2015

IFRS Foundation: Framework-based IFRS Teaching Material

Stage 3–
Business Combinations and Consolidated Financial Statements: the Acquisitive case study

IFRS

The Acquisitive case study

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This material has benefited greatly from the feedback and comments from people attending a series of workshops on the Framework-based approach to teaching International Financial Reporting Standards (IFRS) organised by the IFRS Foundation and others and from peer review by a number of anonymous reviewers.

Background

Jane Doe is the recently appointed Group Accountant at Acquisitive—a company listed on the Antarctican Stock Exchange.[1] She is preparing to deliver 'her' first press release and investor conference call—to announce Acquisitive's preliminary consolidated results for the year ended 31 December 20x5, and she anticipates receiving a number of questions from existing and potential shareholders and the financial press about some significant issues that are mentioned in the forthcoming release.

Jane is aware that Acquisitive has operated successfully in the Antarctican manufacturing sector for more than fifty years and for many years has prepared its financial statements in accordance with International Financial Reporting Standards (IFRS). In accordance with the listing requirements of the Antarctican Stock Exchange, Acquisitive also prepares half-yearly interim financial statements in accordance with IAS 34 *Interim Financial Reporting*.

Issue 1—goodwill

On 1 July 20x5 Acquisitive gained control of Introspective when it purchased all of Introspective's issued equity for CU25 billion cash.

Jane observes that the forthcoming release includes a statement that a CU2 billion goodwill asset is, in accordance with IFRS 3, recognised in Acquisitive's accounting for the acquisition of Introspective. Her examination of the due diligence reports that informed the acquisition decision identifies, in support of recognising CU2 billion goodwill:

- CU1 billion—significant synergies between Acquisitive's pre-existing operations and Introspective's operations;
- CU0.4 billion—synergies between the assembled collection of net assets that make up Introspective's business; and
- CU0.6 billion—premium paid solely to entice the last remaining pre-existing Introspective shareholders to sell their shares to Acquisitive.

[1] The names of individuals, companies and places in this case study are fictitious. Any resemblance to people or entities is purely coincidental.

For the six-month period ended 31 December 20x5 Introspective's operations decreased the Acquisitive group's profit by CU1 billion. The loss related primarily to the three months' production lost at its Antarctican ice lolly plant, which was due to sustained industrial action. Introspective's other businesses all performed in line with, or better than, management's forecasts made on the basis of the due diligence reports that informed the acquisition decision.

Issues for class discussion
Do any of the following 'items' satisfy the definition of an asset (as defined in the IASB's *Conceptual Framework*)? • significant synergies between Acquisitive's pre-existing operations and Introspective's operations; • synergies between the assembled collection of net assets that make up Introspective's business; and • the premium paid to entice the last remaining pre-existing Introspective shareholders to sell their shares. Economically, is goodwill: • a wasting asset—in other words, the service potential of goodwill is consumed as it is used to support the sale of goods over time; or • an indefinite-life asset—in other words, it is not consumed through use but is subject to impairment? Assume you[2] are in early 20x6 considering acquiring some Acquisitive shares. What information about the goodwill that arose from the accounting for the acquisition of Introspective in accordance with IFRS 3 *Business Combinations* would you consider useful to inform your investment decision?

Issue 2—controlling shareholder buys out the non-controlling interests

On 1 July 20x5 Acquisitive increased its equity interest in its subsidiary Booming from 75 per cent to 100 per cent in exchange for CU10 billion cash. While Jane is aware that this transaction is between equity holders (and consequently, in accordance with IFRS, has no effect on reported earnings) she recalls last night reading a related issue in Warren Buffett's letter to Berkshire Hathaway Inc. shareholders (see extract reproduced below) and consequently she expects that some might ask her about the effects of Acquisitive's purchase of Booming's non-controlling interests on Acquisitive's soon-to-be released preliminary consolidated financial information.

> Extract from Warren Buffett's letter to Berkshire Hathaway Inc. shareholders 2013 (see http://www.berkshirehathaway.com/letters/2013ltr.pdf)

[2] You cannot require Acquisitive to provide information directly to you and consequently you must rely on its IFRS financial statements for much of the financial information you need.

> "Last year we invested $3.5 billion in the surest sort of bolt-on: the purchase of additional shares in two wonderful businesses that we already controlled. In one case—Marmon—our purchases brought us to the 100% ownership we had signed up for in 2008. In the other instance—Iscar—the Wertheimer family elected to exercise a put option it held, selling us the 20% of the business it retained when we bought control in 2006. These purchases added about $300 million pre-tax to our current earning power and also delivered us $800 million of cash. Meanwhile, the same nonsensical accounting rule that I described in last year's letter required that we enter these purchases on our books at $1.8 billion less than we paid, a process that reduced Berkshire's book value. (The charge was made to "capital in excess of par value"; figure *that* one out.) This weird accounting, you should understand, instantly increased Berkshire's excess of intrinsic value over book value by the same $1.8 billion."

Jane is aware that, unlike Acquisitive (which reports its financial information in accordance with IFRS), Berkshire Hathaway uses US GAAP[3]. However, she recalls that IFRS 3 *Business Combinations* is the product of a joint FASB[4] and IASB[5] project, so she expects that the same (or similar) issues would exist for Acquisitive. This is confirmed when she reads a UBS Research Footnotes Compendium issued by Dennis Jullens, former UBS Accounting and Valuation Analyst (8 December 2010)—an extract from which is set out below.

> "In 2009, Swiss company Roche increased its stake in US group Genentech from 56% to 100% by buying out the minority interest. As Roche already fully consolidated Genentech, the transaction from the accounting perspective was viewed as a transaction between shareholders that does not give rise to goodwill.
>
> In the case of the Roche/Genentech transaction, the difference between purchase price and net asset value of minority interest of CHF 43.8bn was charged to Roche's shareholders' equity. This accounting adjustment caused return on equity to increase from 17% in 2008 to 119% in 2009... (p68) However, the principal reason for Roche's return on equity is accounting rather than underlying economics. (p71)
>
> The rationale here is that the wealth-generating ability of business assets is unaffected by the acquisition of the minority interest. That is to say, the parent is not investing in more or new assets. It is simply acquiring more rights to income from the assets it already controls, but to which non-controlling interests previously had rights..." (p68)

Jane's preparations for the forthcoming release also led her to an article by Dr Alan Teixeira (2014): *The International Accounting Standards Board and Evidence-Informed Standard-Setting, Accounting in Europe, DOI: 10.1080/17449480.2014.900269*. In particular, her attention is drawn to the following extract:

[3] US Generally Accepted Accounting Principles (US GAAP).
[4] The Financial Accounting Standards Board (FASB) is the US financial reporting standard-setter.
[5] The International Accounting Standards Board is the IFRS Foundation's standard-setting body. It sets IFRS.

> 'When the IASB developed IFRS 3 *Business Combinations* we faced significant opposition from lobby groups. One of the issues was the proposed treatment when non-controlling (minority) interests were acquired by the controlling interest. Opponents claimed that most of the equity of listed European companies would be wiped out. As part of the effects analysis for this Standard, I examined reported equity for the largest 600 European and the largest 600 US-listed entities (IASB, 2008). The analysis found that less than 1% of these entities had economically significant non-controlling interests. An analysis of the individual cases provided the IASB with evidence that non-controlling interests were less economically significant than had been asserted by our detractors. And the reasons for the high proportion of non-controlling interests in the few cases we did observe made economic sense.[[6]] We also ran a series of calculations to estimate the likely effect on financial reports of various buy-out scenarios. The analysis suggested that the assertions and claims against us were without foundation.'

Jane is aware that Acquisitive's soon-to-be-released preliminary consolidated financial information makes much of Acquisitive's purchase of the 25 per cent non-controlling interests in Booming for CU10 billion, which results in non-controlling interests declining by CU4 billion and equity attributable to Acquisitive's shareholders declining by CU6 billion. She re-examines the due diligence reports prepared before making the decision to purchase the non-controlling interests and is satisfied that the valuations set out therein support her understanding that the transaction was priced 'at the market'. She is also aware that Booming's financial performance in the six months since this transaction has greatly exceeded expectations and has thus contributed greatly to the impressive performance of Acquisitive for the six months ending 31 December 20x5, thereby providing good value to Acquisitive's shareholders for the CU10 billion cash spent to buy out the non-controlling interests in Booming.

Issues for class discussion
Assuming that the purchase of the non-controlling interests in Booming is priced at the market—why does this transaction, when accounted for in accordance with IFRS, result in the net assets (and equity) of the Acquisitive group declining by CU6 billion? Reflecting on Warren Buffett's commentary, how would you advise Jane Doe to explain this transaction to Acquisitive's shareholders at the forthcoming earnings release? What changes, if any, do you think could be made to IFRS to provide information in a way that addresses the question raised by Warren Buffett? Would your answer to the question above be affected by the option chosen by Acquisitive when, many years ago, measuring non-controlling interests in its accounting for the acquisition of Booming—that is to say: (i) fair value (sometimes called 'full goodwill method') or (ii) the present ownership instruments' proportionate share in the recognised amounts of the Booming's identifiable net assets (sometimes called 'partial goodwill method')?

[6] The reasons included, for example, a group with wholly owned subsidiaries that were making losses whereas the subsidiaries with non-controlling interests were profitable.

Issue 3—reorganisation[7]

On 31 December 20x5 Acquisitive acquires all the equity of Ation from Conglomerate in exchange for CU20,000 million in cash. Mrs C owns all the equity of Conglomerate and controls both Conglomerate and Acquisitive.

Summary financial information for Acquisitive and Ation on 31 December 20x5 (immediately before the transaction above) is as follows:

	Acquisitive		**Ation**	
	Carrying amount	*Fair value*	*Carrying amount*	*Fair value*
	CU'millions	*CU'millions*	*CU'millions*	*CU'millions*
Identifiable assets	300,000	600,000	35,000	50,000
Liabilities	(200,000)	(190,000)	(32,000)	(29,000)
Contingent liabilities	–	(10,000)	–	(3,000)
	100,000	**400,000**	**3,000**	**18,000**

At the insistence of Mrs C, in its consolidated financial statements, Acquisitive accounted for the acquisition of Ation as follows:

	CU'millions
Debit identifiable assets	35,000
Credit identifiable liabilities	(32,000)[8]
Credit asset: cash	(20,000)
Debit equity	17,000

Issues for class discussion
How would you advise Jane Doe to explain the financial effects of this transaction in Acquisitive's consolidated financial statements to Acquisitive's non-controlling shareholders at the forthcoming earnings release? What other accounting, if any, in accordance with IFRS could Acquisitive have adopted for this reorganisation in its consolidated financial statements? Which method of accounting for the reorganisation do you believe best serves the objective of IFRS financial reporting (and why)?

[7] This reorganisation is adapted from the Amalgam case study (see http://www.ifrs.org/Use-around-the-world/Education/Documents/Framework-based%20teaching%20materials/IAS%208%20hierarchy%20case%20study%20(final).pdf).

[8] Because in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* Ation did not recognise the contingent liabilities, in accounting for the business combination using the pooling of interests method, the contingent liabilities were also not recognised by Acquisitive.