

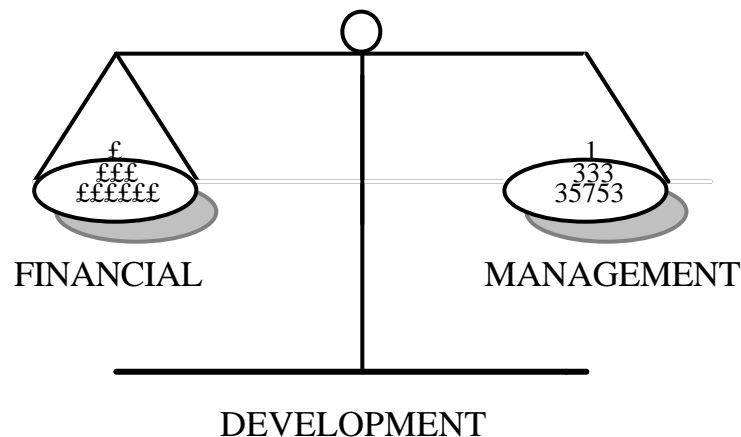
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Acquisitions

NO 154

MERGER ACCOUNTING OR POOLING OF INTERESTS



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

MERGER ACCOUNTING OR POOLING OF INTERESTS

Merger Accounting or “Pooling of Interests” is an accounting presentation frequently used by companies who have made a substantial acquisition. It has multiple impacts on reported earnings. The rules as to when its use is allowable and the details of its implementation are complex and currently under review. This note sets out some of the key features of the approach. It is not designed as a technical document. If the approach is to be adopted professional advice should be sought.

1. Avoidance of the recognition of Goodwill/Share Premium

Assume company A wishes to take over company C by an issue of shares. Company C has a book value of assets in its Balance Sheet of £2 million yet its market value is £9 million. Under normal accounting conventions the Goodwill of £7 million would be recognised and the value of the shares issued would be shown as £9 million. With merger accounting the book value remains in the Balance Sheet and the Goodwill is ignored. The Balance Sheet thus looks smaller and the purchased Goodwill is treated in the same way as internally generated goodwill i.e. it is ignored.

2. Avoidance of Goodwill Write Off

The fact that the Goodwill is not recognised allows the P&L A/C to remain free of any charge for writing it off. Thus if the company above had adopted normal acquisition accounting the Goodwill of £7 million would have had to be written off. Approaches vary (in the UK it has been written off immediately against retained earnings; in the US it could be written off over up to 40 years). If the acquiring company C were to show the Goodwill as an asset and write it off over (say) 20 years the additional charge against profits would be £350 million per year.

3. Restatement of Past Results

Since merger accounting treats the new enlarged company as if it had always been one entity - by ignoring internally generated Goodwill - it is reasonable to adjust the past data by including the revenues, profits, assets and liabilities etc. of both companies in the comparative figures for previous years. The rules for this - particularly with regard to Earnings per Share - are complex. However, the end result is to give a better basis for projections for the future at the expense of accuracy in the past data - which is altered to reflect the result of an entity which did not exist. In particular, the Earnings per Share data is restated to reflect the new shares issued as part of the acquisition.

The adoption of Merger Accounting, or Pooling of Interests helps to show the size and track record of the enlarged organisation. However, it ignores the Goodwill and can disguise the true performance of the shares held in the individual entities.

The accounting treatment has no impact on cashflow which for many analysts is the key indicator of corporate performance.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development.

He has worked as a Financial Controller and Company Secretary in the Finance Industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over thirty major organisations including Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, The Post Office, Rothmans and Zeneca. International training experience includes work in Denmark, Kenya and the Czech Republic for Unilever, in Dubai for Al Atheer, in Holland and the U.S. for Avecia and Zeneca and in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. A key output from the training is demonstrable use of the knowledge and skills acquired to enhance corporate profitability. In addition he has run courses in acquisition evaluation (The Economist, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). He has also developed material for delivery by in house personnel (Royal Mail, Lloyds Bowmaker and Conoco) and computer based training packages (The Post Office, Unilever and BP).

He is a prolific writer of case studies, role plays and course material, he has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants and the need for taxation awareness training for general managers.

He is married with one grown up daughter and his outside interests include being The Treasurer of the Hospice of St. Francis (Berkhamsted), and a member of the Catholic Alpha Training Team (Promoting the Alpha course on Basic Christianity). He was a Governor of Luton University for nine years and a school Governor for four years.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).