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COURSE
21805A

M&A Accounting and Financial Statement Fraud Detection

Mergers and acquisitions create some of the most complex—and manipulable—accounting scenarios in practice. This course breaks down how M&A transactions are recorded and how purchase accounting affects reported results. Then it tackles a critical question: can fraud actually be detected from financial statements? You'll explore red flags, analytical techniques, and real-world patterns that can help you spot irregularities. Valuable for CPAs involved in due diligence, forensic accounting, or advising clients through transactions.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the requirements of Financial Accounting Standard No. 141.
- Recall the fallout from the Enron scandal.

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Publication Date: May 2026

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Chapter 1: MERGERS-AND-ACQUISITIONS ACCOUNTING

Chapter Objective

After completing this chapter, you should be able to:

- Recall the requirements of Financial Accounting Standard No. 141.

Business combinations attract vast attention beyond the investment world for a variety of reasons. Consolidation of smaller enterprises into larger ones often produces economies of scale and scope that contribute to economic efficiency and growth. In some instances, though, the antitrust authorities seek to block a proposed merger or acquisition, alleging that it will cause an industry to become overly concentrated. That could enable the combined company to extract monopolistic profits, a detriment rather than a benefit tothe economy. Fees from advising on M&A transactions are an important revenue source for investment banks. Hollywood occasionally puts the drama of takeover battles onscreen.

Investors often attribute value to companies, over and above what is justified by their earnings prospects and risks, based on their perceived attractiveness as acquisition candidates. In these transactions, the acquirer typically pays a substantial premium to the target company's prevailing share price. The acquiring company's shareholders can benefit when an M&A deal genuinely creates synergy, but they must be on guard against corporate managers' efforts to produce the illusion of value creation through financial reporting gimmickry.

Inflating reported earnings in the context of M&A has a long history. **Pooling-of-interests** accounting was a favorite device of 1960s conglomerates, which were popularly described as operating on the 2 + 2 = 5 principle. In a transaction that qualified for pooling treatment, the cost of paying a premium to the acquired company's prevailing stock price conveniently disappeared.

Reform was slow in coming, thanks is no small part to lobbying by companies that liked the latitude afforded by the M&A accounting rules then in place. In 2000, three decades after first lambasting pooling-of-interests in an article titled "Dirty Pooling," *Barron's* took aim at Cisco's burying of costs associated with its frequent acquisitions[1]. Accounting watchdog Abraham J. Briloff calculated that in the case of the networking solutions company's acquisition of GeoTel Communications for $2 billion in Cisco stock, just $41 million of that cost went onto Cisco's balance sheet.

In 1997, four years before Briloff's Cisco critique, the *Wall Street Journal* reported that FASB was at long last considering restricting or abolishing the use of pooling-of-interests. FASB spokesperson Deborah Harrington explained that allowing the option of pooling treatment prevented investors from comparing economically similar acquisitions that were accounted for differently. The issuers

of financial statement, true to form, overwhelmingly preferred the method that made it difficult to compare deals booked as poolings to those recorded through purchase accounting. According to Securities Data Co, poolings had outnumbered purchase-accounting-method deals by a ratio of ten to one over the preceding five years. Chief SEC accountant Mike Sutton reported that over 40 percent of his staff's time was absorbed by tussles over which mergers qualified for pooling.

Not until 2001, four years after the news arrived that the accounting rule-maker was taking up the issue, did Financial Account Standard No. 141 finally go into effect. The new standard required the use of purchase accounting for all mergers and acquisitions.

Investors should not have been lulled into thinking that reform put an end to M&A accounting gimmickry. In 2003, the *Financial Times* noted an interesting pattern in industrial components maker Danaher's financial statements[3]. The prevailing rules enabled companies to write up the value of goodwill created in an acquisition after fully evaluating the transaction. FT contributor John Dizard found that following its frequent acquisitions, Danaher wrote up the goodwill while at the same time writing down the value of tangible assets such as inventories and receivables.

Danaher's management declined to answer Dizard's questions about the rationales for deciding that the acquired companies' tangible assets were worth less than they had been carried at on the acquired companies' books. He could therefore only hypothesize how this process could be abused to fabricate earnings. As Dizard explained, a company could game the accounting rules and bolster the earnings that support its stock valuation by writing down supposedly unsalable inventories and allegedly uncollectible receivables. Upward revaluation of goodwill would more than offset those losses. Subsequently, the company could find that those purportedly unsalable inventories were salable after all and, lo and behold, the ostensibly uncollectible receivables were in fact collectible. The profits resulting from the associated sales and collections would be greater than if the assets had not been sharply written down in the post-acquisition phase.

FASB further refined the M&A accounting standards in 2007 by replacing purchase accounting with **purchase acquisition accounting**. Despite continuing reforms in financial reporting standards, however, analysts still need to keep their guard up when gauging the earnings impact of business combinations.

In 2019 *MarketWatch* reported that the Securities and Exchange Commission had stepped up its efforts to discourage acquisition-related adjustments for deferred revenue that was written off under GAAP. Some acquisitive companies were adding back this "ghost revenue" in calculating adjusted revenue numbers commonly used by analysts. In June 2019, for example, Ribbon Communications responded to an SEC comment letter by agreed to drop its acquisition-related revenue adjustment from future filings[4].

The two following case studies highlight financial signals that can help investors dodge nasty M&A-related shocks.

GOODWILL GOES BAD

"When one door closes, another one opens," said Alexander Graham Bell. Acquisition-happy companies did not fail to see the door that FASB opened for would-be abusers of financial reporting rules at the same time that it closed the door on pooling-of-interests accounting. At that point, the accounting rule-maker also ended the requirement for annual amortization of goodwill. Since then, public companies have been required only to examine their goodwill at least once a year and take a write-down if they find that its value has been impaired. That change removed some of the pre-2001 purchase accounting method's disincentive to paying an excessive premium over an acquired company's net value. Under the old standard, the more goodwill that was created in an acquisition, the greater was the annual hit to earnings from mandatory goodwill amortization. Now, companies could buy earnings through acquisitions at rich prices with relative impunity[5].

Not total impunity, mind you. In 2015, General Electric paid $10.1 billion for the French company Alstom's energy businesses. Those operations had a book value of –$7.2 billion. GE booked the difference between the two figures as goodwill, justifying the price it paid by synergies that it could achieve by such means as cross-selling complementary product lines to generate incremental revenues. The resulting, greater-than-100-percent ratio of goodwill to acquisition price was a rarity. That ratio averaged just 65 percent in the preceding five years' industrial-sector acquisitions[6].

On October 1, 2018, GE announced that it would write off $23 billion from the value of its power equipment business. The charge was mostly related to the ill-fated acquisition of the Alstom energy businesses. On the following day, GE fired its CEO after just 14 months in that position and Standard & Poor's downgraded the company's credit rating from A to BBB+. The company's disclosure that it would miss its 2018 earnings and cashflow goals was a contributing factor in both of those developments.

GE's stock actually rose on October 1, reflecting investor enthusiasm for the executive chosen as the company's new CEO, Larry Culp. As Jack Cieselski of *Analyst's Accounting Observer* noted, the power business' troubles were well known by then and were already incorporated in the share price. The outgoing CEO, John Flannery, had acknowledged in 2017 that if he had it to do over again, he would pay a substantially lower price for the Alstom Assets. Between the November 2, 2015, close of the Alstom deal and the October 1, 2018, write-down of the former Alstom businesses and other power division assets, GE's stock plunged by 36 percent while the S&P 500 climbed by 39 percent. In short, the market imposed a large penalty on shareholders well before the company officially conceded that the goodwill it recorded in the Alstom deal was illusory.

DOUBLE TROUBLE

On November 20, 2012, Hewlett-Packard announced that it would take an $8.8 billion write-down on the UK software company Autonomy Corp. that it acquired on October 3, 2011. HP's share place

dropped by 12 percent on the day of the announcement while the S&P 500 edged 0.7 percent higher. The wide-ranging technology company stated that more than $5 billion of the Autonomy write-down was related to financial reporting improprieties that it discovered only after the acquisition closed. According to HP, the fraudulent accounting went undetected by the leading auditing firms that scrutinized Autonomy prior to the acquisition but came to light when a whistleblower stepped forward.

Controversy arose immediately. Autonomy co-founder Mike Lynch denied the claims of improper accounting. He blamed the loss of value on post-acquisition mismanagement by Hewlett-Packard. The stock market's previous assessment of HP management lent some support to that notion. In the five years preceding the Autonomy write-down, HP's stock price declined by 67 percent.

Some commentators were skeptical that with a balance sheet of just $3.5 billion shortly before being acquired, Autonomy could have created as much as $5 billion of false value through financial reporting improprieties. They suggested that as in the GE-Alstom affair discussed earlier, the underlying problem was a too-high price paid in the acquisition.

Lynch hotly denied that Autonomy misrepresented any financial reporting data under his leadership. In a 2010 speech, however, he had recounted that in the company's startup phase he placed a sign reading "Authorized Personnel Only" on an office door. Behind that door, he told visitors, were 500 engineers working on top-secret projects. In reality, it was a door to a broom closet. Autonomy's colorful CEO gave the company's conference rooms names drawn from James Bond movies and at one point filled the office fish tank with pirhanas[7].

Nine years after Hewlett-Packard's $8.8 billion write-down, the issues it raised were still not fully resolved. Autonomy's former CFO was convicted of falsifying financial statements in 2018, but in October 2021 Lynch was still awaiting a decision on a $5 billion lawsuit brought against him by Hewlett-Packard, the largest-ever U.K. fraud trial. More important for analysts than the apportionment of blame for the $23 billion write-down are lessons that can be drawn from the debacle. By learning those lessons, investors may avoid huge losses of value in future M&A transactions. Leaving aside issues of quality of management, which require study of corporate strategy and execution, the lessons to derive from this case study fall into two categories – financial reporting matters and valuation of acquisition targets.

Financial Reporting

Australian investor John Hempton labeled Autonomy's financial reporting "perverse" in light of the norms of its industry[8]. He explained that software companies ordinarily have very few receivables because they sell their products upfront and for cash. At the same time, they have obligations to service their software for a long period after they sell it. Consequently, software companies' unearned income is typically a multiple of receivables. Autonomy's balance sheet, on the other hand, showed large receivables. This was the result of booking sizable income for which the

company had not received cash, while booking no obligation for future services. Hempton emphasized that these facts could all be ascertained by examining Autonomy's balance sheet.

Renowned short seller James Chanos stated that in early 2011, several months before Autonomy's acquisition, the software maker was his largest European short position. Chanos's firm, Kynikos Associates, criticized the company's financial reporting in a report of July 2009. The payment of an unusually large premium for Autonomy was a factor in Chanos's naming of Hewlett-Packard as an "ultimate value trap" at the July 2012 Delivering Alpha Conference sponsored by CNBC and Institutional Investor.

An October 31, 2009, article in the *Daily Telegraph* maintained that the length of Autonomy's **cash conversion cycle** "should ring alarm bells for investors." One implication of this divergence from the industry norm was that the company was generating growth through acquisitions rather than organic growth. In July 2010 an analyst at KBC Peel Hunt cited concerns about increased capitalization of research and development costs at Autonomy.

In summary, outside analysts pointed out signs of potential financial reporting chicanery at Autonomy well before HP signed on the dotted line to buy the company. It was later reported that HP personnel studying the potential acquisition heard talk of accounting irregularities and looked into it. In the end, though, the company accepted documentation from Autonomy that refuted the allegations[11].

Valuation

It was not solely with 20/20 hindsight that some financially astute individuals judged the price paid by Hewlett-Packard to be excessive. Oracle CEO Larry Ellison stated that in April 2011 his company turned down a chance to acquire Autonomy. At a **market capitalization** at the time of $6 billion, Oracle's M&A head and its president told Lynch that Autonomy was already extremely overvalued. Six months later HP paid $11.7 billion[12].

Within HP, Chief Financial Officer Cathie Lesjak reportedly opposed the Autonomy acquisition because she considered it too expensive. According to reporting by *Fortune*, she pointed out that HP was proposing to pay 11 times revenue while similar companies were trading at three times revenue[13]. At the time as well, according to the *New York Times*, board member Meg Whitman complained to other directors about the price tag on Autonomy[14]. Shortly after the deal was struck, Whitman became HP's CEO and in that role defended the acquisition. Technology analyst Toni Sacconaghi of Sanford C. Bernstein said that in the days following the acquisition announcement he spoke to many of HP's major shareholders and not one thought the company should go ahead with the transaction[15]. (See Chapter 1 of course 21807B for metrics commonly used in valuing companies' stocks.)

Analytical Takeaways

For analysts, the key question about Hewlett-Packard's ill-fated Autonomy acquisition is not how the blame of the $8.8 billion Autonomy write-down should be allocated among financial reporting improprieties, an excessive acquisition price, and post-acquisition missteps by HP management. Instead, the point is to identify signs of potential trouble in future M&Adeals that can be identified in advance from financial data available to outsiders. The financial reporting red flags spied by critics of Autonomy and of its acquisition[10] by HP included Autonomy's unfavorable comparisons with peers on the level of receivables and the length of the cash conversion cycle. Similarly pointing to trouble were valuation metrics that were out of line with those of comparable companies.

CONCLUSION

A consistent theme through financial history has been corporations' efforts to boost reported earnings and therefore their stock prices by exploiting weaknesses in accounting standards for business combinations. Over time, reforms of those standards have shifted the specific tactics employed by issuers of financial statements. The rule changes have not, however, completely insulated investors from nasty surprises when the artificiality of much M&A-based value creation comes to light. Analysts should study each new blowup to determine whether earlier financial statements contained clues that trouble was brewing. That process will enable them to develop a checklist to aid in spotting potential for massive value destruction in the future.

[1] Abraham J. Briloff, "Pooling and Fooling," Barron's, October 23, 2000, 26.

[2] Elizabeth MacDonald, "Merger-Accounting Method Under Fire," Wall Street Journal, April 15, 1997, A4.

[3] John Dizard, "When Accountants Go Goodwill Hunting," Financial Times, May 30, 2003, 25.

[4] Ciara Linnane, Francine McKenna, and Katie Marriner, "SEC May Be Set to Crack Down on Companies that Adjust Revenue." MarketWatch, November 26, 2019.

[5] For a good discussion of this point, see Jonathan Ford, "Goodwill Witchcraft Led to GE's monster $17 billion write-down," Financial Times, October 8, 2018. Note that the $17 billion figure refers to the portion of the GE write-down announced on October 1, 2018, that was specifically related to goodwill created in the acquisition of Alstom's energy businesses.

[6] Ed Crooks, "GE's $23bn Hit Reveals Goodwill Turned Bad," Financial Times, October 5, 2018, 16.

[7] Ben Worthen, Paul Sonne, and Justin Scheck, "Long Before H-P Deal, Autonomy's Red Flags," Wall Street Journal, November 27, 2012, A1, A14.

[8] "Delivering Alpha," CNBC.com, November 21, 2012.

[9] John Carney, "How Jim Chanos Spotted the HP Scandal," CNBC.com, November 20, 2012.

[10] Stanley Marrical, Plaintiff. Complaint filed in United States District Court, Northern District of California, San Jose Division, December 19, 2012, 34.

[11] Ben Worthen, "H-P Says It Was Duped, Takes $8.8 Billion Charge," Wall Street Journal, November 21, 2012, A1, A14.

[12] "Delivering Alpha." Autonomy founder Mike Lynch disputed Ellison's statement that the company had been shopped prior to its acquisition by Hewlett-Packard. "If some bank happened to come with us on a list, that is nothing to do with us." Ellison retorted that Lynch had accompanied investment banker Frank Quattrone on the "sales pitch" and that Oracle still had the PowerPoint slides from the presentation.

[13] Stanley Marrical, 30–31.

[14] Quentin Hardy and Michael J. de la Merced, "Hewlett's Loss: A Folly Unfolds, by the Numbers," New York Times, November 21, 2012, A1, B6.

[15] James B. Stewart, "From H.P., a Blunder that Seems to Beat All," New York Times, December 1, 2012. Stewart argued that Hewlett-Packard's acquisition of Autonomy deserved consideration for the title of worst corporate deal of all time.