



Accounting for In-Process R & D at Simpco Incorporated

By Larry M. Prober, Ph.D., CPA

Simpco has used acquisitions along with restructurings to further their strategic goals. Is management right? Will projected earnings impress Wall Street analysts?

Abstract

Acquisitions at Simpco Incorporated have been instrumental in helping to develop and exploit new technologies. In these acquisitions the accounting for purchased research has usually meant large write-offs to in-process research and development. The following case highlights the accounting rules for this treatment and the issues involved in determining their application. It addresses the impact on the company's income statement and the perceptions of its significance as Kathy Oberlin, Simpco's controller, considers the underlying nature of this charge and its importance to the company's reported income..

Background

Simpco Incorporated is a global science and technology company that develops and manufactures a variety of plastic, agricultural and chemical-based products to customers in over 150 countries. Its operations, including services, consist of 12 global businesses that employ nearly 30,000 people throughout the world. After years of stagnating sales and litigation involving its ownership of a related company, the business has embarked on acquisitions that it hopes will refine and extend its product lines as well as offer increased sales opportunities.

Company executives have used acquisitions along with restructurings to further their strategic goals, and they are confident that future earnings will impress Wall Street analysts. While the accounting for these acquisitions has complied with generally accepted accounting principles and usually used the conceptually preferable purchase method for recording acquired firms, there is some concern at the company about recent developments regarding the valuing of acquired assets. Central to these concerns are the valuations for in-process research and development (IPR&D) recorded as part of the acquisitions. In the past the company has sought to include as much of a purchase price toward IPR&D as allowed. Often the final number for IPR&D was developed by valuation consultants who knew Simpco's preferences and sought to place as high a value on IPR&D as could be justified. Many at the company believe that purchased research should have the same identity as internally developed research, and that this philosophy is consistent with their overall accounting for R&D expenditures, which requires immediate expensing of such items.



Kathy Oberlin, Simpco's controller, has recently received several documents issued by the Securities and Exchange Commission that require more detailed accounting for the valuations used in mergers and acquisitions. The SEC is particularly concerned about the amount of IPR&D that companies are allowed to expense immediately under Financial Accounting Standards Board Statement No. 2, *Accounting for Research and Development Costs*, and FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method: an interpretation of FASB Statement No.* The SEC has reservations about acquisition valuations when the amount charged to IPR&D is a significant percentage of the acquisition price. They note that when IPR&D is based on future cash flows, inflated values for IPR&D imply significant profits after the project is completed. The SEC believes that to identify meaningful asset allocations, a close examination of the acquisition from a business perspective is necessary. Issues to be resolved include the purpose of the acquisition as well as the benefits obtained from access to new market channels, new customers, additional products with existing capacity and synergies through cost containment. Other information regarding presentations to the board of directors may also provide evidence of what motivated the transactions. Some of the problems identified with valuations for purchased R&D include failing to recognize the full value of existing products, incomplete analysis for determining the elements inherent in projects and the computation of an investment value for the R&D project, rather than its fair value. This last value would reflect the expected exchange price between a buyer and seller. Highly publicized adjustments of IPR&D for companies such as America Online concern Ms. Oberlin as she develops the final numbers to be used in 20X2.

The Problem

Kathy Oberlin is aware that certain income- and cash-based approaches were used in the IPR&D valuation of recently acquired Adelphi Industries. She also knows that the work of independent appraisers is both useful and necessary since it provides the objective valuations needed by the company and its auditors. Nevertheless, Ms. Oberlin has some reservations about the current valuation report received from DC&A Consultants. The consultants include several values for IPR&D that relate to R&D amounts from Adelphi that may have current value to Simpco. In these costs are \$10 million that should enhance some of Simpco's current product lines, and have future worth to the firm. In addition, amounts totaling another \$30 million may also be considered future value. Ms. Oberlin is worried that an SEC inquiry may necessitate an adjustment to the company's accounting for IPR&D as it now exists.

Ms. Oberlin also worries because the total of the IPR&D from the Adelphi deal is about 40% of the acquisition price. She believes this will present a red flag to the commission, and that they will scrutinize the category and perhaps discover other items for adjustment. She further worries that although other areas, such as accounting for restructuring costs, are well documented and in compliance with SEC rules, a thorough review of those costs may uncover other adjustments. Thus, she is considering another meeting with John Kramer, vice-president of the finance group, to bring these matters to his attention. She hopes that her fears can be put to rest but would like to know how upper management is prepared to deal with these issues.



Before her meeting with Mr. Kramer, Ms. Oberlin has sought some additional data from the product research staff. She believes that the company's experience with research efforts and its past successes in R&D are important inputs for the estimates needed in IPR&D valuations. She wants to make sure that before any decision is made on the final valuation of IPR&D all necessary personnel have been consulted and all relevant data have been considered so that the company cannot be accused of purposely using information to arrive at desired conclusions. She is also studying valuation methods and the rationales used by DC&A. Since this group has been used on several previous occasions, and their results rarely questioned, she has confidence that they can justify their current position. Nevertheless, she knows that SEC investigators are holding companies to a higher threshold in classifying IPR&D amounts than in previous years. In addition, she is aware that SEC staff are concerned about the dual impact of other accounting issues, such as restructuring charges, and the impact that several items may have on a company's reported earnings and earnings trends. Finally, Ms. Oberlin has heard rumors that Simpco is considering another merger in the near future. Although she is not aware of any specific candidates, she believes that any publicity devoted to accounting irregularities may jeopardize the chance to have meaningful talks with any potential partner. Thus, even the hint of an accounting problem may have consequences for future strategic initiatives.

Financial Information

The following is abbreviated information pertaining to IPR&D and special charges as they pertain to the income statement.

IPR&D Charges

1. Purchased in-process research and development (IPR&D) is the value assigned in a purchase business combination to R&D projects of the acquired business that have commenced but have not yet been completed at the acquisition date and have no alternative future use.
2. The calculations for IPR&D were based on income or cash flow methods and included estimates of operating earnings, capital charges, trade name royalties, core technology charges and working capital requirements to support the cash flows attributed to the research efforts. Relevant stages of technology were also evaluated in this framework. The company's substantial experience in research and development projects for new products provides a solid basis for establishing realistic estimates for the completion of such projects and their expected completion dates.
3. In 20X2, the allocation of the purchase price of Dalton Inc. resulted in \$35 million of IPR&D. The projects associated with the technologies acquired in this purchase included process development of a selective herbicide, nutrient concentrates and fine chemicals. These projects should be completed by 20X3 year-end.
4. In 20X2, Simpco acquired shares of Adelphi Industries in two steps, resulting in an IPR&D allocation charge of \$105 million. Acquired projects yet to be completed include Bt technology, which is used to protect crops from insects, and various biotechnology initiatives that will enhance crop quality. These projects



- are expected to be completed in years 20X4 through 2X11 at an estimated additional cost of \$95 million.
5. In 20X2, Simpco completed an appraisal of an acquired 40% interest from Agrilin Inc. of SimElanco and recorded an IPR&D charge of \$135 million. Acquired projects include herbicides, fungicides and other biotechnology efforts to enhance crop output. Three of the projects are expected to be completed in 20X3, with the remaining ones accomplished in years 20X8 through 2X10 at an estimated additional cost of \$125 million.

20X2 Special Charges

A **special** charge of \$225 million was recorded in the first quarter of 20X2, including \$150 million for the write-down of several assets and \$75 million for severance. The asset-write downs included McNabb International and Simpco-Technology Products, both of which were subsequently sold. In the third quarter, based on changes in the estimated fair values, an \$18 million adjustment for the reduced values of the assets to be disposed was recorded.

In the fourth quarter of 20X2, a special charge of \$101 was recorded for the closure of the magnesium business and the associated manufacturing plant in Texas, and additional severance costs. The closure plan is expected to be completed in 20X3.

Preliminary Consolidated Statements of Income (\$000s)

	20X2	20X1	20X0
Net Sales	14,752	16,014	16,025
Operating Costs and Expenses			
Cost of sales	11,240	12,085	11,510
Research and development	605	590	575
Selling, general and administrative	1,341	1,504	1,710
Amortization of intangibles	62	48	29
Purchased in-process research and development	315	--	--
Special charges	365	--	--
Total operating costs and expenses	<u>13,928</u>	<u>14,227</u>	<u>13,824</u>
Operating income	824	1,787	2,201



	20X2	20X1	20X0
Other income, various	780	401	321
Interest income, net	<u>(110)</u>	<u>(145)</u>	<u>(230)</u>
Income before income taxes	1,494	2,043	2,292
Provision for income taxes	<u>522</u>	<u>715</u>	<u>802</u>
Net Income	972	1,328	1,490

The Choices

Is Kathy Oberlin justified in recommending an adjustment to IPR&D? What issues should she consider in her decision? How will any adjustment impact Simpco's reported profits? Does the combined accounting for special charges and IPR&D provide any insights into the company's accounting strategy?

Comments on "Accounting for In-Process R & D at Simpco Incorporated"

Stephen J. Cosgrove is Vice President, Consumer Sector Finance, at Johnson and Johnson Inc.

Johnson and Johnson is engaged in the manufacture and sale of a broad range of products in the health care field in many countries of the world.



"Kathy should be reviewing the IPR&D valuation to carve out as goodwill any values due to synergies and alternative future uses of technologies."

Simpco Incorporated is a large, multinational company with a history of acquiring companies and successfully accounting for those acquisitions. Ms. Oberlin has the responsibility to make sure that in accounting for acquisitions at Simpco, the methodologies used to determine in-process research and development are in line with the new guidelines developed by the Securities and Exchange Commission and the AICPA task force.



Simco seems to have a robust process for valuing acquisitions and has used a reputable consultant, DC&A, to help in the valuation process. Despite this history, Ms. Oberlin is right to take steps to challenge the internal and external valuation processes that will become the basis for accounting for acquisitions to determine if they comply with the new guidelines. She should rely on her external auditors for help in fully understanding if the company's procedures comply with the guidelines.

Two issues of concern to Ms. Oberlin are the company's past practice of including as much of the purchase price toward IPR&D as allowed and her fear that IPR&D exceeding 40% of the acquisition price will attract SEC scrutiny. Both of these issues can be resolved if Ms. Oberlin takes the steps necessary to ensure that the IPR&D guidelines are well understood inside the company and by the consultants. She has a responsibility to establish procedures that reflect those guidelines for the company to use when it decides to make an acquisition. In this regard she can ensure that all future acquisition decisions are made with a strong degree of confidence in the accounting treatments. She should ensure that DC&A uses the percentage-of-completion methodology favored by the SEC. If a different methodology has been used, she should require a comparison to ensure the results of the DC&A methods were not materially different from the percentage-of-completion method. If she does the right job, the company will meet the SEC guidelines—and as a result satisfy the company's own objective of taking the maximum allowed. If the guidelines are properly applied she should not be concerned with SEC scrutiny—no matter whether the IPR&D amount is 20%, 40% or 60% of the acquisition.

To deal with the current acquisition, Ms. Oberlin is taking positive steps to correctly account for a past acquisition. She should rely on the documented rationale the company used to make the acquisition and information obtained from the product research staff to determine the proper valuation splits for the acquisition. Among other issues, she should be reviewing the IPR&D valuation to carve out as goodwill any values due to synergies and alternative future uses of technologies.

By measuring existing procedures against the new guidelines and adjusting where necessary, Ms. Oberlin can strengthen what appears to be an already robust accounting process and fulfill her responsibility to accurately portray the results and quality of Simco earnings.

Mike Cohen, CPA, is Director of Technical Services for the NJSCPA.

He previously worked at Ernst & Young as a specialist in technical matters and before that he was a project manager with the FASB.

“The more subjective and arbitrary the write-off is, the more it smacks of artificial earnings management.”



Miss Oberlin is caught between two opposing accounting principles. In-process research and development is a nebulous asset whose value is very difficult to establish. The costs incurred bear no direct relationship to the ultimate benefits to be realized. Therefore, to maintain a conservative balance sheet, generally accepted accounting principles require that R&D expenses be charged to expense when they are incurred. As a corollary, it follows logically that when a company buys another business that has extensive R&D activities, part of the purchase price should be assigned to those projects, and that assigned cost should be written off immediately. That is what Simpco is proposing to do, at the recommendation of DC&A Consultants.

But this conservative accounting treatment, when carried to an extreme, runs the risk of creating a different type of error. Writing off more costs this year sets the stage for charging fewer costs in future years. The more subjective and arbitrary the write-off is, the more it smacks of artificial earnings management. Income statements also should be conservative and should not reflect charges before the appropriate time. The preliminary statement of income for 20X2 reflects a concentration of IPR&D and special charges that, in combination with the decline in sales and operating income before these charges, hints at earnings management--an attempt to get all the bad news out of the way and set the stage for a dramatic recovery in later years.

The tension between these opposing principles creates the dilemma that threatens to KO Katherine Oberlin. She has to skate a fine line between the excesses on either side. She should scrutinize and probe all aspects of the valuations established by DC&A and consider whether Simpco's board of directors' discussions about the Adelphi acquisition point to any other assets to which values should be assigned.

She most certainly should immediately alert John Kramer about the sensitive nature of the issues and the steps she plans to take to resolve them. She also should consult with Simpco's auditors sooner rather than later. They in turn will have to inform Simpco's audit committee about the sensitive estimates, the process management used in formulating those estimates and how the auditors satisfied themselves about the reasonableness of those estimates.

Looking ahead, the footnote discussion of these estimates in the 20X2 financial statements should be complete and candid, as should the discussion in Simpco's management discussion and analysis about significant known uncertainties.

The special charges seem, on their face, to be straightforward. But, in conjunction with the significant IPR&D, they probably will get increased scrutiny from security analysts and the Securities and Exchange Commission staff. Ms. Oberlin should be absolutely sure that those charges include only the direct effects of the disposals, and that they will happen within one year.

Grace Pownell, Ph.D., joined the Goizueta Business School Faculty, Emory University in the fall of 1993.

She is the author of "How Frequently Do Managers Disclose Prospective Earnings Information?" The Journal of Financial Statement Analysis, Spring 1998. (Co-authors: C. Kile & G. Waymire).



“Ms. Oberlin is justified in worrying that the auditors, analysts, investors and the SEC, will be skeptical about whether expense recognition is based on managers' best unbiased judgment.”

This case provides an excellent scenario in which to consider issues related to the company's intentional management of reported net income to achieve some reporting goal other than the truthful and accurate measurement of profits during the period. In general, we think of the managers of U.S. businesses as having incentives to overstate net income to achieve higher stock prices and higher managerial incentive compensation. However, in years in which net income, operating income, earnings per share or some other accounting construct for profitability will fall short of the level needed to preserve the positive trend in earnings, the company takes something called a “Big Bath.” In other words, the company purposely speeds up the recognition of expenses in a year in which earnings are below the long-term trend line to enhance accounting profitability in future years.

Examination of the abbreviated information given in the case, and particularly the Preliminary Consolidated Statements of Income, shows that Simpco's sales, operating income and net income would have been lower than the prior year's measurements even without the write-off of in-process research and development acquired in several takeovers and restructuring changes in 20X2. Therefore, Simpco's 20X2 fiscal year was a good time to consider taking a Big Bath. By writing off as much of the purchase price of acquisitions as possible (by classifying the assets purchased in the acquisitions as IPR&D), Simpco avoids having to classify that part of the purchase price as goodwill (subject to amortization in future years) or other assets (subject to amortization and depreciation charges in future years). By doing so, Simpco anticipates expenses from future years into the current fiscal year, making a bad year even worse but setting up future years to be more profitable since the company will recognize lower expenses for depreciation and amortization than would be the case without the Big Bath.

The \$365 million in restructuring charges are also troublesome. Restructuring charges are subject to substantial managerial discretion both as to magnitude and timing. The company proposes to recognize large (relative to net income) restructuring charges in a



fiscal year in which (a) sales, operating income and net income are low relative to the benchmark of the previous year--even without any unusual discretionary charges; and (b) significant portions of several acquisition prices are written off as IPR&D--arguably another instance of substantial managerial discretion. Ms. Oberlin is entirely justified in worrying that the SEC, as well as the company's auditors, the analysts and current and potential investors, will be skeptical about the extent to which the recognition of the unusual charges is due to the managers' best unbiased judgment about judgments and estimates embedded in the charges.

Nita Clyde, Ph.D., CPA, is a partner at Clyde Associates.

Clyde Associates is a boutique consulting firm located in Dallas, TX where Nita specializes in accounting education with a particular emphasis on issues of professional ethics. She chairs the AICPA/NASBA Joint Committee on Continuing Professional Education Standards, as well as a Special Committee on Ethics in the CPA Profession. She is a past member of the AICPA Board of Directors, and is currently a member of its governing Council. Nita was a university professor for almost 20 years.

Controller Kathy Oberlin appears to be more obsessed with what she can “get away with” in her company’s Securities and Exchange Commission filings than in making a fair presentation of Simpcos financial results. Without addressing what constitutes proper accounting for the various transactions, there are still several ethical issues to consider.

First of all, a CPA is obligated to follow generally accepted accounting principles, including, in this case, those established both by the SEC and the Financial Accounting Standards Board. Kathy worries that while some “hot” areas are well documented, there are others that might not bear close scrutiny and thus would be subject to adjustment.

Kathy has an obligation to diligently investigate the alternative methods of financial statement presentation available to the company. She and her staff must be competent in making their assessment of the various estimates, and her professional judgment cannot be influenced by pressure to present the company’s financial situation in the best light, regardless of what it takes to do so. Because her judgment is relied upon, she should share her concerns with management, including any reservations she may have about the work of DC&A Consultants. While there is always room for varying opinions relative to certain accounting issues, if Kathy is certain that elements of the financial presentation are misleading and/or inaccurate and management refuses to allow her correct them, she should remove herself from the situation. Her professional obligations extend beyond the company itself to current and prospective equity and debt providers.

This case is a good illustration of the complexity and inter-relatedness of various accounting and internal control issues, including the relations among managers' personal incentives (including bonus payments and personal credibility), investor relations



programs, earnings management, cost of capital and accounting controversies with auditors and regulators.

Turning first to the earnings management issues, although the abbreviated income statement shows a pattern that is consistent with Exozol having taken a Big Bath in 20X1 (intentionally accelerating the recognition of expenses in a year during which earnings are below the long-term trend line to improve accounting profitability in future years), the discretionary charges taken in 20X2 are not consistently of the income-increasing variety. In 20X1, Ed Keys took estimated restructuring charges in excess of the amount that was ultimately justified. In 20X2 some of the charges were reduced, but another set of restructuring charges was recognized, some of which (particularly those related to shutdown expenses for the production systems in the Midwestern plant) proved to be excessive before the end of the year. These 20X2 restructuring charges caused net income for that fiscal year to fall below the trend line, although not by as much. In addition, the issue is clouded by the pattern of research and development charges, which in 20X1 were summarily reduced from the percentage of commitment typically recognized in the industry but were also increased by the immediate charge-off of in-process R&D purchased in the acquisition of Puma Lubricants. Because a clear pattern does not emerge from these unusual charges, investors and analysts are likely to be confused about management's intentions and are also likely to find it difficult to forecast future cash flows and earnings. This confusion could well lead to an increased cost of capital for Exozol, and to be inconsistent with Ed Keys' stated focus on shareholder interests.

To his credit, James Linwood is concerned about his relationship with the investment community. He no doubt understands the results of the research on the inverse relations between increased disclosure and transparency in financial statements and cost of capital to a business. Other factors that have been shown to be inversely related to share prices are controversies with auditors and regulators that lead to restatements of prior year financial statements. These events should be avoided as part of a good investor relations program.

Exozol's main financial reporting problems appear to be a function of Ed Keys' autocratic management style. He is not committed to good process and proper authorization by the board of directors for plans and commitments. He does not respect chain of command in making accounting decisions, and appears to be using the suspension of bonuses for decision-making personnel as a tool to exercise power over managers rather than as an incentive structure to facilitate delegated decision making in shareholders' best interests. A useful exercise might be to attempt to construct and evaluate a justification of Ed Keys' actions, decisions and incentives.