

# ACCT 743 – Accounting for Complex Mergers and Acquisitions

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## NOTE

- **merger requires** – acquisition of all of T's equity + combination of two entities into 1

### I. Purchase Accy

- **General**
  - valuation = arbitrary (less so w/ tax election b/c IRS oversight)
  - acquisition date = date (a) consideration sent or (b) assets received or (c) parties designate specific date (if in writing + no S/H approval required + no gov't approval required)
  - income – s/b allocated to pre / post acquisition periods
  - **asset valuation** ~ arbitrary practice
- **Process** – (i) add T's A, L at FV + (ii) increase A's C/S by par value of amts issued + (iii) eliminate T's total equity + (iv) increase A APIC by amount related to C/S + (v) plug G/w
  - **business combo costs** – direct = capitalized; indirect = expensed; securities related = charged to APIC
- **Other issues**
  - **Determining A** (~reverse acquisition) – factors = who gets more vote + BOD composition + Chairman of combined company + top mgmt of combined Company + relative FV of companies + composition of S/H (and restrictions on large S/H)
  - **Push-down Accy** –
    - want none if planning to spin off sub – b/c reduces sub's earnings
    - available only when – (i) consolidate (i.e., so can leave purchase step up at consolidated level) + (ii) > 80% ownership
    - required when sub becomes substantially owned (> 95%) unless T has public debt / PS registered w/ SEC
    - amounts pushed down = only T amounts (not Holdco Acquisition debt unless guaranteed / serviced by T)
  - **JT Ventures** –
    - benes – risk sharing + combine tech, markets, human resources, etc.
    - reporting –
      - ◆ managing investors participating in corp JV → record as equity investment

- ◆ investors w/o mgmt influence → cost method
- ◆ > 50 % investment in corp stock of JV → accounted for as subsidiary investment = equity method

- Leveraged Recap – (see p 108)
  - bene – allow change in control of corp w/o triggering purchase accy b/c no pushdown accy when acquire > 95%
  - process – (i) issue shs to new investor + (ii) issue debt + (iii) stock redemption of old S/H
  - used by – most often = private investors unable to consolidate (b/c avoids need to reflect purch accy on T books)
- Negative G/W – process – (i) writedown N/C assets + (ii) if N/C assets = 0 → create negative G/W
- Paper Earnings –
  - situation - (i) overpay for bad loans + (ii) different liability reversal rate for liab than G/W amortization
  - FASB solution – loan portfolios & G/W m/b written off at same rate
- Disappearing G/W
  - p. 111 - ???
  - In Process R & D – US GAAP allows up front write-off of in process R & D (whose value was reflected in G/W)
- Quasi Pooling –
  - possible b/c – Accy rule allows P w/ majority owned sub to swap assets b/w subs w/o revaluing assets
  - in effect – creeping acquisition when (i) P buys T + (ii) later swaps T assets to other sub for more stock
- **Policy**
  - R/E eliminated b/c purchase of an asset should never effect Buyer's R/E

**II. Pooling Accy**

- **General**
  - treated as if occurs at BOY
  - requires – autonomous companies (2 yrs) + independent (10%) + single transaction + common stock exchange (90% subst all rule) + no prior equity exchange ( 2 yr rule) + sh repurchase only if unrelated to combo + no change in proportionate interests + voting rights immediately exercisable + combo resolved at consummation + issuing company <> agree to reacquire shs + issue company <> plan to dispose assets w/i 2 yrs
  - common problems – A cannot own > 10% of T + A must issue own C/S + A prohibited from sh buyback programs + A prohibited from offering contingent consideration to T S/H that substitute cash for equity + A cannot dispose of significant T business / assets
- **Process** – (i) add T's A, L, R/E at BV + (ii) increase A's C/S by par value of amts issued + (iii) eliminate T's S/H equity + (iv) plug APIC + (v) reduce R/E if APIC plugged below zero
- **Pooling Diff from Purchase** = depr / amort + record date + **business combo costs** + speed (cash faster than equity) + other countries' treatment (protectionism, state involvement, less sophisticated, corruption)
  - **business combo costs** – all expensed (~ b/c no adjustment to basis)
- **Policy**
  - combining assets <> a purchase → treat as if always one firm
  - post combo stock buyback ~ purchase accy b/c gives cash to new owners

	<b>Pooling</b>	<b>Purchase</b>
Theory	A & T come together to share risks	A acquires T like an asset
B/S Effect	BV for both A & T	BV for A + FV for T
I/S Effect	favorable	old - unfavorable (G/W Amort) new – unfavorable (stepped up depr)
C/F Effect	small	same as pooling if stock swap

Structuring	little flexibility	very flexible
Business Combo Exp	- Direct = exp - Indirect = exp - Sec Regist = exp	- Direct = capitalized - Indirect = exp - Sec Regist = APIC
Algorithm	i) Add A & T assets & liab @ HC ii) A C/S add par value of new stock issued iii) Eliminate T S/H Equity iv) Add A & T R/E v) Plug A's APIC vi) If A's APIC reduced to zero, reduce R/E for deficit	i) Add A Assets / liabilities @ HC to T's @ FV ii) A C/S add par value of new stock issued iii) Increase A's APIC by APIC on shs issued iv) eliminate T total equity - R/E eliminated b/c purchase of asset s/n effect A's R/E v) Plug to G/W for difference b/w cost and FV o fnet assets
Record Date	BOY	a) Date cash disbursed / securities issued b) Agreed upon end of accy period IFF (i) in writing + (ii) no S/H approval required + (iii) no gov't approval required
Depreciation	None	G/W + Stepped up basis
Speed	Slow b/c equity issues	Faster b/c cash c/b used
Pre-closing adjustments	None	IFF material → net income prior to closing + imputed interest on assets / liab

### III. Goodwill

- **Applicable Rules**
  - SFAS 141 (Business Combinations) – requires Purchase Accy + recognition of assets + allocate purchase price b/w assets & G/W
  - SFAS 142 (G/W & intangibles) – post-acquisition treatment, including impairment loss
  - SFAS 121 (Impairment Loss) –
- **Amortization**
  - GAAP – none now
  - Tax – 15 yrs
  - IAS = 20 yrs

### IV. Tax

- **4 Possible Situations**
  - **i) Asset Purchase** – A has step up basis; ***Seller pays for tax bene gained*** (~ A pays more to S to compensate for taxes)
  - **ii) Stock Purchase** – ***A pays for tax benefit gained***
    - **a) no election** –
    - **b) 338(g) election** – ***A makes election***
      - ◆ Acquirer – A treated as buying stock of New T

- ◆ Seller – not effected by A's election + taxed on sale of stock
- ◆ T - treated as selling assets to New T (T pays tax for basis step up) + **may use NOL's to offset gain** + remaining tax attributes are lost
- ◆ remember –
  - > **deemed purchase price** = amt paid by A + liab assumed by New T (including tax on sale gain)
    - allocated to New T assets using residual method
  - > no § 338(g) if no NOLs present
- **c) 338(h)(10) election – jt. election by A & S**
  - ◆ election = jt b/w A & S
  - ◆ A – makes jt election w/ S + treated as buying stock of New T
  - ◆ S – pays tax on gain realized by T's deemed sale to New T + **inherits T's tax attributes (NOL's)**
  - ◆ T - treated as selling assets to New T + liquidates in tax free transaction to S
  - ◆ remember – benefit is either that S gets T's NOL's or can offset S NOL's w/ gain on stock
- **Grouping** (i.e., when A maintains T as separate sub)
  - **unaffiliated** – A & T pay taxes individually
  - **affiliated group** – if A owns ≥ 80% of T's outstanding C/S
    - bene = 100% of inter-corporate dividends excluded for tax purposes
    - A& T may file as consolidated entities or separately
    - consolidation – allows NOL of each entity to offset income of other (but less flexibility ~ tax yr, accy procs, etc)
- **Remember** - there is no free lunch

## V. EPS

- **Required Disclosures** – (EXCEPTION = if numbers are same OR difference is not material OR if NIAC ≤ 0)
  - **Basic EPS** (solely C/S outstanding) = **NIAC / CSO**
    - **i) Net Income Available for Common (NIAC)** = Net income – preferred requirement
    - **ii) Weighted Avg CS O/S (CSO)** – weight stock transactions for period of year O/S (splits / dividends = retroactive; ignore T/S)
  - **Diluted EPS** = (include dilutive securities convertible into C/S)
    - represents worse case scenario
    - **i) compute dilution TR for each issue of securities**
      - ◆ **convertible bonds** = [int exp during fraction of period bonds O/S \* (1 – tax rate)] / **ES**
        - > **ES** (weighted avg equivalent shares) = # units of convertible securities \* conversion ratio \* fraction of period convertible security O/S
      - ◆ **convertible preferred** = Div required / **ES**
      - ◆ **options (under Treasury Stock method)** =  $0 / (NS - SP)$  [always dilutive]
        - > **NS** = number of shares required to satisfy options
        - > **SP** = shares purchase (at avg Market P during period) w/ any money received from exercise
        - > **Treasury Stock Method** –

– applies only in quarter after option is above water for substantially (11 weeks out of quarter) all of 3 consecutive months

◆ **out of the money options** = ignore

– **ii) Test dilution TR for each security issue**

- ◆ **a)** compare smallest TR to BEPS – if TR < BEPS then (b); Q/W stop
- ◆ **b)** include TR in BEPS (add numerator and denominator) + repeat step (a)

• **Acquisition**

- numerator – enhanced by additional income / decreased by interest on debt (including OCoC)
- denominator – possible dilution
- **F:**  $[A N/I + Q\% \text{ of } T N/I - \text{Int expense to acquire } (1-t)] / A \text{ CSO} + A \text{ equity issued in acquisition}$ 
  - **Int expense to acquire** – includes OCoC
- **Key** – what combination of debt / equity gives > est EPS

➤ **cash v. equity**

- – A EPS = reduced by servicing interest (1-t)
- = greater EPS than all equity (due to dilution)
- **maximizing EPS** → maximize equation by solving for N that maximizes

$$[A \text{ Income} + T \text{ Income} - (T \text{ sh } P)(N) (\text{base } r + PN * \text{var } r) * (1 - t)] / [A \text{ shs} + (\text{exchange rate} * T \text{ shs})]$$

- ◆ where N = number of T shs acquired for cash
- ◆ if N = 0 → all cash

• **Consolidated EPS**

- remember – consolidated earnings = undiluted → cannot use S equity earnings IFF S has dilutive shs outstanding
- P consolidated earnings – P equity in S realized income + [(NI avail to Pref & Common) / (Common + Pref) \* S shs held by P] (~ **P equity in S earnings**)

• **Earnings Confusion**

- analysts / investors need – standardized operating # + audited Net Income number + reconciliation b/w these
- remember – GAAP number is always available even w/ all pro-forma numbers
- sources of confusion – FASB + S&P + company + Wall Street

• **Remember**

- numerator = income available to C/S S/H
- denominator = avg number shs O/S for period (~ avg b/c assume earnings earned evenly throughout period)
- substantial use of EE stock options makes diluted EPS more interesting

**VI. Accy for Investments**

• **Accy Methods**

➤ **A) Cost (0-20%)**

- when – investment < 20% unless investor has significant influence
- process – (i) record investment @ cost + (ii) record receipt of div as income
- **Accy** -

- ◆ I/S – Dividends
- ◆ B/S (Investment in Sub) – initial investment - dividends in excess of investors share of post acquisition earnings

➤ **B) Equity / One line Consolidation (20-50%)**

- required – if both (i) **significant influence** over investee and (ii) investment is < 50%
  - ◆ **significant influence** – factors ~ permanent nature (ignore if temporary) + presence of opposition to investor + surrender of S/H rights by investor + concentration of majority ownership +

inadequate information to apply equity method + failure to obtain representation on investee BOD

- how – Investment in Target = one line summary of O/W on a consolidated B/S (~ **one line consolidation**)
- Key (over consol) – no impact on A financial ratios b/c simply offset T debt / assets (avoid incorporation of Sub's debt / low  $\pi$  ops on consolidated entity's T/R)
- process - (i) record investment @ cost + (ii) increase investment by share of earnings + (iii) reduce investment by div / amortization of excess of cost over book
- **Accy** -
  - ◆ I/S (Equity in Sub Income) – income - dividends
  - ◆ B/S (Investment in Sub) – initial investment + income – dividends + / - amortization of excess cost over book

➤ **C) Consolidated** (50-90%)

- required – if **(a)** effective control or **(b)** > 50% ownership
- **Accy** -
  - ◆ I/S – add accounts – prorate portion prior to acquisition – Minority interest
  - ◆ B/S – add accounts (exclude Sub Equity) – minority interest

➤ **D) ??** 90-100%

• **general**

- **effective control** ~ greater than 50% interest in T
- issue – can there be defacto control b/c K w/ distant parent are so valuable (~bottlers allow KO to isolate loss business from  $\pi$  business)

**VII. Special Purpose Entities**

**VIII. Issuance of Shs by Sub**

• **two alternatives** –

- **i) Change in Equity = Post equity of Sub (P ownership % after sale) – Pre equity of Sub (P ownership % before sale)**
  - i.e., force plug for difference in equity ownership before and after
  - **Credit APIC (Dr Equity of Sub)**
- **ii) Implicit Sale of Shs (SAB 51 Gains) = [(# Sub shs sold) (market P) (P ownership % after sale)] – (Pre-Investment in Sub) [(P ownership % before sale - P ownership % after sale) / P ownership % before sale]**
  - % share of Proceeds (@ post sale ownership %) – cost basis of equity sold (% change in investment acct)
  - **Credit Gain on Sale (Dr Equity of Sub)**

• **remember** -

- Credit amounts are equal under either method unless (Investment in Sub) <> (Equity of Sub)(P ownership % before sale)

**IX. Complex Affiliations**

• **Algorithm**

- **i) recognize that** -
  - $C_i$  = (separate, realized earnings of accounting entity i) – (amortization of G/W on i's investments)

- $P$  = net income of Parent
- $S_i$  = net income of Sub  $i$
- $Q_{ij}$  = separate legal and accy entity  $i$ 's % ownership in entity  $j$  ( $Q_{ii} = 0$  by defn)
- **ii) simultaneous equations**
  - $P = C_0 + \sum_{j=0}^n Q_{0j} S_j$
  - $S_1 = C_1 + \sum_{j=0}^n Q_{1j} S_j$
  - .....
- **iii) solve simultaneous equations** for unknown  $P, S_1, \dots$
- **iv) allocate Consolidated Earnings among Parent and minority interest** –
  - **Consolidated Net Income** =  $P \times (1 - \sum_{i=0}^n Q_{i0})$
  - MI NI in sub 1 =  $S_1 \times (1 - \sum_{i=0}^n Q_{i1})$
  - .....
- **In practice**
  - **i)** find consolidated income = eliminate inter-co transfers /  $\pi$
  - **ii)** solve for each sub separate consolidated income (simultaneous equations) = contribution to consol income (from i above) + % share of own subs  $\pi$  (~ equity method)
  - **iii)** minority interest = MI % x separate sub consolidated income

## X. Working Paper Adjustments

- **Entries (Equity)**
  - **S** –
    - eliminate S Equity accts (BOY) against BV in P Investment Account
    - eliminate pre-acquisition income
      - ◆ ARB 51 –
        - > i) consolidate as if P held interest for whole year
        - > ii)
    - recognize Minority Interest (BOY)
  - **A** – recognize unamortized allocations (BOY) created by original investment against P Investment Account
  - **I** – eliminate equity earnings accrued by parent against P Investment Account
  - **D** – eliminate interco Div paid by S to P (**R/E**) against P Investment Account
  - **E** – recognize Amort Expense (CY) on individual assets against Consol Income
  - **P** – eliminate interco Payables against Receivables (and vice versa)
- **Entries (Cost)**
  - **C\*** - convert cost basis balance to equity basis; relates solely to PY; DR – Investment in S; CR – R/E P
  - **S** -
  - **A** -
  - **I** – eliminates dividends
  - **E** – brings CY amort exp into F/S
- **Contingent Purchase Price** -
  - if based solely on future earnings → no impact on initial P (future payments received = addition to purchase P in yr received + any change in amort exp = recorded over remaining life)
  - if based on future stock P → treated as guarantee of initial consideration (not increase to P)
    - effect at future issuance of added consideration = reduce initial consider (APIC) + record additional consideration (par value)
- **Push Down Accy**
  - policy for – ownership change creates new accy basis + P could acquire assets / dissolve company (subst over form)
  - SEC SAB 54 – push down required where no substantial outside ownership exists of CS, PS, public debt
- **remember**
  - bargain purchase – amort in subsequent years creates entity w/ consol income > separate company income

## X. Inter-company Transactions

### • A) Inventories

#### ➤ A) downstream sale – no income to P

##### – Income from S

- ◆ =  $Q\% * S \text{ N/I} + \text{Unrealized } \pi \text{ in BOY Inv} - \text{Unrealized } \pi \text{ in EOY Inv}$
- ◆ =  $S \text{ N/I} + \text{Unrealized } \pi \text{ BOY} - \text{Unrealized } \pi \text{ EOY} - \text{MI N/I}$   
 $> \text{MI N/I} = (1-Q\%) * S \text{ N/I}$

##### – Consol N/I = P exclusive N/I + Income from S

##### – W/P adjustment (don't ask, just do) –

##### ◆ a) CY -

- ◆ 1) amount of sale to S: **Dr** - Sales + **Cr** - COGS
- ◆ 2) **P gross  $\pi$  still in S Inventory**: **Dr** - COGS + **Cr** - Inventory  
 $> \text{amt} = (1 - \% \text{ of goods sold}) \times \text{P gross } \pi$

##### ◆ b) NY: P gross $\pi$ still in S inventory: **Dr** - Investment in Sub + **Cr** - COGS

##### – remember - reduce S COGS by P $\pi$ % on interco transfer (COGS should = cost to parent)

#### ➤ B) upstream sale – no income to P or MI

##### – Income from S

- ◆ =  $Q\% \text{ of } S \text{ N/I} + (Q\% * \text{Unrealized } \pi \text{ in BOY Inv}) - (Q\% * \text{Unrealized } \pi \text{ in EOY Inv})$
- ◆ =  $S \text{ N/I} + \text{Unrealized } \pi \text{ in BOY Inv} - \text{Unrealized } \pi \text{ in EOY Inv} - \text{MI N/I}$   
 $> \text{MI N/I} = (1-Q\%) * S \text{ N/I} + (1-Q\%) * \text{Unrealized } \pi \text{ in S BOY Inv} - (1-Q\%) * \text{Unrealized } \pi \text{ in S EOY Inv}$

##### – Consol N/I = P exclusive N/I + Income from S

##### – by convention – MI shares responsibility for unrealized upstream sales

##### – WP adjustment –

##### ◆ a) CY - exactly reversed (except in Yr 2)

- > 1) amount of sale to P: **Dr** - Sales + **Cr** - COGS
- > 2) **S gross  $\pi$  still in P Inventory**: **Dr** - COGS + **Cr** - Inventory  
 $\rightarrow \text{amt} = (1 - \% \text{ of goods sold}) \times \text{S gross } \pi \dots$

##### ◆ b) NY –

- > i) P% of S gross  $\pi$  still in P inventory: **Dr** - Investment in Sub + **Cr** - COGS  
 $\rightarrow = Q\% (1-\% \text{ of inventory sold}) \times \text{S } \pi$
- > ii) MI % of S gross  $\pi$  still in P inventory: **Dr** - Minority Interest + **Cr** - COGS

### • B) Non-depreciable Assets (Land)

#### ➤ Key = have to adjust Inv in Sub + Land accts every yr that Land remains on the books of Sub

#### ➤ Downstream

- no effect on MI
- if equity method applied correctly →

#### ➤ Upstream

- recognize impact on MI

### • C) Depreciable Assets

- assume (for this class) – after sale, next entity depreciates in full
- Adjust
  - N/Y – depr exp +
- **D) Bonds**
  - Assume – Disc / Prem is amort S/L until maturity
  - S Acquires P Bonds
    - **MI** – no bene (bene = to consol entity thru Parent's reduced interest expense)
    - **CY**
      - ◆ i) recognize constructive G / L on repurchase of own bonds (= Principal – Purchase)
      - ◆ ii) reverse of interest income received by P (**net of amort of Discount / premium**)
      - ◆ iii) Eliminate Bonds (principal) from Sub's books
      - ◆ iv) reverse P investment in Bonds (**after** CY amort)
      - ◆ v) reverse S interest expense
    - **NY**
      - ◆ i) adjust Inv in Sub for unamortized amount
      - ◆ ii-v) same
  - P Acquires S Bonds
    - **MI** – Gets share of amort
    - **CY** -
      - ◆ i) Recognize constructive G / L on repurchase of own bonds (= Principal – Purchase)
      - ◆ ii) reverse P's share (1-MI%) of interest income received by S (net of amort of Discount / premium)
      - ◆ iii) Eliminate Bonds (principal) from Parent's books
      - ◆ iv) reverse S investment in Bonds (after CY amort)
      - ◆ v) reverse P interest expense
      - ◆ **remember** – Inv in Sub = Plug
    - **NY** –
      - ◆ i) adjust Inv in Sub for **P's share** (1-MI) of unamortized amount
      - ◆ ii) adjust M/I BOY for MI share of unamortized amount
      - ◆ iii) same as (ii – v) above
      - ◆ **remember** – Inv in Sub = Plug

<b>XI. Foreign Currency</b>
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- **Translation**
  - process -
    - i) record Sub's F/S in **functional currency** (FC)
      - ◆ **functional currency** = currency of the primary economic environment in which the entity operates
        - > ~normally = the environment in which it primarily generates / expends cash
        - > determined by company mgmt
    - ii) adjust F/S to compliance w/ GAAP (still in FC)
    - iii) translate balance of each F/S account to P's reporting currency
      - ◆ **A & L** ~ current exchange rate (~ **C**)
      - ◆ **inventory** = BI + Purch -COGS
      - ◆ **rev, exp, G & L** ~ historical rate (~**Avg**)
      - ◆ **equity** ~ historical rate (~**H**)
      - ◆ **R/E** ~ historical rate (~**H**) ??
    - iv) record equity adjustment = effect of translation
  - applies when – prep of Sub's F/S for consolidation
  - policy –
    - measures relative values for reporting purposes (not intended to represent anticipated effect on Sub C/F)

- not recognized as actual G / L

- **Re-measurement**

- process –
  - **i)** re-measure amounts into Sub's FC
    - ◆ **monetary A & L** ~ current exchange rate (~ **C**)
    - ◆ **all other accts** ~ historical rate (~ **H**)
  - **ii)** recognize G / L on re-measurement (offsets increase / decrease to A / L acct)
- applies when – individual transactions denominated in a currency other than the functional currency
- policy –
  - presumed to have a measurable effect on Sub's C/F
  - recognize G/L
- NOTE – if Sub F/S not recorded in FC → re-measure (not translate) amounts into FC

- **Inter-company loans**

- denominated in F/C – floats on P books at YE rate
- denominated in R/C (translated) – floats on S books @ wgtd avg rate
- denominated in R/C (remeasured) – no adjustment - any G/L just in remeasurement G/L

<b>XII. LBO's</b>
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## App. A – Goodwill Background

### A) Prior Rules - Purchase v. Pooling under APB 16

#### generally -

- Acquirer chooses accy method by controlling consideration used
- **criticisms** -
  - ◆ Purchase v. Pooling debate = wrong questions
    - > asks - what kind of acquisitions establish a new cost basis
    - > should ask - what events trigger revaluation
    - > answer = lok to 1<sup>st</sup> principals of accy (what are purposes + what are risks of error)
  - ◆ allowed parties to plan which method to use
  - ◆ barrier conditions to pooling can be dismantled – see SEC caving to ATT re: purchase of NCR and pre-existing violations of conditions

#### i) Purchase -

- **theory** – A buys assets + reflects economic reality
- **application** – where primarily cash consideration use
- **methodology** -
  - ◆ **1**) assets recorded at A cost (including FMV of non-cash consideration + PV of liability assumed)
  - ◆ **2**) allocate total cost between assets (based on FMV) – up to assets total MV
  - ◆ **3**) either -
    - > **A**) excess price paid = G/W (amortized over ≤ 40 yrs) **OR**
    - > **B**) excess of market value over price paid reduces non-current assets (other than LT investment in marketable securities) w/ negative G/W only if non-current assets reduced to 0 AND never increase S/H equity
- **APB 16 criticisms** -
  - ◆ difficult to value property (especially intangible assets) – *BUT valuing stock c/b difficult also*
  - ◆ G/W not determinable b/c in negotiations, the G/W of both companies is relevant
  - ◆ does not reflect economic reality b/c only captures FV & G/W of T
  - ◆ application in a down market artificially inflates A future earnings (e.g., amort of neg. G/W)

#### ii) Pooling -

- **theory** – acquisition is merely form over substance (S/H remain same + no true acquirer + no reason to change historic cost) + represents an exchange b/w S/H + no distribution / reduction of corp assets + no new capital received + each S/H group (T & A) maintain / shift same risk elements + change in circumstances captured by changed equity (new shs issued) & EPS
- **application** – only allowed when all of following
  - ◆ **1) independent ownership interests combined in entirety** – requires each company be -
    - > **a**) = autonomous (<> division / sub of other company w/i 2 yrs) **AND**
    - > **b**) = independent (holds ≤ 10% of voting stock of other company)
  - ◆ **2) combination occurs thru exchange of voting C/S interests** – including all the following -
    - > **a**) combination concluded in **(i)** single transaction OR **(ii)** specific plan w/i 1yr
      - changing terms = new plan
      - exception – delay is beyond control of companies b/c govt action / litigation
    - > **b**) consideration = C/S w/ rights identical to current C/S of A for **subst. all** (≥ 90%) of T C/S
      - **exceptions** –
        - **1**) de minimis cash allowed for fractional shs / minority int
        - **2**) if other A stock O/S → may issue other stock proportionately
    - > **c**) neither combining company changes equity int of C/S in contemplation of combination w/i 2 yrs before
      - exception – normal dividends allowed
    - > **d**) purchases of treasury stock = for reasons other than combination
      - exceptions – systematic pattern of reacquisition starting ≥ 2 yrs prior
    - > **e**) relative interests of S/H in each company remain the same
    - > **f**) S/H retain voting rights in C/S
    - > **g**) combination consummated when plan finished (no contingent issue of stock OR issuance of stock to escrow stock)
  - ◆ **3) absence of planned transactions**, including re-acquisition of C/S, for benefit of Old S/H, to divest stock w/i 2 yrs
- **methodology** – simply add assets, liabilities, equity
- **effect** = lower Net Income than pooling (assuming rising market)
- **criticisms** –

- ◆ can allow mgmt manipulation of earnings
- ◆ all acquisitions are essentially a bargained purchase (even if consideration used is stock)
- ◆ significant size differences limit risk sharing b/w S/H of T & A
- ◆ inflates profit on subsequent sale by A
- ◆ stock v. cash = different form (not different in substance)
- ◆ difficulty in asset valuation cannot defeat air presentation

## B) New Regime – Purchase Accy w/o G/W amortization (SFAS 141 & 142)

- **i) theory** – A buys assets + reflects economic reality
  - SFAS 141 - purchase transaction = basis for recognizing G/W b/c it cannot be purchased separately
- **ii) application** – applies to **business combinations**
  - **business combination** = when **entity** acquires either **(i)** net assets constituting a business **OR (ii)** equity interests of one / more entities and obtains **control**
    - ◆ **entity** = business enterprise, new entity formed to complete business combination (which may not be A), mutual enterprise
    - ◆ **control** – direct / indirect ownership of > 50% voting shares
    - ◆ **excludes** – JV + acquisition of non-controlling interests + NFP organizations
- **iii) methodology** –
  - **a) identify acquiring entity** – based on F&C considering certain **factors** -
    - ◆ **factors** = distributing cash + issuing equity + relative size (assets, revenues, earnings) + post combo voting rights + largest min. interest if no majority + governing oversight + control of sr. mgmt + which company initiated if multiple entities
  - **b) determine cost of T acquisition to A** – include all of the following
    - ◆ **1)** either **(a)** pre / post acquisition market quote of T securities **OR (b)** value assets directly **AND**
    - ◆ **2)** direct costs of acquisition **AND**
    - ◆ **3)** contingent consideration – affects cost only **(i)** at resolution of contingency + **(ii)** IF
      - > **A)** = additional securities issued based on subsequent earnings results noting that -
        - **i)** ~ restate earlier consideration to current price and amortize any discount on debt over remaining term
        - **ii)** div / interest distributed also affects cost
      - > **B)** <> IF additional securities issued based on subsequent security prices
  - **c) Allocate cost to assets / liabilities** –
    - ◆ **1) tangible assets and liabilities** – see para. 37, 40, 41
    - ◆ **2) intangible assets** –
      - > **non-G/W** – recognized separately if either **(a)** arises from K / legal rights **OR (b) separable**
        - **separable** – if may be separated and sold, transferred, licensed
      - > **G/W** -
        - positive = residual excess
        - negative – reduces non-current assets to zero + excess treated as extraordinary gain
      - > **why treat separately** – more useful F/S + G/W is indefinite lived asset that s/n/b amortized
    - ◆ **3) R&D expenditures** – expense if no alternative future use
  - **d) financial stmt disclosure** – see para. 51-58
  - **e) subsequent treatment of intangibles** – SFAS 142
    - ◆ **1) current costs** (of maintaining / restoring) = expenses when incurred
    - ◆ **2) capitalized costs** –
      - > **non-G/W** –
        - **i)** amortize over useful life **unless** life is indefinite
        - **ii)** review **at least annually** for **(a) impairment loss** (SFAS 121) - ignoring any gain + **(b)** finite life in respect of indefinite lived assets
          - **impairment loss** = excess of carrying amount over FV
      - > **G/W** –
        - **i)** NOT amortized
        - **ii)** review **at least annually** for G/W impairment **unless (i)** asset / liab value <> change since last test **OR (ii)** prior review showed substantial excess FV making impairment highly unlikely –

- a) Does carrying value of **reporting unit** (w/ G/W) exceed **FV**? **if YES then (b)**
    - **reporting unit** = operating segment **OR** one level below operating segment
    - **FV** = amount at which asset / liab bought / sold in current transaction b/w willing parties not in a forced / liquidation sale
  - b) Does the carrying amount of reporting unit G/W exceed **implied FV of G/W**? **if Yes then (c)**
    - **implied FV of G/W** = residual FV of reporting unit beyond FV allocated to its assets
  - c) recognize impairment loss equal to excess **on both B/S and I/S**
- **iii) benes** (Gordon) – more diverse consideration / deal structures + frees ability to restructure O/W limited under old pooling + T mgmt may expect more equity compensation + hostile exchange offers become more feasible + A has more flexibility in course of bid + required identification of A + **periodic review for impairment ensures more accurate value than S/L amortization would allow under straight purchasing**

## App. B – Tax Background

### possible sources of tax favoritism -

- i) **pure tax gains** = not achievable in other form (~ step up basis)
- ii) **tax gains preferable thru acquisition** – but achievable thru other mechanisms
- iii) **but for cause of acquisitions** – not testable

### A) Taxation of Corp Acquisitions – the relevant rules

- i) Tax free reorgs –
  - a) **requires** - all of following
    - ⇒ 1) **business (~ non-tax) purpose AND**
      - ❖ BUT – unclear if non-tax purpose m/b primary motivation
    - ⇒ 2) **continuity of interest / enterprise** – requires (i) **substantial portion** be Acquirer stock (voting / non-voting) + (ii) T S/H hold A stock for period (222) + (iii) **continuity of business enterprise AND**
      - **substantial portion** – IRS = 50%; US = 38%; 6<sup>th</sup> = 25%; practitioners = 40%
      - **continuity of business enterprise** – for 2 yrs A either (i) continues historic business **OR** (ii) uses significant portion of T assets
    - ⇒ 3) **step transaction doctrine** – can steps be collapsed to resemble something taxable
      - ❖ TA – steps as far apart as 22 months have been collapsed
    - ⇒ 4) **one of § 368(a)(1)(a-c) requirements -**
      - ❖ **A) A reorg** (stat merger) -
        - **what happens** – (i) T S/H become A S/H BUT consideration need not be stock **AND** (ii) some T S/H may be cashed out
        - **consideration** – no restriction (BUT judicial continuity of interest doctrine (above requires stock))
        - **tax free** - to extent of qualifying consideration (~ stock) received
          - non-stock consideration = taxable (§ 354)
        - **types** -
          - **a) cash election merger** – each T S/H elects whether to receive cash or stock (w/ limit to prevent violating continuity of interest requirement)
          - **b) two step cash election merger** – (i) cash offer to buy shares + (ii) leg up option to buy shs directly from T (will not count for continuity of interest requirement) + (iii) securities offered (when delay less of an issue)
        - **basis** – Acquirer gets T assets directly **w/ c/o basis** (§ 362(b))
        - **tax attributes** – carryover to A (§ 381)
      - ❖ **B) B reorg** (stock for stock) -
        - **requires** – A acquires ≥ 80% T stock from T S/H for A stock + T S/H can make taxable by selling
        - **consideration** – only voting stock (no boot)
        - **basis** – Acquirer gets T stock - so T retains basis in assets **unless**
          - **a) (i) T liquidated + (ii) step transaction doctrine applies = treated as C reorg OR**
          - **b) (i) T merged into A + (ii) step transaction doctrine applies = treated as A reorg**
        - **tax attributes** –
          - remain at subsidiary T unless / until T liquidated (when attributes c/o to A (§ 332))
          - consolidated T/R – allows tax attributes limited application b/w affiliated entities (80% common ownership)
        - **cons** – securities registration needed





- **Congress' response** – § 338 requires A to choose b/w basis step up and c/o of tax attributes (??)
- ii) **post-1986** – IF A elects § 338 step up in basis **THEN** T recognized corp level gain
  - **A) stock purchase** – G/L recognized to T (b/c no longer deemed to occur per § 337)
  - **B) asset purchase** – G/L recognized to T even if assets transferred pursuant to plan of liquidation (T treated as having sold)
- iii) **post 1997** – § 355 amendments change treatment of **Morris Trusts**
  - **Morris Trust** – (i) T spins off unwanted subs + (ii) A acquires T w/ remaining desired assets
  - **limit** – T recognizes corporate level taxable gain if 3<sup>rd</sup> party acquires ≥ 50% of T shs w/i 3 yrs
    - > **exception** – stock-for-stock merger where T S/H hold more than 50% of A shs

## B) Does the Tax System Favor Acquisitions?

- i) **step up in basis** –
  - a) **is net tax gain possible through tax free reorg?**
    - ⇒ **pre 1987** -
      - ❖ **key factors** = higher basis + short life + no corporate level tax
      - ❖ **impact on constituents** -
        - A – reduced future income due to increased tax depreciation
        - T – tax to recapture accelerated depr.
        - T S/H - immediate cap gains tax (less than OI tax)
      - ❖ **conclusion** – net tax gain possible
    - ⇒ **post 1986** –
      - ❖ **key changes** = change in individual tax rates (reduce benefit of C/G / OI) + corp level taxation of T
      - ❖ **conclusion** – NO net tax gain possible
      - ❖ **question** – why do companies choose taxable transaction form, to detriment of S/H, when N/T alt available?
    - ⇒ **alternatives to achieve basis step** -
      - ❖ **1) reorg** – many costs (T/C + changed mgmt + changed mgmt performance incentives + less efficient use of assets + severance costs)
      - ❖ **2) sale leaseback** – defers S/H level taxation + avoids most costs of reorg
      - ❖ **3) installment sale of assets** – defers cap gains tax + deferred depreciation recapture tax (pre 1984)+ monetary risk of installment note c/b monetized by 3<sup>rd</sup> party guarantee
  - b) **do tax gains from basis step up influence premiums?**
    - ⇒ **Gilson** = only if tax gains are unanticipated (e.g., b/c of inside info)
    - ⇒ **tax related acquisition premium** = actual tax gain from acquisition – greater of (a) expected tax gain X expected probability would occur OR (b) tax gain achievable through most effective technique not requiring change in control
- ii) **S/H tax deferral** –
  - a) **does deferral of T S/H gain motivate acquisitions?** Gilson = this is tautology
  - b) **does acquisition allow T S/H to diversify w/o taxation?** –
    - ⇒ no barrier and lower T/C to diversification at S/H level (unless CHC limits ability to diversify or corp acquisition O/W gives access to inaccessible market)
    - ⇒ **Conclusion** – deferral <> acquisition motive (people pick reorgs simply b/c of tax treatment more favorable)

- **c) does tax deferral affect size of premium?** Gilson = Yes b/c acts as bargaining chip where known
- **iii) Transfer of NOLs -**
  - **a) are T's NOL's worth more to A than T? –**
    - ⇒ **Gilson** - only if **(i)** NOL survive + **(ii)** NOL usable against future A income
    - ⇒ **Post 1986** - net tax gain = tax savings from sheltering income of acquired businesses – tax savings of sheltering int income
  - **b) are acquisitions best method for LossCo to capture value of NOL?**
    - ⇒ LossCo has other alts – restructure assets (get rid of low explicit tax / high implicit tax assets ~ equity) thru sale / leaseback + restructure equity (issue equity to loan to others / )
    - ⇒ acquisition = sale of equity in NOLs to other company
    - ⇒ non-acquisition alts = lower info / transaction costs
    - ⇒ **Gilson** – not relevant claim after 1986
  - **c) do tax gains from NOLs affects premiums?** Gilson – probably not b/c NOLs are visible / gains visible
- **iv) Tax treatment of Debt –**
  - **a) does deductibility of interest provide tax gains through acquisitions?**
    - ⇒ **limits on deductibility of interest** -
      - ❖ § 279 – denies deduction for int > \$5M re: acquisition related indebtedness w/ equity feature (~ convertability) issued by highly leveraged company
      - ❖ § 172 – limits c/b of interest related NOL
      - ❖ § 163 – limits deduction of interest deduction on zero coupon / PIK bonds until cash paid
    - ⇒ **practical argument** – tax gains on int deduction achievable w/o acquisition
  - **b) are acquisitions the best way to capture tax gains from leverage?**
    - ⇒ note – leveraged recapitalization does not change control / concentrate equity
    - ⇒ acquisitive LBO may facilitate change (either w/ a new owner or old mgmt taking defensive action)
    - ⇒ problem – new mgmt may be worse
  - **c) do tax gains from interest deductions affect acquisition premiums?** – Gilson – probably not b/c potential leverage gains visible

### **C) Empirical Evidence – Tax as an Acquisition Motive**

- **i) Acquisitions generally (Auerbach & Reishus) – sample covering 1968-1983**
  - **hypothesis** – if taxes are important acquisition motive → actual mergers should result in higher tax benefits than pseudo mergers
  - **methodology** -
    - ⇒ **i)** for each merger, randomly identify pseudo Target and Parent from universe of industrial similarly sized firms
    - ⇒ **ii)** compare
  - **findings** -
    - ⇒ NOL – accounted for no more than 10% of premium
    - ⇒ step up in basis – very small gains (but may not capture post 1981 accelerated rate of depreciation)
    - ⇒ leverage – minimal gain b/c increased minimally on avg through LBO process
  - **Conclusion** – actual mergers no more likely than pseudo mergers to produce tax gains
- **ii) LBOs (Schipper & Smith) -**
  - **basis step up** –
    - ⇒ desirable if PV of increased future depreciation exceeds recapture tax
    - ⇒ findings = most firms did not step up basis
  - **deductibility of interest** – can explain ~ 90% of premium (but ignores tax cost to the recipient of int income)
- **iii) LBOs (Kaplan) –**
  - **basis step up** - most firms did not step up basis
  - **deductibility of interest** - ???
- **iv) Cost of MBO to US treasury (Jensen, Kaplan, Stiglin) – found that US Treasury gains from LO activity**
  - **finding** = revenue gains flowing from LBO efficiency gains exceed revenue losses flowing from the tax consequences of the transaction itself
  - Gilson – study does not isolate true tax gain associated with LBO (really only looks at tax effect of LBO gains)
- **v) effect of tax law change on T/O activity (Scholes & Wolfson)**
  - **hypothesis** - if tax motives = major determinant of acquisition activity, then number of acquisitions should **(i)** increase in quarter preceding enactment of 1986 Act **AND (ii)** decrease markedly thereafter

- **findings** – acquisition activity increased / decreased as hypothesized
- **limits** – study does not tell why activity level changed OR how important tax law change was

#### ***D) Conclusions***

- tax gains were possible pre-1986
- no support that tax gains influence acquisition premiums OR level of acquisition activity
- tax system = regulatory regime w/ partial function to subsidize certain activities at expense of others