

BFF5580 MERGERS AND ACQUISITIONS HP and Autonomy: Who's Accountable?

GROUP 8

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I. Introduction

Mergers and acquisitions are viewed by many companies as a way to grow their businesses and this is possible because there is always one company that is bigger than the other (Renaud, 2020). While acquiring another company opens up numerous growth opportunities for the acquirer, it can turn out to be a tragedy as well. This report discuses one such case when Hewlett-Packard (HP) acquired Autonomy Corporation (Autonomy) and ended up writing down the $11.2 billion acquisition with a span of one financial year.

II. HP acquires Autonomy

Tight competition in product, cost and profit margin in hardware business forced HP to seek another opportunity in another segment. A shift in the trend among the consumer market from PC's to tablets and smartphones threatened to shrink HP's market share. Legal process discrepancy round the world also cause a problem with HP operation.

HP considered Autonomy as a part of its plan to enter a high profit margin software industry. Autonomy's tech on cloud computing and unstructured big data process are also a main attraction for HP to gain control and capitalize in the future.

HP's decision to acquire Autonomy fits with their strategy to diversify and expand. However, the premium paid over the fair value of Autonomy can be viewed as exorbitant. The high premium involved in the deal can be attributed to the adjustments HP made to the discount rate used to discount the future cash flows.

III. Purchase price and its allocations

The allocation of purchase price is expressed in Exhibit 1. The purchase price of $11.2 billion consists of Market Value of Equity and Goodwill of Autonomy. The market value of equity was recorded as amortizable intangible assets of about $4.6 billion and Goodwill was about $6.6 billion (HP 2011).

A normal acquisition transaction would involve the acquirer debiting Other Investments and Goodwill while crediting Cash in their balance sheet; however, HP recorded the transaction as amortizable intangible assets to receive the tax shield because these assets could be amortised over its useful live.

Market Value of assets and liabilities together add up to the Market Value of Equity. Market value of liabilities are estimated to be $1.2 billion as it is less likely to be different

than its book value, thus it is estimated as about $1.2 billion. Hence, estimated market value of assets is $5.8 billion.

Market value of assets contain market value of intangible and tangible assets. As Autonomy is a technology firm, specialised in processing unstructured data and or means-based computing; the integral part of total assets would be intangible assets. Particularly, from Autonomy 2010 balance sheet, except for cash and cash equivalent, the tangible assets only account for 26.1% of total assets, whereas intangible assets account for 41.5% (Autonomy 2010). Hence, assuming that market value of tangible assets is equal to its book value of about $1.9 billion. Leaving with the market value of intangible assets to be $3.9 billion.

IV. HP's Goodwill Calculation on Acquisition of Autonomy

HP acquired Autonomy on 31st October 2011 with purchase price of $11.2 billion, yet the latest financial statement of Autonomy was FYE2010. Thus, the projected revenue and balance sheet has to be acquired first in order to estimate the goodwill of the transaction at the acquisition date. Assumptions used are sales growth of 18% from FYE2009 to FYE2010 and the percentage of each balance sheet accounts in FYE2010 over its sales to estimate balance sheet accounts in 31st October 2011 (Refer to *Exhibit 2*).

After acquiring the projected balance sheet, net current asset (current asset – current liabilities), fixed tangible asset (non-current asset – goodwill and deferred tax), and non-current liabilities can be obtained to calculate the goodwill (Hawkins and Jerez, 2010). In computing the goodwill, the market value of intangible asset is assumed to be $3.9 billion as mentioned before. The goodwill is expected to be $6.6 billion. (Refer to *Exhibit 3*).

V. Impairment of HP's Goodwill in 2012

From the acquisition of Autonomy, HP recorded increase in goodwill to $44.6 billion in 2011 from $38.5 billion in 2010. Apart from it, HP's intangible asset also increased to $10.9 billion in 2011 from $7.8 billion in 2010 ("Hewlett-Packard Company 2011 Annual Report", 2012). Later, in 2012, HP declared impairment of goodwill along with impairment of their intangible asset of their Autonomy acquisition amounting to $8.8 billion, which consists of $5.7 billion goodwill impairment and $3.1 billion intangible asset impairment (HP 2012). These impairments increase HP's expenses and decrease their net income, resulting negative net income in 2012.

It is believed that the purchased value of Autonomy is too high, resulting high goodwill in HP's account. However, the financial statements that are used to value the company have some dubious transactions. First, Autonomy already recorded future sales although there are possibilities of cancellations. It means that they should have recorded it as unearned revenue, but they have recorded it as sales (Ciesielski 2016). Moreover, Autonomy has bought back some of its products at higher cost. Due to these transactions, HP's CEO suggested to reduce Autonomy's sales by 25%, 38%, 36% for 2009 up to 2011, respectively (Hopkins and Yemen, 2018). Furthermore, the discount rate used to calculate Autonomy's value is perceived to be too low. By adjusting Autonomy's sales and discount rate, HP has to record the impairments as the value of Autonomy is expected to be way below 2011's valuation.

VI. 8-K press release

In the acquisition deal the purchase price is first allocated to the target's tangible assets, intangible assets and its liabilities and any money paid in excess of the acquisition price is allocated to goodwill (Usvyatsky, 2020). Outlook on the market condition for the Enterprise Servers (ES) reporting unit did not look promising as initially thought, triggering HP to check for potential impairment. As an accounting practice, HP carries out the impairment test on its intangible assets annually to account for any changes in its intangible assets and to provide investors with more accurate figures and information of the company. The discount rate used to discount the future cash flows was adjusted upward following a drop on the market capitalization in early 2012. As a result, there was a significant reduction in the fair value of the ES reporting unit which led HP to record a $8 billion goodwill impairment charge. For an impairment of this size one year after the acquisition, it implies that the carrying value of the reporting unit is significantly higher than its fair value and raises question on the initial fair value of the asset and liabilities of Autonomy and/or HP's failure to meet synergy expectations.

According to HP, executives at Autonomy mischaracterized revenues generated from clients such as Tottenham Hotspur and BBC to inflate sales figures. Autonomy was also reported to have excessively sold low-margin goods to inflate revenue to boost its valuation, shifting COGS to marketing expense to hide that low margin, and also probably to shift some variable cost to fixed cost to increase operating leverage, underestimating COGS margin and increasing upside when inflated revenue forecasts significantly exceeds fixed costs (Newquist, 2012). Autonomy's R&D expense was capitalized to increase net profits as well (Greenberg, 2012). Autonomy also had no obvious customer base when it was discovered

that its software sales to tech resellers had a vast mix of customers. It was also alleged that Autonomy concealed these transactions from its auditors Deloitte (Jolly, 2020). Furthermore, HP was kept in the dark when Autonomy failed to disclose key documents (Fox, 2020). While the inception of the problem at hand was due to the questionable accounting practices carried out by Autonomy, HP's lack of comprehensive due diligence partly fuelled the disastrous deal. There were reports that signalled Autonomy's red flags and HP could have walked away from the deal if they had looked deeper. The writing down of $8.8 billion because of Autonomy's accounting improprieties is likely justified.

VII. Effects of high CEO turnover

HP's high CEO turnover over the years is likely to also have affected the acquisition negatively. A study conducted by PwC states that the median tenure of a CEO has been 5 years while that of a successful CEO is 14 years (PwC, 2018). HP had 4 different CEOs from 2000-2011 with 5 different acquisition strategies. This resulted in multiple short-term business and fixing strategies for each of HP's business units, namely the PC unit, IT and server's unit, and EDS unit (Thibodeau, 2012). Moreover, each CEO turnover at HP has caused large fluctuations in HP's stock price as referenced in *Exhibit 4* as each new CEO is employed at the bottom of the cycles and are unable to maintain their respective stock uptrends. Therefore, a high CEO turnover induces high volatility and risk, as well as indicates the incapability of the management team of HP to manage the post-acquisition entity effectively and the incapability of the board to select CEOs, further giving reasons for investors to doubt the acquisition of Autonomy, adding to the existing doubts on the compatibility and synergy of the acquisition and the high premium price tag. This is worsened knowing that HP's pre-acquisition business units like the PC unit was failing and the "confused" EDS unit is the product of too many CEO directions (Thibodeau, 2012). Consequently, HP's stock price fell when the acquisition was announced, possibly giving Autonomy's shareholder and management leverage to negotiate for a higher cash payment as compensation for the higher risk. This could also be the reason for the cash-for-stock deal structure decision as Autonomy shareholders have little confidence in future synergies and thus uninterested to participate in future capital gains from the stock.

Aside from that, HP's high CEO turnover also resulted in unnecessarily higher expenses in the form of stock compensation. HP's method to incentivize CEOs to increase stock price has been through golden parachutes and HP's CEOs' compensations are known to be one of the highest in the industry (Bort, 2015). At termination of their employment, previous HP

CEOs like Carly Fiorina, Mark Hurd, and Leo Apotheker all received generous compensations (Bort, 2011), increasing the stock compensation expense in the income statement, and reducing net profits and retained earnings. This is likely to affect the synergy valuation of the acquisition as these costs seem to be a recurring statement and therefore not removed during the normalization of the financial statements. It was reported that HP had 3 CEOs from 2012-2020 noting that present case CEO Meg Whitman stepped down in 2015, hence justifying this expense as recurring. HP's synergy valuation unlikely accounted for the recurring high stock compensation expense and the dysfunctional business units that needed to be settled before the acquisition, the acquisition then becomes unattractive to investors, HP shareholders, and Autonomy shareholders, believing that the valuation was unrealistic/unsustainable and leading to the selloff of HP shares from 2011 to 2012 and the higher cash consideration for Autonomy shareholders.

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Exhibits

Exhibit I: Purchase price allocation

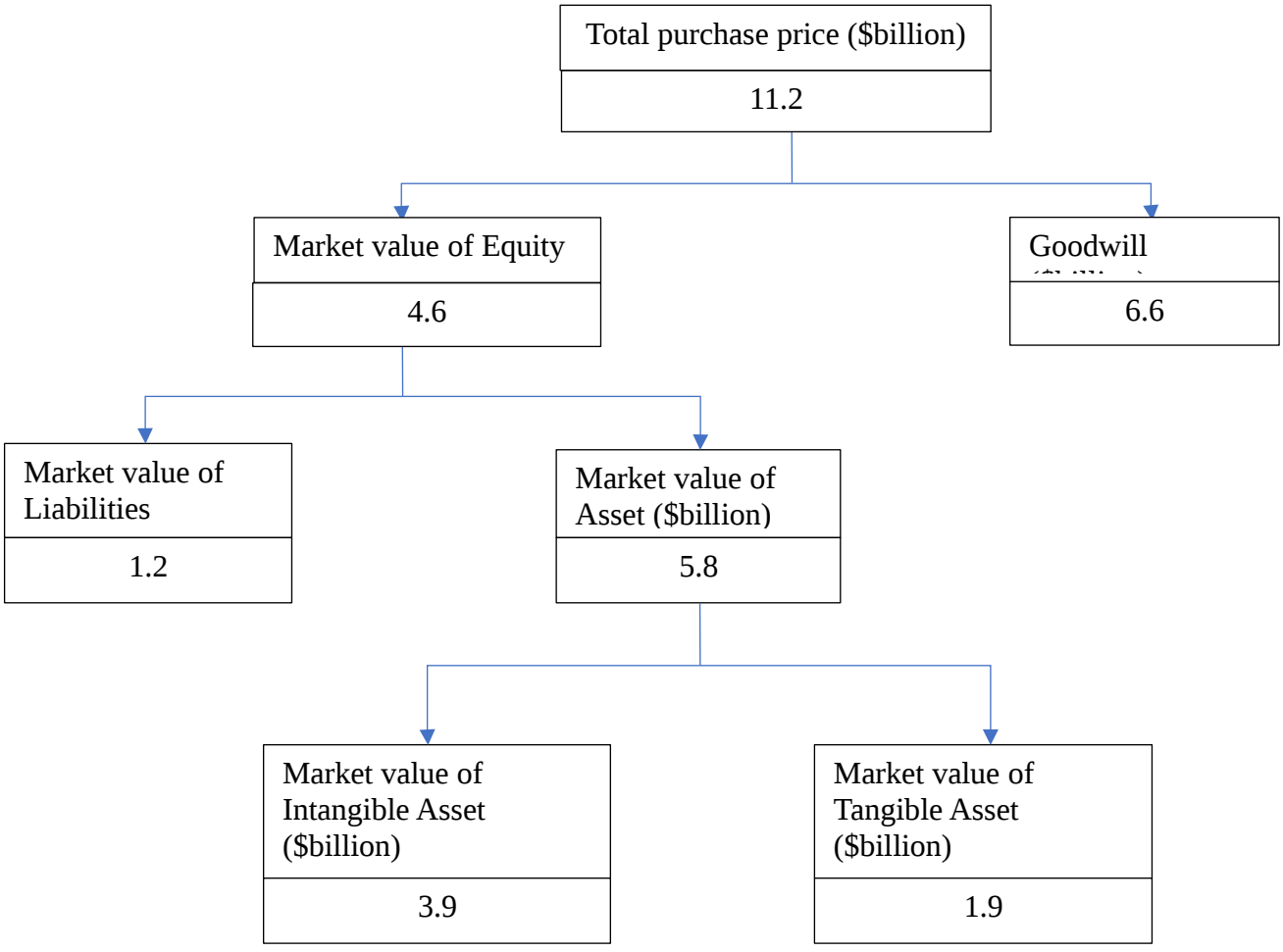


Exhibit 2: Autonomy balance sheet

Autonomy' Balance Sheet in $ '000	31-Dec-09	31-Dec-10	%	31-Oct-11
Sales	739,688	870,366	1.00	853,442
Current asset				
Trade and other receivables	275,450	330,117	0.38	323,698
Inventories	486	116	0.00	114
Cash & cash equivalents	242,791	1,060,600	1.22	1,039,977
Total current asset	**518,727**	**1,390,833**	1.60	**1,363,789**
Non current asset				
Goodwill	1,287,042	1,361,900	1.56	1,335,418
Other tangible assets	399,277	400,372	0.46	392,587
PP&E	33,886	42,554	0.05	41,727
Equity and other investment	16,608	68,600	0.08	67,266
Deferred tax asset	24,015	16,263	0.02	15,947
Total non-current asset	**1,760,828**	**1,889,689**	2.17	**1,852,945**
Total Asset	**2,279,555**	**3,280,522**	3.77	**3,216,733**
Current liabilities				
Trade and other payables	69,443	75,411	0.09	73,945
Bank loan	52,375	78,745	0.09	77,214
Tax liabilities	43,338	33,210	0.04	32,564
Deferred revenue	164,931	170,256	0.20	166,945
Provisions	2,731	1,661	0.00	1,629
Total current liabilities	**332,818**	**359,283**	0.41	**352,297**
Non-current liabilities				
Bank loan	145,152	66,407	0.08	65,116
Convertible loan notes	-	681,791	0.78	668,534
Deferred tax liabilities	85,087	91,072	0.10	89,301
Deferred revenue	8,576	7,421	0.01	7,277
Other payables	1,020	3,702	0.00	3,630
Provisions	5,123	3,597	0.00	3,527
Total non-current liabilities	**244,958**	**853,990**	0.98	**837,384**
Total Liabilities	**577,776**	**1,213,273**	1.39	**1,189,681**
Shareholders' equity				
Share capital	1,333	1,344	0.00	1,318
Share premium account	1,130,767	1,247,907	1.43	1,223,642
Capital redemption reserve	135	135	0.00	132
Own shares	- 845	- 788	0.00	- 773
Merger reserve	27,589	27,589	0.03	27,053
Stock compensation reserve	21,959	27,881	0.03	27,339
Revaluation reserve	4,499	47,415	0.05	46,493
Translation reserve	- 12,032	- 30,161	-0.03	- 29,575
Retained earnings	528,374	745,927	0.86	731,423
Total equity	**1,701,779**	**2,067,249**	2.38	**2,027,052**

Source: Autonomy Corporation plc 2011 Annual Report (2012)

Exhibit 3: Balance sheet adjustments

Acquisition of Autonomy	Balance Sheet Adjustments				
	Asset	=	Liabilities	+	Equity
Net current assets	1,011,492				
Fixed tangible assets	501,580				
Market value of Intangible Asset	3,900,000				
Non-current liabilities			837,384		
Consideration					11,200,000
Total	5,413,071		837,384		11,200,000
Goodwill	**6,624,313**				

Exhibit 4: HP's stock price between 1992-2012

