

In process randd
essay



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PURCHASED IN-PROCESS RESEARCH AND DEVELOPMENT

When one company purchases another, it absorbs the acquired firm's assets and liabilities onto its balance sheet. One part of the acquired company that belongs to neither area is in-process research and development. " Acquired in-process research and development (IPR&D) that is written-off represents purchased research and development that has not yet demonstrated technological feasibility and has no alternative future use"(http://usserve. us. kpmg. com/valserv/tech/html/page1. htm). In other words, it is work that has not yet been used to produce an output and is questionable if it ever will. For this reason, according to current accounting rules and standards, a company is allowed to write-off this part of the purchase price. The in-process technology can be a large factor in making the acquisition of a firm because reporting of earnings can be considerably influenced by the amount of purchase price allocated to an in-process R&D write-off.

Effects on Future Periods

Current and future results can be affected significantly by the allocation of the purchase cost of a business. When the acquired company is involved in research and development for products not yet developed, generally accepted accounting principles (GAAP) allow the acquirer to allocate a portion of the purchase price to IPR&D. If IPR&D were an asset, it would have to be subtracted little by little from future earnings. Amounts paid in the business combination are written-off immediately as purchased R&D. A large up-front write-off avoids future amortization and depreciation expense. Since the rules are not yet clear, and there is still some question as to whether

IPR&D is an asset, a company can simply take an excessive loss up-front to the benefit of future periods. The misleading result in periods immediately after the acquisition are higher earnings, higher earnings per share, higher return on assets, and higher return on equity ([http://www. sec. gov/news/speeches/spch251. htm](http://www.sec.gov/news/speeches/spch251.htm)).

Past to Present

The first widely reported use of a sizable IPR&D write-off occurred in 1990 when Lotus Corporation acquired Samna in a \$65 million transaction in which Lotus wrote off approximately \$53 million of the purchase price. Five years later, Lotus was the target when IBM acquired Lotus in a \$3. 2 billion transaction and wrote off 57 % of the acquisition cost ([http://www. tht. com/vuspring99_dirty_poolings. htm](http://www.tht.com/vuspring99_dirty_poolings.htm)). An increasing amount of companies have found this loophole in accounting standards very lucrative and rewarding. Recent articles and research indicate that the amounts written-off by public companies as acquired in-process research and development (“IPR&D”) have increased dramatically both in magnitude and frequency over the last decade”([http://www. sec. gov/offices/account/aclr1009. htm](http://www.sec.gov/offices/account/aclr1009.htm)). “ Researchers at New York University’s Stern School of Business found no more than three business combinations where purchased R; D was written-off during the 1980’s. But in only the first seven months of 1996, the researchers identified 147 such instances.

By 1998, the valuations had reached a magnitude and frequency that defied belief. Some have estimated that, in 1998 alone, perhaps more than \$16

billion of value was attributed to purchased R; D and written off" (<http://www.sec.gov/news/speeches/spch251.htm>).

Reason For Increase

This increase is primarily due to the swelling amount of technology companies coming into the market. The reason technology companies are the main culprits in the loophole is that a large percentage of their business is comprised of R&D. Unlike steel mills, bottlers, or construction companies whose main assets are tangible, like property and equipment, a technology company's assets are mostly intangibles. For the most part, they make their money from ideas and research. When a business combination occurs, there is no a sure-fire way to put a price on R&D, which may or may not serve some purpose in the future.

SEC AND FASB POSITION

The SEC's concerns regarding the potential abuse of this special accounting treatment afforded acquired IPR&D was heightened during the 1990s when mergers in the high-tech industry soared. In particular, the SEC is concerned about how acquirers determined the fair value of acquired IPR&D at the acquisition date. Higher values, sometimes 100 percent of the purchase price, yielded large one-time charges to earnings, thus minimizing earnings charges in future periods. (http://web4.iac-insite.com/insite/session...nks=1&uspec=1& citas_hot=1&cit1=1&citn=20).

Cause For Concern

Many of the valuations of purchased R&D were not grounded in basic business sense. In case after case, the staff has found that management's considerations in negotiating the acquisition failed to support and contradicted its assertions in the financial statements that the R&D project was the most valuable acquired asset. There appeared to be a complete disconnect between management's business judgments and the appraisals it was tendering to the independent accountant in support of the accounting.

After an acquisition, the write-off of acquired IPR&D-that average write-off was an astounding 72% of the purchase price.

Last year, a total of 247 companies took IPR&D write-offs totaling more than 19 billion, according to figures tracked by The Analyst's Accounting Observer, an advisory service for securities analysts, based in Baltimore. Baruch Lev's study shows that subtracting IPR&D from revenue right away boosted the reported earnings of the companies by 22%. It boosted return on equity by 40%. What high-tech CFO wouldn't fall in love with such numbers? No wonder why the U. S. SEC cried foul. Lynn Turner, the SEC's Chief Accountant, detailed the abuse in a letter to the American Institute of Certified Public Accountants (AICPA) in New York. In one of the most flagrant cases, a company wrote off virtually all of the purchase price as IPR&D. In another instance, a company attributed the vast majority of the purchase price to IPR&D, even though only a small amount of work was required to bring the next version of the acquired company's product to market. (.../DOC_? ldoc= 2&lastidoc= 33&str= IPR%26D&sty= lkw&mlinks= 1&uspec= citas_hot= 1&cit18/1/99).

EFFECTS ON THE MARKET

“ This trend of larger write-offs could undermine public confidence in financial statements and presents significant challenges for the accounting profession”(http://www. sec. gov/offices/account/aclr1009. htm). Over the long term, the willingness of investors to accept risk is directly related to their confidence in the accuracy and completeness of the information they use to weigh alternative investments. But it is the confidence that accounting rules will be applied consistently, comparably, and transparently over time, and among different companies, which allows investors to make sense of financial statements and use those numbers in their investment decision models. “ As a result, I fear that we are witnessing an erosion in the quality of earnings and therefore, the quality of financial reporting”(http://www. sec. gov/news/speeches/spch220. txt). The more serious threat is that erosion of credibility that can occur if investors perceive that companies are routinely playing accounting games. Abusive accounting for purchased R&D could poison the well from which companies draw their financial sustenance. Complete disclosure and consistent accounting nurture investor confidence and risk tolerance (http://www. sec. gov/news/speeches/spch251. htm). “ What’s at stake is nothing less than the credibility of the U. S. financial-reporting system, traditionally thought to be the best in the world. It will not now be undermined by managements obsessed with making their numbers. (http://library. northernlight. com/DG19990720010000131. html? cb= 13&sc= 0).

Action Taken by SEC and FASB

The FASB has put in-process research and development on a fast track to resolution. As a result of these events and the confusion in the marketplace surrounding acquired IPR&D, the FASB voted on Feb. 24, 1999 to require that purchased IPR&D be recognized as assets and written-off to expense over their estimated useful lives. IPR&D write-offs could be eliminated by the end of the year. “ The SEC has begun studying specific IPR&D write-offs and have begun taking accounting firms to task for their valuations” (<http://nvca.org/randd.htm>).

Further, the SEC is requiring public companies intending to use IPR&D write-offs to disclose much more detailed information in their periodic SEC reports, and financial statements regarding the research and development projects acquired. Lynn Turner (Chief Accountant) is calling for immediate and coordinated action. This includes technical rule changes by the regulators and standard setters to improve the transparency of financial statements, enhanced oversight of the financial reporting process by those entrusted as the shareholders’ guardians, and nothing less than a fundamental cultural change on the part of corporate management. The commission is challenging the profession, through the AICPA, to clarify the ground rules for auditing of purchased R&D. (<http://www.sec.gov/news/speeches/spch251.htm>). Also, it is continuing to press registrants for disclosures that explain the value and risks of the purchased R&D and enable investors to hold management accountable for that expenditure.

Once the SEC is satisfied with a company’s methodology for valuing acquisitions and the inherent IPR&D, that company may have to restate earnings for previous quarters or years. Industry watchers said while such

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restatements may lower earnings and shake investor confidence, they do not necessarily signal serious trouble.

Experts emphasized that the rules set by the Financial Accounting Standards Board and the American Institute of Certified Public Accountants have not changed. But the SEC's enforcement of those rules has gotten tougher, in part because of the recent merger mania in business, particularly the high-tech sector. (http://web4. iac-insite. com/insite/sessio...ks= 1&uspec= 1&citas_hot= 1&cit1= 21&citn= 20). "Restatement of financial statements will be necessary if a registrant's valuation of IPR&D is materially misleading" (<http://www. sec. gov/offices/account/aclr1009. htm>).

Response To Action By SEC and FASB

As a result of the SEC's letter to the AICPA in September, companies are being required to apply different valuation methodologies to determine the amount of IPR&D charges. In response, registrants have "revalued" previously written-off acquired IPR&D amounts and have been agonizing over whether to restate prior earnings results to comply with the SEC's new guidance. In a Jan. 30 letter, Lynn Turner responded to the association claiming the SEC does not favor any one approach to valuing acquired IPR&D but simply expects registrants to value this asset under a methodology that incorporates reasonable assumptions. The SEC's position on the issue has caused delay in many offerings and resulted in a number of companies restating their previously published financial results. (http://web4. iac-insite. com/insite/sessio...nks= 1&uspec= 1&citas_hot= 1&cit1= 1&citn= 20).

Some notable examples are: Cadence Design Systems Inc., Citrix Systems

Inc and LSI Logic Corp. LSI was forced to reduce the IPR&D write-off it took for its acquisition of Symbiosis Inc., a chip company in Colorado Springs, CO, from \$225 million to \$146 million. In the last half of 1998, the average size of a write-off fell from 72% to 45% of the purchase price, according to a follow-up study by Lev. And with continued SEC scrutiny, it should keep shrinking.

(.../DOC_? ldoc= 2&lastidoc= 33&str= IPR%26D&sty= lkw&mlinks= 1&uspec= citas_hot= 1&cit18/1/99).

OPPOSITION TO CHANGE

While the SEC's position is that the valuation methodologies are not a change in rules or policy, many companies believe that the SEC is adopting new rules retroactively, without giving companies a chance to adjust. Also, without the benefit of public comment and the protections of the rulemaking process, and that the SEC has unfairly targeted companies that have made acquisitions prior to September 1998. The retroactive re-valuation of write-offs that was required by the SEC's position has caused many companies substantial problems, including financial restatements, uncertainty with respect to prior transactions, delays in pending financing transactions and other legal difficulties. (http://www.tht.com/vuspring99_dirty_poolings.htm).

Software & Information Industry Association

In response to the SEC's policy and guidelines on the use of IPR&D, the Software & Information Industry Association (SIIA) sent a letter to SEC Chairman Arthur Levitt requesting that the SEC reconsider its decision to apply its new rules retroactively. The SIIA announced that it would oppose

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the changes proposed by the FASB. The letter noted that, normally, notice and comment periods are involved in instances where the SEC is instituting new rules or policies. In this case, no notice of the SEC's intent to change the policy surrounding IPR&D write-offs was given (<http://siiia.net/ga/finance/SECinprocess1-99.htm>). "The agency has not been deterred by the threat of a lawsuit that may be initiated against it by the Software Industry and Information Association (SIIA) alleging retroactive application of 'new' SEC IPR&D rules violates law" (<http://nvca.org/randd.htm>). "FASB, on the other hand and with consent of the SEC, appears ready to officially call for the elimination of the immediate write-off of IPR&D".

Information Technology Association of America

The Information Technology Association of America (ITAA) sent a letter to the Financial Accounting Standards Board (FASB). The letter specifically called for the Board to reinstate the in-process research and development (IPR&D) issue into its Business Combinations project and expressing general disappointment with the Board's decisions on a number of recent issues. Over twenty-five executives from the information technology industry signed the letter. Mentioned is the issue that IPR&D particularly impacts the high-tech industry, an industry characterized by rapid growth through acquisition and significant R&D (http://web4.iac-insite.com/insite/session...nks=1&uspec=1&citas_hot=&cit1=1&citn=20).

Technology's Fears and Excuses

The whining from the technology industry is still going full blast. Another gripe: Reducing the write-offs would squelch merger and acquisition activity. <https://assignbuster.com/in-process-randd-essay/>

Companies would stick to developing technology in-house rather than acquiring it. There was also fingerpointing. It was the accounting firms' fault for not valuing the R&D correctly, some executives claimed. Tech companies were just doing what their auditors and appraisers told them. Behind all these protests lurked the real reason for high-tech's panic: fear of lower stock prices(.../DOC_? Idoc= 2&lastidoc= 33&str= IPR%26D&sty= lkw&mlinks= 1&uspec= citas_hot= 1&cit18/1/99).