Accounting for Acquisitions

Purchase Method

The purchase accounting method of reporting acquisitions requires that the assets of the target firm be reported at their fair market value on the books of the bidder

With this method, an asset called goodwill is created for accounting purposes

Goodwill is the difference between the purchase price and the estimated fair market value of the net assets (assets less liabilities) acquired

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Purchase Method

Firm A acquires Firm B, thereby creating a new firm, AB. The balance sheets for the two firms on the date of the acquisition are shown below

Firm A				Firm B			
Working capital	$ 4	Equity	$20	Working capital	$ 2	Equity	$10
Fixed assets	16			Fixed assets	8		
Total	$20	Total	$20	Total	$10	Total	$10

Firm A pays $18 million in cash for Firm B. The money is raised by borrowing the full amount. The net fixed assets of Firm B, which are carried on the books at $8 million, are appraised at $14 million fair market value.

Accounting for Acquisitions

Pooling of Interest

Under a pooling of interests, the assets of the acquiring and acquired firms are pooled, meaning that the balance sheets are just added together

Earlier example under "Pooling of interest" method

Does M&A Really Add Value

- Anticipated merger gains may not be completely achieved, and shareholders thus experience losses. This can happen if managers of bidding firms tend to overestimate the gains from acquisition
- The bidding firms are usually much larger than the target firms. Thus, even though the dollar gains to the bidder may be similar to the dollar gains earned by shareholders of the target firm, the percentage gains will be much lower
- Management may not be acting in the interest of shareholders when it attempts to acquire other firms. Perhaps it is attempting to increase the size of the firm, even if this reduces its value per share

Does M&A Really Add Value

- The market for takeovers may be sufficiently competitive that the NPV of acquiring is zero because the prices paid in acquisitions fully reflect the value of the acquired firms. In other words, the sellers capture all of the gain.
- Finally, the announcement of a takeover may not convey much new information to the market about the bidding firm. This can occur because firms frequently announce intentions to engage in merger "programs" long before they announce specific acquisitions. In this case, the stock price for the bidding firm may already reflect anticipated gains from mergers.

Divestitures and Restructurings

- **Sale**

The sale of a division, business unit, segment, or set of assets to another company. The buyer generally, but not always, pays in cash

- **Spin-Off**

In a spin-off, a parent firm turns a division into a separate entity and distributes shares in this entity to the parent's stockholders.

- Parent firm receives no cash from a spin-off
- Initial stockholders of the spun-off division are the same as the parent's stockholders

Divestitures and Restructurings

- **Carve-Out**

The firm turns a division into a separate entity and then sells shares in the division to the public. This is similar to a spin-off, but the difference is that the firm receives cash from a carve-out