



A Troubled Acquisition for Websave

By a Fortune 100 Executive

Carmenez, VP Mergers and Acquisitions, is concerned about the board's reaction to merger results. What advice should CFO McGuire offer on the accounting for an acquisition that has not met her company's expectations?

Abstract

Chief financial officer Shirley McGuire must offer advice on the accounting for an acquisition that has not met her company's expectations. Evaluate each of the accounting options to improve the results of IVI and the accounting justifications for the positions taken. What hurdles would Websave face in attempting to apply pooling accounting to this transaction?.

Background

It was December 15, 2000, at 10:00 p.m., and Max Carmenez, vice-president of mergers and acquisitions, and Shirley McGuire, chief financial officer, were preparing for a meeting with the board of directors of Websave the next morning. Carmenez was the driving force behind Websave's purchase of IVI Systems on January 30, 2000. IVI had created a new Internet browser package that offered commercial and consumer users a much more efficient and powerful search capability. Carmenez believed that there were innumerable potential operating synergies between IVI's product that could produce over \$100 million in incremental revenues from Websaves' existing customer base each year. More important, Carmenez saw significant cross-selling opportunities with IVI that could provide an immediate expansion to Websave's customer base. With McGuire's help, Carmenez had been successful in creating great excitement about this opportunity among Websave senior management and the board of directors. Amid competitive bidding, Websave ended up paying a whopping \$1.5 billion for the company, a \$500 million premium to the book value of IVI assets on the date of close.

Unfortunately for Websave, three of IVI's key engineers left the company shortly after the acquisition, leaving the company struggling to update software needed to introduce new products and to meet existing customers' specific needs. IVI sales had slowed, costs were up and Websave was staring at a \$25 million loss from operations on this business for the 11 months ended December 31, 2000. As champion of the deal, Carmenez was concerned about the board's reaction to IVI's results and the impact that this might have on his ability to gain approval for future acquisitions. For her part, McGuire had reviewed and approved the pro forma projections of the acquisition, which the Websave board relied on to approve the deal. The \$25 million loss now expected was a long way from the original planned income of \$30 million for this same period. McGuire was even more



concerned about the potential impact these results would have on Websave's debt ratings once the rating agencies saw them.

McGuire explained that the accounting rules allowed up to 12 months after an acquisition is completed to "fine tune" the purchase accounting and related adjustments for the deal. She thought that there might be room to improve the results using some "creative accounting." She put together an agenda for Carmenez to discuss the following items related to the IVI purchase:

I. Goodwill Allocation Period

A 10-year amortization period was selected when the IVI acquisition was presented to the Websave board for investment approval. Although Accounting Principles Board Opinion No. 17 allows for an amortization of up to 40 years, 10 years was considered appropriate for the following reasons:

- The relatively short life of Websave's technology in the quickly changing high tech area.
- Websave's historical conservatism with respect to acquisition accounting. McGuire was concerned about a significant buildup of goodwill on the balance sheet.
- The potential impact of large goodwill balances on company reviews by Moody's, Standard & Poor's and other rating agencies.

Despite all of this, Carmenez and McGuire realized that an extension of the goodwill period could provide immediate earnings improvement for Websave. Based on the total recorded goodwill of \$513.8 million, even a five-year increase to the goodwill amortization period would produce incremental pretax earnings of \$17.1 million per year and \$10.3 million after tax.⁴ McGuire explained that such an adjustment was still allowed because the one-year purchase accounting remained open; however, they would need a sound basis to support this longer amortization period.

II. Discontinued Operations

As part of their due diligence, McGuire and Carmenez had contemplated closing IVI's commercial browser department (CBD) due to overlap with existing operations. After several key engineers left the business, Websave did in fact shut down CBD operations, resulting in a \$1 million loss, detailed in exhibit one:

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Calculated as $\$513.8/10 =$	\$51.40
Less: $\$513.8/15 =$	\$34.30
Pre tax =	\$17.10
Taxes at 40%	\$6.80
Net after tax	\$10.30



Exhibit One – Discontinued Operations

<u>Category</u>	<u>(millions)</u>
Assets of CBD written off	\$0.50
Severance to employees	\$0.20
Patents/trademarks	\$0.10
Facilities closure	\$0.10
Miscellaneous	<u>\$0.10</u>
Total write-off	\$1.00

McGuire explained that the accounting rules were somewhat gray in this area. She was not sure whether the charge should be treated as 1) a current-year loss on the income statement or 2) a capitalized charge added to goodwill to be amortized over the goodwill life.

III. Covenant Not to Compete

There were significant negotiations surrounding the question of whether IVI engineers could compete should they quit Websave after the acquisition. In the end, all IVI engineers agreed to a 10-year non-compete agreement. However, any engineer could terminate this agreement at five years at a cost of \$50,000 per engineer. Due to the huge technology benefits IVI brought to Websave, McGuire had ascribed significant value (\$3.75 million) to these non-compete agreements. McGuire and Carmenez were now considering the correct period over which to amortize these costs. Should they be amortized into expense over (1) the five-year guaranteed term of the agreement, (2) the longer potential 10-year term or (3) the amortization period for goodwill?

IV. Research and Development Costs

As an Internet development company, IVI was required to invest large sums of money to maintain its product and develop applications for new markets. The majority of these expenses (95%) related to the wages, benefits, travel and other costs of IVI engineers who developed these product enhancements. Before the acquisition, IVI had capitalized these expenses and amortized the related costs over the estimated useful life of the product developed. The expenses averaged \$10 million annually and were amortized over five years, resulting in a \$25 million research and development asset on IVI's balance sheet at the time of acquisition.

Gene Bis, Websave's controller, questioned IVI's accounting treatment for R&D expenses at the time of acquisition. As a public company, Websave's approach was that its accounting policies should be held to a higher standard, which included regulations promulgated by the Securities and Exchange Commission. Websave had consistently expensed all internally generated R&D costs as opposed to building an asset and deferring the related costs. This presented two questions for the acquisition accounting

team that had been debated throughout the year and still had not been resolved by year-end:

1) *How should the \$25 million R&D asset on the closing date balance sheet for IVI be handled?*

One option would be simply to carry over the \$25 million asset on Websave's balance sheet and amortize the remaining balance over five years. A second would be to write off this asset in purchase accounting and increase goodwill by \$25 million. Carmenez preferred this option because it would result in a 10-year amortization period (in accordance with the 10-year goodwill life) versus the faster five-year period adopted by IVI.

2) *Should IVI's prospective R&D expenses continue to be capitalized or should they be expensed as incurred?*

Carmenez did not understand why this was even being debated. "Why should we change the way that these expenses were historically handled by IVI? If it was good enough for them, it should be good enough for us. When we modeled this acquisition, we assumed that these expenses would continue to be capitalized. If we now decide to expense them, we will never get this business back to the pro forma projections presented to the board!" However, Bis argued that, as a public company, Websave was required to expense these costs. In addition, he did not see how Websave could have a wholly owned subsidiary (IVI) that had different accounting policies for R&D expenses from the parent company.

McGuire still had not made a decision on this point. However, she realized that there would be a significant increase to income from operations in the current year if she sided with Carmenez.

V. Purchase vs. Pooling Accounting

At the time of acquisition, Carmenez and McGuire did not think much about a possible pooling of interests. They had heard that the Financial Accounting Standards Board was planning to discontinue pooling of interests accounting effective December 31, 2000, and did not feel it was an option. Carmenez had some questions for McGuire, however, because a recent *Wall Street Journal* article indicated that perhaps pooling was not going away, certainly not by the end of 2000.

Carmenez was not an expert on pooling accounting because Websave had always accounted for acquisitions under a purchase accounting method. However, he remembered that pooling provided for a combination of businesses at their historical costs. In effect, the balance sheets of the two "merged" entities would be combined at the book values immediately before the acquisition. This avoided a fair market valuation of the balance sheet and recognition of a goodwill asset. The immediate benefit was that there was no charge to current period earnings for the amortization of the recorded goodwill. Given the large goodwill balance in the IVI deal, Carmenez felt that this could be a huge potential improvement to IVI's operating results.



McGuire was much more skeptical about applying pooling of interests in this case. She realized that although the FASB still allowed pooling, there were substantial hurdles to get over to allow its application. Among other things, the acquiring entity had to prove that:

- The transaction was a “merger of equals” rather than one firm acquiring another. The deal must be accomplished by an exchange of stock between the two parties.
- There were no changes in the equity interests of the voting common stock of *either* company for two years before the acquisition.
- At the date of combination, each company was independent of each other.

McGuire was also concerned because Websave had entered into a \$10 million stock buyback program on January 1. She was not sure, but she thought that this program might limit Websave’s ability to apply pooling accounting. Carmenez understood all of these hurdles, but he was still pushing the idea. This decision would significantly affect the results of the IVI acquisition for the year.

Exhibit Two IVI Acquisition

Goodwill Reconciliation

	<u>(millions)</u>
Cash paid	1,520.0
Asset book value at close	<u>1,010.0</u>
Total premium	510.0

Adjustments to Goodwill

Asset FMV adjustment(1)	-1.0
Covenant not to compete (2)	3.8
Increase bad debt allowance (3)	<u>1.0</u>
Total goodwill	513.8

Goodwill amortization period 10 years

Pretax amortization per year 51.4

Open: Capitalized R&D Costs (4) 25.0

- (1) To adjust the historical cost of IVI assets to FMV at the date of close.
- (2) To establish a separate asset for the purchase price related to IVI’s covenant not to compete for software engineers.
- (3) To adjust IVI’s bad debt reserve to cover anticipated exposures.
- (4) Item remained open at December 15, 2000. Websave was still discussing how to treat this asset in purchase accounting.



How should Shirley McGuire handle the current situation? Are any changes from the original estimates necessary? What criteria or considerations should be used in making this determination?

Comments on “A Troubled Acquisition for Websave”

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There are a variety of macro observations to be made at the outset of this case study.

1. The financial accounting rules for the purchase or pooling methods of accounting for business combinations are not elective. The transaction is evaluated based on its unique substance and form. This evaluation of the facts will determine which accounting method is to be used. Many companies prefer to account for transactions using the pooling-of-interests method. To do so requires careful upfront analysis to ascertain whether each of the companies met the specific criteria, and then thoughtful consideration of how to structure the transaction to ensure it meets the specific and unique requirements associated with pooling of interests. If, for whatever reason, all of the conditions are not met, then the transaction must be accounted for using the purchase method.

In this case, one need not look very hard at the facts to conclude the pooling conditions are not met. The consideration issued in the transaction was cash not stock.

2. The allocation of the purchase price to net assets acquired generally requires an appraisal by a qualified independent expert. The allocation of value starts with current assets to long-lived assets to intangible assets. Intangible assets might be either identifiable (such as acquired software, patents and copyrights and the value of the workforce) and non-identifiable (which is classified as goodwill). Generally, value is allocated among the various elements of intangible assets to create tax basis. From a financial reporting perspective, there is virtually nothing to distinguish these attributes. The primary reason it that goodwill in a technology business has a very short life. In fact, in this case study, the goodwill has an assumed life of 10 years. It is my opinion that this time period is too long. Given the rate of innovation, anything greater than five years is questionable.

3. The analysis and reporting of how the company was performing after the transaction must be specific to the unique drivers of the business. That means evaluating the performance based on all of the goals and objectives, one element of which is the



financial performance. The financial performance must be assessed not simply on the bottom line but, more important, on the individual criteria that were the basis for doing the deal. To say the financial objectives were met--because the goodwill amortization period changed relative to the original assumption--is clearly misleading.

4. The accounting policies of the parent and its subsidiaries must be consistent. That should have been taken into consideration in the financial modeling performed at the outset to evaluate the merits of the business combination. Again, to say that the financial goals of the transaction were met because of changed bookkeeping assumptions is misleading and inaccurate.

5. The one-year look-back window in accounting for business combinations is to be used to fine-tune the valuation of acquired assets and liabilities. It is not intended to be a vehicle to compensate for poor post-acquisition integration and management of the acquired entity.

Final Observations

At no point in this case did company executives discuss the fundamentals of the acquired business. All of the effort was placed on window dressing the bookkeeping. If they had focused on driving the business forward, the associated bookkeeping concerns would be a secondary issue. As for debt ratings, it is unlikely that increasing the time period over which goodwill was amortized would make any difference. Likewise, the financial results from operating activities are not at all substantively affected by the accounting method used in the transaction. The only substantive difference to the income statement is that there is a non-cash charge that can be clearly isolated as goodwill amortization if the purchase method of accounting is used. The balance sheet is affected by a different issue. In this case study, cash was the asset used as consideration--this fact alone would merit review by rating agencies. If stock were the consideration, there would likely be a different evaluation.

The hard part of business combinations is not in getting the deal done—it is managing the acquired company post transaction. Financial reporting can be an early warning indicator to operational management if the transaction's business objectives are not being met. To be effective, the goals and objectives must be defined in a measurable fashion. While some of these business objectives may not be directly measurable from a financial perspective, there are often ways to create reporting that will shed light on whether the business unit is on track. Effectiveness also depends on timeliness. To evaluate the financial performance 11 months after the closing date is poor financial and operational management.

It's very clear that the chief financial officer and vice-president of mergers and acquisitions were both confused about their overriding responsibilities. Perhaps a starting point to resolving these issues would be to replace the CFO.



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Author’s note:

The commentary below represents my own personal views and observations.

Many people in the corporate environment have differing views on mergers and acquisitions. Most often, those in business development seek acquisitions that build on possibilities. They tend to use surface-level reviews of the target company to emphasize the rosier end of the range of possible outcomes--most synergies, fewest disruptions. Once these scenarios are developed, it is difficult to be the cynical reviewer who is asking what could go wrong.

Websave seems to have followed this pattern. Mr. Carmenez pitched the acquisition of IVI based on an analysis that showed huge potential operating synergies and cross-selling opportunities, with seemingly little worry about execution risk. Ms. McGuire reviewed that analysis, and appeared to accept it. The fact pattern discussed in the case doesn’t indicate that anyone--Mr. Carmenez, Ms. McGuire or the board—asked what could go wrong.

While there is some flexibility in the accounting rules for business combinations, Ms. McGuire’s overall approach is not correct. Accounting rules are not meant to be used to cover up poor forecasting or performance. If IVI has a fundamental performance problem, all members of management should address it immediately so that it does not further diminish the value to the shareholders.

To examine specific options in this case:

Extending the goodwill allocation period from 10 to 15 years. There is no evident basis for increasing the allocation period, and perhaps one could argue that 10 years is too long. This is not a viable alternative.

Timing of the discontinued operations. Given the fact pattern outlined in the case, it would be difficult to conclude that this decision was made prior to or on the date of the acquisition. In that case, it should be treated as a current period expense rather than an addition to goodwill. With respect to the circumstances that gave rise to this loss, it would seem important that the board be made aware of the circumstances, particularly as it could significantly affect future IVI performance.

The value of investments made in start-up high technology companies. It would be interesting to understand if Ms. McGuire had any basis for recording the value of the investments at other than the appraised value of \$5.5 million. Did she know of

impairment in the underlying entities? Had market conditions deteriorated such that the underlying entities were experiencing funding problems? Based on the facts presented, it seems as if Ms. McGuire believed the “true” market value was \$5.5 million. In that case, the accounting treatment proposed by Ms. McGuire is not only risky, it is simply wrong.

Covenants not to compete and how to amortize them. There is definitely some latitude here, but I would caution that the impact to earnings per share should not be the overriding consideration. Clearly the value of these agreements should be analyzed thoroughly, with particular emphasis on the extent to which Websave intends to enforce them. There should be evidence available, since three key engineers have already left IVI. While I don’t believe that there are enough facts presented to draw a conclusion, I would be hard pressed to believe that the value should be amortized over a period longer than the five-year guaranteed term.

Allowance for bad debts. When did the receivable really go bad? If the receivables were bad on the date of acquisition, then the allowance for bad debts should be adjusted on the opening balance sheet even if it is 10 months after the original determination was made. If receivables are good but have not been easy to collect due to the distraction of the merger, then any conclusion to forego collection and write down the receivable should be viewed as a decision subsequent to the acquisition date and a charge to the income statement.

Treatment of IVI’s capitalized research and development costs, and the go-forward accounting policy for the combined companies’ R&D costs. The accounting rules are fairly clear in this area. The key determining factor is whether the IVI “asset” has value, either as a tangible asset that has alternate uses or as an intangible asset relating to a specific project. In the first case, the asset with alternate uses most commonly would be a building or materials. This does not seem to be the case for the asset on IVI’s books. In IVI’s case, it appears that the costs relate to specific projects that had been or were in the process of being completed. These costs should have been expensed as incurred on IVI’s books. The company should examine whether there are any in-process R&D projects that Websave “valued” in its determination of the purchase price of IVI. If so, they should perform a valuation of those IPR&D projects and place a value on the opening balance sheet. Then Websave should take a charge for expensing the acquired R&D immediately after the acquisition.

Pooling vs. purchase. The interesting fact here that cannot be ignored is that changing the accounting to pooling does not change the operating performance since acquisition, nor does it improve comparability to the pro forma results presented to the board. The pro forma results would have to be recast to reflect the “what if?” under the pooling method, and the poor operating performance would still be evident. Whether pooling is possible is a complex analysis that has to consider the fact pattern presented and many other items. In any case, the underlying operating performance should not be masked by the accounting choices that are made.



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“My recommendation would be to hire an independent valuator to assist in assigning fair values to each of these classes of intangible assets.”

Unfortunately, this transaction was consummated without a thorough understanding of all the accounting consequences and it is difficult for the accounting to mitigate any of the unfavorable results now.

This transaction will most likely not qualify for pooling-of-interests as it appears that the entire purchase price was paid in cash. However, the effect on future earnings may not be as adverse as it appears. The Financial Accounting Standards Board is considering a new statement that will require accounting for all business combinations under the purchase method. Under the current proposal, goodwill associated with all acquisitions (including those that occurred before the effective date of the proposed new statement) will not be amortized but will only be assessed for impairment. Accordingly, even though impairment may still be at risk, the income statement will not be adversely affected by the amortization of the goodwill associated with the IVI acquisition.

Under purchase accounting, entities must assign fair values to the acquired company's identifiable assets and liabilities as of the date of the acquisition. A certain grace period, normally a year, is allowed to finalize the valuation of these identified assets and liabilities. This is permitted because companies may not necessarily have the information available at the time of the acquisition to finalize these valuations. Identifiable assets and liabilities would also include certain intangible assets, such as developed software, workforce in place, trademarks and customer base. My recommendation would be to hire an independent valuator to assist in assigning fair values to each of these classes of intangible assets. It would be inappropriate to assign values solely on current book values; for example, the capitalized cost of the research and development.

This case study highlights again the importance of planning and coordinating all transactions up front. Over the last few years, accounting rules and regulations have increased exponentially in difficulty and complexity. This complexity combined with added pressures from Wall Street should establish the accountants as integral parts of the decision-making process within each successful business organization. However, a lot of companies believe the role of accountants is merely to record past results without affecting the future. The challenge to all accountants should be to equip themselves with necessary tools to enable them to deliver value and to be the company's radar, identifying opportunities and risks long before they emerge.