Notes on Accounting for Mergers & Acquisitions

Accounting Choices

Accounting for mergers and acquisitions is in principle straightforward. It involves selection of an accounting method and implementation of the accounting method to determine its impact on reported results.

Accounting method selection for business combinations involving transfer of majority ownership interest is either (1) consolidated "combined company" reporting, or (2) equity method reporting. Current U. S. GAAP essentially requires consolidated reporting when one entity acquires a controlling ownership interest in another.[1] Here, we'll briefly discuss equity method accounting and then focus our attention on consolidated reporting.

Equity method accounting involves accounting for the pro rata equity interest of the investor in the investee's book value. Since the investment is assumed to be an active interest by the investor in the operations of the investee, the investee's income is income to the investor and distributions to the owners by the investee are distributions of wealth. Hence, the investment is recorded at cost and adjusted by recognition by the investor's pro rata interest in the investee's reported income. While this is income to the investor and increases the investor's book value of the investment in the investee, dividends from the investee to the investor are reductions in the book value of the investor's investment.

The second step in accounting method selection is determining whether **consolidated reporting** for the combination is a purchase or a pooling-of-interests. [2] Pooling-of-interests implies that the owners of the combining companies maintain their positions as owners in the combined company. On the other hand, when one firm acquires controlling interest in another firm by supplanting a majority of the investee's owners it is a

[1] FASB statement 94 almost entirely eliminated majority-owned nonconsolidated equity method reporting as was typically employed for example by wholly-owned financial subsidiaries of manufacturing firms prior to the statement's issuance.

purchase. Thus, historically a stock-for-stock merger was accounted for as a pooling-of-interest; while a cash acquisition of the stock was a purchase. This is straightforward and remains the guiding principle. However, the proliferation of novel and complex business combinations and hybrid securities (such as convertible securities) has clouded the picture somewhat.

Consequently, the Accounting Principles Board promulgated Opinion 16, effective in October 1970, that establishes twelve criteria necessary to qualify a merger for pooling-of-interests accounting. Failing to satisfy any of the conditions disqualifies the merger for pooling-of-interests accounting. Also, the Securities and Exchange Commission frequently releases new interpretations and continually advises managers and accountants on the qualifications of specific business combinations for pooling-of-interests accounting. The twelve criteria can be grouped into three (nonmutually-exclusive) categories: combining company attributes, conditions on the combination, and conditions on postcombination activities. A brief sketch of the conditions necessary for pooling-of-interests accounting is below:[3]

Combining company attributes:

1. Each of the combining companies must be autonomous and must not have been a subsidiary or division of another corporation during the two-year period prior to the initiation of the combination plan.
2. None of the combining companies can hold more than 10 percent of the outstanding voting common stock of any other combining company. In other words, the combining companies must be independent of other combining companies.

Conditions on the combination:

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[2] Pooling-of-interest accounting has effectively been eliminated by the FASB (FSAS 141) but could return in the future.
[3] This discussion may seem unduly lengthy however Coopers & Lybrand's *The SEC Manual* includes more than fifty pages on qualifying for pooling-of-interests accounting.

3. The combination must be effected by a single transaction.
4. The surviving corporation must issue only common stock for “substantially all” of the voting common stock of the combining companies; substantially all is interpreted as 90 percent or more.
5. Each of the combining companies must maintain substantially the same voting common stock interest; that is none of the companies may change those interests by exchanges, retirements or distributions to stockholders to effect the combination.
6. The combining companies may reacquire shares of voting common stock only for purposes other than business combinations.
7. The relative ownership interest of the owners of each of the combining companies cannot change to effect the business combination; that is, one group such as management cannot be given preferential treatment relative to other owners to effect the combination.
8. The voting rights of the common stock interests in the combined company cannot be restricted.
9. The combination must be resolved at the date the plan is consummated; there cannot be any contingent issuances of shares.
10. The combined corporation cannot agree to retire or reacquire any of the common stock issued to effect the combination.
11. The combined corporation must not enter into any financial arrangements, such as a loan guaranty secured by the stock issued in the combination, to benefit the former stockholders of a combining company.

Conditions of postcombination activities:

12. The combined company must not intend to dispose of a significant part of the assets of combining companies within two years of the combination.

This latter condition has been interpreted quite broadly by the SEC and has become a driving force toward purchase accounting election by managers of combining companies.[4]

Implementation of the elected accounting method follows three steps: (1) combine the results of the combining companies by adding like-items as one item, (2) eliminate intercompany activities and accounts of the combining companies, and (3) revaluation adjustment of assets and equities and related income effects.

Combining like-items for the combining companies is straightforward. The items (cash, receivables, other assets, liabilities, revenues, and expenses) are simply added together.

Elimination of intercompany accounts and activities, such as intercompany sales or loans, is also straightforward. For example, if one firm has made a loan to another of the combining companies the related receivable and liability as well as the related revenues and expenses are eliminated. Otherwise the reports would include obligations and receivables of the combined company owed and receivable to and from itself, as well as revenues and expenses for services from and to itself -- obviously these are not economically meaningful.

[4] Qualifying a business combination for pooling-of-interests accounting is the continuing subject of debate. Near the center of the controversy is why managers care about these matters when reported cash flows are no different for either purchase or pooling accounting treatment. Nonetheless, the evidence on management's interest in qualifying for pooling is striking. For example, in September 1991 AT&T completed an all-stock merger with NCR valued at $7.5 billion -- the largest deal of the year and the largest at that time in the computer industry. The deal was hardly met with enthusiasm by AT&T shareholders as AT&T stock value dropped by between $3.9 and $6.5 billion during the negotiation of the merger; while NCR shareholders' wealth was enhanced, the overall deal resulted in an estimated decline in value of between $1.3 and $3 billion. Further and more to the point, AT&T management reportedly paid between $50 and $500 million to qualify the merger for pooling-of-interests accounting. These were costs associated with remedying actions taken by NCR's management to disqualify the merger for pooling-of-interests accounting (and effectively fend off the originally unwanted acquisition by AT&T) involving changes in equity interests and selective payments to some but not other NCR shareholders (items 5 and 7 above). (See Lys and Vincent, (1995) "An analysis of value destruction in AT&T's acquisition of NCR," *Journal of Financial Economics* 39 (Oct-Nov), 353-378, for details related to the value impact of the merger and the cost of pooling qualification.) The final chapter of this deal was seemingly written in January 1997 when AT&T abandoned the merger by spinning-off the stock of NCR and NCR resumed trading as an independent company.

Revaluation adjustments apply only to purchase accounting and only to the pro rata share of the acquired net assets.[5] Under purchase accounting, the combination is valued at the market value of net assets on the date of the acquisition. The total value is typically determined by the value of consideration given up by the investor to acquire the net assets of the investee. Accordingly, individual assets and liabilities are revalued based on the fair market value at the time of combination. Any excess (deficit) of the purchase price over the sum of the fair market values of assets net of values of liabilities is treated as goodwill (or negative goodwill in the case of a deficit). The revalued assets become the basis for determining income related items. For example, excess (or reduction in) depreciation expense applies to any difference produced by the write-up (write-down) from the investee's book value to market value of property, plant, and equipment over its remaining life. Similar adjustments are made to other assets including goodwill (remember goodwill only arises for accounting purposes when purchase accounting is applied to business combinations). The APB called for goodwill to be amortized against combined company income over a maximum of 40 years. However, the FASB recently mandated purchase accounting for M&A activities with goodwill subject to asset impairment accounting (SFAS 141 and 142 is specific to goodwill but is similar to general asset impairment discussed in SFAS 144).

As a pooling-of-interests is treated as the continuation of business by the combining companies, their accounting continues to be based on the prevailing book values of assets and liabilities at the time of the combination. Specifically, all of the asset and equity accounts except contributed (equity) capital are combined at the combining companies' book values. Par value of contributed capital is reported as the number of outstanding shares after the merger times the par value per share; the acquired companies' common stock is treated as though it's retired and removed from the consolidated balance sheets. Additional paid-in capital is a residual item or plug figure to make consolidated assets and equities balance in the reported consolidated balance sheet. Consolidated retained earnings are typically the sum of the combining companies' retained earnings.

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[5] If the acquiring company acquires say 90% of the stock of acquired and the fair value of acquired's net assets exceeds book value by $100, then the revaluation adjustment of net assets (excluding goodwill) is

Since acquiring a majority interest frequently means less than 100 percent ownership in the acquired firm, the minority owners' interest in the acquired firm requires specific acknowledgment. This is necessary to avoid overstatement of the ownership interest in the acquired firm as 100 percent of the like-item accounts have been summed. That is, minority interests are identified to avoid overstatement of net assets owned (even though they are controlled by the acquiring company). Any minority (ownership) interests remaining for the acquired companies are reported (based on the acquired firm's book values) between liabilities and owners' equity in the consolidated balance sheets. Further, the pro rata share of minority interests in the acquired companies' income are reported as reductions in consolidated income. This produces the same impact on reported results as equity method accounting, excluding the effect of valuation adjustments that apply to purchase accounting.

$90 at the acquisition date.