in equity interests. As a general rule, anything falling within two years of the transaction is presumed to be "in contemplation" of the

transaction. It is increasingly difficult to disprove this presumption the closer the event occurs to the actual transaction.

Q. What is your understanding of the sec staff's views regarding the impact of "in contemplation" specifically as it relates to the alteration of equity interests?

A. It is my understanding that the SEC staff takes the position that any change in equity interests that occurs within two years of initiation of a business combination is presumed to have been made in contemplation of the combination. In other words, any action which would result in an alteration of equity in contemplation of the combination would preclude pooling.

Q. Has Arthur Andersen published an interpretation of this?

A. Yes. Arthur Andersen has issued a publication which presents an interpretation of this concept. These interpretations are intended to present our understanding of current practice. Interpretation 47c-18 of *Accounting for Business Combinations, ninth edition* addresses the issuance of options, the key considerations of which are summarized as follows:

1. Awards or grants made within two years are presumed to be in contemplation of a combination.
2. The presumption (in contemplation of the combination) may be overcome if awards or grants are made under pre-existing plans, and are granted under normal terms of the plan and in normal amounts. In assessing this, the SEC staff considers this historical pattern of awards under the plan.
3. In some situations, factual evidence may support a contention that an issuance was not in contemplation. Such factual evidence must be clear; the closer the issuance to the initiation of the combination, the more difficult for any factual evidence to be persuasive.

4. Once an issuance is determined to be in contemplation, the change can only be "cured" by rescinding the options so long as no option holder has exercised any of the options issued.

Q. Could the UtiliCorp stock option award be presumed to be in contemplation of the acquisition?

A. Yes. UtiliCorp issued a stock option award under its 1991 Employee Stock Option Plan in November of 1998. During the week of November 9, 1998, SJLP representatives contacted UtiliCorp. By the end of November, UtiliCorp had expressed its intent to make a bid for SJLP. This is an extremely tight timeline between the award issuance and the initiation of discussions with SJLP. Clearly, a presumption exists that this award was in contemplation of the combination. UtiliCorp would bear a heavy burden in proving otherwise.

Q. Are you aware of any other factual information, other than the timeline included in the joint proxy statement/prospectus dated May 6, 1999 and the information supporting Mr. Hyneman's timeline on page 25 of his testimony, that could clearly demonstrate that the stock options were not issued in contemplation of the acquisition?

A. I am not aware of any other substantive, factual information which could clearly refute the "in contemplation" presumption.

Q. You stated above the presumption (in contemplation of the combination) may be overcome if awards or grants are made under pre-existing plans, and are granted under normal terms of the plan and in normal amounts. Could you please explain what this means?

A. The SEC staff has developed a model for determining whether an award can be considered "normal". In assessing the "normality" of a stock option award, the SEC staff looks to the historical pattern of awards. This includes the following:

1. Who is receiving the awards.
2. What are the sizes of the awards by employee levels within a company.
3. Timing of awards.
4. Terms of the awards, including exercise price, vesting and exercise period.

Q. Did UtiliCorp conclude that the award was normal?

A. No, it did not.

Q. Do you concur with UtiliCorp's opinion?

A. Yes, I believe it would be very difficult to prove that the 1998 option award would meet the definition of "normal". Mr. Hyneman's own testimony suggests that the award was not "normal" when he states on page 27, line 25 through page 28, line 4:

> . . . it would be reasonable for the SEC to take into consideration that, unlike most companies' stock option plans, UtiliCorp's Employee Stock Plan is unusual and options under this plan are not intended to be issued on a regular basis . . . irregular issuances of stock options should be considered normal because this conforms to the plan's intent and the plan's history.

I believe the SEC staff would have agreed with Mr. Hyneman: The award was unusual (only one award in previous 6 years) and the issuances were irregular (no systematic pattern for granting the award). Accordingly, the SEC staff would have rejected the notion that the plan was "normal".

Q. You have stated that 1.) A presumption exists that the award was in contemplation of the acquisition, 2.) The presumption cannot be overcome because of the proximity of the

option award date to the acquisition agreement, and 3.) It is your belief that the SEC would not consider the option awarded in November, 1998 to be normal. Can this problem be "cured"?

A. Technically, it can be cured. UtiliCorp could have rescinded the options. However, from a practical business standpoint it is not curable as UtiliCorp stated in response to Staff Data Request No. 167:

> The only cure would have been rescinding or canceling the options. The Company did not feel this would have been in the best interest of employee morale and there were still uncertainties with regard to the eventual consummation of the transaction.

Q. What would the impact of the share rescission have been to the employees?

A. If the option award had been rescinded, the employees would have forfeited the rights to 1,278,713 options. While they vest in one year, they do not expire until 10 years following issuance. To an employee, these options have unknown future potential value. UtiliCorp would have been precluded from issuing or promising (written or unwritten) any additional compensation to the employees in exchange for the rescission.

Q. On pages 28 and 29 of Mr. Hyneman's testimony, he suggests that the reason UtiliCorp may not be pursuing pooling more aggressively is its intent to sell the generation assets of SJLP at some point in the future. Could this preclude pooling?

A. Yes, selling assets can preclude pooling. However, the relative size of SJLP to UtiliCorp, makes it unlikely that a disposition of certain assets would preclude pooling. The significance of a disposal is generally evaluated in terms of the assets, revenues, and earnings. Significance is also evaluated in terms of the gain or loss on the disposition. The disposition of SJLP generating assets would not be considered significant and would

not preclude pooling unless the gain or loss on the sale exceeded 10% of UtiliCorp's earnings.

Q. On page 23, lines 25-27, Mr. Hyneman states that "UtiliCorp should have vigorously presented its case to the SEC that the November 1998 stock option issuance was not done "in contemplation" of the merger." Could UtiliCorp have taken this issue to the sec for pre-clearance?

A. Yes, they could have taken this issue to the SEC for pre-clearance.

Q. What would have been the likely outcome of that effort?

A. In my opinion it is unlikely that the outcome would have been successful. Based on my experience and the recent actions of the SEC, the presumption of "in contemplation" caused by actions taken by a company in the six months prior to the announcement of a merger are extremely difficult to overcome. UtiliCorp would not likely have been successful.

Given the circumstances, I believe UtiliCorp acted in a prudent manner in addressing this pooling concern by acknowledging the inability to use the pooling method early, rather than dedicate additional resources to address all the pooling criteria, identify all the potential issues requiring SEC clearance, and present its case to the SEC. This process have been expensive, time-consuming, and most likely not successful.

INCOME TAXES

Q. As currently structured, the merger of UtiliCorp and SJLP is a tax-free merger under IRC Section 368(a)(1)(a). On page 69 and 70 of Mr. Hyneman's testimony, he asserts that if

the merger is determined to be taxable the deferred taxes of SJLP may be lost. Is this true?

A. No. UtiliCorp is acquiring the stock of SJLP. This includes all the deferred tax assets and liabilities of SJLP. The ultimate determination of the transaction as being taxable or non-taxable will not impact the fact that the deferred tax assets and liabilities of SJLP were acquired by UtiliCorp and will survive the transaction.

Q. Does this conclude your surrebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company for Authority to Merge St. Joseph Light & Power Company with and into UtiliCorp United Inc., and, in Connection Therewith, Certain Other Related Transactions.	)))))))	Case No. EM-2000-292

County of Jackson)
)
State of Missouri)

AFFIDAVIT OF ROBERT C. KEHM

Robert C. Kehm, **being first duly sworn,** deposes and says that he is the witness who sponsors the accompanying testimony entitled surrebuttal testimony; that said testimony was prepared by him and or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

Robert C. Kehm

Robert C. Kehm

Subscribed and sworn to before me this 16th day of June, 2000.

M. Claire Fitzsimmons

Notary Public

M. CLAIRE FITZSIMMONS
Notary Public - Notary Seal
State of Missouri
Jackson County
My Commission Expires Apr 12, 2004