Accounting for Business Combinations

15.511 Corporate Accounting

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MANAGEMENT

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:

Ownership:	<20%	20-50%	>50%
Influence:	"passive"	"significant influence"	"controlling"
Reporting Method:	*Mark-to-market*	*Equity*	*Consolidation*

Equity Investment Accounting Rationale

- **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.

	Cash	Long-term Investment	R/E	Comment
1. Purchase	(480,000)	480,000		
2. Dividends	24,000	(24,000)		40% × $60,000
3. Aff. earnings		40,000	40,000	Investment income

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

Control → Consolidation Method

- 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.

Issues In Goodwill Accounting

- 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