Chapter 3

Accounting for M&As

I. Historical Background
   A. M&As require accounting knowledge in order to understand what is behind the numbers
   B. The Financial Accounting Standards Board (FASB) made a controversial decision to eliminate the pooling-of-interests accounting method in January 2001
   C. In August 1970 Accounting Principles Board (APB) issued
      1. Opinion 16 dealing with accounting guidelines for corporate mergers
         a. Pooling retained original “historical cost” basis of assets and liabilities; earnings combined for reporting periods
         b. Purchase required determination of a new “historical cost”; earnings only reported from acquisition date forward
      2. Opinion 17 dealing with goodwill arising from mergers
      3. Some of these rules still prevail but pooling-of-interests was eliminated
   D. Prior to FASB decision to eliminate pooling, there was much criticism
      1. Merrill Lynch predicted a decline in consolidation and the economy
      2. Dennis Powell of Cisco predicted a decline in innovative technology
      3. Lehman Brothers managing director: “Managements care about this issue intensely. They’ll try to avoid goodwill at all cost.”

II. Pooling of Interests Accounting
   A. The logic of the accounting regulations was that acquiring firm and target firm be approximately the same size — the combined firm would reflect a continuity of the influence of both companies
   B. Twelve tests were needed to qualify combination as merger among equals and pooling of interests method to be employed
      1. If all 12 tests were met, combination should (in theory) be a merger between firms of comparable size
      2. Two of the rules relate to stock repurchase; could make the deal indirectly like a purchase transaction
      3. In practice, comparable size was not a compelling requirement
   C. Defects in pooling
      1. Pooling was used by firms to buy assets with low historical values; the assets could be immediately sold and recorded as a gain to increase income
      2. The SEC often made rulings on combining firms’ share repurchase activities
         a. First Bank dropped merger with First Interstate when SEC ruled share repurchase program would have to be suspended for two years
         b. Chrysler (28 million shares) and Waste Management (20 million) were forced to sell shares to offset prior share repurchases in order to qualify for pooling

III. FASB Elimination of Pooling
   A. FASB argued that virtually all combinations were acquisitions, and all combinations should be recorded in the same way
   B. Reasons given by FASB to eliminate pooling (Financial Accounting Series, No. 200-B, 8/31/99)

1. Economically similar transactions should not have substantially different accounting methods
2. Pooling method provides less information to investors
3. Pooling method ignores the values exchanged in a business combination
4. Under pooling method, financial statements do not provide information on how much was invested in the transaction or information to track subsequent performance of the investment
5. Difficult for investors to compare companies when they used different methods to account for business combinations
6. Pooling method artificially boosts earnings although cash flows are the same
7. Business combinations should be recorded based on the value that is given up in exchange

IV. Purchase Accounting
   A. Purchase accounting basics
      1. One company identified as the buyer and records acquisition at price paid
      2. All identifiable assets acquired and liabilities assumed should be assigned a portion of the cost of the acquired company, equal to their fair market value
      3. Excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill
      4. If transaction is taxable, new stepped-up basis is depreciable for tax accounting
   B. Purchase accounting adjustment entries (AOL Time Warner example)
      1.

Debit ($ billion)	
TWX shareholders' book equity	$10.0
Other miscellaneous adjustments, net	(30.9)
Goodwill and other intangibles	174.0
Total pro forma debit adjustments	153.1

Credit ($ billion)	
AOL common stock at par issued to pay for TWX	$0.1
Addition to AOL paid in capital	153.0
Total pro forma credit adjustments	$153.1

      2. AOL gave 1.5 shares (valued at $72.88) times TWX 1.4 billion shares outstanding gives purchase price of $153.1 to be allocated
      3. Due to large increase in goodwill account, percentage of tangible assets dropped from 51.2% (TWX) to 15.3% (combined firm)
      4. Large equity increase (from credit to paid in capital) results in lower book leverage
   C. Amortization and impairment rules
      1. Opinion 17 (from 1970) specified that goodwill and intangible assets had finite lives, so would be amortized over no longer than 40 years
      2. Revised under Statement No. 142
         a. Goodwill and some intangibles may have indefinite lives – do not require amortization
         b. Useful life should reflect period of time asset will contribute to cash flows
         c. Replaced amortization with impairment tests
            (1) Annual tests of market value of intangible assets (including goodwill) with indefinite lives

(2) Impairment write-off results when book value exceeds market value
(3) Impairment rules are equivalent to standard valuation methods – comparable transaction and DCF methodologies

3. AOL Time Warner impairment (12/31/01-12/31/02)
   a. Intangible assets subject to amortization decreased from $7.3 to $7.1 billion
   b. Intangible assets (not including goodwill) not subject to amortization decreased from $37.7 to 37.1 billion
   c. Goodwill decreased from $127.4 to $37.0 billion – large impairment resulting from loss of market value of stock acquired in the merger

V. Empirical studies
   A. Acquiring firms prefer pooling method to avoid negative impact of goodwill amortization on reported earnings per share
   B. Stock prices of acquiring firms are not penalized when purchase method accounting is used. Stock price reactions are more positive for purchase accounting firms, but generally not statistically significant
   C. Some commentators believe that acquirers are willing to pay more to gain pooling-of-interests accounting
      1. AT&T may have paid as much as $500 million more to acquire NCR under pooling rules
      2. Lys and Vincent found other indirect costs to AT&T
         a. Forced to arrange discounted sale of NCR stock
         b. AT&T was willing to pay a higher premium
         c. AT&T managers believed investors based the value on EPS
   D. No statistically significant difference in stock price reactions in nontaxable transactions that compared pooling versus purchase transactions.