Accounting for Business Acquisitions: Xerox's 2010 ASC Acquisition Demonstrates Financial Reporting Risks

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Business combinations have always been a popular route for corporate growth, allowing companies to leapfrog or eliminate competitors, gain critical mass, enter new lines of endeavor, and, perhaps less admirably, satisfy executive ambitions to play in a bigger pond. Acquisitions can be accomplished in one of two ways – by purchasing operations and/or assets, or by obtaining a majority stock holding in the target company. If the latter approach is employed, the acquirer generally inherits not only the business, but also any of its obligations, whether disclosed or undisclosed. Risks posed by this approach are most recently demonstrated by the just-announced news that the SEC is investigating Xerox Corporation for possible revenue reporting missteps by its ACS subsidiary, which was acquired in 2010 in a cash-and-stock deal valued at $6.4 billion.

It appears that the matter now at issue revolves around the gross vs. net reporting of certain ACS transactions, most of which occurred before the Xerox purchase. Briefly, Generally Accepted Accounting Principles (GAAP) requires that certain transactions create reportable revenue for only the net fee charged, rather than for the gross amount of the transaction. This applies particularly where the entity is acting only as an agent or broker, as in the case of real estate agents whose top line revenue is only the 6% fee charged, not the actual property selling price. It would appear from news accounts that ACS might have reported equipment resale transactions as gross, which the SEC may be finding objectionable. Although this would not alter most key financial statement statistics, such as gross margins and net income, it would have inflated gross revenues, which is often viewed as an important indicator of a company's performance, particularly of its period-over-period growth and potential.

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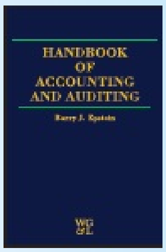

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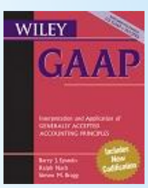

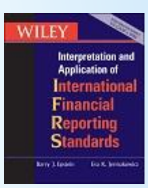

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Xerox was last caught up in an SEC investigation over a decade ago, involving the unrelated issue of accounting for leasing transactions, which resulted in both Xerox and its then-auditors, KPMG, each paying substantial fines. The company presumably engaged in the usual due diligence before completing the ACS acquisition, and it must be assumed that this gross vs. net issue either escaped notice or was deemed an immaterial risk. Without pre-judging the outcome of the current investigation or the propriety of the accounting by ACS, which seemingly continued after the Xerox acquisition, at least for a period of time, the company may now suffer some reputational harm from the mere fact that this investigation is happening.

A Historical Look at Financial Reporting Fraud in Business Combinations

More broadly, and without implying intentional financial reporting fraud by ACS or Xerox in the present matter, many financial reporting frauds have historically been associated with business combinations accounted for as purchases. One popular device has been to provide a so-called "cookie jar" of unneeded reserves or estimated liabilities, ostensibly required to absorb post-merger costs, such as the elimination of duplicative facilities. However, when these have later been found to be excessive they have been absorbed back into income, particularly during periods of otherwise disappointing fiscal performances. One example of this type of manipulation involved the not-for-profit Allegheny Health, Education and Research Foundation (AHERF). The foundation made many acquisitions of medical practices and hospitals which it used as opportunities to create excessive estimated future expenses reserves that were later employed to smooth earnings. This caught the attention of the SEC because of financial filings made in connection with the foundation's issuance of private-purpose municipal bonds, and this case was a landmark in extending the SEC's regulatory oversight to this previously unsupervised market.

The more-recent Olympus Corporation fraud illustrates another misuse of business combinations to conceal or perpetrate financial reporting fraud. In this instance, losses which had been accumulated years earlier from other ill-conceived Olympus ventures had been improperly concealed using a variety of off-the-books entities, where they grew to over $600 million, an amount that would ultimately have to be addressed. An unrelated business acquisition provided the vehicle to finally deal with this problem. The losses were rolled onto the corporation's balance sheet, ostensibly representing costs incurred for business brokerage and other services, as part of the purchase of Gyrus Group. Doing this improperly inflated the always-suspect balance sheet account goodwill, which was later written off, falsely characterized as being in recognition of the disappointing prospects from newly acquired Gyrus. This sequence of fraudulent actions permitted management to ascribe the losses actually incurred from past managerial missteps to the presumably less objectionable grounds of goodwill impairment, which is a not-infrequently observed non-cash charge that often gets little attention, particularly during challenging economic times when these adjustments are commonplace.

Yet another fraudulent device sometimes observed is the deliberate misallocation of purchase price, often to long-lived assets, which will only impact future earnings over the longer term, as opposed to goodwill, which must be regularly assessed for impairment, or other intangibles having shorter periods of amortization and thus more immediate effect.

A variant on this same theme is to under-allocate purchase price, ignoring or under-valuing liabilities being assumed. The aggregate effect would be to inappropriately characterize the transaction as being a bargain purchase that, under current accounting rules, would result in a gain that would be immediately recognized in the acquirer's earnings, possibly boosting market valuation of the company's shares. Although such bargains have been observed to occur, they are rare, since they imply that the sellers failed to negotiate a fair price – unlikely in an arm's-length transaction with well-informed parties on both sides.

Less obvious, but occurring in transactions in which the acquirer purchases a controlling but not-100% share in the acquiree, is the deliberate mis-valuation of the non-controlling or minority interest in the target company. Under GAAP, this will appear as equity in the newly combined company's consolidated balance sheet. If incorrectly computed, this might affect the allocation to depreciable assets or, even better, to the amount of goodwill recognized, which will not have to be amortized. In some cases, the effect is to recognize gain that will immediately be included in earnings, if the transaction can be viewed as a bargain purchase.

These are some, but not all, of the devices by which business combinations can provide the opportunity for accounting fraud. Even absent fraud, however, accounting properly for such transactions – including, where necessary, changing the predecessor entity's accounting practices, if found to be less than acceptable under GAAP – requires close attention by acquirers and their professional advisors.

Lessons to be Learned in Accounting for Acquisitions

Thus, among the lessons to be learned by management from the most recent Xerox investigation are that companies making business acquisitions must carefully scrutinize accounting by targeted companies, since the acquirers may have to suffer the cost, embarrassment and reputational harm of infractions committed by predecessor managers. For auditors, the lessons include the need to very closely review both the accounting for the acquisitions themselves and the accounting practices of the acquirees. Failures to do so can have serious consequences for all concerned.

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