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The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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Appendix II: Managing Earnings around M&A

In this appendix we provide more detail, illustration and interpretation of some of the creative accounting devices deployed in connection with M&A and discussed in Chapters 9 and 10.

Ahead of an Offer

The main thrust of creative accounting at this stage is to flatter current performance by bringing profit forward from future accounting periods. The aim is thereby to secure a higher share price than would otherwise be warranted, and to use the bidder's own shares as payment for the target (Shleifer and Vishny 2003). A similar strategy has been observed ahead of other major financial transactions such as seasoned equity offerings unrelated to M&A (Rangan 1998). A symmetric strategy—managing earnings downwards so that the managers secure a more favourable deal with the owners—has been observed ahead of management buyouts (Perry and Williams 1994). If successful, the profit enhancement strategy brings a once-and-for-all financial gain to the acquirers: they secure the deal on more favourable terms. In the absence of such major transactions, earnings management would produce only temporary gains in share price, which would be reversed in future periods. Such shifting of profit between periods could, however, still be favoured for other reasons—for example, to smooth earnings or to take advantage of the terms of a performance-related pay contract, timing the earnings for when they would generate the biggest bonuses (Chapter 2).

The illustrations we give come from the US and the UK. They span different regulatory regimes, and some have since been outlawed by the accounting regulators. They do not all relate directly to M&A

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strategies—they are chosen because they are well documented, and undisputed, and help illustrate the mechanisms of creative accounting. As Chapter 9 explained, many cases of creative accounting cannot be proved without access to detailed internal information.

1.Delaying Recognition of Costs of Multi-year Contracts

Opportunities for such manipulation arise in the common case where a fixed price is charged for delivering products or services over several years, and the future costs of delivery are inevitably uncertain. In the early years of the contract executives have to take a view on the distribution of costs—and therefore of profits—over the lifetime of the contract. Profits can be front-loaded by end-loading the costs. One such opportunity was exploited by Xerox. They supplied office equipment through leases which charged an annual fee covering both the initial capital cost of the equipment, and provision of servicing through its lifetime, and a finance charge for the capital outlay. The SEC (2002a) alleged that creative accounting "accelerated Xerox's recognition of equipment revenue by over $3billion and increased its pre-tax earnings by approx. $1.5billion over the four-year period from 1997 through 2000". The manipulation added in the most affected quarter some 50% to earnings per share—at a time when Xerox made "four offerings that registered nearly $9billion worth of debt securities" (SEC 2002a). Xerox paid a $10 million fine to the SEC, "but without admitting or denying the allegations in the complaint" (SEC 2002b). Because the manipulation was buried in the unreported calculations underlying the published accounts, it is unlikely that outside investors would have been able to see through and reverse out the earnings management.[1] The offerings were not directly related to acquisitions, though Xerox did acquire Tektronix in 2000 for towards a billion dollars.

Then Gryta and Mann (2020) give an example for the Power division of serial acquirer GE:

1 These are intended only as illustrations of the opportunities for earnings manipulation. Others, including the manipulation of inventory valuations, provisions for bad and doubtful debts, sale and repurchase and sale and leaseback, are discussed in Jones (2011), Mulford and Comiskey (2005), Sherman et al. (2003), Schilit and Perler (2010), Smith (1992, 1996), and Tweedie, Cook and Whittington (forthcoming).

> To GE investors, Power seemed to have been making its numbers and putting up solid profits. But those were illusory. The accounting tricks that looked like profits were actually just borrowing from the company's future earnings to cover up problems in the present.
>
> Power had sold service guarantees to many of its customers that extended out for decades. By tweaking its estimate of the future cost of fulfilling those contracts, it could report boosts to profit as needed. [...] In this period, GE was acquiring about four businesses a month. (Gryta and Mann, pp. 7, 17).

In the UK, a parliamentary committee investigated the record of the serial acquirer, Carillion, after it failed (Carillion is discussed at length in Chapter 11). Shortly before its failure a reappraisal of the prospective costs relating to long-term construction contracts led it to 'reduce the value of several major contracts by a total of £845 million'. Soon after, '£200 million extra was added, completely wiping out the company's last seven years of profits' and leaving it insolvent (net liabilities of £405 million) (HoC 2018, p. 79)

The difficulty for an outsider to see through such disparities in earnings is illustrated by the fact that the company had in the preceding years of these contracts received unqualified audit reports from Big 4 auditors KPMG, who had access to internal records and the company's staff. But as one of Carillion's principal investors commented, 'changes of this magnitude do not generally materialize "overnight"' (HoC, p. 81)

2.Accelerating Sales and Profits

Sherman et al. (2003) give several examples of companies using opaque devices which bring forward or front-load earnings. In one of these, Coca Cola used a 'channel stuffing' device: they persuaded local bottler-franchisees to take delivery of concentrate, ahead of when it was needed, achieving the bottlers' cooperation by paying the storage costs and deferring the payment date until the time when the product would normally have been delivered. The shipment would be included in Coca Cola's sales and would swell its profit in the earlier period.

3.Deferring Interest Charges

In the last century, banks in the UK developed a rash of complex financial instruments which deferred interest payments on company borrowing—and the charges in the profit and loss account, thereby bringing forward reported (post-interest) earnings. These included stepped interest bonds, deep discount bonds, and convertible loan stock with premium puts (Tweedie et al. forthcoming). These instruments were widely used in a period of intensive merger activity until the Accounting Standards Board's's FRS4 required the finance costs associated with such liabilities to be allocated to accounting periods at a constant rate irrespective of the structure of the cash payments stipulated by the instrument (Tweedie et al. forthcoming).

4. Rescheduling Profits by Manipulating the Valuation of Assets and Liabilities on the Balance Sheet

Assigning a value to some components of the balance sheet requires assumptions and forecasts. And the executives are typically best-informed to make those assumptions and forecasts. A change in the value assigned to an asset or liability will generally translate into a change in profit. The creative accountant has to adopt a different strategy over such valuations depending on the stage of the acquisition process. Ahead of a deal (in particular a share for share deal) the creative accountant will typically want to overstate assets and understate liabilities, to give a short-term, pre-bid boost to profits and the share price. But when integrating the target upon acquisition, the creative accountant will face opportunities to flatter post-merger profits by understating some of the acquired assets and overstating provisions triggered by the acquisition.

In relation to inventory, accounting rules generally require valuation as the lower of cost or net realisable value (NRV). NRV may fall below cost when, for example, the inventory is perishable (e.g. fish), out of fashion (e.g. clothing), or obsolescent (e.g. tech products). Auditors will look to executives to assess such deterioration; and in examples we cite below the discretion afforded to executives amounted to $290 m in one year at Cisco (Sherman et al. 2003), and £334 million at Guinness (Paterson 1988).

When businesses are assessing how much of the money owed to them by customers (or by banks' borrowers) will be repaid in full, they have to take a view on how much they will recover from customers they know are bankrupt, and how many debtors who appear healthy might become financially distressed before they have paid outstanding amounts.

A whistleblower from inside Tesco led to the company being accused by the Financial Conduct Authority of improper overstatement of receivables in the form of rebates expected from suppliers, thereby inflating profit by £326 million (Felsted and Agnew 2014). Tesco paid £215 million in a fine, and compensation to investors who had been misled. However, Tesco used a "Deferred Prosecution Agreement (DPA)", which does not require an admission of wrongdoing.

Understating payables similarly brings a short-term profit gain. And Tesco was accused by the UK Groceries Code Adjudicator of understating payables, having unilaterally withheld full payment to suppliers (Ram 2016; Vandevelde and Thomas 2016). In this case, Tesco faced no financial penalty as the misconduct predated the Adjudicator's power to impose fines.

Accounting for the Deal

When it comes to recording the impact of the deal on the acquirer's accounts, creative accountants have for the last many decades been preoccupied with 'purchased goodwill'. Purchased goodwill is a nebulous, transient sort of asset—a residual, calculated as the difference between the purchase consideration for an acquired business and the fair value of its separable assets. It is rationalised as an entitlement to future profits arising from the merger.

The sums involved are material, and growing. If we think of the price paid for a target, it will typically exceed the accounting book value of the target's assets for two reasons. First, the market price of the target's share before a deal is contemplated has typically been of the order of 160% of the book value of the target's assets (Penman and Reggiani 2014)—albeit varying a good deal from firm to firm and year to year. Then the acquirer typically has to pay a substantial premium over the previous share price to gain acceptance of a bid by the majority of the target's

shareholders—of the order of 30% (Amel-Zadeh and Meeks 2019). So if the acquirer integrates the individual target assets at their book value, there will be a significant residual to be allocated to goodwill. Where the target has relied heavily on internally generated intangible assets which—following accounting rules—have not been recorded in its balance sheet, the acquisition will lead to especially significant goodwill in the acquirer's balance sheet. For example, when Vodafone paid £101 billion for Mannesmann, purchased goodwill represented £83 billion of the total. Likewise, purchased goodwill was the major component of HP's purchase of Autonomy and SoftBank's acquisition of Arm. And purchased goodwill has become ever more important for the company sector for two reasons. First, as we reported in Chapter 1, expenditure on M&A globally has grown vigorously: in the West, in aggregate it has overtaken CAPEX—investment in new tangibles (Mauboussin and Callahan 2014, 2015). And, second, business spending on intangibles has grown much faster than investment in tangible assets over recent decades (Corrado and Hutton 2010, Srivastava 2014)—think of Apple, Facebook, and Microsoft…

When shareholders' funds are used to buy tangible assets with finite lives—such as machines, aircraft, vehicles and computers—the initial outlay is charged to the Profit and Loss Account (P&L)—as depreciation—over the lifetime of the asset. This keeps a check on whether the executives' spending on the assets has been recouped through subsequent revenue—whether the executives have been effective stewards of the investors' funds. At times, the accounting standard-setters have required that an analogous annual charge—amortisation of a portion of the cost—be made to the P&L to write down the cost of goodwill over its lifetime. Such charges can make a huge difference to the bottom line of the P&L—think of Vodafone's £83 billion of goodwill (above). And acquirers' executives have made extraordinary efforts to avoid amortisation of this goodwill—with the corresponding hit to profits.

By late last century the national accounting standard-setters in the UK and US had determined to clamp down on devices allowing executives to obscure spending on goodwill and thus avoid amortisation. The UK's innovative ASB required in almost all cases that the goodwill appear in the balance sheet with its depletion recorded via amortisation in the

P&L (supplemented by impairment—discretionary write-downs—if amortisation did not keep pace with the depletion of goodwill). The Financial Accounting Standards Board (FASB) in the US proposed similar arrangements.

However, FASB's proposal triggered a fierce counter-attack by American executives and their lobbyists (see Beresford 2001, Zeff 2002). One Cisco executive even protested to a Senate hearing that the proposed accounting would 'stifle technology development, impede capital formation and slow job creation'.[2] Accountants had never realised they were so powerful!

FASB backed down. They abandoned amortisation and left it to executives to decide on any impairment.

When, soon afterwards, the International Accounting Standards Board (IASB), the international standard-setter, was formed, its American members had no appetite to re-open this dispute, and the US impairment-only regime was adopted for international standards. When UK listed companies became governed by IASB standards from 2005, amortisation was ruled out for them too.[3]

This reform actually turned out to provide a great opportunity for creative accountants. It created opportunities to construct the combination's accounts so that strong profits could be reported after merger even if the merger failed in the sense of reducing underlying operating profits.

Before then, another device had been available to avoid amortisation. This presented acquisitions as mergers of equals ('pooling' or 'merger' accounting), where the purchase consideration never appeared in the accounts. This avoided any goodwill amortisation in the P&L. In one such deal, the bidder, AT&T, was prepared to expend as much as $500 million of its shareholders' funds just to have the transaction classified and accounted for without goodwill amortisation (Lys and Vincent 1995). Then Tweedie and Whittington (2020) report that the finance director of BP actually told the press that avoiding amortisation through pooling was an advantage of its acquisition of Amoco. Li (2007) estimates in this case that, had the combination instead been reported

2 Dennis Powell, quoted in Beresford (2001).

3 By 2020 FASB were minded to reintroduce the amortisation of goodwill (Lugo 2020).

as an acquisition, accompanied by amortisation, the amalgamation's earnings would have been reduced by percentages ranging from 8% to 37% in subsequent years. Another contrivance (common in the UK) wrote off the purchased goodwill immediately against reserves, thereby avoiding the need for any amortisation of goodwill and damage to the profit and loss account (Griffiths 1987). Wild (1987) gives the example of Saatchi and Saatchi who in 1985 wrote off £177 million of goodwill; the total capital and reserves left after the write-down was only £73 million.

Under current arrangements, if the target's inventory is marked down (automatically increasing the residual, purchased goodwill), the acquirer's cost of sales in future years (which will include items drawn from the devalued inventory) will be reduced, and reported earnings increased. Guinness were able by this device to stow up to £344 million in the cookie jar (Paterson 1988). The malleability of inventory valuation is suggested by Cisco, who wrote off inventory of $2.2 billion in 2001 (with their auditors' approval) but in the following year were able to sell $290 million of that inventory which they had shortly before valued at zero (Sherman et al. 2003). Then if the value of the target's fixed assets such as plant and machinery is marked down, future depreciation charges in the P&L will be reduced, so that reported earnings are higher. Tiphook boosted profits for the following nine years by this device, (Smith 1992, p. 27). In addition, acquirers have sometimes created a provision or reserve for future costs of reorganising the target, thereby swelling reported profits in future years. In the UK, Coloroll's cookie jar inflated reported profits more than ten-fold by this means, and in the US, Symbol Technologies created up to $186 m, and WorldCom substantial amounts (Mulford and Comiskey 2011, p. 422; Schillit and Perler 2010, p. 186). But the freedom to use this last device was drastically curtailed by the ASB in the 1990s (Tweedie, Cook and Whittington forthcoming).

Accounting Post-merger

Freed from the requirement to amortise goodwill purchased in the course of M&A, companies have had to decide whether, and by how much, to make an impairment charge in the P&L. Evidence on the unreliability and malleability of goodwill impairments has come from

three sources: analysis of relevant disclosures in financial statements (e.g. Comiskey and Mulford 2010, henceforth CM); surveying or interviewing preparers, auditors and standard-setters (e.g. EFRAG/ASBJ/OIC 2014, henceforth ASBJ; and KPMG 2014); and econometric analysis (e.g. Ramanna and Watts 2012, henceforth RW).

Several themes emerge from all three approaches. First, because goodwill consists of 'a present-value estimate of future rents' (RW, p. 755), executives' judgements are inevitably needed when selecting a valuation model, estimating future cash flows and choosing discount rates (CM). 'The subjectivity inherent in estimating goodwill's current fair value is greater than in most other asset classes such as accounts receivables, inventories and plant, making the goodwill impairment test under SFAS 142 particularly unreliable' (RW, p. 750). Auditors or board members find it difficult to challenge management's assumptions or 'to disprove them conclusively even when the assumptions seemed unduly optimistic or were not supported by historical performance' (ASBJ). Ramanna and Watts (2012) discuss the difficulty of disentangling the cash flows attributable to internally generated intangibles from those generated by the purchased goodwill. And they describe allocation procedures open to management, which can delay or accelerate impairment depending on managers' own interests.

Delay might be prompted by managers' wish to avoid or postpone reputational loss or to protect their incomes when their bonus schemes are driven by accounting profits (Elliott and Shaw 1988; Segal 2003; *Economist* 2013). Murphy (1999) reported that accounting-based compensation was usually paid out as a cash bonus, and the accounting-based compensation contracts are usually written on net income (and so include the effect of goodwill write-offs). In some circumstances, managers may have an interest instead in bringing forward or exaggerating impairments. Large impairments sometimes accompany the departure of the CEO who initiated an acquisition (this was observed following the disappointing Vodafone/Mannesmann and HP/Autonomy acquisitions, with goodwill impairments of £23.5 bn in 2006 and $9 bn in 2012 respectively). Such a 'big bath' has the advantage for the incoming CEO of 'disposing of an unwanted debit'(Arnold et al. 1992) at the expense of profit on her predecessor's watch, obviating future impairment charges and setting a low earnings base against which her subsequent performance will be judged.

These problems are recognised in the practitioner literature. '[I] t is impossible for management to have an unbiased view' (KPMG 2014, p. 8): 'management may have incentives to delay (or accelerate) or to minimise (or maximise) an impairment charge for reputational, compensation or financing covenant reasons' (KPMG 2014, p. 5). Hans Hoogervorst, Chairman of IASB, described the biases: '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 recognise hefty impairments on their predecessor's acquisitions' (KPMG 2014, p. 5).

RW test this agency theory prediction—that 'managers (all else equal) will, on average, use the unverifiability in goodwill accounting rules to manage financial reports opportunistically', against the view underpinning the impairment-only policy, that 'the fair value estimates [of goodwill] will, on average, allow managers to convey private information on future cash flows'. They find no evidence to confirm the latter proposition, but 'evidence of managers, on average, using the unverifiable discretion in SFAS to avoid timely goodwill disclosures where they have agency-based motives for doing so' (RW, p. 777). Amel-Zadeh, Faasse, Li and Meeks (2020) argue on the basis of a statistical study for the UK that the UK's (amortisation plus occasional impairment) regime around the millennium secured value-relevant reporting while mitigating the agency/stewardship problems associated with the current impairment-only regimes of FASB and IASB.

A Step Too Far: Accounting for Merger to Conceal a Management Failure

This accounting manipulation differs from the rest in this appendix. First, rather than often preceding failure, this one follows a failure and is designed to conceal that failure (in which it succeeded for some twenty years). Second, it fell foul of the law, something the accomplished creative accountant would never do. This case is Olympus, and is explained in a valuable *mea culpa* report published by Olympus itself (see Olympus Corporation 2011).

The origin of the problem at Olympus was that the managers had embarked on speculative investments which by 1990 had accumulated losses of some ¥100 billion. At that time these losses were not disclosed in the company's financial statements, because the assets concerned were recorded at cost, consistent with the prevailing accounting conventions. But the accounting regulations were about to change to require disclosure of the investments at "fair value"—what they were worth currently on the market.

To avoid disclosure of the latent losses, an elaborate device was created. Off balance sheet vehicles were created (in offshore jurisdictions) to buy these eroded speculative assets from the company—at their original cost. So no loss was recognised in Olympus's books. The off-balance sheet vehicles were financed by banks whose loans were in turn funded by "back-to-back" deposits from Olympus.

In due course a device was needed to deal with the latent losses embedded in the off-balance sheet vehicles, and to repay the banks. So the off-balance sheet vehicles acquired companies at fair value which were then in turn taken over by Olympus, *at inflated prices*. The inflated prices generated surpluses in the off-balance sheet vehicles, sufficient to offset the latent losses on the speculative assets which they had received from Olympus and to allow these vehicles to repay the loans with which they were financed.

At this point, Olympus held taken-over companies valued in their books at the inflated prices which had been paid to the off-balance sheet vehicles. In accordance with accounting regulations, the separable, generally tangible, assets of the new subsidiaries were recorded at fair value, and the excess of the purchase price of the acquired company over the fair value of the separable assets was recorded as goodwill.

Over a period of many years, this set of devices had in Olympus's accounts converted overvalued speculative assets into overvalued acquisitions; and the original speculative losses were invisible in the trail of transactions. The overvaluations were eventually corrected by impairment charges against purchased goodwill—¥55 billion in 2009 alone.

The sequence of acquisitions was prompted by a failure—losses on investments. Then the acquisitions themselves met our definition of failure—zero or negative operating gains combined with transaction

costs. And ultimately (albeit after two decades) the strategy failed in its objective of misleading shareholders and other outsiders without suffering criminal charges.[4]

So two related rounds of M&A were deployed by Olympus (neither of which was concerned with achieving operating gains, and both of which will have imposed transaction costs at investors' expense). And sequences of acquisitions are the subject of Chapter 10. Integrating pre-merger devices with the manipulations available when recording an acquisition requires great skill and draws the admiration of fellow creative accountants. It can transform a series of failed mergers (on our definition) into a self-sustaining record of apparently profitable growth.

4 Directors were fined.