

Educational Report: Monitoring Acquisition Accounting

CFRA notes that there are generally three opportunities for Companies to engage in aggressive acquisition accounting. Those opportunities include the stub period prior the acquisition closing (“Pre-Closing Shenanigans”) and in conjunction with assessing the fair value of the net assets acquired (“Initial Adjustments to Net Assets Acquired”) and “Ex-Post Acquisition Adjustments to Net Assets Acquired”). These categories are discussed below in detail with examples provided in addition to practical information on where to look for related disclosures.

Pre-Closing Shenanigans

Investors should monitor “stub period” performance of acquired companies. Typically there is a time period between when an acquisition is announced and the closing date of the acquisition. There may also be a gap between when the acquired company last published financial statements (as an independent company) and the closing date of the acquisition. CFRA refers to these gaps as “stub periods”. Possible stub period accounting abuses include the acquired company holding back turnover (revenue), writing-off assets (typically future costs), and/or boosting provisions (reserves). By stockpiling turnover or accelerating expenses into the stub period, acquired company’s results in future periods (after the acquisition has closed) may be boosted.

Example: CFRA is concerned that WPP Group plc (“WPP”) may have utilized aggressive pre-closing acquisition accounting related to the Company’s 2001 acquisition of Tempus Group plc (“Tempus”). Specifically, we note the poor stub period performance of Tempus as derived by CFRA (see **Table 1a** below). Whereas for the six months ended June 2001, Tempus’s reported operating profit was positive £7.3 million (operating margin of 8.7%), it plunged to negative £6.4 million (negative 12.7% operating margin) in the four-month stub period just prior to the closing of WPP’s acquisition of the group. Moreover, in addition to the poor operating performance, Tempus recorded a further £17.4 million of exceptional charges in the stub period. Note that WPP did not provide the four-month stub period performance separately but, rather, reported the aggregate (ten month) performance for Tempus, and CFRA derived the four-month stub period by subtracting the results Tempus reported for the six months ended June 2001. For complete information, please refer to our **May 2002 Report on WPP Group plc (WPP.LN)**.

Table 1a: Tempus Turnover, Operating Profit, Exceptional Items and Net Profit, as Reported by WPP and/or Tempus

(£ millions)	4 Mos., 11/01	10 Mos., 11/01	6 Mos., 6/01	12 Mos., 12/00	12 Mos., 12/99
Reported By:	<i>CFRA-Derived</i>	WPP	Tempus	Tempus	Tempus
Turnover	50.5	134.4	83.9	151.3	92.2
Operating Profit	(6.4)	0.9	7.3	18.3	11.3
Exceptional Items	(17.4)	(17.4)	-	-	-
Net Profit	(25.0)	(21.7)	3.3	9.5	7.2

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Where to Look: In the US, stub period performance can often be derived from 8-K filings with the SEC. In Europe, CFRA has found that these disclosures, if available, are typically found in the footnotes related to acquisitions.

Initial Adjustments to Net Assets Acquired

Investors should critically examine any adjustments made to the assets and liabilities of acquired companies. Typically such adjustments fall under the description of “fair value” or “accounting policy alignments”.

When companies make an acquisition, the buyer is given the opportunity to examine the assets and liabilities acquired and make appropriate adjustments. Typical adjustments might include writing down stocks (inventory) to fair value, increasing provisions (reserves) for quantifiable off-balance sheet risks, or adjusting the value of investments carried on the acquired Company’s books at cost. However, such adjustments can be abused and investors are encouraged to view them sceptically. As with the pre-closing shenanigans, companies can boost future reported results by utilizing the acquisition adjustments to aggressively write down costs and/or bolster provisions. CFRA notes that such adjustments are not reported on either Company’s income statement but, rather, increase the goodwill attributable to the acquisition. As goodwill is typically amortized over long periods (if at all), companies may be encouraged to make such adjustments given that they might obtain near-term benefits from the adjustments (i.e. lower depreciation if tangible assets are written down) and will be able to spread the costs (in the form of higher goodwill and future goodwill amortization expense) of the adjustments over longer periods.

Example: In our **August 2001** Report on Kudelski SA (“KUD”), CFRA noted that KUD had apparently created a CHF 10 million restructuring / integration provision (reserve) in conjunction with the Company’s acquisition activity during 2000. We considered this adjustment to be aggressive given that the Company spent only CHF 4.4 million on acquisitions during the year, and the adjustment increased the acquired goodwill by 90% (to CHF 21.1 million from CHF 11.1 million prior to the adjustment). For further details, please see the report.

Where to Look: Outside of the UK it is very difficult to determine acquisition related adjustments. The best chance for investors to monitor such adjustments is when the acquired company was publicly traded as the company’s pre-acquisition net assets can be compared to the post-acquisition, derived net assets (derived by subtracting the purchase price less the related goodwill). Companies should be queried regarding discrepancies. In the UK, adjustments to the net assets of acquired entities are regularly disclosed in the footnotes of the acquirer’s Annual Report, and occasionally in preliminary and interim reports.

Ex-Post Acquisition Adjustments to Net Assets Acquired

Investors should critically examine any *ex-post* adjustments made to the assets and liabilities of acquired companies.

In addition to the initial adjustments, buyers typically have up to one year after an acquisition closes to go back, *retroactively*, and make adjustments to the net assets acquired. CFRA believes that these adjustments should be particularly well monitored as they can be abused and, furthermore, may clue investors in to the fact that an acquisition is not going as planned. Again,

CFRA notes that such adjustments are made with no immediate impact on the buyer's income statement but, rather, simply increase the goodwill attributable to the acquisition. Abuses of ex-post acquisition adjustments are similar in nature (write-off future costs, increase provisions) to initial acquisition adjustments, as described above.

Example: In our **May 2002** Report on BAE Systems plc ("BA"), CFRA cautioned that BA *may* have provided itself with the opportunity to boost its reported results in 2001 by making significant, ex-post adjustments to several acquisitions it made during 2000. Specifically, during 2001 (the year after the acquisitions closed) BA recorded £123 million of additional fair value adjustments to the net assets acquired in conjunction with the Company's acquisitions of Lockheed Martin Control Systems and Lockheed Martin Aerospace Electronics Systems. The adjustments apparently included write-downs of tangible fixed assets and stock (inventory), in addition to increases in provisions related to contract risks, onerous contracts, and other commitments. (See **Table 1b.**) Please see the referenced report for full disclosure.

Table 1b: BA's Purchase Price Allocation for Lockheed Martin Control Systems (LMCS) and Lockheed Martin Aerospace Electronics Systems (AES)

(£ millions)	Final Fair Value	2001 Adjustments	2000 Adjustments	Book Value Acquired
Tangible Fixed Assets	165	(10)	(33)	208
Stocks	58	(23)	(48)	129
Debtors and Deferred Tax	311	(12)	(41)	364
Creditors	(205)	5	(39)	(171)
Provisions	(181)	(83)	(38)	(60)
Net Assets, Excluding Goodwill	148	(123)*	(199)	470
Cash & Other Acquisition Costs	1,598			1,598
Goodwill Arising	1,450			1,128

* Revisions to provisional fair values – Control Systems (£20), revisions to provisional fair values – AES (£79), accounting policy alignment – AES (£24).

Where to Look: Similar to the initial acquisition adjustments, outside of the UK it is very difficult to determine *ex-post* acquisition related adjustments. However, CFRA encourages investors to track goodwill relative to acquisition activity. Increases in goodwill in the absence of acquisition activity may indicate that a Company has made *ex-post* adjustments to prior acquisitions. (Note: beware that currency fluctuations can also explain such movements for multinational companies.) Additionally, CFRA notes that tracking such adjustments may now be easier in the US given that goodwill is no longer amortized and thus, theoretically, should remain more stable (and thus easier to monitor). In the UK, ex-post adjustments to the net assets of acquired entities are regularly disclosed in the footnotes of the acquirer's Annual Report, and occasionally in preliminary and interim reports.