Geoff Meeks and J. Gay Meeks

The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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9. The Accountant's M&A Cookbook[1]

[M&A is]: The Black Hole in British accounting
(David Tweedie, Chair of UK Accounting Standards Board, quoted in Smith 1996)

a powerful incentive for firms to get their equity overvalued, so that they can make acquisitions with stock (Shleifer and Vishny, p. 309).

Suppose you were an executive or adviser constructing a team to deliver a merger which offered no operating gains and would incur significant transaction costs: it was motivated by the benefits for the executive and/or adviser that we discussed in Chapters 2 to 7. Then you would have been well-advised to include in your team a clever 'creative' accountant. They are expensive—in the UK a partner of a Big4 accounting firm is typically paid towards a million pounds a year (O'Dwyer 2021). But they have been able (legally) to do much to smooth the CEO's path to a merger which brought no operating gains.

To secure support and finance for the deal on favourable terms the creative accountant should be able to manage the accounts so as to flatter earnings ahead of the offer—raising expectations of the dividends after the merger and the share price ahead of the bid. To the same end, she will also ensure that optimistic forecasts are issued of the earnings which are expected if the acquisition goes ahead. If the deal does go ahead, then, under current rules, the creative accountant will be able to record the integration of the target in ways which will inflate post-merger earnings reported in the published accounts. This is particularly helpful to acquirer CEOs pursuing acquisitions which deliver operating losses (see Chapter 2): the creative accountant can

1 This chapter draws on Meeks and Meeks (2013).

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mask poor underlying returns in such a failing merger. In the next chapter we explore a potential feedback loop, or ‘virtuous’ circle, for serial acquirers, combining the creative accounting pre-merger with that for integration: spurious profits ahead of a bid secure a share for share acquisition on favourable terms, and the acquisition enables the accountant to create spurious profits after merger, setting the scene for the next deal.

Should the merger fail to deliver the earnings gains promised when the purchase consideration was decided, the creative accountant may be able to avoid or delay an impairment charge reducing profits in the income statement, which would embarrass the acquirer’s CEO. Alternatively, she may be able to exaggerate such a charge if a new CEO (the accountant’s new boss) wants to discredit her predecessor and flatter her own reputation. Finally in this chapter, we show how—if your business needs more intangible assets—anomalies in the current accounting rules mean that your reported earnings over time can be substantially higher if you buy the intangibles as part of an acquisition rather than generate them internally. As an aside in Appendix 2 we also report on a highly sophisticated past M&A accounting device used to hide a business failure—in our illustration, losses on speculative investments. But beware: unlike the other devices we explore, this one was fraudulent, so it doesn’t make it into the chapter. Unless you can muzzle whistleblowers, you may end up in court (as the perpetrators did, albeit very many years later).

In the rest of this chapter and in Appendix 2 we give many examples of creative accounting around M&A. Because most people have limited interest in the intricacies of accounting, we have put much of the detail in the appendix and given just the gist in the chapter. The examples are drawn from different countries and different periods, but especially the UK and US in the last four decades. Standard-setters have in some cases been able subsequently to eliminate particular devices we describe. We advise any readers tempted to try one of the devices to take advice on whether they are still permissible.

Creative Accounting ahead of the Offer

In reporting manipulation of the accounts we note Griffiths' (1986) guidance many years ago: 'the hallmark of [effective] creative accounting is that it does not involve fraud'. It should be discreetly and judiciously employed; it should not get you into jail; it should enhance rather than damage your reputation. The opportunities for such legal and effective earnings management arise particularly in areas where insider executives, in daily contact with their employees, their markets and their trading partners, enjoy an information advantage over outsiders, even including auditors, and where the insiders have to make accounting estimates requiring judgement. Then, if or when the estimates are not confirmed by subsequent outcomes, it may not be possible to discriminate between the role of unanticipated external developments outside the executives' control, on the one hand, and intentional bias in the executives' estimates, on the other. In these circumstances, the 'creative' executives can escape censure. As Dechow et al. (2011) argue, 'the more assets on the balance sheet that are subject to changes in assumptions and forecasts, the greater the manager's flexibility to manage short-term earnings' (p. 19).

If outsiders cannot identify or quantify the resulting earnings management then in a semi-strong efficient market for capital (one which can only be relied upon to reflect public information—Chapter 8), skilful upward manipulation of earnings can raise the share price. If the acquiring management then offer their own (inflated) shares in exchange for those of the target, they can secure the deal on unduly favourable terms. The target shareholders might not have agreed to the deal had the acquirers' share prices not been manipulated. The acquirers' shareholders gain from the sleight of hand—perhaps enough to compensate for the transaction costs of the deal and some operating losses afterwards. The acquirers' executives mostly gain from the deal (Chapter 2), and their advisers almost always do (Chapter 3).

Historically, creative accounting has been just one of the weapons bidders have employed to hoodwink investors. Kynaston lists further 'methods of deception' employed by acquiring businesses in the late-twentieth century to support artificially the price of their own company's stock. In relation to the strategies of one aggressive bidder, Robert Maxwell, the methods included 'changes of year-ends, backdated agreements, imaginary goodwill, trading between public and private companies, inflated stock valuations, returnable 'sales', bogus profit forecasts, furtive disposals of shares, ...' (p. 383). Lawmakers and regulators have worked to curb these abuses: in the UK, many egregious creative accounting devices were outlawed in the 1990s by the pioneering Accounting Standards Board. The US and international standards boards (FASB and IASB) have also worked continually to contain creative accounting. But some devices arise from unavoidable characteristics of accounting; some have been retained against the wishes of the standard-setters, following lobbying by business; and innovative new accounting devices have been developed when old ones have been outlawed.

Past and current creative accounting devices have often been able to mislead investors in a semi-strong efficient market. Often they involve taking an unduly optimistic view of future outcomes when executives review the allocation of costs or revenues to different accounting years. Or they focus on the valuation of assets or liabilities in the balance sheet at the end of the accounting period, where this affects the profits recognised for that period.

A supplier of capital goods or a construction firm partway through a major multi-year contract for which total payment was fixed might take an over-optimistic view of the further costs which would be incurred to finish the project, thereby inflating the profits reported in the short term. Where such manipulation is not available, a business might engage in 'channel stuffing'—persuading a customer to take a shipment earlier than they would normally choose, ahead of the supplier's accounting year-end—swelling sales, receivables and profits in that accounting-year. (When we asked a group of managers in our executive education course how many had been asked by their employers to engineer such an acceleration of revenue as the year-end approached, the majority raised their hands.)

A tech business which holds inventory liable to obsolescence has each year to review its value, and write it down if it can't be sold for what it has cost to produce. This requires managers' judgement. Understate the write down and this year's profit is inflated. Overstate the write-down and then succeed in selling it another year for more than its written-down value, and profits are moved to another year. Businesses which sell goods or services on credit (or banks which lend) need to take a view at the year-end of how many debtors will actually pay: a more optimistic judgement will result in higher profits for the accounting year. Then, last century in the UK, until the ASB intervened, a company could raise funds via complex financial instruments in which interest payments were end-loaded, boosting reported earnings in the early years (Tweedie, Cook and Whittington forthcoming).

The common feature in most of these measures is that the executives are better equipped than their auditors, let alone their shareholders, to make these estimates, and that they are generally not transparent to outsiders. Even where auditors are uncomfortable with a device being used by an auditee, they face a dilemma over whether to challenge its use unless they have a clear mandate from company law or the regulators. The former chairman of the UK Accounting Standards Board and the International Accounting Standards Board explains: '...if you look at the individual partners, the senior partners probably had two big clients each. Well, you lose one of those and your value to the firm is questioned. So there's huge pressure not to lose a client.' (Tweedie, Cook and Whittington)

Illustrations of such accounting devices are provided in Appendix 2—for Xerox, GE, Carillion, Coca Cola, Cisco, Tesco and others.

But there's something puzzling in all this. If, to succeed in misleading investors and boosting share prices in a semi-strong efficient market, creative accounting has to be opaque—outsiders can't see through it—how do <u>we</u> outsiders know that it is happening?

One source we draw on in Appendix 2 is the whistleblower, an insider who reveals the sleights of hand—as in the case of Tesco's understatement of payables, or Olympus's cover-up of losses on investments. A second source recalls one of Warren Buffett's many famous investor quotes: 'It's only when the tide goes out that you discover who's been swimming naked'. When firms go bust, the administrators or liquidators suddenly have access to the internal records and to the employees of such firms. These often reveal accounting manipulation—as in the cases of Carillion, Coloroll, Enron and WorldCom discussed elsewhere in this book—and sometimes insiders spill the beans where there are official public enquiries into a failure which has caused widespread damage (Chapter 11 gives an example). The third source is statistical analysis of large numbers of accounts. In Schipper's (1989) words as to why researchers are able to observe earnings management while users of the manipulated accounts can't: 'a researcher using large historical data sets might be able to document statistically a pattern of behavior consistent with earnings management within the sample, without being able to say with confidence whether earnings were managed for any particular firm in the sample' (p. 97).

In relation to statistical analysis of large historical datasets, much of the research has focused on creative accounting ahead of major financial events, such as IPOs or seasoned equity offerings, or—our concern—share for share acquisitions. We earlier quoted Shleifer and Vishny (2003) on the 'powerful incentive for firms to get their equity overvalued, so that they can make acquisitions with stock' on favourable terms. The emphasis on major financial events is because in the ordinary run of business the benefit from using most of the creative accounting devices we report is likely to be short-lived: many of these devices just bring forward into this year's accounts profits from a future year: any gain this year will be at the expense of profits in one or more future years. And on top of that, if the manipulation becomes known, the executive's credibility will thereafter be dented. But creative accounting ahead of a major financial event such as merger offers the opportunity to lock in a gain—by securing a transaction on terms made more favourable by the temporary inflation of earnings. Moreover, in the case of M&A, we show in Appendix 2 that a clever accountant has sometimes created reported earnings 'out of thin air' in the course of an acquisition, to conceal the negative repercussions of the earlier inflation of short-term profit. This makes it less likely that the executives are 'found out'.

Statistical research on acquirers' use of earnings management ahead of, and to facilitate, M&A has been completed for several countries and periods in recent decades (Erikson and Wang 1999; Louis 2004; Botsari and Meeks 2008, 2018; Gong et al. 2008; Higgins 2013; Botsari 2020). Researchers have found evidence of earnings management (on average) ahead of share for share deals; and evidence that this succeeded in artificially boosting the share price of the acquirer ahead of the deal. By contrast, in cash deals earnings management ahead of the offer is not typically observed (the target's shareholders do not in this case have to be persuaded to accept the acquirer's shares in return for their own).

The pre-bid earnings management is associated particularly with 'hot' stock markets, when M&A markets are most active (Chapter 8).

Great Expectations: Forecasts of Post-merger Earnings

A statistical approach is also valuable in identifying and assessing a second means of flattering accounting information in order to secure advantageous terms for stock-for-stock acquisitions: issuing forecasts of earnings gains from the combination. There are currently few regulatory requirements to issue such earnings forecasts: in our samples of large US deals, forecasts were not published by all bidders.[2] And only a minority issued the most challenging 'point forecasts', committing to a particular earnings increase; the remainder issued qualitative forecasts—e.g. 'the deal will be accretive to earnings'.

On average the subsequent outcomes were markedly lower than the earnings per share (EPS) forecast provided by managers, where available: in the majority of cases the executives got it systematically wrong and over-estimated future earnings following the merger (Amel-Zadeh and Meeks 2020b). This finding would come as no surprise to legendary investor Warren Buffett, whose 1982 letter to shareholders of his Berkshire Hathaway commented: 'While deals often fail in practice, they never fail in projections.' And it is consistent with recent research by the Federal Reserve Bank of New York (Acharya et al. 2022), which concludes that 'M&A announcements are usually accompanied by rosy forecasts about synergies and growth, and, more importantly, a promise to reduce the debt taken on to finance the acquisition. Data indicate that most of these projections were, ex post, not realised'.

Was the stock market impressed by these over-optimistic forecasts? Another analysis (Amel-Zadeh and Meeks 2019) found that in stock-for-stock acquisitions, bidders which had a record of issuing reliable routine earnings—and then issued an optimistic forecast of earnings expected after an acquisition—secured a higher probability of completing the deal, faster completion, and a lower acquisition premium. So it is advisable for the creative accountant to build confidence ahead—by ensuring that earnings are managed such that routine forecasts prove accurate in the years immediately preceding a bid.

2 In the UK some forward-looking financial information has to be provided in some cases to shareholders under Takeover Panel and Listing Rules.

Before the deal is completed the highly skilled creative accountant will have prepared a plan aiming to flatter earnings that are reported afterwards. She will not find this difficult. Accounting rules for assimilating targets in the acquirers' accounts have offered rich opportunities to flatter subsequent earnings. We discuss these in the next section.

We leave unanswered an interesting question about forecasts: does the evidence on unfulfilled forecasts reflect deception or just self-delusion on the part of the bidder executives?

Accounting for the Deal: Creating Spurious Post-merger Earnings

The key accounting device currently available at the time of merger to manipulate post-merger earnings was neatly expressed some time ago by the senior technical partner of one of the major audit firms: 'the trick is to attribute the lowest possible values to the net assets acquired, and correspondingly the highest possible value to the residual goodwill [...] the smaller the assets which remain to be charged against profits the better the post-acquisition results will appear' (Paterson 1988, p. 43).[3]

If, for example, inventory is marked down excessively, reported profit will be inflated when that inventory is subsequently sold. If machinery is marked down, depreciation charges will be lower in subsequent years—again, profits are inflated. Absent goodwill impairment, the higher allocation to goodwill when other assets are marked down <u>will not</u> lead to any subsequent charge against profits: amortisation of purchased goodwill in the profit and loss account (reducing profits year by year) is now generally disallowed for listed companies.[4] This means that marking down the fair value of the assets on acquisition, allocating more of the purchase consideration to the (residual) goodwill account, can, in effect, create a 'cookie jar' from which the accountant can draw

3 This argument applies in those regimes where goodwill is not amortised, and where impairment is not subsequently triggered. In some jurisdictions, amortisation is allowed for private companies. By 2020 FASB were minded to reintroduce the amortisation of goodwill (Lugo 2020).

4 The qualification to this is that goodwill may under current FASB/IASB arrangements be impaired.

extra profits in years following the acquisition. Illustrations are provided in Appendix 2.

The sums involved can be enormous. For example, when Vodafone paid £101 billion for Mannesmann, purchased goodwill represented £83 billion of the total.

There is a paradox with such devices. At first sight, these downward adjustments of the value of the target's net assets when it is recorded in the acquirer's books appear consistent with the conservative/prudent/cautious approach traditionally drilled into accountants from the beginning of their training. As the past Chairman of the ASB and IASB, and scourge of creative accountants, Sir David Tweedie commented, 'you can't stop people writing things down' (Tweedie and Whittington 2020, p. 70). But the accounting model means that the consequence for future years can be anything but conservative/prudent/cautious: subsequent earnings are over-stated.

Artificially enhancing earnings at this point in the M&A process can serve at least three purposes for the acquirer's CEO. First it can hide the hit to reported profits that would follow those creative accounting devices which—ahead of the merger—had 'borrowed' earnings from a future period. Second, it can boost the acquiring executives' own compensation where that is contractually tied to profit measures such as earnings per share—discussed in Chapter 2. And third, it can set the scene for another acquisition on terms unduly favourable to the acquirer. This is important to the next chapter's discussion of virtuous (vicious?) circles in serial acquisition programmes. They represent perhaps the most sophisticated expression of the creative accountant's art.

Creative Accounting Post-merger

Creative accounting activities during merger may then leave the acquirer with a swollen figure for purchased goodwill in its balance sheet. This 'asset' represents the anticipation, or hope, or pretence, of above average returns during future years. If that anticipation is disappointed, listed companies following current IASB or FASB standards are supposed to reduce the goodwill total with an 'impairment' charge to the P&L.

At first sight, impairment seems superior to amortisation as a method of recording the depletion of purchased goodwill. In theory, it represents the <u>actual</u> diminution of the expected earnings underpinning goodwill. And that would seem preferable to amortisation's mechanical, formulaic allocation to each year's P&L of past expenditure on goodwill. But there are strong motives and ample means to manipulate goodwill impairment.

On motives, Hans Hoogervorst, Chairman of IASB, has argued:

> in practice, entities may be hesitant to impair goodwill, so as to avoid giving the impression that they made a bad investment decision. Newly appointed CEOs, on the other hand, have a strong incentive to recognize hefty impairments on their predecessor's acquisitions. (KPMG 2014, p. 5)

Chapter 1 and Appendix 1 give evidence on the prevalence of mergers that were 'bad investment decisions'. Then Appendix 2 gives examples—for Vodafone and HP—of 'hefty impairments on their predecessor's acquisitions'. Such impairments avoid future impairments which would depress earnings on the new executive's watch; and, by depressing earnings at the point of succession, they secure a lower base point against which the newcomer's earnings will be judged.

On means, manipulating goodwill impairment is one of the easiest tasks facing the creative accountant. Appendix 2 gives more detail. Impairment requires a forecast of earnings long into the future; but we earlier reported the inaccuracy of even short-term forecasts. And executives enjoy considerable discretion over the models used to prepare forecasts—inevitable because of the great variation across companies in business models. Then how do you apportion future earnings between the acquirer and the target when the rationale of many deals is to integrate the two? And how do you apportion future earnings between the intangible goodwill purchased with the target and the intangible goodwill already generated internally by the acquirer and that subsequently generated by the merged firm? That distinction, between acquired and internally generated intangibles, is not just important to the impairment calculation: it is part of a much wider challenge for accounting—and opportunity for creative accountants—discussed in the next section.

The Intangibles Anomaly

Intangible assets are one of the most treasured ingredients in the accountant's M&A cookbook. Take a very simple example where a business wants to possess intangibles such as customer loyalty or intellectual property worth $100 million. Suppose it could build up these assets by spending $10 million a year on marketing or R&D for ten years (depressing profits by $10 m p.a.). Or it could buy these assets in the course of an acquisition for a single payment of $100 m. Unlike the $10 m a year spent on internal generation, that $100 m payment would not under current accounting rules be charged against profit as an expense, but would be recorded as the acquisition of an asset. If the asset did not qualify as 'separable' it would typically be recorded as purchased goodwill. And, under present accounting conventions, provided it was not subsequently 'impaired' (written down because it was deemed to have diminished in value), it would never be charged to the profit and loss account, diminishing profit. Meeks and Meeks (2020a) explain and illustrate the process in more detail.

This example shares with the earlier ones the characteristic that accounting conventions cause the same economic activities to be reported for participants in M&A in ways which produce very different values for reported earnings from those prevailing in the absence of M&A. The underlying issue was described by the American Accounting Association (AAA) in 1991: 'The inclusion of purchased goodwill and the omission of internally-generated goodwill is one of accounting's greatest anomalies'. The anomaly identified by the AAA continues, though on a bigger scale than in 1991 because purchased goodwill has been growing exceptionally quickly since then with the surge in M&A; and spending on intangibles representing internally generated goodwill has also expanded at unprecedentedly high rates (see Appendix 2).

There is an irony in all this. In Appendix 2 we report the complaint by an executive lobbying Congress that, if amortisation of goodwill were required, it would 'stifle technology development, impede capital formation and slow job creation'. But actually, under the regime secured by the business lobbyists, why would the CEO of a tech firm with funds to create intangibles spend years depressing reported earnings by generating the intangibles internally when she could just buy them 'ready-made' in an acquisition, with no hit to reported profit?