CL 1

Covewood Research, LLC
149 Westchester Ave. – Suite 30
Port Chester, NY 10573
December 6, 2002

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir or Madam:

I am writing to comment on the Business Combinations Phase I Exposure Draft. I am a life long user of financial statements, a professional investment manager, and an MBA graduate in accounting. I lived through the speculative U.S. markets of the late 1960's which gave us the conglomerate craze, and which also gave pooling-of-interest accounting a bad name. I saw the formation of the Financial Accounting Standards Board (FASB), and I have seen the FASB champion purchase accounting for stock acquisitions.

I would have thought that the experience of the recent past would have changed some minds in the accounting establishment on the purchase/pooling debate. The users of financial statements and the stock market have passed judgment on purchase accounting of stock acquisitions, and they have determined that the treatment is irrelevant and has no bearing on their economic decisions. But the accounting profession refuses to accept the verdict and move on.

<u>The purchase "value" of a stock acquisition</u>

I am sure that there are sound theoretical reasons that the value of a stock acquisition can be viewed as the market value of the exchanged shares. From a pragmatic point of view, those reasons can't make much sense. When two companies negotiate a share exchange ratio they are negotiating the merging of equity interests. The absolute price of the acquirer's stock doesn't enter the picture. They are only interested in the share exchange *ratio* and therefore the relative prices of the two stocks. If two companies are negotiating a one-for-one share exchange they could care less whether the stocks of the respective companies are both selling near 100 or both selling near 1. The absolute price of the acquirer's stock has no bearing on the negotiations. What is actually being negotiated is the ratio at which the companies' respective equity interests are going to be merged. If the purchase "value" of the transaction does not enter into the negotiations, how can it be economically meaningful?

In June 2000, JDS Uniphase (JDS) purchased E-Tek Dynamics (E-Tek). Like JDS, E-Tek was a very successful rapidly growing company in a hot industry with trailing 12 month revenue of $275 million, and net income of $35 million. JDS paid $20.4 billion for E-Tek. In what sense could that be an economically meaningful number? (Yes that's correct. It's 74 times revenues and 583 times healthy earnings). The deal was announced in January with a headline number of $15 billion dollars. JDS stock shot up almost 20% in the following few days. Was the stock market rewarding JDS management for paying $15 billion for a company that couldn't be worth even a small fraction of that amount in any cash buyer's wildest dreams? Probably not.

The real decision

What the acquiring company negotiates is the share exchange ratio, and what that determines is how much of its own equity it must give up to get a share of a bigger stream of future cash returns in the future. In my respectful opinion, that is the reality of what is happening and the basis on which management's decision should be evaluated.

JDS Uniphase management obviously did not decide to pay $15-20 billion for E-Tek. If they had they would have been fired on the spot. What they did do was give up about a 17% equity interest, to acquire a company that represented 22% of the combined trailing 12 months revenue of the two companies. JDS had no trailing 12 months operating earnings, but if you adjusted for already existing good will amortization and acquisition-related R&D write offs, E-Tek's operating profit would still have represented over 17% of the combined companies operating profit. Of course those numbers are just a rough benchmark, but it seems hard to fault JDS management for the decision to merge with E-Tek at the negotiated exchange ratio. In fact the judgement of users of financial statements and the stock market was that they had negotiated a great deal. The stock went up sharply on the news. Pooling accounting would have conveyed this information. The restated per share pooled history of the two companies would have been an improvement over JDS's past performance alone.

Garbage in, garbage out

Because the purchase "value" of a stock acquisition provides no useful information, neither do the earnings from amortizing the good will from that "value". The only outcome for the FASB from requiring amortization of stock acquisition good will was a rash of companies reporting pro forma earnings. Users of financial statements and the stock market seemed quite happy with that solution, which amounted to ignoring the FASB. All the requirement did was give GAAP accounting a black eye. So much so that the FASB abruptly ended it, although, as far as I know, the FASB never publicly acknowledged a reason for doing so.

E-Tek was the largest stock acquisition that JDS made, but by no means the only one. In the quarter following the E-Tek acquisition, JDS reported a GAAP operating loss of $945 million dollars after a good will amortization charge of $1,107 million. The loss was greater than the company's revenues of $787 million for the quarter. It seems clear that it was going to take a very long time before JDS would ever report a profit, although it was already profitable before good will amortization. The company was one of many that regularly reported earnings on a pro forma basis. The stock was gradually declining along with the deteriorating outlook of its industry but still selling at roughly 20 times the company's annual revenue rate despite the catastrophic losses. Apparently users of financial statements and the stock market were still ignoring the accounting profession's version of how much the company paid for its acquisitions and how those decisions affected the company's financial well-being.

<u>The impairment myth</u>

If the purchase "value" of a stock acquisition provides no useful information, then the result of subtracting that value from some estimated value of the acquired company in the future is of little relevance either. The market and everyone else seems quite happy to ignore impairment write downs along with good will amortization. Companies happily announce that major divisions are worth billions less than the last time they looked, and no one seems to notice.

In 2001, JDS declared impairment write downs totaling $50 billion, or 15 times revenues, presumably including a large chunk from their largest acquisition, E-Tek. There was no noticeable reactions by the stock to any of the announcements. The users of financial statements and the stock market were still ignoring the accounting profession's version of reality. The question that seemed most relevant was how those values were ever determined in the first place. If the company had done an impairment study on E-Tek the day after the acquisition, what valuation procedure could have possibly reached the conclusion that E-Tek was worth $20 billion?

It doesn’t matter

Everyone but the accounting profession understands that the value of the exchanged stock in a stock acquisition has no economic relevance. It certainly doesn’t matter to the stock market. It certainly doesn’t matter to acquiring corporations like JDS Uniphase. It has no impact on the economic reality of the transaction, on the operations of the company, on cash flow, or on the value of the stock. If it mattered, JDS stocked would have tanked when it announced the terms of the E-Tek acquisition. If it mattered, JDS stock would have been selling for a pittance as the losses rolled in (instead of at a large multiple of pro forma earnings). If it mattered, JDS stock would have dropped when it announced that its assets were impaired by billions of dollars. If it mattered, JDS would never have made the eminently sensible decision to merge with E-Tek in the first place. Companies and investors continue to make economically sound decisions, even while the accountants tell them they are making insanely unprofitable ones. The outcome of the FASB’s insistence on purchase accounting and good will amortization was so silly that it gave GAAP accounting a bad name and the FASB had to beat a retreat. It had to give up on good will amortization. It had to give companies a way to purge their balance sheets of mountains of meaningless good will. The only mystery is why the accounting profession doesn’t just admit that purchase accounting of stock acquisitions makes no sense. Why do we need to continue this charade?

Does it matter at all?

Although accountants are responsible for implementing the earnings model, they never quite keep in focus why and how it is useful for users of financial statements. Implicitly what investors want to know is what the stream of future cash flows is going to look like because that is what a stock is worth. Of all the accounting principles that matter to an investor, the most important is consistency across time. From that point of view pooling-of-interests accounting is an inspired idea.

A company has a consistent accounting policy which renders the numbers comparable. The more conservative the policy, the greater the premium of the stock price to book value, the higher the return on equity of the company, and the higher the P/E ratio. Changes in accounting basis are anathema to an investor. Past returns on equity and assets (which are the only way an investor can judge the company’s effectiveness in converting costs to revenues) are no longer comparable to the present. That is why the requirement of pooling accounting of restating five years of results as if the companies were combined for that period of time, and continuing that past accounting basis into the future, is a wonderful approach for investors.

Purchase accounting, on the other hand, renders past accounting statements worthless. The method basically requires that some artificial price premium over the book value of the acquired company be used to step up the book value of the surviving company, a book value which hopefully resulted from the conservative and consistent cumulative application of accounting principles. The loss of that book value represents the loss of comparability across time for both companies.

The other kind of acquisition

Another reason it matters at all, is that companies also make cash acquisitions. When a company does so, it represents a real use of economic resources and obviously has a very different affect on cash flows than an exchange of stock. It needs to be viewed as just another economic cost like building a plant, with the presumption that even at the higher accounting basis the company will be able to realize returns on that cash investment comparable to those generated internally or by other uses for the cash. There is no question that the cash amount is the economic value of the transaction and that the good will is a required addition to the balance sheet to reconcile the cash cost to the book value of the acquired asset. The accounts remain comparable across time because the good will represents a true economic cost.

Why the accounting profession thinks that a cash acquisition is equivalent to a stock acquisition and they need to be treated in the same manner is a profound mystery, but that is not the point. A user of financial statements could back out the good will charges if the only source of good will were stock acquisitions. But because good will is not identified by source this can be problematic. If this letter is reviewed by anyone, I would urge that good will be segregated on the balance sheet by source. In today's world, investors avail themselves more and more of electronic data bases of accounting information. If the data cannot be appropriately adjusted, whole classes of companies are lost to further analysis. I do not consider companies with large good will balances, because the data cannot be adjusted on the fly and the unadjusted data will not yield useful results because of the lack of comparability across time. Purchase accounting is an impediment to efficient markets.

Why not pooling?

The accounting profession seems to be in a total hysteria about pooling accounting. I wish I understood the arguments better so I could address them here, but I don't. I hear that purchase accounting results in lower earnings than pooling accounting. Well that's true, but I didn't know that lower stated earnings was an objective of accounting policy. It is pointed out that pooling acquisitions can have an accretive affect on earnings. Well that's certainly true if management negotiates a particularly favorable exchange ratio. Is there some reason that is a bad thing? It is pointed out that pooling can be abused by surreptitious changes in the accounts of the acquired company. Well management can make the same kinds of changes in their own accounts to puff earnings. Why is it a particular problem with pooling or one that cannot be solved by stricter disclosure requirements? I hear that pooling does not adequately recognize that an accounting event has occurred. In view of the nature of the event which is a continuation of all equity ownership interests, and in view of the need for consistency, that doesn't seem like a very convincing problem. I hear it would be a problem if companies can choose whether to use purchase or pooling for a specific transaction. I see no problem requiring pooling for every stock acquisition. I hear that all acquisitions are the same and should be accounted for in the same way. How can anyone take that comment seriously? Pooling perfectly captures the economic reality of the merging of ownership interests. Why not pooling?

The International Accounting Standards Board proposed rule

In October 2000, FASB Chairman Edmund Jenkins made the following pronouncement:

"Currently, investors have no idea of the real cost of a business combination accounted for by the pooling method. In a pooling, the two businesses merely add together the book value of their assets, without showing what price one company paid to acquire the other. Investors cannot determine the purchase price, and it is impossible to track their investment over time."

I can only say that I wish Mr. Jenkins had checked with me before making this pronouncement. One wonders how many other investors he could have checked with. They were obviously not the investors who were buying and selling stocks at the time, since those investors were quite happy to totally ignore the "purchase price" that he so thoughtfully mandated. While Mr. Jenkins makes spurious claims of comparability for purchase accounting, this investor pines for the time when the pooling of interest treatment of stock acquisitions actually made it possible "to track [his] investment[s] over time", precisely because "the two businesses merely add[ed] together the book value of their assets". The earnings model is a very imperfect attempt at matching costs and revenues. The financial statement user's only refuge comes from the principles of conservativeness and consistency. Perhaps it is not surprising that an accounting profession which has abandoned those principles in favor of rule making should also abandon pooling of interest accounting, the best tool ever invented for maintaining conservativeness and consistency in the face of stock acquisition events that would otherwise render comparisons across time meaningless.

JDS Uniphase may be an extreme example, but every less extreme example is identical in principle. What purpose can be served by foisting the fiction on financial statements that the value of the exchanged shares in a stock acquisition has any economic significance? Don't the JDSs of the world prove that it doesn't? If the treatment makes sense, how could the results be so strange, and how could the stock market be so willing to ignore them? The rest of the world has moved on and figured out how to make the correct economic decisions in spite of the accounting profession's inexplicable need to misinform them. I suppose that eventually the charade will be abandoned, whether it happens at this time or at some time in the future. In the mean time, the only purpose served by purchase accounting of stock acquisitions is to make financial statements less useful.

Respectfully,

Gregg Wilson
Chief Investment Officer

gwilson@covewood.com
914 690 9876