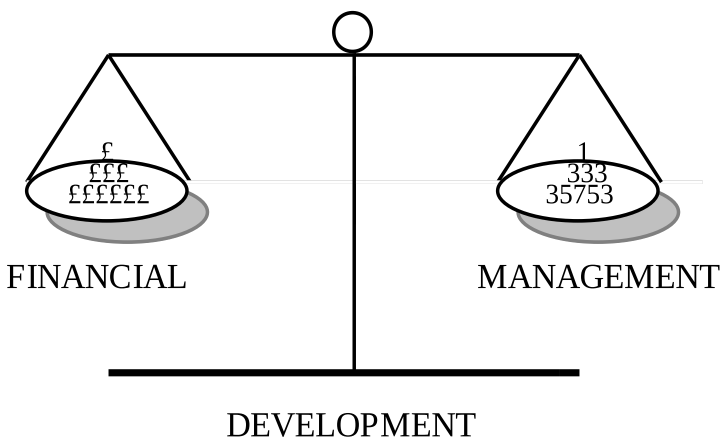
FINANCIAL MANAGEMENT DEVELOPMENT

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 constantly 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. In particular FRS 6 - amended in 2009 sets out the circumstances when it may be appropriate.

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 in the past it has been written off immediately against retained earnings; now it is allowable to recognise it, but it needs to be amortised or constantly reviewed for possible impairment, 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 and has been an Ordained as a Deacon in the Catholic Church.

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 forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

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, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:
FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

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).

