

HP and Autonomy: Who's Accountable?

Mergers and Acquisitions BFF5580

Case Report for Week 12



GROUP 3

Dhara Kothari

Hitakshi Mandani

Prashant Ahuja

William Strapp

Chahana Patel

Chandra Sekhar Reddy

Executive Summary

The HP and Autonomy case aims to examine the impacts of intangible and tangible assets on a company's purchase price, as well as understand the implications of goodwill on the financial statements. We study how changes in corporate structure convert into instability of firms, including its prices, and financials as well as social image. In 2011, as a result of corporate instability and inaccurate accounting protocol, the company ended recording over \$6.6 billion of goodwill and \$4.6 billion in amortizable intangible assets. This represented the first loss in ten years for HP.

Introduction – HP and Autonomy acquisition

In this case, we see the impacts of corporate structure, questionable accounting practices, distorted financial data, and the implications of goodwill and intangibles. HP acquired Autonomy with the hopes of growing its higher margin segments and to strengthen its position in the tech world, as they faced increased technological competition and laws and regulations. There was a shift to software for service, which hinted a change in dynamics following the increased popularity of PC and laptops. At the time, Autonomy held a novel expertise in the unstructured market, as it had developed an algorithmic platform called “Intelligent Data Operating Layer (IDOL) that searched protocols in text pattern and language context recognition”. At this time, HP was going through internal corporate instability and internal management differences, and possibly mismanaged an adequate check of Autonomy's financials. The 2011 acquisition brought out the impacts of loose board coherency and the aftereffects of inaccurate financials.

Challenges posed as Autonomy held heavily in intangibles, which made valuation quite difficult, posing some limitations for the acquisition on HP's side. HP's 2012 annual report showed a shock of a \$11.4 billion write down mainly in the form of goodwill. The reason was cited in the case study to be “accounting improprieties, misrepresentations and disclosure failures. Whitman cited overreliance on audited financials as the main cause of this as the 2011 revenue was 36% lower than expected. In 2018, legal proceedings began between the two firms which ended with the conclusion that HP paid a premium of \$1.8 billion, of which Lynch personally received \$800m compensation. Autonomy's former CFO, Hussain was also charged with 16 fraud convictions with jail time and a \$4m fine. In 2018, HP sold Autonomy to Micro Focus in a \$8.8 billion deal, sending the company back to its home roots in Britain (Sources, the Guardian, and Reuters).

Analysis and Feedback on HP's acquisition of Autonomy Corporation.

HP has to look for another opportunity in another market due to intense rivalry in product, cost, and profit margin in the hardware industry. HP's market share threatened to decrease due to a shift in customer preference from PCs to tablets and smartphones. HP's business is further hampered by differences in legal processes throughout the world. HP evaluated Autonomy as part of their strategy to break into the high-margin software market. HP is also interested in Autonomy's cloud technology and unstructured big data processes in order to acquire influence and profit in the coming. HP's acquisition of Autonomy is in line with its diversification and expansion strategy.

The premium paid over Autonomy's fair market worth, on the other hand, may be considered excessive. HP made modifications to the discount rate used to calculate the net present value, which resulted in a large premium in the agreement.

Purchase price and allocation of the acquisition among assets (intangible and tangible assets)

In 2010, the entire assets of Autonomy Corporation were valued at \$3.28 billion. During the sale in 2011, HP combined Autonomy's assets and liabilities and paid a large sum of \$11 billion for the company. The total sum paid (at a 64 % premium) was made up of cash on outstanding common stock, convertible bonds, money stock awards, and fair value for unvested stock, all based on HP's best estimate.

Autonomy Corporation, which specialised in data and computer services, was an unusual business and product for HP. This affects the value of Autonomy's assets, which had a decent proportion of intangible assets (\$1.3 billion) and tangible assets (\$1.9 billion). HP assessed and recorded these assets as \$6.6 billion in goodwill and \$4.4 billion in amortised intangible assets on its balance sheet. HP utilised accounting methods in which they were manually changed at the start of their fourth fiscal quarter and were deemed to have finite useful lifetimes. The important thing to remember was that there were no intangible assets with an indefinite life span included in the deal.

When comparing Autonomy's total assets of \$3.3 billion to the amount paid by HP (\$11 billion), it's clear that HP relied on and trusted Autonomy's accounting procedures, and that they completed the deal with little knowledge of Autonomy's assets or operations, and that they overestimated the potential of its assets for cash flow generation.

HP's accounting process for calculating Goodwill and reporting in 2012.

Purchased goodwill and intangible assets are often not amortised, but rather assessed for impairment at least once a year (compare carrying value to fair value). This was the initial stage, and HP began tracking impairments in its fourth fiscal quarter, or whenever an event or change occurs that indicates the asset's carrying value may not be recoverable, and they calculated fair value using an income and market-based approach. The income approach determines the fair value of a company by estimating future cash flows based on sales growth and margins while taking market conditions into account. The market technique estimated fair value based on market multiples of similar publicly listed companies or operations, which was sometimes unpredictable, therefore the income approach was usually used. HP also determines a control premium by subtracting the estimated fair value from the company's market capitalization and comparing it to other recent purchases.

If the fair value is below the carried value, HP performs a second imperial test in which the fair value is dispersed among the reporting unit's assets (including tangible and intangible) and liabilities and compared to the entire fair value, as if it were an acquiring enterprise. The estimated difference is the reporting unit indicated fair value, and if the goodwill is less than its carrying value, the goodwill is considered impaired, and the extra amount is recorded as an impairment loss.

HP reported a second stage in its impairment test in the fourth quarter of 2012, as discussed owing to its market condition, stock price value – an indicator after the study of its reporting unit, Enterprise Servers (ES). They had to increase the discount rates due to decreased predicted revenue and profitability, which considerably reduced the fair value of its ES reporting unit, among others. HP had expected revenue of \$32.2 billion but ended up with \$29.96 billion and a \$6.85 billion deficit in the fourth quarter. Following this, HP reported \$8.8 billion in impairment costs and a \$1.2 billion carrying value of Autonomy goodwill due to its operations with Autonomy and alleged accounting improprieties, disclosure errors, and misrepresentation. HP's stock price plunged by 12% in November 2012, closing at \$11.71 a share, its lowest level since 2002.

Impairment and 8K Press release consequences.

The 8-K press release is specifically designed to inform the public of any crucial information the SEC deems necessary when one is to invest in a public company. This is important as it contains factual information only and in this situation, provides the public with knowledge of a significant devaluation of the company. This announcement may signal to bearish investors Autonomy ran a 'shady' operation and sold an inflated company to an incompetent buyer; thus, choosing to exit their investments. On the contrary, it may signal to bullish investors the company is now in good hands, as HP have corrected the error, and therefore it may be a good time to invest. However, I believe the announcement indicates the acquisition will not be as profitable as originally predicted due to the misrepresentations of expected future financial performance. Nevertheless, it may be beneficial for HP in the long-run as they may put a greater focus on increasing their operating and profit margins by expanding out of the hardware business and into the software business.

HP's history of corporate governance

HP's history has shown repeated instances of senior management changes, each time with a distinct reason. It is a common industry practice for senior executives to change positions, but we argue that senior level instability combined with internal politics and changes to the public image after several issues, demonstrated a weakening command of the executive leadership, especially given the short time frame for these changes. As a result, we see in Exhibit 1 that the stock price has suffered. Not only does this increase risk, but it shows the public inability of effective governance.

After HP's founders handed the CEO role to Carly Fiorina in 1999, there were four new CEOs in the short 10–11-year span, far less than the average CEO tenure of 7.2 years in 2020(Harvard Law). Following some accusations of Hurd having sexually harassed an employee, the board asked Hurd to resign in 2010. Apotheker thus become the new CEO with roots from SAP. He was responsible for the Autonomy acquisition and decided to split the firm, which posed issues with the board. With a short tenure of 9 months, the board again was responsible for his resignation, whereas they hired Meg Whitman under his role. This shows that within a time span of 10-11 years there were 4 changes to the executive board, each with different strategies. Prior to 1999, the founders held the company for nearly 30 years. We can assume given the growth rates and diversified product range, there was more stability given they were the founders, and their corporate management well exceeded the version of the latter management.

While we understand the need to address concerns over CEO actions such as for Hurd, it seems a common theme of the HP board to remove CEOs with whom they have management differences with. They are changing CEOs quite frequently, and this may not be healthy. Say other firms like PepsiCo, their former CEO Nooyi stayed for 12 years. The present CEO of Google, Pichai has held the position for over 6 years following the handover from one of the founders, Larry Page. Facebook CEO has held his position since inception from 2004.

Impact on Accounting of Acquisition

Definitely, this would have an impact on the accounting for the acquisition as political and corporate instability demonstrates weak leadership which is likely to under examine many facets of a deal, in this case the acquisition. While board was busy restructuring its corporate leadership, how well were managers/analysts accounting figures checked and confirmed? The company hired external auditors such as Ernst & Young, I believe they should have had more internal cost analysis as well but given weak leadership this would not have been executive priority. While CFO Lesjack did not approve of the deal, HP still went ahead. This shows inability of the board to work effectively with one other. Also, there are performance-based bonuses, so it can be possible that many numbers were inflated. Previous CEO's received high performance bonuses, which means less profits for other equity holders. In summary, HP has a history of corporate instability, especially given that Whitman ended her tenure in 2015, well below the average tenure.

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