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6th Edition

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6TH EDITION

# ADVANCED ACCOUNTING

DEBRA C. JETER

PAUL K. CHANEY

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# ABOUT THE AUTHORS

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# PREFACE

Convergence with international accounting standards has played an important role in virtually every project entered into by the Financial Accounting Standards Board (FASB) in recent years. Accounting for business combinations is no exception. In the Sixth Edition of Advanced Accounting, we compare and contrast U.S. standards and international principles throughout the book, drawing the readers' attention to remaining differences with an IFRS icon. The reader is made aware of important changes, both present and forecasted. We also incorporate the FASB's codification system for referencing standards.

This book is designed for advanced courses dealing with financial accounting and reporting in the following topical areas: business combinations, consolidated financial statements, international accounting, foreign currency transactions, accounting for derivative instruments, translation of financial statements of foreign affiliates, segment reporting and interim reporting, partnerships, fund accounting and accounting for governmental units, and accounting for non-government—nonbusiness organizations. The primary objective of this book is to provide a comprehensive treatment of selected topics in a clear and understandable manner. The changes related to FASB ASC Topics 805 and 810 (*SFAS No. 141R* and *160)* are integrated throughout the edition. As in previous editions, we strive to maintain maximum flexibility to the instructor in the selection and breadth of coverage for topics dealing with consolidated financial statements and other advanced topics.

We have further expanded the number and variety of exercises and problem materials at the end of each chapter. We include codification exercises that require the student to research the FASB's Codification to determine the appropriate GAAP for a variety of issues. In addition, we include financial statement analysis exercises that relate to real companies and practical applications in virtually every chapter.

All chapters have been updated to reflect the most recent pronouncements of the Financial Accounting Standards Board and the Governmental Accounting Standards Board as of this writing.

In teaching consolidation concepts, a decision must be made about the recording method that should be emphasized in presenting consolidated workpaper procedures. The three major alternatives for recording investments in subsidiaries are the (1) cost method, (2) partial equity (or simple equity) method, and (3) complete equity (or sophisticated equity) method. A brief description of each method follows.

1. *Cost method.* The investment in subsidiary is carried at its cost, with no adjustments made to the investment account for subsidiary income or dividends. Dividends received by the parent company are recorded as an increase in cash and as dividend income.
2. *Partial equity method.* The investment account is adjusted for the parent company's share of the subsidiary's reported earnings or losses, and dividends received from the subsidiary are deducted from the investment account. Generally, no other adjustments are made to the investment in subsidiary account.
3. Complete equity method. This method is the same as the partial equity method except that additional adjustments are made to the investment in subsidiary account to reflect the effects of (a) the elimination of unrealized intercompany profits, (b) the amortization (depreciation) of the difference between cost and book value, and (c) the additional stockholders' equity transactions undertaken by the subsidiary that change the parent company's share of the subsidiary's stockholders' equity.

We continue to present all three methods, using generic icons to distinguish among the three methods. The instructor has the flexibility to teach all three methods, or to instruct the students to ignore one or two. If the student is interested in learning all three methods, he can, even if the instructor only focuses on one or two. Also, we believe this feature makes the book an excellent reference for the student to keep after graduation, so that he or she can adapt to any method needed.

## WHAT'S NEW IN THE TEXT?

- Author-created online videos explain some of the critical concepts of advanced accounting and walk students through how to solve selected problems throughout the book.
- A continuous consolidation problem is introduced in Chapters 4 and 5. This allows students to build on concepts learned in prior chapters.
- The coverage of certain topics has been expanded (such as contingent consideration and bargain purchases) to incorporate information gleaned from the FASB's Post-Implementation Review of FASB Statement No. 141R and to include more realistic real-world issues.
- Chapter 11 on International Accounting has been updated to reflect the current status of international financial reporting standards (IFRS) around the world and the SEC's position with respect to U.S. adoption. In addition, we pay particular attention to the remaining major joint projects of the two boards (FASB and IASB), which include revenue recognition, accounting for leases, insurance contracts, and financial instruments.
- The chapters on fund accounting and governmental accounting (Chapters 17 and 18) were updated to reflect the latest GASB pronouncements, including changes in the classification of the fund balance.
- An appendix to Chapter 1 has been posted online at www.wiley.com/college/jeter. This appendix illustrates a strategy or technique for analyzing a given company, such as a potential acquisition target. This strategy may be applied in some of the end-of-the-chapter Analyzing Financial Statements (AFS) problems. Several additional online appendices (including coverage of deferred taxes, as they pertain to individual topics throughout the text) may also be found at www.wiley.com/college/jeter.

## OTHER HIGHLIGHTED FEATURES OF THE TEXT

1. We include a feature that requires students to research the FASB Codification in order to locate the current standard that applies to various issues. These exercises appear before the problems at the end of each chapter and often, but not always, relate to topics addressed in that chapter. (Similar questions appear on the CPA exam.)
2. We include a discussion of international accounting standards on each topic where such standards exist, and compare and contrast U.S. GAAP and IFRS. An IFRS icon appears in the margins where this discussion occurs.
3. A discussion of the joint projects of the FASB and the IASB is incorporated throughout the textbook where appropriate, with an expanded discussion in Chapter 11.
4. FASB's conceptual framework is discussed as it relates to Advanced Accounting in Chapter 1. We also include marginal references to ***Related Concepts*** throughout the book. The GASB's conceptual framework is discussed in Chapters 17 and 18.
5. Questions or problems related to ***Business Ethics*** are included in the end-of chapter materials for every chapter.
6. We include real-company annual reports or excerpts from reports with related questions ***(Analyzing Financial Statements)*** in the end-of-chapter materials and/or online for most chapters excluding Chapters 15 and 16.
7. In Chapter 9 of the 6th edition, the homework material includes the effective interest, in addition to the straight-line method for amortization of bond premiums and discounts. The Sixth Edition also includes online appendices on deferred taxes which are related to the topics in Chapter 6 & 7. (Go to www.wiley.com/college/jeter.)
8. The ***in-the-news*** boxes that appear throughout the book reflect recent business and economic events relevant to the subject matter.
9. We have integrated ***goodwill impairment*** into some illustrations in the body of Chapter 5, as well as in several homework problems. We illustrate the goodwill impairment test described in FASB ASC topic 350 (*SFAS No. 142*), discussing its frequency, the steps laid out in the standard, and some of the likely implementation problems. The simplification of these tests for smaller companies is also discussed along with the role of qualitative factors for determining whether the steps are necessary. There are exercises on this topic in Chapters 2 and 5.
10. At the beginning of Chapter 4 we discuss three methods of accounting for investments, depending on the level of ownership and the presumption of influence or control. We emphasize the importance of the complete equity method for certain investments that are not consolidated, or in the parent-only statements. In addition, online materials include an expanded discussion of the ***accounting for investments***. (See www.wiley.com/college/jeter.)
11. ***Learning objectives*** are included in the margins of the chapters, and relevant learning objective numbers are provided with end-of-chapter materials.
12. We continue the use of ***graphical illustrations***, which was introduced in prior editions.
13. A few short-answer questions (and solutions) are periodically provided throughout each chapter to enable students to test their knowledge of the content before moving on.
14. The organization of the worksheets applies a format that separates accounts to the income statement, the statement of retained earnings, and the balance sheet in distinct sections. The worksheets are placed near the relevant text.

**15.** All illustrations are printed upright on the page and labeled clearly for convenient study and reference.

**16.** Entries made on consolidated statements workpapers are presented in general journal form. These entries are shaded in blue to distinguish them from book entries, to facilitate exposition and study. To distinguish among parent company entries and workpaper entries in the body of the text, we present parent entries in gray and workpaper entries in blue.

**17.** Summaries appear at the end of each chapter, and a glossary of key terms is provided at the end of the book.

**18.** Chapters 17 through 19 reflect the latest GASB and FASB pronouncements related to fund accounting.

Clearly there are more topics in this text than can be covered adequately in a one semester or one-quarter course. We believe that it is generally better for both students and instructors to cover a selected number of topics in depth rather than to undertake a superficial coverage of a larger number of topics. Modules of material that an instructor may consider for exclusion in any one semester or quarter include the following:

- Chapters 7–9. An expanded analysis of problems in the preparation of consolidated financial statements.
- Chapter 10. Insolvency—liquidation and reorganization.
- Chapters 11–14. International accounting, foreign currency transactions and translation, and segment and interim reporting.
- Chapters 15 and 16. Partnership accounting.
- Chapters 17 through 19. Fund accounting, accounting for governmental units, and accounting for nongovernment–nonbusiness organizations (NNOs).

## SUPPLEMENTS

The following supplements are available on the book companion web site: Study Guide, Excel Templates, PowerPoint Slides, Instructors' Manual, Solutions Manual, Test Bank, and videos. These materials are accessible form www.wiley.com/college/jeter.

## WileyPLUS

*WileyPLUS* is an online learning and assessment environment, where students test their understanding of concepts, get feedback on their answers, and access learning materials like the eText and multimedia resources. Instructors can automate assignments, create practice quizzes, assess students' progress, and intervene with those falling behind.

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# 1

# INTRODUCTION TO BUSINESS COMBINATIONS AND THE CONCEPTUAL FRAMEWORK

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## LEARNING OBJECTIVES

1. Describe historical trends in types of business combinations.
2. Identify the major reasons firms combine.
3. Identify the factors that managers should consider in exercising due diligence in business combinations.
4. Identify defensive tactics used to attempt to block business combinations.
5. Distinguish between an asset and a stock acquisition.
6. Indicate the factors used to determine the price and the method of payment for a business combination.
7. Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.
8. Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.
9. Discuss the *Statements of Financial Accounting Concepts (SFAC)*.
10. Describe some of the current joint projects of the FASB and the International Accounting Standards Board (IASB), and their primary objectives.

## 1.1 GROWTH THROUGH MERGERS

The merger between American Airlines and US Airways in 2013 has been the latest in a string of acquisitions in an industry described by Warren Buffett a few years earlier as typifying the "worst" sort of business. He went on to describe such a business as one that grows fast, earns next to nothing, and takes large amounts of capital to engender growth. Twenty-nine bankruptcies in 30 years support Buffett's allegations. Still, the belief is growing that maybe now, at last, airlines have finally cut capacity sufficiently to earn profits in the long run.[1]

Growth through mergers and acquisitions (M&A) has become a standard in business not only in America but throughout the world. In the new millennium, the most recent in a series of booms in merger activity was sparked by cheaper credit and by global competition,

[1] WSJ, "Airlines Haven't Reached Escape Velocity," by Justin Lahart, 4/1/2013.

in addition to the usual growth-related incentives predominant during the boom of the 1990s. By the end of 2008, however, uncertainty in the commercial credit markets had led to anxiety about whether merger transactions could continue to be achieved successfully in the current environment, and by the middle of 2009 M&A activity had nearly come to a halt. With plunging market values and tightened credit, the mix and nature of the financing components were clearly in flux, and major adaptations needed to consummate any new deals.

As the markets began to recover in the second half of 2009, however, merger transactions picked up once more. Banks made capital available for bigger companies, such as Kraft, who looked to acquire Cadbury, and corporate debt offerings soared. By 2010, several huge deals were in the works.

Merger activity has historically been highly correlated with the movement of the stock market. Increased stock valuation increases a firm's ability to use its shares to acquire other companies and is often more appealing than issuing debt. During the merger cycle of the 1990s, equity values fueled the merger wave. The slowing of merger activity in the early years of the 21st century provided a dramatic contrast to this preceding period. Beginning with the merger of Morgan Stanley and Dean Witter Discover and ending with the biggest acquisition to that date—WorldCom's bid for MCI—the year 1997 marked the third consecutive year of record mergers and acquisitions activity. The pace accelerated still further in 1998 with unprecedented merger activity in the banking industry, the auto industry, financial services, and telecommunications, among others. This activity left experts wondering why and whether bigger was truly better. It also left consumers asking what the impact would be on service. A wave of stock swaps was undoubtedly sparked by record highs in the stock market, and stockholders reaped benefits from the mergers in many cases, at least in the short run. Regulators voiced concern about the dampening of competition, and consumers were quick to wonder where the real benefits lay. Following the accounting scandals of 2001 (WorldCom, Enron, Tyco, etc.), merger activity lulled for a few years.

Also in 2001, the *Financial Accounting Standards Board* (*FASB*) voted in two major accounting changes related to business combinations. The first met with vehement protests that economic activity would be further slowed as a result and the second with excitement that it might instead be spurred. Both changes are detailed in Chapter 2.

By the middle of 2002, however, these hopes had been temporarily quelled. Instead of increased earnings, many firms active in mergers during the 1990s were forced to report large charges related to the diminished value of long-lived assets (mainly goodwill). Merger activity slumped, suggesting that the frenzy had run its course. Market reaction to the mergers that did occur during this period typified the market's doubts. When ***Northrop Grumman Corp***. announced the acquisition of ***TRW Inc***. for $7.8 billion, the deal was praised but no market reaction was noted. In contrast, when Vivendi Universal admitted merger-gone-wrong woes, investors scurried.

By the middle of the first decade of the 21st century, however, the frenzy was returning with steady growth in merger activity from 2003 to 2006. In 2005, almost 18% of all M&A (mergers & acquisitions) deals were in the services sector. In a one-week period in June of 2006, $100 billion of acquisitions occurred, including Phelps Dodge's $35.4 billion acquisition of Inco Ltd. and Falconbridge Ltd. In addition, because of the economic rise in China and India, companies there were looking to increase their global foothold and began acquiring European companies. Thus cross-border deals within Europe accounted for a third of the global M&A deals.

However, by the end of 2008, a decline in overall merger activity was apparent as the U.S. economy slid into a recession, and some forecasters were predicting the next chapter in mergers and acquisitions to center around bankruptcy-related activity. Data from Thomson Reuters revealed that in 2008, bankruptcy-related merger activity increased for the first time in the last six years. For example, the number of Chapter 11 M&A purchases rose from 136 for the entire year of 2007 to 167 for the first ten months of 2008, with more to come. Overall mergers, on the other hand, decreased from $87 billion in the United States ($277 billion globally) during October 2007 to $78 billion in the United States ($259 billion globally) during October 2008, based on the Reuters data.

"If we are going to ride the IASB and the IFRS [International Financial Reporting Standards] horse, we want to make sure that it's as good as it can be. We want to make sure that the IASB is strong, is independent, is well resourced, and is properly funded in a broad-based and secure way."[2]

"By 2006, the percentage of the mergers and acquisitions market accounted for by private-equity firms had increased to approximately 15 percent from around 4 percent in 1990."[4]

After several lean years, U.S. M&A volume reached $1 trillion in 2013. Scott Barshay of Cravath, Swaine, & Moore, a major law firm, claims that this growth was caused by "a stronger economy, . . . Congress behaving more responsibly, and . . . all appearances of stability at the Fed."[5]

On December 4, 2007, FASB released two new standards, *FASB Statement No. 141 R*, Business Combinations, and *FASB Statement No. 160*, Noncontrolling Interests in Consolidated Financial Statements [ASC 805, "Business Combinations" and ASC 810, "Consolidations," based on FASB's new codification system]. These standards have altered the accounting for business combinations dramatically.

Both statements became effective for years *beginning after December 15, 2008*, and are intended to improve the relevance, comparability and transparency of financial information related to business combinations, and to facilitate the convergence with interna tional standards. They represent the completion of the first major joint project of the FASB and the IASB (International Accounting Standards Board), according to one FASB member, G. Michael Crooch. The FASB also believes the new standards will reduce the complexity of accounting for business combinations. These standards are integrated throughout this text.

### Planning M&A in a Changing Environment and Under CHANGING Accounting Requirements

1. The timing of deals is critical. The number of days between agreement or announcement and deal consummation can make a huge difference.
2. The effects on reporting may cause surprises. More purchases qualify as business combinations than previously. Income tax provisions can trigger disclosures.
3. Assembling the needed skill and establishing the needed controls takes time. The use of fair values is expanded, and more items will need remeasurement or monitoring after the deal.
4. The impact on earnings in the year of acquisition and subsequent years will differ from that in past mergers, as will the effects on earnings of step purchases or sales.
5. Unforeseen effects on debt covenants or other legal arrangements may be lurking in the background, as a result of the changes in key financial ratios.[3]

Growth is a major objective of many business organizations. Top management often lists growth or expansion as one of its primary goals. A company may grow slowly, gradually expanding its product lines, facilities, or services, or it may skyrocket almost overnight. Some managers consider growth so important that they say their companies must "grow or die." In the past hundred years, many U.S. businesses have achieved their goal of expansion through business combinations. A **business combination** occurs when *the operations of two or more companies are brought under common control*.

## 1.2 NATURE OF THE COMBINATION

A business combination may be friendly or unfriendly. In a **friendly combination**, *the boards of directors of the potential combining companies negotiate mutually agreeable terms of a proposed combination*. The proposal is then submitted to the stockholders of the involved companies for approval. Normally, a two-thirds or three-fourths positive vote is required by corporate bylaws to bind all stockholders to the combination.

An **unfriendly (hostile) combination** results when *the board of directors of a company targeted for acquisition resists the combination*. A formal ***tender offer*** enables the acquiring firm to deal directly with individual shareholders. The tender offer, usually published in a newspaper, typically provides a price higher than the current market price for shares made available by a certain date. If a sufficient number of shares are not made

[2] "Change Agent: Robert Hertz discusses FASB's priorities, the road to convergence and changes ahead for CPAs," *Journal of Accountancy*, February 2008, p. 31.

[3] BDO Seidman, LLP, "Client Advisory," No. 2008-1, January 31, 2008.

[4] *The New York Post*, "Money to Burn," by Suzanne Kapner, March 28, 2006, p. 33.

[5] "Markets Buoyant, Merger Activity Picks Up," by David Gelles, *The New York Times*, DealBook, January 1, 2014.

Men's Wearhouse acquired all the outstanding shares of Jos. A Bank with a per share offer that represented a 56% premium over Jos. A. Bank's closing share price. During a six month period, Jos. A. Bank made several offers to acquire Men's Wearhouse. At the end of this six month period, Men's Wearhouse, using a Pac Man strategy, made an offer to acquire Jos. A Bank. No rebranding of the companies is expected and Men's Wearhouse shareholders hope to benefit from $100 to $150 million in synergies.[6]

available, the acquiring firm may reserve the right to withdraw the offer. Because they are relatively quick and easily executed (often in about a month), tender offers are the preferred means of acquiring public companies.

Although tender offers are the preferred method for presenting hostile bids, most tender offers are friendly ones, done with the support of the target company's management. Nonetheless, hostile takeovers have become sufficiently common that a number of mechanisms have emerged to resist takeover.

## Defense Tactics

LO 4 Defensive tactics are used.

Resistance often involves various moves by the target company, generally with colorful terms. Whether such defenses are ultimately beneficial to shareholders remains a controversial issue. Academic research examining the price reaction to defensive actions has produced mixed results, suggesting that the defenses are good for stockholders in some cases and bad in others. For example, when the defensive moves result in the bidder (or another bidder) offering an amount higher than initially offered, the stockholders benefit. But when an offer of $40 a share is avoided and the target firm remains independent with a price of $30, there is less evidence that the shareholders have benefited.

A certain amount of controversy surrounds the effectiveness, as well as the ultimate benefits, of the following defensive moves:

1. *Poison pill:* Issuing stock rights to existing shareholders enabling them to purchase additional shares at a price below market value, but exercisable only in the event of a potential takeover. This tactic has been effective in some instances, but bidders may take managers to court and eliminate the defense. In other instances the original shareholders benefit from the tactic. Chrysler Corp. announced that it was extending a poison pill plan until February 23, 2008, under which the rights become exercisable if anyone announces a tender offer for 15% or more, or acquires 15%, of Chrysler's outstanding common shares. Poison pills are rarely triggered, but their existence serves as a preventative measure.
2. *Greenmail:* The purchase of any shares held by the would-be acquiring company at a price substantially in excess of their fair value. The purchased shares are then held as treasury stock or retired. This tactic is largely ineffective because it may result in an expensive excise tax; further, from an accounting perspective, the excess of the price paid over the market price is expensed.
3. *White knight or white squire:* Encouraging a third firm more acceptable to the target company management to acquire or merge with the target company.
4. *Pac-man defense:* Attempting an unfriendly takeover of the would-be acquiring company.
5. *Selling the crown jewels:* The sale of valuable assets to others to make the firm less attractive to the would-be acquirer. The negative aspect is that the firm, if it survives, is left without some important assets.
6. *Leveraged buyouts:* The purchase of a controlling interest in the target firm by its managers and third-party investors, who usually incur substantial debt in the process and subsequently take the firm private. The bonds issued often take the form of high-interest, high-risk "junk" bonds. Leveraged buyouts will be discussed in more detail in Chapter 2.

## 1.3 BUSINESS COMBINATIONS: WHY? WHY NOT?

LO 2 Reasons firms combine.

A company may expand in several ways. Some firms concentrate on **internal** expansion. A firm may expand internally by engaging in product research and development. Hewlett-Packard is an example of a company that relied for many years on new product

[6] "Men's Wearhouse Reaches $1.8 Billion Deal to Acquire Jos. A. Bank," by Maggie McGrath, Forbes.com, March 11, 2014.

development to maintain and expand its market share. A firm may choose instead to emphasize marketing and promotional activities to obtain a greater share of a given market. Although such efforts usually do not expand the total market, they may redistribute that market by increasing the company's share of it.

For other firms, **external** expansion is the goal; that is, they try to expand by acquiring one or more other firms. This form of expansion, aimed at producing relatively rapid growth, has exploded in frequency and magnitude in recent years. A company may achieve significant cost savings as a result of external expansion, perhaps by acquiring one of its major suppliers.

In addition to rapid expansion, the business combination method, or external expansion, has several other potential advantages over internal expansion:

1. ***Operating synergies*** may take a variety of forms. Whether the merger is **vertical** (*a merger between a supplier and a customer*) or **horizontal** (*a merger between competitors*), combination with an existing company provides management of the acquiring company with an established operating unit with its own experienced personnel, regular suppliers, productive facilities, and distribution channels. In the case of vertical mergers, synergies may result from the elimination of certain costs related to negotiation, bargaining, and coordination between the parties. In the case of a horizontal merger, potential synergies include the combination of sales forces, facilities, outlets, and so on, and the elimination of unnecessary duplication in costs. When a private company is acquired, a plus may be the potential to eliminate not only duplication in costs but also unnecessary costs.

   Management of the acquiring company can draw upon the operating history and the related historical database of the acquired company for planning purposes. A history of profitable operations by the acquired company may, of course, greatly reduce the risk involved in the new undertaking. A careful examination of the acquired company's expenses may reveal both expected and unexpected costs that can be eliminated. On the more negative (or cautious) side, be aware that the term "synergies" is sometimes used loosely. If there are truly expenses that can be eliminated, services that can be combined, and excess capacity that can be reduced, the merger is more likely to prove successful than if it is based on growth and "so-called synergies," suggests Michael Jensen, a professor of finance at the Harvard Business School.

*IN THE NEWS*

Views on whether synergies are real or simply a plug figure to justify a merger that shouldn't happen are diverse. Time Warner, for example, has fluctuated back and forth on this issue in recent years. President Jeffrey Bewkes recently was quoted as saying, "No division should subsidize another." When queried about the message his predecessors sent to shareholders, he said, "It's bull—"[7]

**GAINS FROM BULKING UP[8]**

| *Industry* | *Key Benefit of Consolidation* |
|---|---|
| Antenna towers | Frees up capital and management time for wireless communications operators |
| Funeral homes | Yields greater discounts on coffins, supplies, and equipment |
| Health clubs | Spreads regional marketing and advertising costs over more facilities |
| Landfill sites | Lets operators cope with the new environmental and regulatory demands |
| Physician group practices | Reduces overhead and costs of medical procedures |

2. Combination may enable a company to compete more effectively in the **international marketplace**. For example, an acquiring firm may diversify its operations rather rapidly by entering new markets; alternatively, it may need to ensure its sources of supply or market outlets. Entry into new markets may also be undertaken to obtain cost savings realized by smoothing cyclical operations. Diminishing savings from cost-cutting

[7] *WSJ*, "After Years of Pushing Synergy, Time Warner Inc. Says Enough," by Matthew Karnitschnig, 6/2/06, p.A1.

[8] *Business Week*, "Buy 'Em Out, Then Build 'Em Up," by Eric Schine, 5/18/95, p. 84.

More than a third of bankruptcy merger activity in 2008 took place in financial services, with the sale of assets by Lehman Brothers (New York investment bank) and the $2.8 billion acquisition by a consortium of Ashikaga Bank (Japan). Others included Thornwood Associates' $900 million purchase of Federal-Mogul, Mendecino Redwood's $600 million acquisition of Pacific Lumber, and NBTY's $371 million purchase of Leiner Health Products.[9]

*within* individual companies makes combination more appealing. The financial crisis in Asia accelerated the pace for a time as American and European multinationals competed for a shrinking Asian market. However, a combination of growing competition, globalization, deregulation, and financial engineering has led to increasingly complex companies and elusive profits.

3. Business combinations are sometimes entered into to take advantage of **income tax** laws. The opportunity to file a consolidated tax return may allow profitable corporations' tax liabilities to be reduced by the losses of unprofitable affiliates. When an acquisition is financed using debt, the interest payments are tax deductible, creating a **financial synergy** or "tax gain." Many combinations in the past were planned to obtain the advantage of significant operating loss carryforwards that could be utilized by the acquiring company. However, the Tax Reform Act of 1986 limited the use of operating loss carryforwards in merged companies. Because tax laws vary from year to year and from country to country, it is difficult to do justice to the importance of tax effects within the scope of this chapter. Nonetheless, it is important to note that tax implications are often a driving force in merger decisions.
4. **Diversification** resulting from a merger offers a number of advantages, including increased flexibility, an internal capital market, an increase in the firm's debt capacity, more protection from competitors over proprietary information, and sometimes a more effective utilization of the organization's resources. In debating the tradeoffs between diversification and focusing on one (or a few) specialties, there are no obvious answers.
5. **Divestitures** accounted for 30% or more of the merger and acquisitions activity in each quarter from 1995 into mid-1998 and from 2001 to 2010. Shedding divisions that are not part of a company's core business became common during this period. In some cases the divestitures may be viewed as "undoing" or "redoing" past acquisitions. A popular alternative to selling off a division is to "spin off" a unit. Examples include AT&T's spin-off of its equipment business to form ***Lucent Technologies Inc.***, Sears Roebuck's spin-off of ***Allstate Corp.*** and ***Dean Witter Discover & Co.***, and Cincinnati Bell's proposed spin-off of its billing and customer-management businesses to form ***Convergys Corp.***

Notwithstanding its apparent advantages, business combination may not always be the best means of expansion. An overriding emphasis on rapid growth may result in the pyramiding of one company on another without sufficient management control over the resulting conglomerate. Too often in such cases, management fails to maintain a sound enough financial equity base to sustain the company during periods of recession. Unsuccessful or incompatible combinations may lead to future divestitures.

In order to avoid large dilutions of equity, some companies have relied on the use of various debt and preferred stock instruments to finance expansion, only to find themselves unable to provide the required debt service during a period of decreasing economic activity. The junk bond market used to finance many of the mergers in the 1980s had essentially collapsed by the end of that decade.

Business combinations may destroy, rather than create, value in some instances. For example, if the merged firm's managers transfer resources to subsidize money-losing segments instead of shutting them down, the result will be a suboptimal allocation of capital. This situation may arise because of reluctance to eliminate jobs or to acknowledge a past mistake.

Some critics of the accounting methods used in the United States prior to 2002 to account for business combinations argued that one of the methods did not hold executives accountable for their actions if the price they paid was too high, thus encouraging firms to "pay too much." Although opinions are divided over the relative merits of the accounting alternatives, most will agree that the resulting financial statements should reflect the economics of the business combination. Furthermore, if and when the accounting standards

[9] "Water Cooler: What Players in the Mid Market Are Talking About," *Mergers & Acquisitions*, December 2008.

and the resulting statements fail even partially at this objective, it is crucial that the users of financial data be able to identify the deficiencies. Thus we urge the reader to keep in mind that an important reason for learning and understanding the details of accounting for business combinations is to understand the economics of the business combination, which in turn requires understanding any possible deficiencies in the accounting presentation.

## 1.4 BUSINESS COMBINATIONS: HISTORICAL PERSPECTIVE

LO 1 Historical trends in types of M&A.

In the United States there have been three fairly distinct periods characterized by many business mergers, consolidations, and other forms of combinations: 1880–1904, 1905–1930, and 1945–present. During the first period, huge holding companies, or trusts, were created by investment bankers seeking to establish monopoly control over certain industries. This type of combination is generally called **horizontal integration** because it involves the combination of companies within the same industry. Examples of the trusts formed during this period are J. P. Morgan's U.S. Steel Corporation and other giant firms such as Standard Oil, the American Sugar Refining Company, and the American Tobacco Company. By 1904, more than 300 such trusts had been formed, and they controlled more than 40% of the nation's industrial capital.

The second period of business combination activity, fostered by the federal government during World War I, continued through the 1920s. In an effort to bolster the war effort, the government encouraged business combinations to obtain greater standardization of materials and parts and to discourage price competition. After the war, it was difficult to reverse this trend, and business combinations continued. These combinations were efforts to obtain better integration of operations, reduce costs, and improve competitive positions rather than attempts to establish monopoly control over an industry. This type of combination is called **vertical integration** because it involves the combination of a company with its suppliers or customers. For example, Ford Motor Company expanded by acquiring a glass company, rubber plantations, a cement plant, a steel mill, and other businesses that supplied its automobile manufacturing business. From 1925 to 1930, more than 1,200 combinations took place, and about 7,000 companies disappeared in the process.

The third period started after World War II and has exhibited rapid growth in merger activity since the mid-1960s, and even more rapid growth since the 1980s. The total dollar value of mergers and acquisitions grew from under $20 billion in 1967 to over $300 billion by 1995 and over $1 trillion in 1998, and $3.5 trillion by 2006. Even allowing for changes in the value of the dollar over time, the acceleration is obvious. By 1996, the number of yearly mergers completed was nearly 7,000. Some observers have called this activity **merger mania**, and most agreed that the mania had ended by mid-2002. However, by 2006, merger activity was soaring once more. Illustration 1-1 presents two rough graphs of the level of merger activity for acquisitions over $10 million from 1972 to 2012 in number of deals, and from 1979 to 2012 in dollar volume. Illustration 1-2 presents summary statistics on the level of activity for the year 2012 by industry sector for acquisitions with purchase prices valued in excess of $10 million.

This most recent period can be further subdivided to focus on trends of particular decades or subperiods. For example, many of the mergers that occurred in the United States from the 1950s through the 1970s were **conglomerate** mergers. Here the primary motivation for combination was often to diversify business risk by combining companies in different industries having little, if any, production or market similarities, or possibly to create value by lowering the firm's cost of capital. One conjecture for the popularity of this type of merger during this time period was the strictness of regulators in limiting combinations of firms in the same industry. One conglomerate may acquire another, as Esmark did when it acquired Norton-Simon, and conglomerates may spin off, or divest themselves of, individual businesses. Management of the conglomerate hopes to smooth earnings over time by counterbalancing the effects of economic forces that affect different industries at different times.

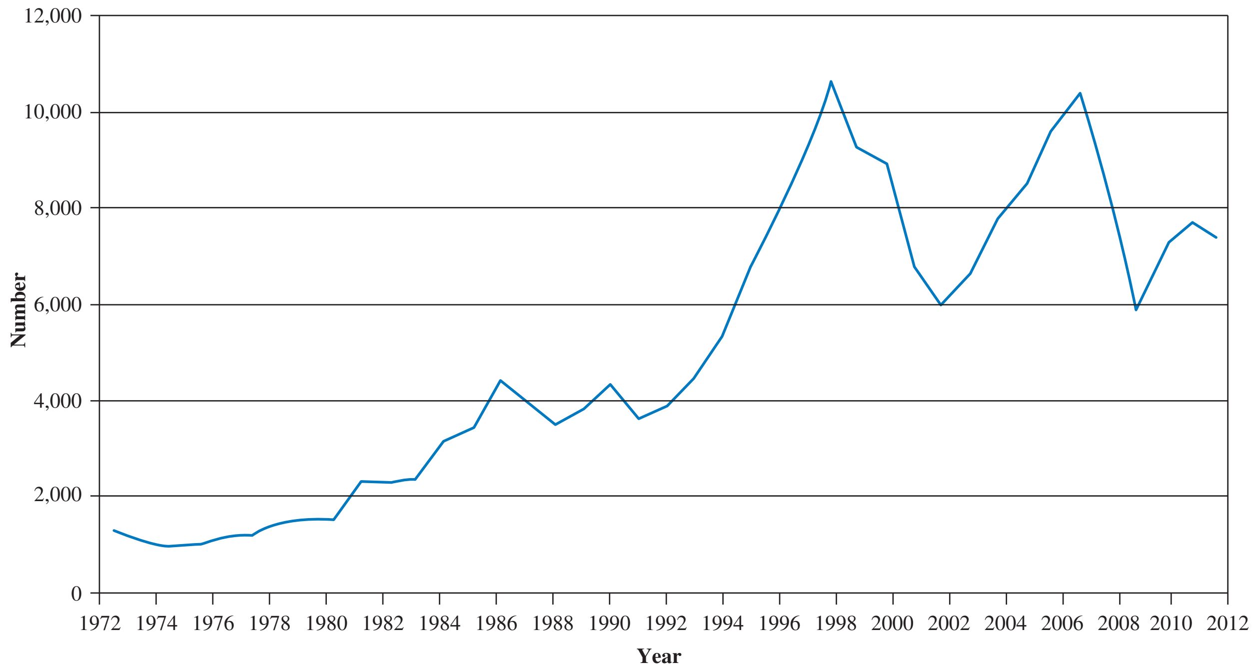
In contrast, the 1980s were characterized by a relaxation in antitrust enforcement during the Reagan administration and by the emergence of high-yield junk bonds to finance acquisitions. The dominant type of acquisition during this period and into the 1990s was the **strategic acquisition**, claiming to benefit from **operating synergies**. These synergies may arise when the talents or strengths of one of the firms complement the products or needs of

the other, or they may arise simply because the firms were former competitors. An argument can be made that the dominant form of acquisition shifted in the 1980s because many of the conglomerate mergers of the 1960s and 1970s proved unsuccessful; in fact, some of the takeovers of the 1980s were of a disciplinary nature, intended to break up conglomerates.

Deregulation undoubtedly played a role in the popularity of combinations in the 1990s. In industries that were once fragmented because concentration was forbidden, the

**ILLUSTRATION 1-1 PART A**

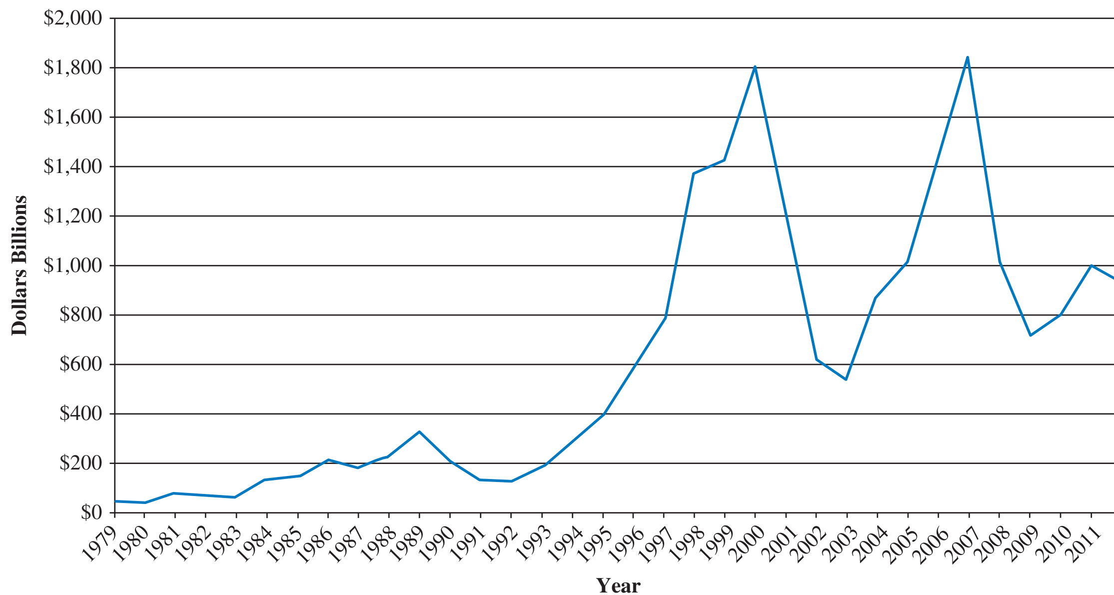
**Number of Mergers and Acquisitions over $10 Million 1972 to 2012**




Data source: *Mergers and Acquisitions*, February 2002, 2004, 2006, 2009, 2010, 2013 March/April 1999, May/June.

**ILLUSTRATION 1-1 PART B**

**Value of Mergers and Acquisitions over $10 Million 1979 to 2012**




Data source: *Mergers and Acquisitions*, February 2013, 2010, 2009, 2006, 2004, 2002, March/April 1999, May/June 1989, 1982 Almanac & Index.

**ILLUSTRATION 1-2**

**10 Most Active Industries (Domestic Deals) by Number and Value of Transactions in 2012**

| | Number of Deals | | | Value of Deals | | |
|---|---|---|---|---|---|---|
| *Industry* | *Rank* | *Number of Deals* | *% of All M&A Deals* | *Rank* | *Value ($ billions)* | *% of Total M&A Value* |
| Business Services | 1 | 957 | 18.8% | 8 | 24.9 | 4.0% |
| Software | 2 | 428 | 8.4% | 7 | 28.8 | 4.6% |
| Real Estate | 3 | 307 | 6.0% | 4 | 35.7 | 5.7% |
| Health Services | 4 | 300 | 5.9% | 3 | 45.0 | 7.2% |
| Oil & Gas | 5 | 210 | 4.1% | 2 | 67.0 | 10.7% |
| Insurance | 6 | 171 | 3.4% | 10 | 41.6 | 6.6% |
| Commercial Banks | 7 | 169 | 3.3% | – | 31.0 | 4.9% |
| Investment and Commodity Firms | 8 | 146 | 2.9% | 9 | 22.2 | 3.5% |
| Measuring, Medical & Photographic Equipment | 9 | 140 | 2.7% | 6 | 30.8 | 4.9% |
| Wholesale Trade—durable goods | 10 | 139 | 2.7% | – | 25.8 | 4.1% |
| Drugs | – | 83 | 1.6% | 5 | 32.6 | 5.2% |
| Electric, Gas, and Water Distributions | – | 83 | 1.6% | 1 | 116.6 | 18.6% |

Data source: *Mergers & Acquisitions*, February 2013, p. 37.

pace of mergers picked up significantly in the presence of deregulation. These industries include banking, telecommunications, and broadcasting. Although recent years have witnessed few deals blocked due to antitrust enforcement, an example of a major transaction dropped in 1996 because of a planned FTC (Federal Trade Commission) challenge was in the drugstore industry. The FTC challenged the impact of a proposed merger between ***Rite Aid Corp***. and ***Revco D.S. Inc***. on market power in several sectors of the East and Midwest. Nonetheless, subsequent deals in the industry saw both companies involved: Rite Aid acquired ***Thrifty PayLess Holdings Inc.***, and ***CVS Inc***. purchased Revco in February 1997.

Later, the Justice Department sued to block Primestar's acquisition of a satellite slot owned by ***MCI*** and ***News Corp***. Other deals were dropped in the face of possible intervention, including a planned merger between CPA firms KPMG Peat Marwick and Ernst & Young in 1998. Nonetheless, over time the group of large CPA firms once referred to as the Big 8 has blended into the Big 4, raising concerns about a possible lack of competition in the audit market for large companies. The Justice Department reached a settlement in 2013 with American Airlines and US Airways requiring them to sell facilities at seven airports before being allowed to consummate the planned merger.[10]

Before the announcement of the merger between AT&T and T-Mobile, phone handset makers such as HTC and Motorola had two major carriers (ATT and T-Mobile) who could buy their GSM-based phones. They just lost any ability to control price and profits on handsets because now a single buyer that can dictate what GSM phones come to market. Even with LTE becoming the standard for the 4G world, it would essentially be a market dominated by three buyers, which would place handset makers at the mercy of the giants.[11]

Virtually every deal in the 2010 Wall Street lineup of potential mega-mergers faced regulatory challanges both in the United States and in Europe. Examples include Oracle and Sun; Exxon and XTO Energy; Yahoo and Microsoft, Kraft and Cadbury.

[10] CNN Money, "US Air and American Airlines Reach Deal with Justice to Allow Merger," by C. Isadore and E. Perez, 11/12/2013.

[11] *Gigaom.com* "In AT&T & T-Mobile Merger, Everybody Loses," by Om Malik, 3/20/2011.