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Autonomy/HP analysis: The accounting argument

by Stephen Bouvier 16 Jan 2014

THE FAILED TAKEOVER of software outfit Autonomy by technology giant Hewlett-Packard has loomed large in the headlines recently. And despite an abundance of commentary on the doomed deal, no-one it seems wants to speak out on the record.

What we do know is this. On 19 October 2011, HP purchased Autonomy for $11.1bn (£6.7bn) and on 20 November 2012 announced it would write down the goodwill on that acquisition totalling $8.8bn. The largely converged business combinations literature on both sides of the Atlantic simplifies the task of unpicking HP's move. M&As are accounted for under IFRS 3 Business Combinations in the European Union and FASB ASC 805 Business Combinations in the United States.

Both standards require businesses to apply the so-called acquisition method. The assumption is that when an acquiror pays a premium price, it does so because it can see added value in the business. This premium is treated as goodwill and recognised as an asset. It is this asset that HP has written down.

HP said in its statement that "the majority of this impairment charge is linked to serious accounting improprieties, disclosure failures, and outright misrepresentation at Autonomy." Those improprieties allegedly include inappropriate recognition of revenue on software sales to value added resellers.

Strong stuff. Then, on 18 December 2012, HP shareholders filed a verified shareholder derivative complaint. This action names HP's management, among them CEO Meg Whitman, and advisers as co-defendants, and alleges that "proper due diligence" would have flagged up the deal as a dud.

The deal is now the subject of separate investigations on both sides of the pond, by the US Department of Justice and the Serious Fraud Office in London. Separately, an investigation by the US Air Force into the affair led to a call from USAF to ban Autonomy's founder and CEO, Mike Lynch, and others from contracting with the U.S. government.

Autonomy's former managers vigorously deny any impropriety and now protest their innocence on a website. In an open letter to HP, they argue that their policies were "[c]onsistent with IFRS and IAS 18."

It is worth noting that there is no explicit prohibition in IAS 18 on the recognition of revenue immediately on a sale from a manufacturer to a reseller. IFRS is much less detailed and prescriptive than US GAAP, which has specific guidance on software sales - SOP 97-2. Indeed, it is these differences that the IASB's joint revenue recognition project with the FASB sets out to fix.

Put crudely, many of the differences between IFRS and US GAAP amount to the critical events that trigger revenue recognition. IFRS requires preparers to exercise judgement around the question of whether or not the risks and rewards under a contract have transferred, and whether the inflow of benefits is probable before a reseller has an onward sale of the product.

The landscape is complicated by the fact that some technology-sector preparers fall back on US practice when developing their accounting policies. Equally, reseller arrangements vary and each must be assessed against the criteria in IAS 18.

How this plays out in the real world is perhaps best illustrated with Alcatel-Lucent's latest 20-F filing. Assuming the relevant conditions are met, Lucent books revenue "on shipment to the distribution channel if such sales are not contingent on the distributor reselling the product to a third party and the distribution channel contains no right of return." Otherwise it recognises revenue "when the reseller or distributor sells the product to a third party."

Time, and quite possibly the courts, will tell whether HP was short-changed or the victim of its own hubris.

Stephen Bouvier is a freelance journalist