Accounting for Business Combinations

15.511 Corporate Accounting
Summer 2004

Professor SP Kothari
Sloan School of Management
Massachusetts Institute of Technology

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Investments and Acquisitions

Agenda

- Understand that the accounting method used for acquisitions depends on the extent to which the investor exerts influence over the investee.
- Understand the effects of dividends received and investee income on the financial statements of the investor under the equity method.
- Understand the effects of consolidated accounting on the balance sheet and income statement of the investor.
Investments in the Stock of Other Companies

- The accounting method for stock investments depends on the degree of influence the investing company has on the decisions of the investee.
- Three methods of accounting for this investment:

<table>
<thead>
<tr>
<th>Ownership:</th>
<th>&lt;20%</th>
<th>20-50%</th>
<th>&gt;50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Influence:</td>
<td>“passive”</td>
<td>“significant influence”</td>
<td>“controlling”</td>
</tr>
<tr>
<td>Reporting Method:</td>
<td><em>Mark-to-market</em></td>
<td><em>Equity</em></td>
<td><em>Consolidation</em></td>
</tr>
</tbody>
</table>
For any company:
Ending RE =
Beginning RE + Net Income – Dividends
Following the same logic =>
Ending value of investment on investing company’s books =
Beginning value of investment + investor’s share of investee’s net income – investor’s share of investee’s dividends
Significant Influence ➔ Equity Method

Assume the following events

1. Purchase: Investor acquires 48,000 shares amounting to 40% of EE Corporation for $10 per share
2. Dividends: EE Corporation pays a dividend of $60,000 or 50 cents per share
3. Affiliate earnings: EE Corporation Earns $100,000 in Net Income

Record these events on BSE of investor company.

<table>
<thead>
<tr>
<th>Event</th>
<th>Cash</th>
<th>Long-term Investment</th>
<th>R/E</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Purchase</td>
<td>(480,000)</td>
<td>480,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Dividends</td>
<td>24,000</td>
<td>(24,000)</td>
<td>40% × $60,000</td>
<td>Investment income</td>
</tr>
<tr>
<td>3. Aff. earnings</td>
<td>40,000</td>
<td>40,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Equity Investment Journal Entries – For The Investing Company

- At the time of investment
  - Dr Long Term Investments 480,000
  - Cr Cash 480,000

- At the time of dividends payment
  - Dr Cash 24,000
  - Cr Long Term Investments 24,000

- At the time investee declares net income
  - Dr Long Term Investments 40,000
  - Cr Investment income 40,000
When the investor controls the investee,

- The investor corporation = parent.
- The investee corporation = subsidiary.
- The parent prepares consolidated financial statements that treat the parent and the subsidiary as a single *economic entity* even though they are separate *legal* entities.

Consolidated financial reporting brings together multiple sets of financial records *at the time of reporting to outsiders*

- Each subsidiary maintains its own set of books that is independent of who owns it, whether it is one person/company or one million.
- Parent has its set of books pre-consolidation.
What Happens To Goodwill in Subsequent Years?

- After goodwill is determined, it has to be “assigned” to specific business units within the merged entity (FAS 142)
- Before July 2001 (FAS 142), goodwill had to amortized over a maximum period of forty years
- Now, goodwill does not have to be amortized
- It is tested for impairment annually
Goodwill Impairment

- What is goodwill impairment?
  - Reduction in value of goodwill

- When does impairment occur?
  - Technically speaking when “implied goodwill” from fair value of business unit is below book value of goodwill assigned to that unit.
  - Requires accountants to value unlisted business units of the merged entity!

- What happens when goodwill is impaired?
  - Company writes down the value of goodwill and recognizes a corresponding loss in the Income Statement
Goodwill impairment charges

- In practice, what do you think will trigger goodwill impairment?
  - *Decline in stock prices*

- In 2002, American companies wrote off close to $750 billion (HUGE write-downs by AOL Time Warner, AT&T, Nortel, Corning, Blockbuster)

- An additional $200 billion of goodwill impairment charges expected in 2003.
Under FAS 142, what exactly does goodwill capture?

- The value of synergies

What does goodwill impairment imply?

- Synergies lost

What else could they be the result of?

- A desire to “clear the decks”, or, in other words, our old friend “the big bath”
Overall Idea Behind Consolidation

Adjustments

- Consolidation combines the financial statements of parent and subsidiaries, resulting in one set of F/S.
- But there are numerous items that appear twice.
- Adjustments correct for the double-counting that would result from simply adding the financial statements together.
- Some other adjustments we haven’t addressed:
  - Inter-company receivables and payables
  - Inter-company sales, costs, and profits
  - Following through the adjustments of S’s net assets to FV
Summary

- Accounting for long-term investments depends on degree of influence as determined by percentage holdings.
- In equity method and consolidation, the investment account:
  - increases when investee earns profits and
  - decreases and when investee pays dividends.
- Consolidation process:
  - Shows the combined F/S of parent and sub, and
  - Removes any double-counting
- Acquirer records goodwill when it pays more than fair value of the investee’s net assets.
- Goodwill accounting raises some fairly complicated issues