WHEN COMPANIES COMBINE, AND OTHER ACCOUNTING CONFUSIONS

By Haruki Toyama

Companies can choose one of two methods of accounting for mergers and acquisitions. But the FASB is planning on eliminating one and modifying the other. Understanding the method used is vital for investors because, in the long run, the value of any business is determined by the profits it earns, and different methods can give entirely different pictures of profitability for the same transaction.

To many investors, accounting is a dull, complicated, even mysterious subject that they're happy to ignore. Just give us the numbers and we'll accept them.

However, the numbers companies report can be very misleading, including those that result from corporate mergers and acquisitions. So they deserve close scrutiny.

Now the confusion is being compounded by the plan of the Financial Accounting Standards Board (FASB) to eliminate one of the longstanding accounting methods for mergers and acquisitions (pooling of interests) and modify the other method (purchase accounting). The proposed changes could take effect as early as the fall of 2001.

Don't fall asleep just yet. We promise not to lead you into an impenetrable thicket of accounting.

WHEN COMPANIES COMBINE

When Company A acquires Company B, for stock or cash, or when Company C merges with Company D, the financial accounts must reflect the transaction.

In almost every case, one company is simply buying another. Most deals touted as mergers of equals are not that at all. Just ask the shareholders and former management of Chrysler how equal their marriage with Daimler has been. Or the shareholders and former management of Bank of America ("merged" with NationsBank). Or Mobil (with Exxon). In business terms, these were all acquisitions by one company of the other. Yet the myth of mergers has influenced our accounting standards.

A basic rule of accounting is that when a business buys anything, the cost of the item is either charged immediately to earnings (like steel purchased to manufacture a car), or it is placed on the balance sheet to be charged gradually against future earnings as the item's value diminishes over time through use (such as a factory building or machine tool).

The difficulty in applying this accounting concept to corporate acquisitions is that many businesses have values over and above those of their assets, customarily physical ones, that are recorded on their balance sheets. Often, a major portion of the prices that acquirers pay is attributable to these unrecorded intangibles.

Accounting practice classifies these as "goodwill," an old-fashioned term dating back to the days when the friendly neighborhood baker enhanced his business by being nice to his customers and turning out especially tasty bread. He had a lot of goodwill.

In similar fashion, Coca-Cola and PepsiCo have built up extremely strong customer acceptance for their flagship drinks. General Electric, under Jack Welch, has done the same with its superb customer service, and Pfizer has great value from its outstanding research and development. Geographical

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advantage, an experienced sales force, and management skill are other commonly cited justifications for paying a premium over a firm's recorded assets.

So when companies with real, or imagined, intangible assets of substantial value are sold, very logically buyers pay a price well above what the physical assets are worth.

THE ACCOUNTING DILEMMA

Let's say Company A buys Company B for $100 million. Company B has $10 million in net assets (assets minus liabilities). In the "purchase" method of accounting for acquisitions, Company A must first allocate the $100 million it is paying to the appraised market value of Company B's net assets and then assign any remaining balance to a new asset called goodwill. So if Company A determines that Company B's $10 million in net assets are worth $20 million, Company A would record $20 million in acquired assets and $80 million of goodwill. The goodwill must be amortized, through annual charges to earnings, over a period no longer than 40 years.

But in what the transacting parties call a merger, often the accounting is done on a "pooling of interest" method. Here, the financial statements of the two companies are simply combined as if they had always been one company. No assets are written up, no goodwill is created, and the combined firm continues with its old cost basis. Company A would pay $100 million in stock to acquire Company B, but the combined firm would only have $10 million of Company B's assets in its accounts. It is as if you were to buy a Van Gogh painting for $100 million and value it in your accounts at the $10 million that the previous owner had paid for the painting.

In some cases, the distortion can really get out of whack through a chain process. If the seller of the painting, and all other previous owners, had used the pooling method, you would actually record it in your accounts at the $5 worth of supplies that Van Gogh used over a century ago to paint it!

The end result is that compared to the purchase method, pooling produces lower costs and higher profits for the new company, making it the preferred accounting method for management. To continue with the Van Gogh thread, you purchase a painting for $100 million, and record it for $10 million under the pooling method. If you were to sell the painting a few years later for $20 million, you would record a profit of $10 million, yet we guarantee you would not feel richer (except perhaps spiritually).

There is a list of necessary conditions, such as the use of stock rather than cash, for the use of pooling in an acquisition, but no such criteria for the purchase method. Despite the hurdle, as much as 50% to 70% of transactions by deal value in recent years were accounted for with the pooling method.

Public companies often perform circus-like contortions to meet the criteria for a pooling deal. Yet, the acquirer can never enhance the *economic value* of a deal by choosing pooling over purchase; in fact, with some of the pooling criteria, such as the restriction on share buybacks, lower tax cost basis, and limitations on asset divestitures, structuring a deal under pooling can actually cost the acquirer more money or reduce management's flexibility.

Knowing which method a company uses is vital for investors; in the long run, the value of any business, and thus its stock, is determined by the profits it earns, and the two methods can give entirely different pictures of profitability for the same transaction.

In years gone by, investors paid great attention to the quality of reported earnings. Were they conservatively stated or inflated by various sorts of liberal accounting? Depending on the answer, reported earnings would be valued highly in the market or discounted by investors as somewhat phony.

Over the last five to 10 years, though, most investors have lost their sense of discrimination and accorded high valuations to companies with what we might politely call "generous" accounting. Note that generous accounting doesn't necessarily imply fraudulent; on the contrary, it is almost always properly within the wide boundaries of generally accepted accounting principles (GAAP). But it does gild the lily.

One of the tasks of the investment analyst is to look through the different accounting measures used by various companies in order to make apples-to-apples profitability comparisons and, if possible, get to the "true" economic earnings of a company. Thus, the proposed changes in the accounting for mergers and acquisitions are quite relevant to investors.

CONTROVERSY & COMPROMISE

In 1999, the FASB proposed to eliminate the use of the pooling of interests method for acquisition accounting. A brouhaha promptly ensued. Defenders of pooling began an intense lobbying effort. Unabashedly making little claim about the validity of pooling as an accounting measure, they instead droned on about how the banning of pooling would restrain merger and acquisition activity, stifle innovation, and confine the U.S. to an economic backwater; one would have thought we were about to revert to the days before plumbing or mechanized agriculture.

Needless to say, investment bankers and high-tech district congresspersons were the most vociferous in their opposition. Mergers and acquisitions are their lifeblood. The FASB held its ground. The goal of financial accounting is to fairly and adequately reflect economic reality, not to encourage any particular type of corporate behavior.

How did this proposal not go the way of stock option accounting reform—i.e., to Never-Never Land? A compromise, naturally. Along with the elimination of pooling, the FASB has also proposed to abolish the mandatory goodwill amortization charges that result from the remaining sole alternative, purchase accounting.

Those who supported pooling did so not so much because they liked pooling, but because they argued that the goodwill amortization charges created by purchase accounting were artificial (and, of course, they "depressed" reported earnings). Remember that goodwill represents the value of intangible assets that the acquirer paid for. GAAP deems that this asset, like most others, gradually loses its value. And because of the imprecision in measuring how goodwill loses its value, accountants require that it be annually amortized in even amounts, over a period of no more than 40 years.

Most executives, many investors, and some accountants deem this treatment to be too arbitrary at best, and at worst, simply wrong. They claim that goodwill is unusual in that it does not have a finite life, unlike most physical (machine tools) or other intangible (copyrights) assets. Or even if goodwill did have a finite life, that would only be evident after some amount of time has passed; to make the initial assumption that all goodwill has a finite life, and therefore needs to be amortized, *is* arbitrary.

The truth is that neither side is entirely correct or incorrect. Properly managed, with favorable industry conditions, goodwill should not only maintain its value, it should increase in value. Improperly managed, or in a competitive industry, goodwill surely erodes over time.

Coca-Cola's Coke brand value has more than maintained itself over the decades and is much more powerful than it was 40 years ago. In contrast, Tab, Coca-Cola's precursor to Diet Coke, has seen its brand value diminish markedly over the past 20 years. Two intangible assets (though neither was acquired), two different results.

Thus, the real problem with the mandatory amortization of goodwill is that it doesn't allow for the widely varying outcomes of acquisitions. The FASB's new solution to this is a sensible compromise. Instead of requiring annual amortization charges, it will allow goodwill to remain untouched on the balance sheet. Management is then obligated to review this intangible asset periodically, and if they find that its value has diminished, they must reduce its balance sheet value through an "impairment" charge to earnings.

We have heard it expressed that this is akin to asking the movie director to write his own review. In reality, current rules already require that management write down goodwill if it is deemed impaired, and this is no different than the standards ruling other types of assets.

BETTER RESULTS FOR ALL

Whether or not one agrees with these new standards, there is one clear benefit. Financial comparability between companies will improve tremendously for investors, with only one method of accounting for acquisitions to be permitted.

Let's take two acquisitions that occurred in the same industry. In 1997, Safeway, a West coast-based supermarket chain, purchased Vons, a southern California supermarket chain. Safeway paid $2 billion in stock for Vons and accounted for the transaction under the purchase method. Identifying $500 million of Vons' net assets, Safeway allocated $1.5 billion to goodwill. While Safeway enjoyed the full benefit of the additional sales from Vons, its incremental reported profits were reduced by the resulting goodwill amortization of $38 million a year ($1.5 billion divided by 40).

Shortly thereafter, in 1998, competitor Fred Meyer purchased grocery rival Quality Food Centers for $1.2 billion in stock. Fred Meyer was able to account for the acquisition as a pooling of interests. So even though Quality Food only had $330 million of net assets, there was no goodwill creation of $870 million. Therefore, in the subsequent financials that Fred Meyer reported, it enjoyed the benefit of *all* the additional profits acquired from Quality Food Centers, without any associated goodwill expense.

Similar transactions, different accounting. The new FASB proposal would eliminate this confusion, to the benefit of all investors.

The new rule would not be without its disadvantages, though. With the mandatory periodic "impairment" review replacing the annual amortization of goodwill, the incidence of "impairment" charges will probably increase, joining the litany of popular "one-time" charges that pepper income statements these days, usually sweeping corporate mistakes under the rug. No doubt, management will do their best to train investment analysts to ignore this new addition as well.

To counter any possible abuse, the FASB is offering stricter guidelines for disclosure in the allocation of goodwill and other intangibles. Investors, therefore, should be able to see more clearly the thinking behind management's reasons for paying a premium over the target company's net assets. Investors can then hold management accountable in future periods for their valuations, and the rationale behind any subsequent "impairment" charges should be better revealed as well.

There could be an unintended, positive side effect of the new rules. By eliminating the misleading pooling of interests method for acquisitions using stock, and forcing more detailed disclosure, it could discipline management to evaluate acquisitions in more appropriate economic terms.

On the other hand, the removal of the burdensome, arbitrary goodwill charges might mean that CEOs would overpay for acquisitions.

Investors, too, must battle the same conflicts. On one hand, we will have better disclosure and better comparability among companies. On the other, if we focus solely on the reported income statement, without looking at the premiums, which sit on the balance sheet as goodwill, that companies have paid for past acquisitions, we will often miss critical information about a company's true performance.

Let's hope that the new FASB proposals, if they become effective, will lead to better decisions by investors. ✦

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