

Advanced Group Accounting (RIKA)

Block 2

RECHTSWISSENSCHAFT WIRTSCHAFTSWISSENSCHAFTEN

Foto: Thomas Müller Ivan Reimann

Course Structure

Block	Topic
	<i>Preparation: recap double-entry bookkeeping (online, self-study)</i>
1	Key Concepts
2	Acquisition Method
3	Consolidation
4	Subsequent Consolidation Goodwill Impairment
5	Joint Arrangement and Investments at Equity Changes in Control
6	Analyzing Consolidated F/S

Course Structure

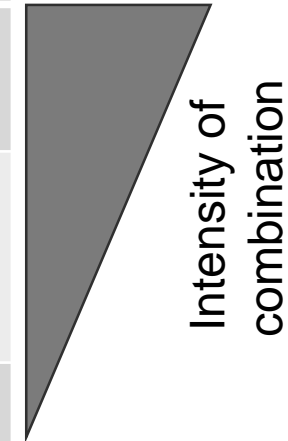
Block	Topic
2	Acquisition Method
2.1	Basic Idea
2.2	Step 1: Identify the Acquirer
2.3	Step 2: Determine the Acquisition Date
2.4	Step 3: Measure and Recognize Assets / Liabilities
2.5	Step 4: Measure and Recognize Goodwill



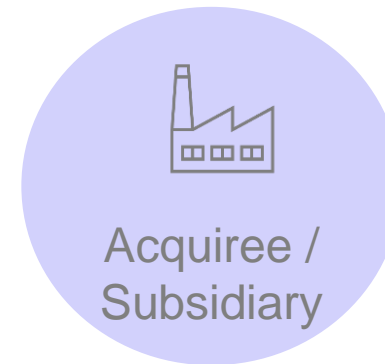
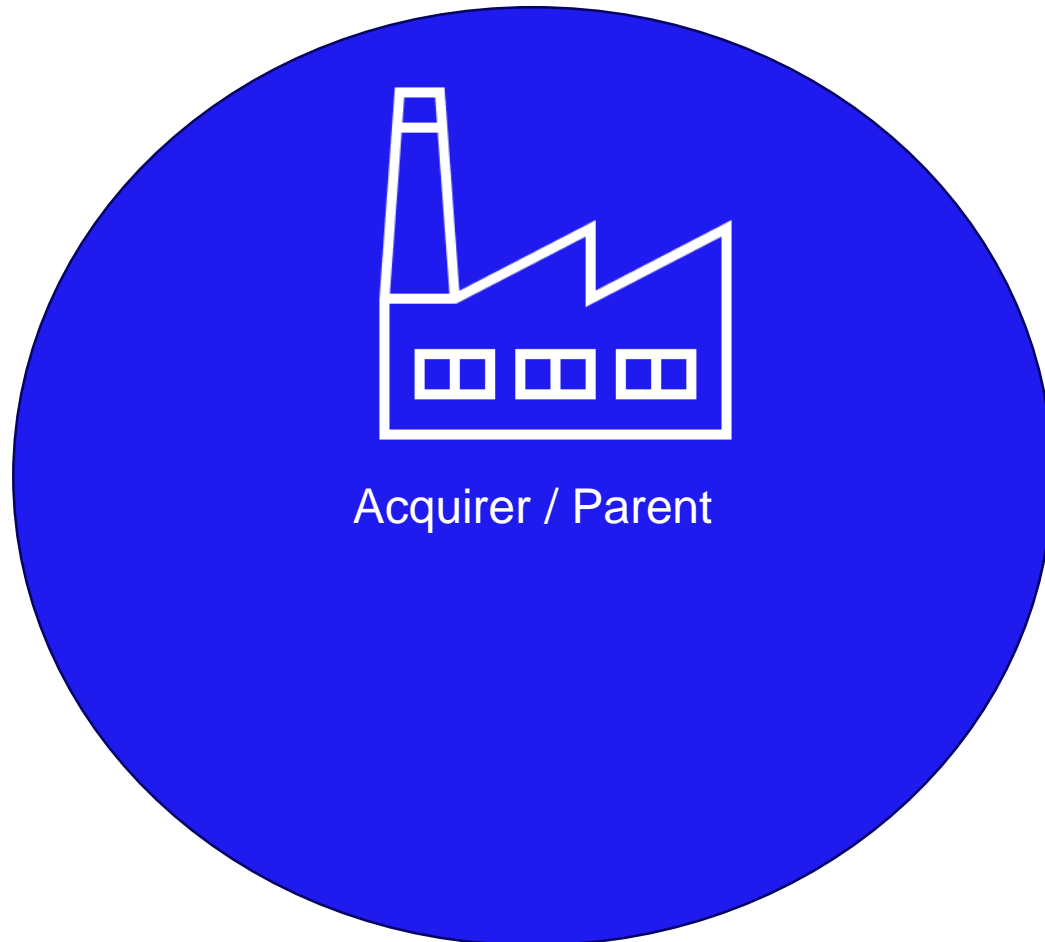
- What is the acquisition method?
- How does application of the acquisition method matter for consolidation?

Recap: M&A transactions (and their accounting) differ, depending on intensity of the combination

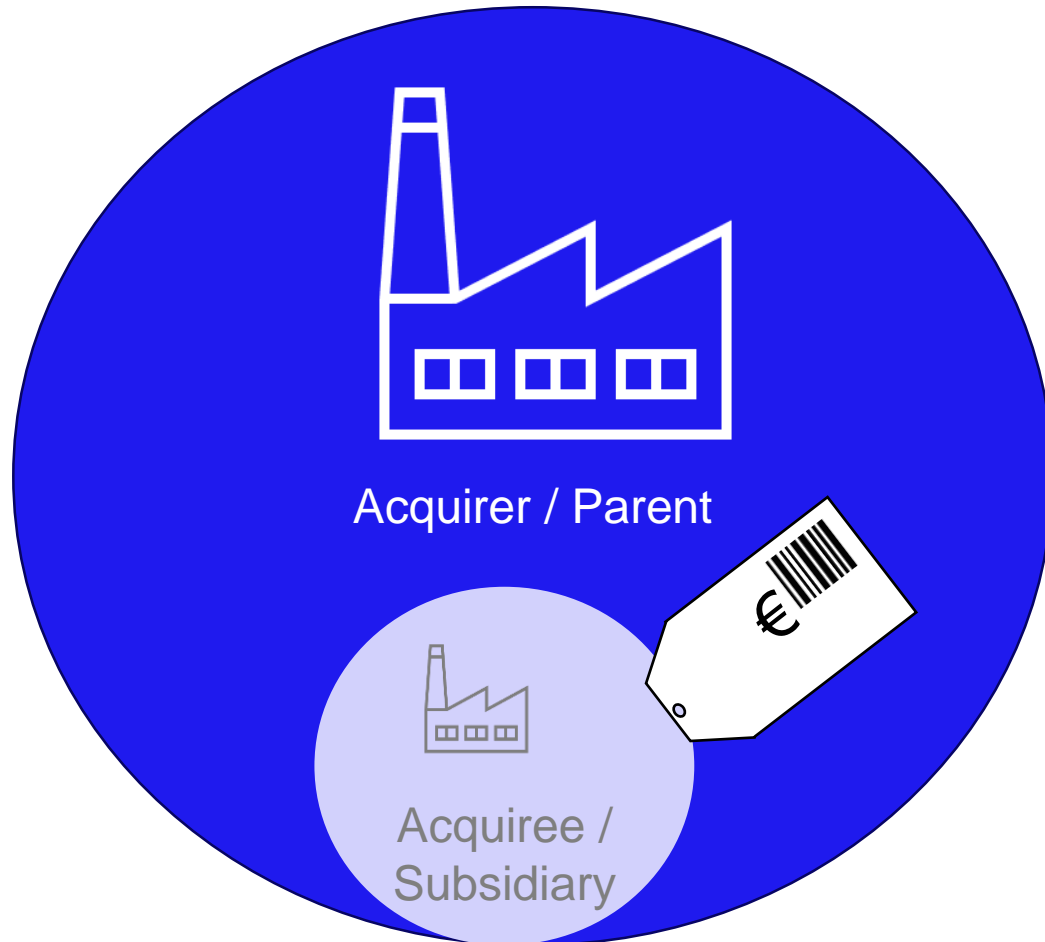
Type of investee	Relation	Accounting implication
Subsidiary	Control	Full consolidation / acquisition method
Joint arrangement	Joint control	Equity method (mostly) Partial consolidation (special cases)
Associated entity	Significant influence	Equity method



Acquisition method: basic idea

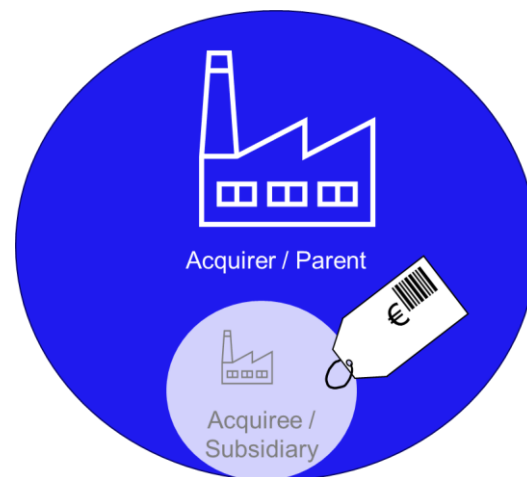
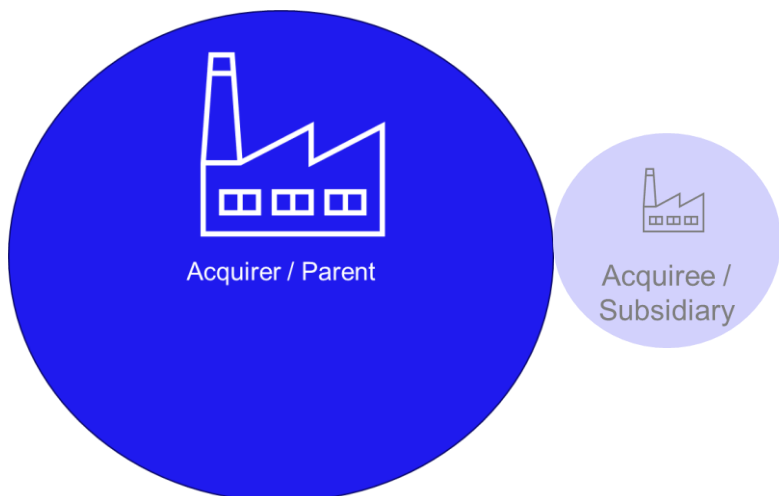
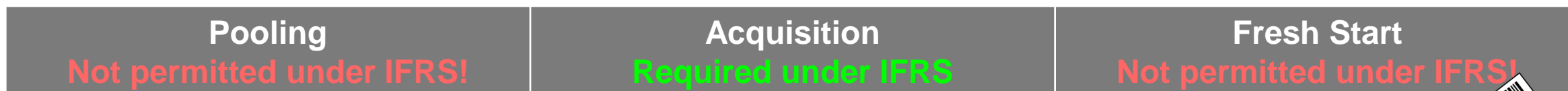


Acquisition method: basic idea



- Acquirer obtains control over acquiree
- No new entity created, but acquiree becomes part of acquirer's corporate group
- Consolidated balance sheet features mixed values:
 - Assets/liabilities of acquirer at historical cost
 - Assets/liabilities of acquiree at fair value

What would be the alternatives?



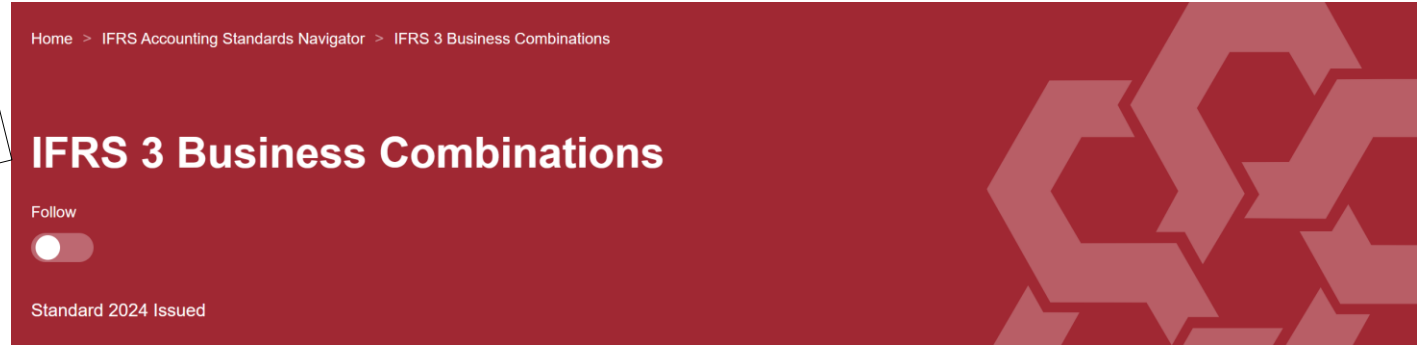
- Parties continue to exist after transaction
- “True” merger
- No revaluation of assets

- Acquirer purchases acquiree
- Purchase transaction leads to revaluation of acquiree, but not of acquirer

- Acquirer and acquiree form a new economic entity
- Because there is a new economic entity, assets/liabilities of both acquirer and acquiree are revaluated

How to account for a business combination?

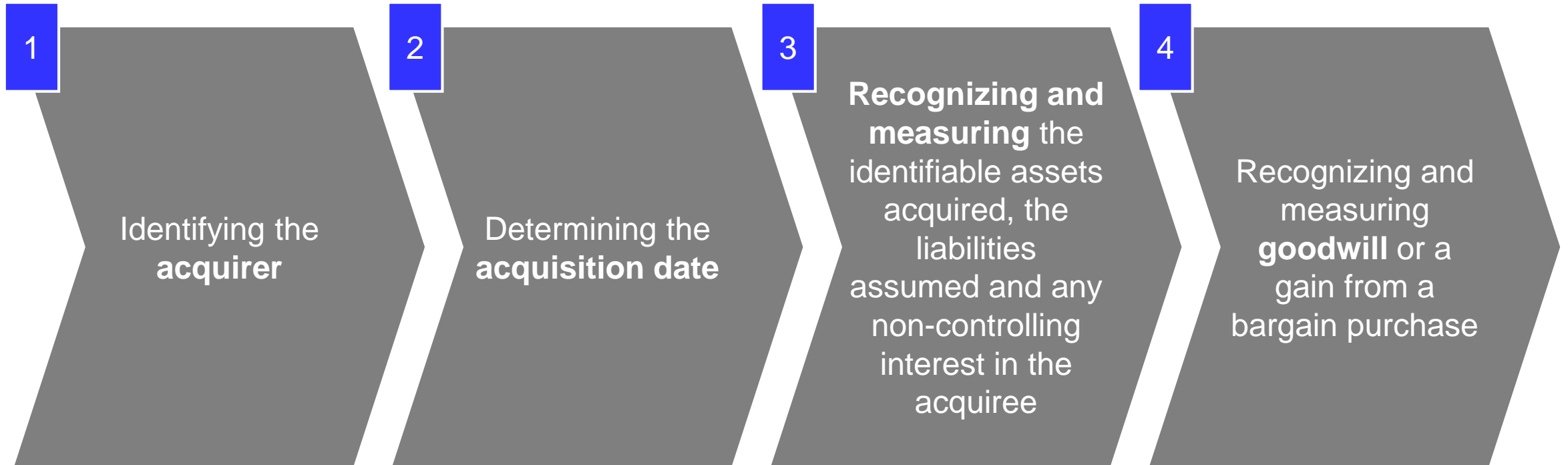
Transaction or event in which an acquirer obtains **control** of one or more businesses



The acquisition method

- 4 An entity shall account for each business combination by applying the acquisition method.
- 5 Applying the acquisition method requires:
 - (a) identifying the acquirer;
 - (b) determining the acquisition date;
 - (c) recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and
 - (d) recognising and measuring goodwill or a gain from a bargain purchase.

Acquisition method: Steps



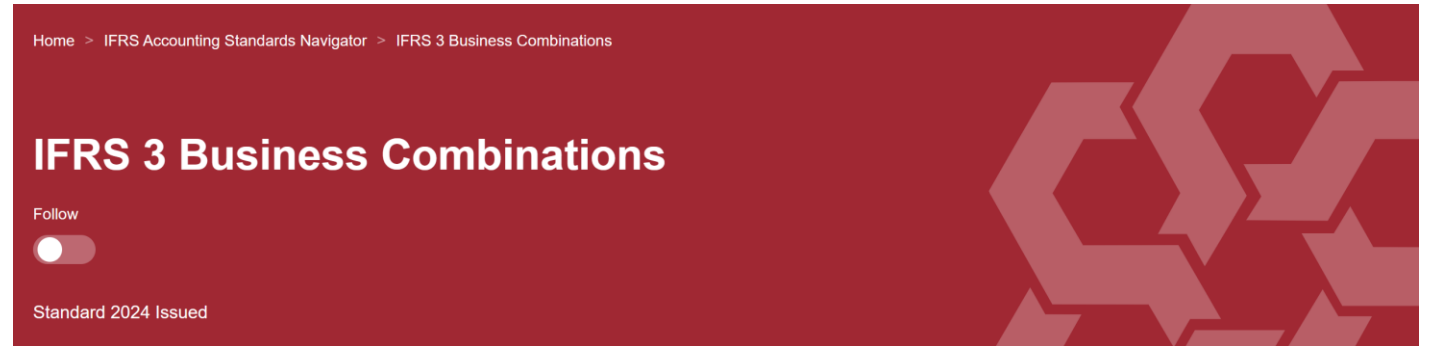
Course Structure

Block	Topic
2	Acquisition Method
2.1	Basic Idea
2.2	Step 1: Identify the Acquirer
2.3	Step 2: Determine the Acquisition Date
2.4	Step 3: Measure and Recognize Assets / Liabilities
2.5	Step 4: Measure and Recognize Goodwill



- Who is the acquirer in a business transaction?

Step 1: Identifying the acquirer



Appendix A Defined terms

This appendix is an integral part of the IFRS.

acquiree	The business or businesses that the acquirer obtains control of in a business combination .
acquirer	The entity that obtains control of the acquiree .

Step 1: Identifying the acquirer

Power-so-as-to-benefit model

IFRS 10 Consolidated Financial Statements

Follow



Standard 2024 Issued

Control

- 5 An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.
- 6 An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.
- 7 Thus, an investor controls an investee if and only if the investor has all the following:
 - (a) power over the investee (see **paragraphs 10–14**);
 - (b) exposure, or rights, to variable returns from its involvement with the investee (see **paragraphs 15 and 16**); and
 - (c) the ability to use its power over the investee to affect the amount of the investor’s returns (see **paragraphs 17 and 18**).

Course Structure

Block	Topic
2	Acquisition Method
2.1	Basic Idea
2.2	Step 1: Identify the Acquirer
2.3	Step 2: Determine the Acquisition Date
2.4	Step 3: Measure and Recognize Assets / Liabilities
2.5	Step 4: Measure and Recognize Goodwill



- What is the relevant date for revaluating the assets/liabilities of the acquiree?

Step 2: Determine the acquisition date

- IFRS 3.8: The acquirer shall identify the acquisition date, which is the date on which it obtains **control** of the acquiree.
- The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the **closing** date.
- However, the acquirer might obtain control on a date that is either earlier or later than the closing date.
- For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date.

Course Structure

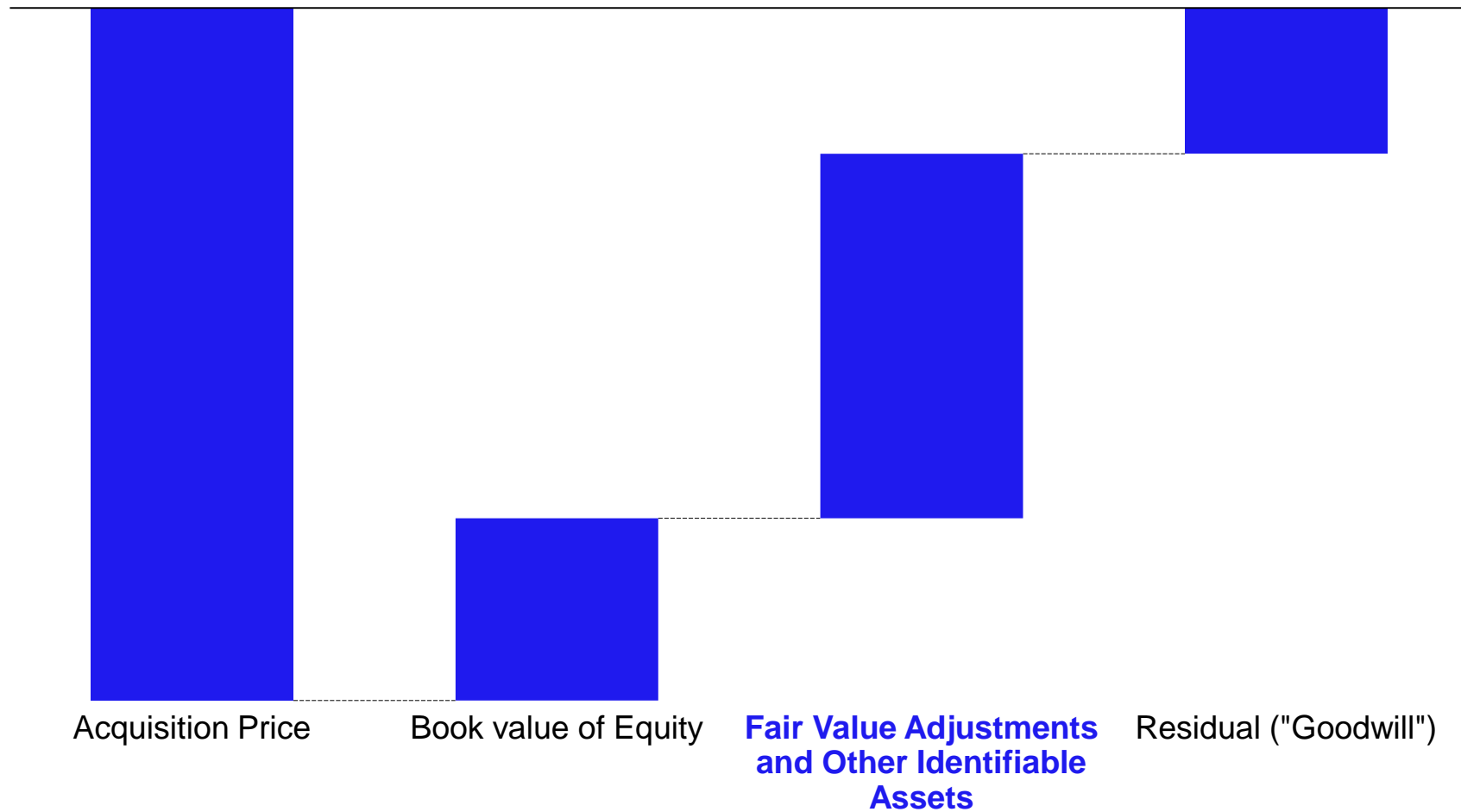
Block	Topic
2	Acquisition Method
2.1	Basic Idea
2.2	Step 1: Identify the Acquirer
2.3	Step 2: Determine the Acquisition Date
2.4	Step 3: Measure and Recognize Assets / Liabilities
2.5	Step 4: Measure and Recognize Goodwill



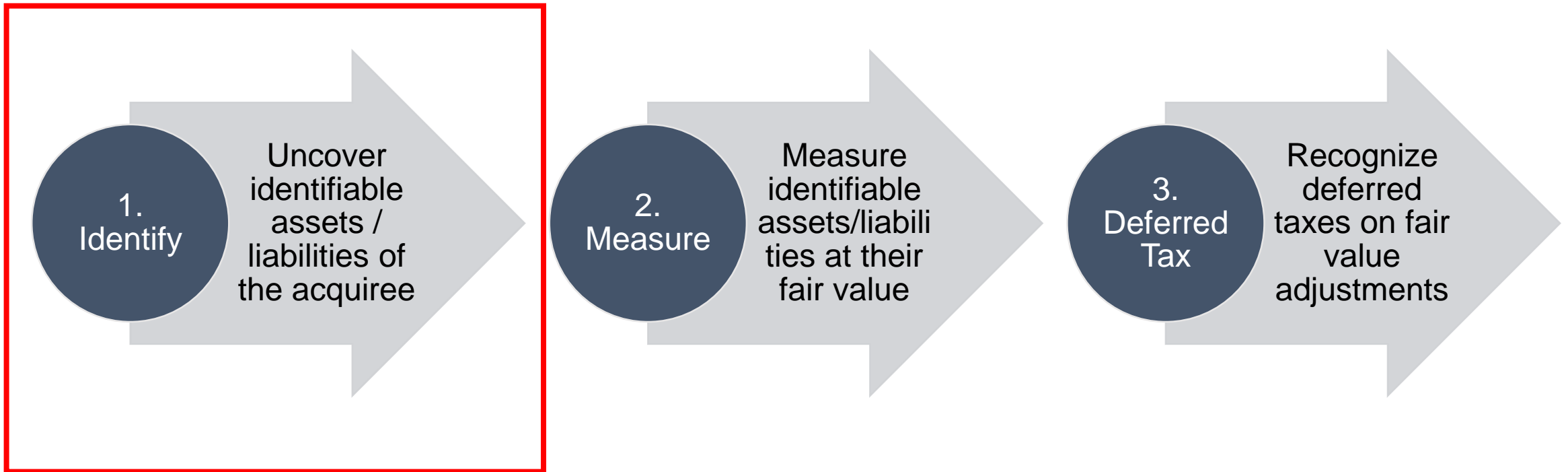
- How are assets/liabilities of the acquiree revaluated at the acquisition date?

Step 3: Measure and recognize identifiable assets/liabilities

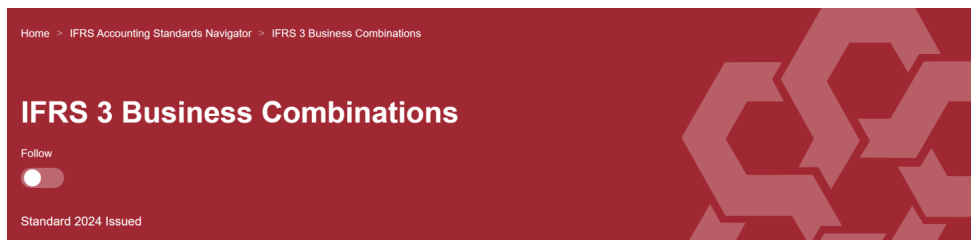
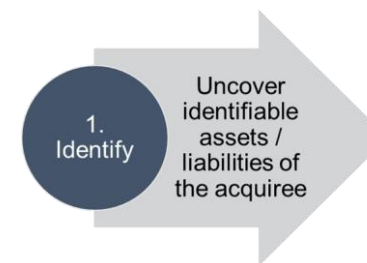
Purchase Price Allocation



What do we need to do?



Recognizing identifiable assets/liabilities



identifiable

An asset is *identifiable* if it either:

- (a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
- (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

- Additional conditions for recognizing identifiable assets/liabilities:
 - Meet asset/liability definition
 - Including assets/liabilities that had not been on acquirees' balance sheet! (especially: intangible assets)
 - Asset/liability exchanged in business combination, not in separate transaction

Example: identifiable asset/liability?

- a) Target owns a machine. By obtaining control over Target, Buyer also obtains control over the machine.
- b) As in a), but the machine is a highly specialized equipment that can only be used in Target's operations.
- c) Buyer expects that Target's employees will negotiate significant pay raises after completion of the transaction.
- d) Target owns a license to operate a technology patent. The license cannot be transferred or sold.

Two pharmaceutical companies

Roche Group consolidated balance sheet

	31 December 2018
Non-current assets	
Property, plant and equipment ⁸	21,818
Goodwill ⁹	8,948
Intangible assets ¹⁰	9,346
Deferred tax assets ⁵	3,895
Defined benefit plan assets ²⁶	877
Other non-current assets ¹⁵	1,389
Total non-current assets	46,273
Current assets	
Inventories ¹¹	6,621
Accounts receivable ¹²	9,776
Current income tax assets ⁵	208
Other current assets ¹⁶	2,521
Marketable securities ¹³	6,437
Cash and cash equivalents ¹⁴	6,681
Total current assets	32,244
Total assets	78,517

Roche Group consolidated income statement 1

	Group
Sales ^{2,3}	56,846
Royalties and other operating income ^{2,3}	2,651
Revenue^{2,3}	59,497

Consolidated balance sheets

(At December 31, 2018 and 2017)

(USD millions)	Note	2018
Assets		
Non-current assets		
Property, plant and equipment	9	15 696
Goodwill	10	35 294
Intangible assets other than goodwill	10	38 719
Investments in associated companies	4	8 352
Deferred tax assets	11	8 699
Financial assets	12	2 345
Other non-current assets	12	895
Total non-current assets		110 000
Current assets		
Inventories	13	6 956
Trade receivables	14	8 727
Income tax receivables		248
Marketable securities, commodities, time deposits	15	2 693
Cash and cash equivalents	15	13 271
Other current assets	16	2 861
Total current assets without disposal group		34 756
Assets of disposal group held for sale	2	807
Total current assets		35 563
Total assets		145 563

(USD millions unless indicated otherwise)	Note	2018
Net sales to third parties	3	51 900
Other revenues	3	1 266



Intangibles at Novartis

The following table summarizes the movements of goodwill and intangible assets in 2018:

(USD millions)	Goodwill	Intangible assets other than goodwill						Total
	Total	In-process research and development	Alcon brand name	Technologies	Currently marketed products	Marketing know-how	Other intangible assets	
Cost								
January 1, 2018	32 179	6 462	2 980	6 638	34 105	5 960	1 852	57 997
Cost of assets related to disposal group held for sale ¹		- 9		- 276	- 1 116		- 2	- 1 403
Impact of business combinations	4 084	10 224			2 531		1	12 756
Reclassifications ²		- 697			479		218	
Additions ³		477		2	728		385	1 592
Disposals and derecognitions ⁴		- 214		- 70	- 928		- 183	- 1 395
Impairment charge ⁵	- 183							
Currency translation effects	- 380	- 76		- 41	- 387		- 18	- 522
December 31, 2018	35 700	16 167	2 980	6 253	35 412	5 960	2 253	69 025

Intangibles at Roche

Income statement

	2019 (CHF m)	2018 (CHF m)
IFRS results		
Sales	61,466	56,846
Royalties and other operating income	2,285	2,651
Revenue	63,751	59,497
Cost of sales	(18,351)	(17,269)
Marketing and distribution	(10,960)	(10,109)
Research and development	(12,774)	(12,092)
General and administration	(4,118)	(5,258)
Operating profit	17,548	14,769
Financing costs	(993)	(770)
Other financial income (expense)	59	149
Profit before taxes	16,614	14,148
Income taxes	(2,506)	(3,283)
Net income	14,108	10,865

Notes to the F/S

Research and development

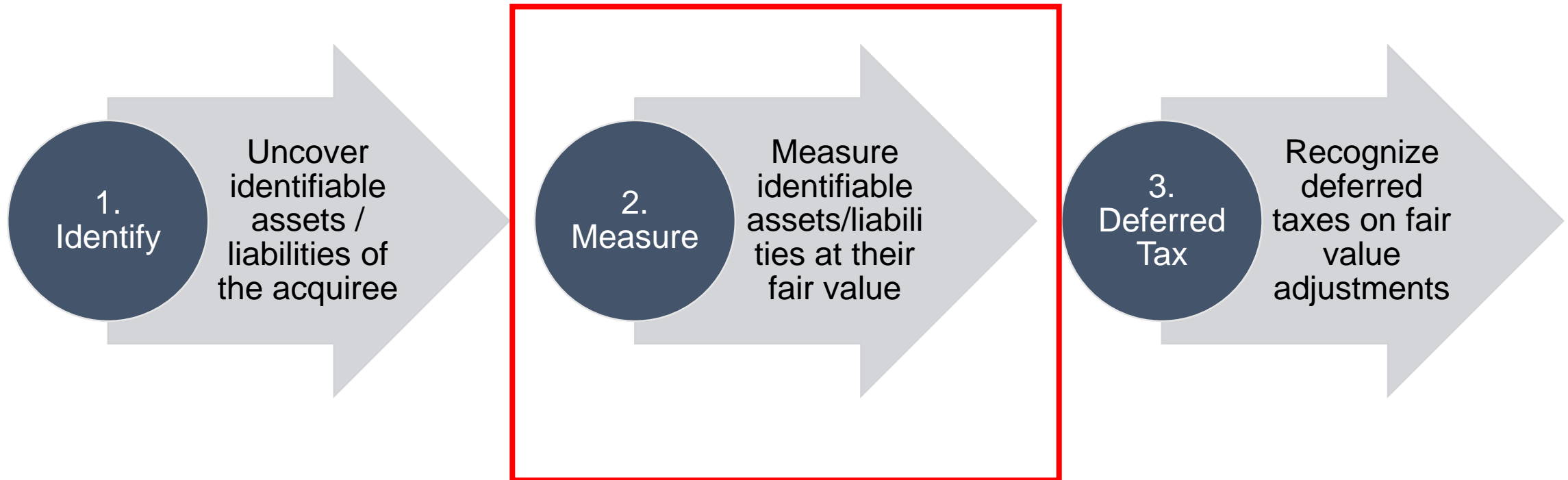
Internal research and development activities are expensed as incurred for the following:

- Internal research costs incurred for the purpose of gaining new scientific or technical knowledge and understanding.
- Internal development costs incurred for the application of research findings or other knowledge to plan and develop new products for commercial production. The development projects undertaken by the Group are subject to technical, regulatory and other uncertainties, such that, in the opinion of management, the criteria for capitalisation as intangible assets are not met prior to obtaining marketing approval by the regulatory authorities in major markets.
- Post-marketing studies after regulatory approval, such as phase IV costs in the pharmaceuticals business, generally involve safety surveillance and ongoing technical support of a drug after it receives marketing approval to be sold. They may be required by regulatory authorities or may be undertaken for safety or commercial reasons. The costs of such post-marketing studies are not capitalised as intangible assets as, in the opinion of management, they do not generate separately identifiable incremental future economic benefits that can be reliably measured.

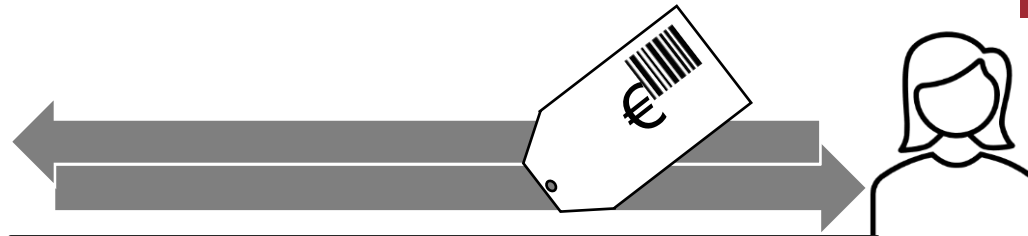
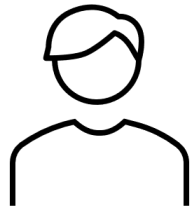
Growth strategies and accounting implications

Organic growth (internal R&D)	External growth (M&A)
<ul style="list-style-type: none">▪ Not all intangibles can be capitalized on the balance sheet (e.g., prohibited according to IAS 38: self-generated brand, customer lists)	<ul style="list-style-type: none">▪ Acquiree's intangibles "uncovered" via M&A transaction / purchase price allocation
<ul style="list-style-type: none">▪ Innovation/marketing efforts charged through P&L (R&D expenses, marketing expenses)	<ul style="list-style-type: none">▪ Purchase price allocated to identifiable intangible assets (capitalization on consolidated financial statements)
<ul style="list-style-type: none">▪ Subsequent periods: no amortization expense (no asset)	<ul style="list-style-type: none">▪ Subsequent periods: amortization expense and/or impairment testing

What do we need to do?



Fair Value Measurement



Price:
directly observable
or estimated using
valuation technique

Fair Value:
The **price** that would be received to
sell an asset / paid to transfer a liability

in an **orderly transaction**
between **market participants**

at the measurement date

Orderly transaction:

- Marketing activities that are usual and customary
- Not: forced transactions

Market participants:

Buyers/sellers in the principal market:

- Independent (i.e., unrelated)
- Knowledgeable
- Able and willing to transact
- Assumed to act in their best economic interest (highest and best use of asset)

Fair Value Measurement: Highest and Best Use

- Entity acquires R&D project in a business combination.
 - Intention: not to complete, but kill the project
 - Why?

Interview mit Ex-Coach

Klinsmann: FC Bayern München kauft seit 40 Jahren die Gegner schwach

Teilen Pocket



Jürgen Klinsmann: Konkurrenten fehlt Entschlossenheit

© 2021 SID

Killer Acquisitions

Colleen Cunningham, Florian Ederer, and Song Ma

PDF PDF PLUS Abstract Full Text Supplemental Material

Abstract

This paper argues that incumbent firms may acquire innovative targets solely to discontinue the target's innovation projects and preempt future competition. We call such acquisitions "killer acquisitions." We develop a model illustrating this phenomenon. Using pharmaceutical industry data, we show that acquired drug projects are less likely to be developed when they overlap with the acquirer's existing product portfolio, especially when the acquirer's market power is large because of weak competition or distant patent expiration. Conservative estimates indicate that 5.3%–7.4% of acquisitions in our sample are killer acquisitions. These acquisitions disproportionately occur just below thresholds for antitrust scrutiny.



Journal of Political Economy
Volume 129, Number 3
March 2021

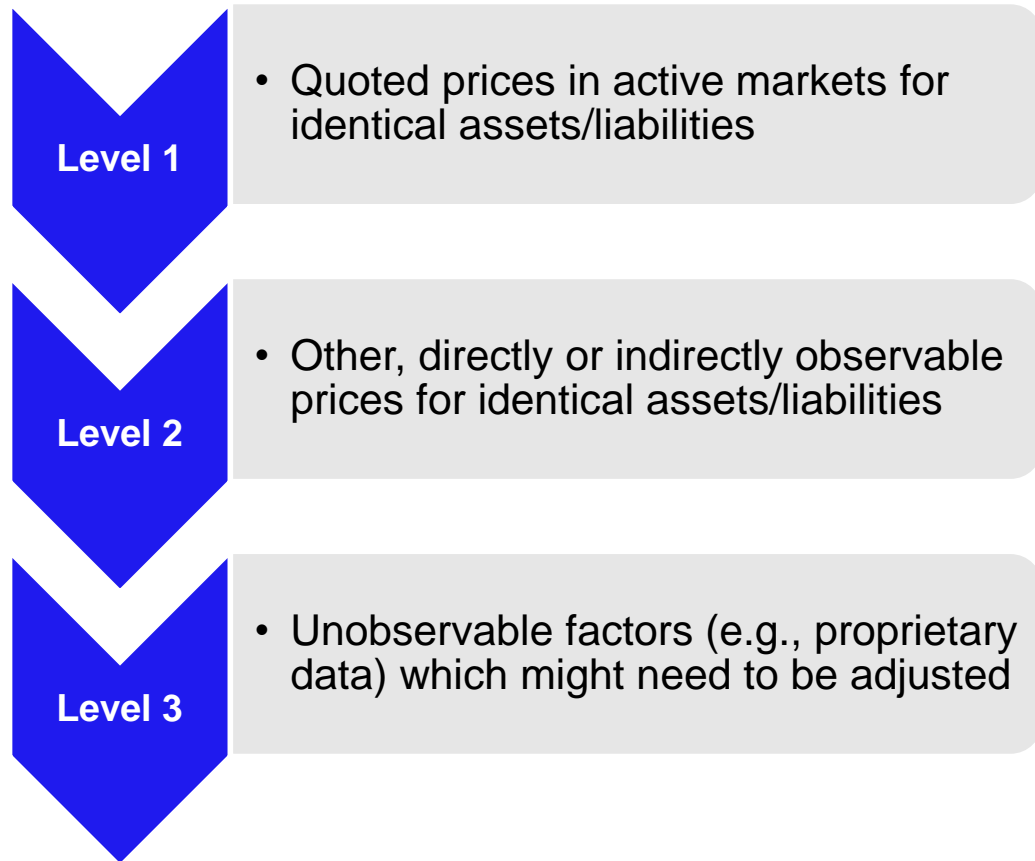
Fair Value Measurement: Highest and Best Use

- Company acquires R&D project in a business combination.
 - Intention: not to complete, but kill the project
 - “Lock up” technology, prevent competitors from access
 - Defensive value, muting future competition and improving prospects for company’s own technology
- How to determine fair value? (Based on IFRS 13.IE9)
 - Basis: use by market participants
 - If market participants would continue project: price received in a current transaction selling the project, assuming use of the project
 - If market participants would kill the project for competitive reasons (lock up): price received in a current transaction selling the project, assuming lock up
 - If market participants would discontinue the project because of lack of profitability: price received in a current transaction selling the project (possible zero)

IFRS 13 *Fair Value Measurement*

Fair value hierachy

- Basis: Input parameters used in the valuation techniques applied

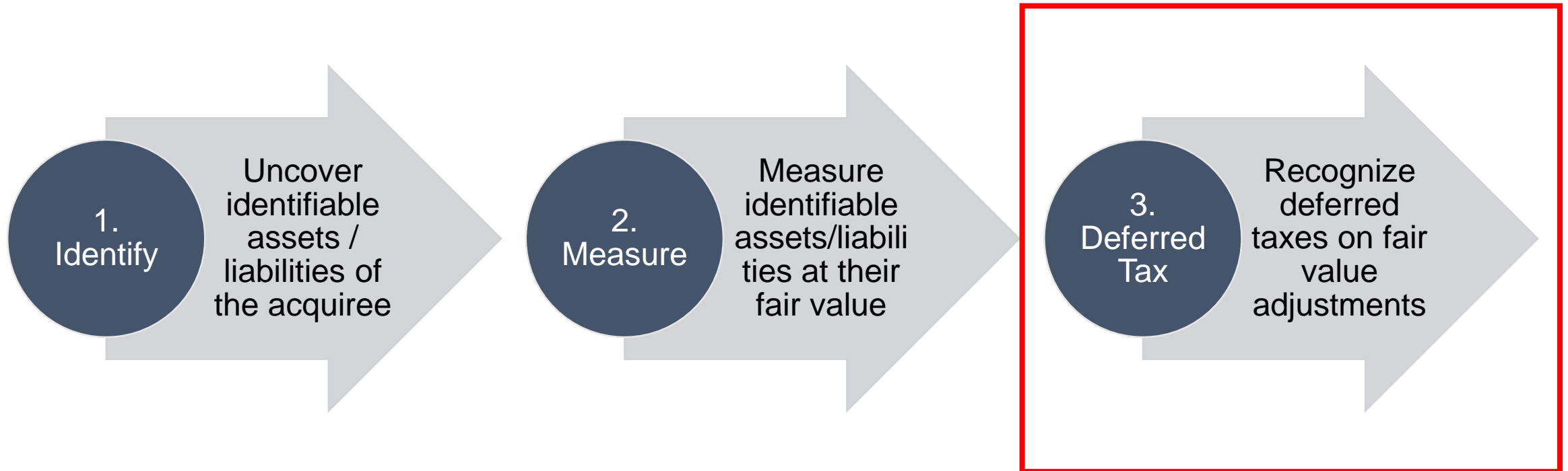


Valuation technique

- Shall be chosen with a view to maximizing the use of observable and minimize the use of unobservable input parameters

Valuation techniques	
Market model	fair value derived from market transactions
Cost model	fair value derived from replacement cost
Income model	fair value derived from valuation models (e.g., discounted cash flow model)

What do we need to do?



Considering deferred taxes

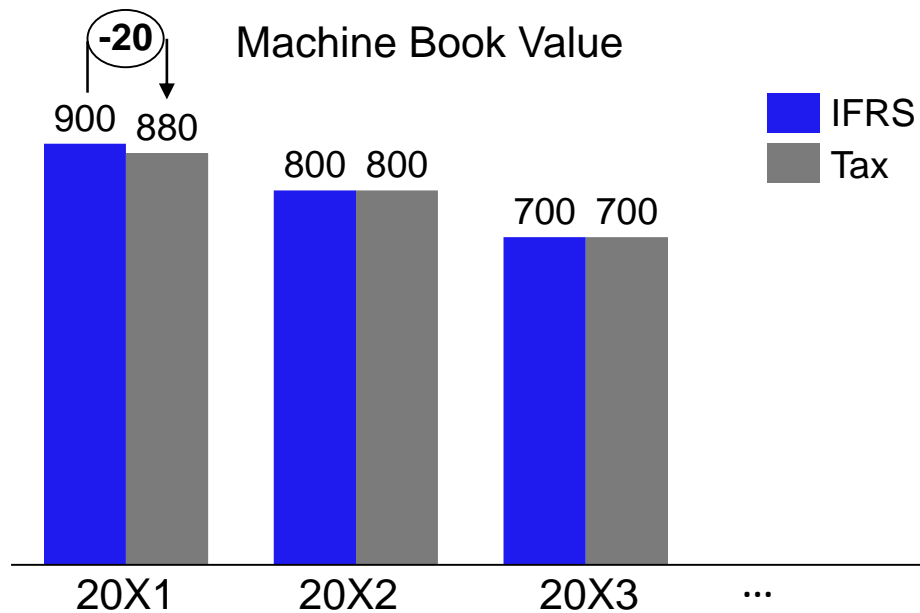


- General:
 - Deferred taxes account for differences between a reporting entity's IFRS financial statements and its tax accounting.
- Business combinations:
 - Differences arising from revaluation via purchase price allocation (i.e., in IFRS consolidated financial statements), but not in investee's tax statements

Deferred taxes: why do we need them?

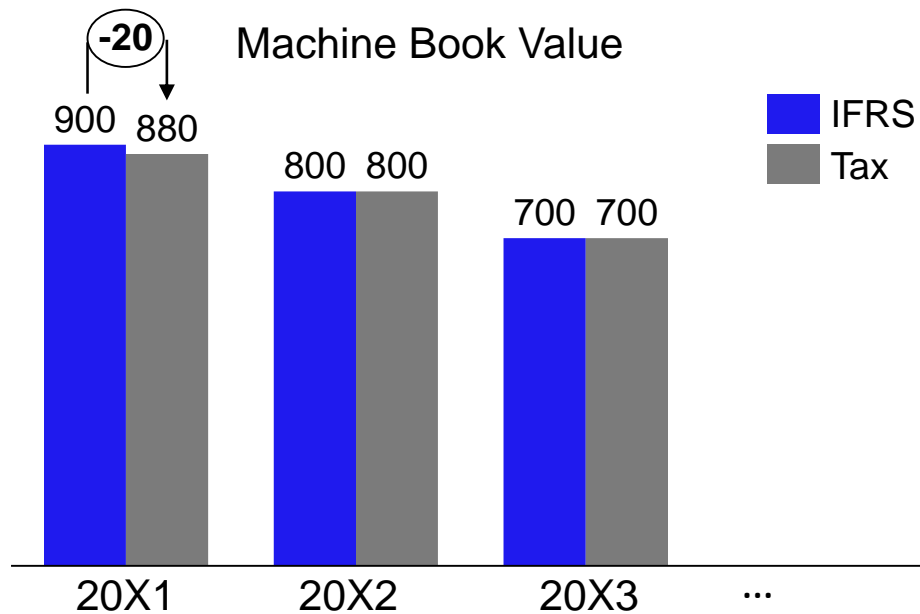
Fact pattern

- Company X purchases a machine for EUR 1,000 at the beginning of 20X1.
- Assume that Company X pays a flat tax rate of 30% on its taxable income.
- Under IFRS, Company X depreciates its assets on a straightline basis. Under its tax rules, Company X is allowed to pull parts of its depreciation forward.
- There are not other transactions than those associated with revenues and depreciation.



	20X1	20X2
Revenue	200	200
Depreciation (tax)	120	80
Taxable income		
Current tax expense		
Tax rate (tax law)		
Depreciation (IFRS)	100	100
Profit before tax (IFRS)		
Current tax / profit before tax (IFRS)		

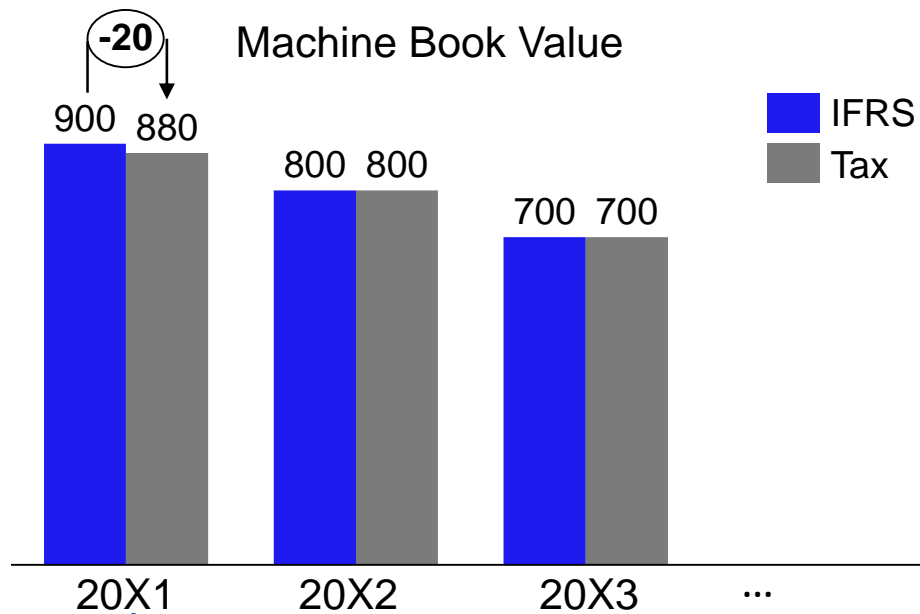
Deferred taxes: why do we need them?



	20X1	20X2
Revenue	200	200
Depreciation (tax)	120	80
Taxable income	80	120
Current tax expense	24	36
Tax rate (tax law)	30%	30%
Depreciation (IFRS)	100	100
Profit before tax (IFRS)	100	100
Current tax / profit before tax (IFRS)	24%	36%

- 20X1: understatement of tax rate suggested by IFRS statements relative to statutory (“true”) tax rate
- 20X2: overstatement of tax rate suggested by IFRS statements relative to statutory (“true”) tax rate

Deferred taxes: why do we need them?



	20X1	20X2
Revenue	200	200
Depreciation (tax)	120	80
Taxable income	80	120
Current tax expense	24	36
Tax rate (tax law)	30%	30%
Depreciation (IFRS)	100	100
Profit before tax (IFRS)	100	100
Current tax / profit before tax (IFRS)	24%	36%
Temporary difference (IFRS – Tax)	20	0
Deferred tax expense/income (IFRS)	6 (expense)	6 (income)
Effective tax rate	$(24 + 6) / 100 = 30\%$	$(36 - 6) / 100 = 30\%$

Deferred taxes: why do we need them?

- Journal entries and calculations:

Deferred taxes: why do we need them?

Journal entries and calculations:

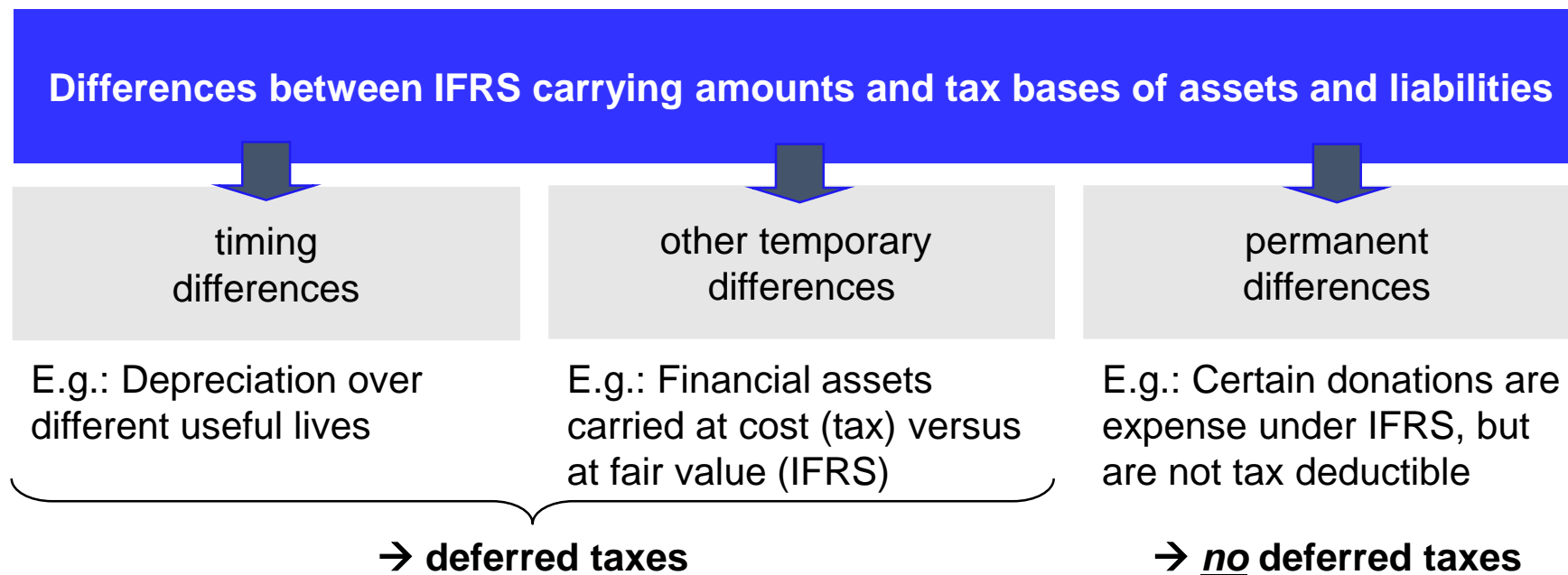
20X1:

- Book value (tax): $1,000 - 120$ (depreciation) = 880
- Book value (IFRS): $1,000 - 100$ (depreciation) = 900
- Temporary difference in asset values: $880 - 900 = -20$
- Deferred tax liability recognized on temporary difference: $20 * 30\% = 6$
- Dr. Deferred tax expense Cr. Deferred tax liability 6

20X2:

- Book value (tax): $1,000 - 120$ (depreciation 20X1) – 80 (depreciation 20X2) = 800
- Book value (IFRS): $1,000 - 100$ (depreciation 20X1) – 100 (depreciation 20X2) = 800
- Temporary difference in asset values: none
- Deferred tax liability recognized in 20X1 needs to be resolved
- Dr. Deferred tax liability Cr. Deferred tax income 6

Considering deferred taxes



The uncovering of **hidden reserves and previously unrecognized intangible assets** during the purchase price allocation process frequently gives rise to taxable or tax-deductible temporary differences, which result in deferred taxes.

BUT: no deferred taxes are to be recognized on goodwill arising from purchase price allocation in consolidated financial statements!

Deferred Taxes: Temporary Concept

- Calculate the difference between the IFRS carrying amount and tax amount
- If the difference is temporary, decide whether the difference gives rise to a tax asset or liability:

	IFRS carrying amount less tax base	Type of temporary difference	Gives rise to ...
Asset	Positive	Taxable	Deferred tax liability
Asset	Negative	Deductible	Deferred tax asset
Liability	Positive	Deductible	Deferred tax asset
Liability	Negative	Taxable	Deferred tax liability

- Exceptions:
 - Goodwill (no deferred taxes)
 - First-time recognition of an asset/liability, **except for those originating from business combinations**

Deferred Taxes - Example

- Company A owns investment property, which it accounts for using fair value (IAS 40). For tax purposes, the investment property is carried at depreciated historical cost.

- Facts:
 - Purchase of investment property at the beginning of 20X1, price: 10,000 €
 - Fair value at the end of 20x1: 11,8000 €
 - Depreciation (tax): linear, 50 years of useful life

Deferred Taxes - Example

- Company A owns investment property, which it accounts for using fair value (IAS 40). For tax purposes, the investment property is carried at depreciated historical cost.

- Facts:
 - Purchase of investment property at the beginning of 20X1, price: 10,000 €
 - Fair value at the end of 20X1: 11,8000 €
 - Depreciation (tax): linear, 50 years of useful life
 - Tax rate: 30%

- Solution:
 - IFRS carrying amount, end of 20X1: 11,800€ (equals fair value)
 - Tax carrying amount, end of 20X1: 9,800€ (10,000€ - 10,000€/50)
 - Book-tax difference: 2,000€ (11,800€ - 9,800€)
 - Journal entries (end of 20X1):

<i>Dr. Investment Property</i>	<i>Cr. Fair Value Gain</i>	<i>1,800€</i>
<i>Dr. Deferred tax expense</i>	<i>Cr. Deferred Tax Liability</i>	<i>600€ (=2,000€ *30%)</i>

Fair Value Adjustments and Deferred Taxes

- Buyer acquires 100% equity stake in Target for 20 CU.
- Balance sheets (unconsolidated) after acquisition:

Buyer (<u>Unconsolidated</u>)	
Assets	Equity & Liabilities
Investment in Target	Equity
20	20

Target (<u>Unconsolidated</u>)	
Assets	Equity & Liabilities
Cash	Equity
10	10
Other assets	Debt
20	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

- Task: Please calculate Target's revalued equity, considering deferred taxes (tax rate: 30%).

Fair value adjustments and deferred taxes

	Carrying amount at the date of acquisition	Adjustment to fair value	Fair value at the date of acquisition
Intangible assets (brand)			
Other assets			
Cash			
Deferred tax liability			
Debt			
= Revalued equity			

Fair value adjustments and deferred taxes

	Carrying amount at the date of acquisition	Adjustment to fair value	Fair value at the date of acquisition
Intangible assets (brand)	-	6	6
Other assets	20	2	22
Cash	10	0	10
Deferred tax liability	-	(2.4)	(2.4)
Debt	(20)	-	(20)
= Revalued equity	10	5.6	15.6

Fair Value Adjustments and Deferred Taxes: Effects on Profit/Loss

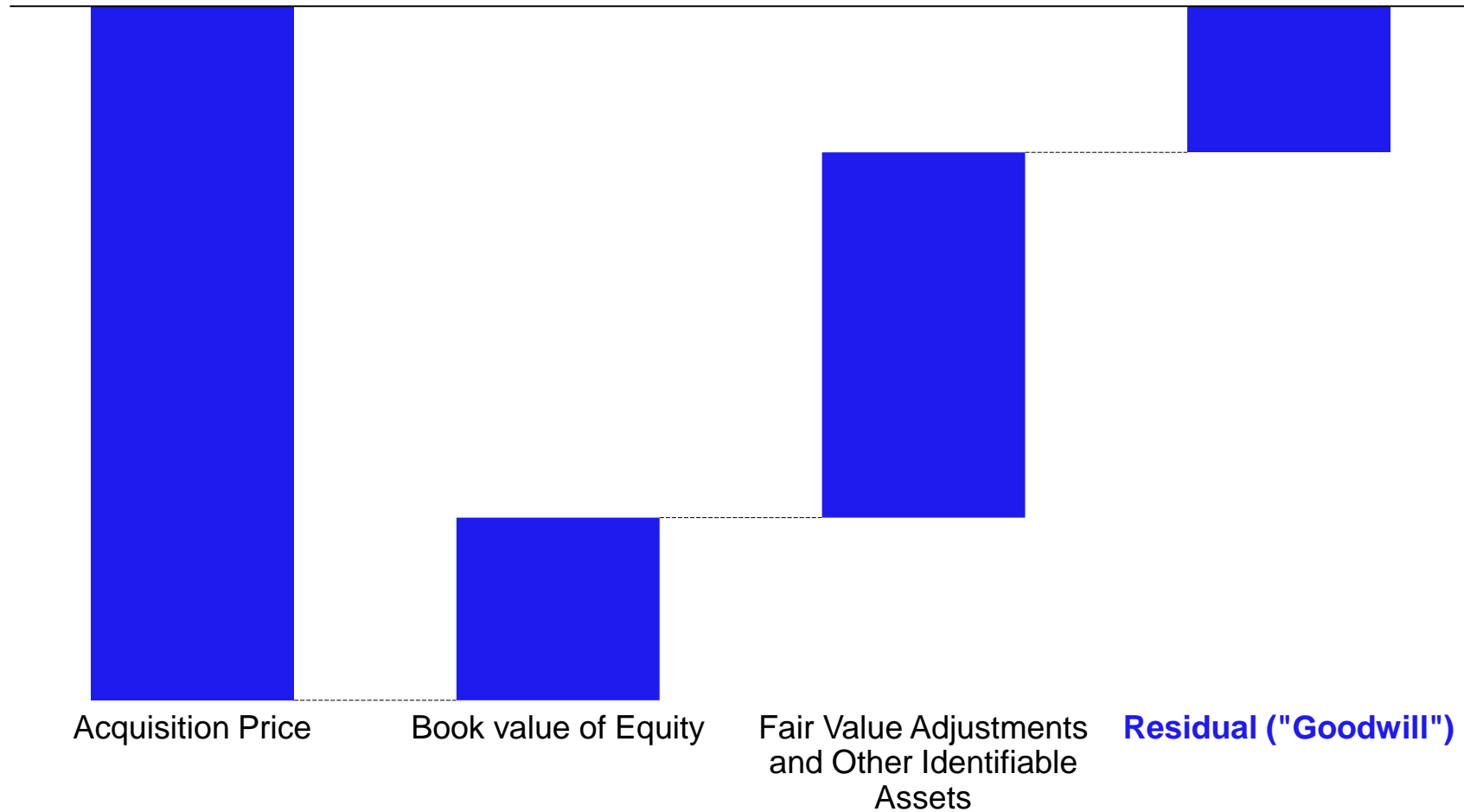
- At the time of **initial consolidation**, the deferred tax liability is accounting for through Other Comprehensive Income (OCI):
 - *Dr. Other Comprehensive Income (OCI)* *Cr. Deferred Tax Liability*
- In **subsequent periods**, the deferred tax liability is resolved via OCI or via profit/loss, depending on the accounting for the underlying asset. (More details will follow in Block 4!)

Course Structure

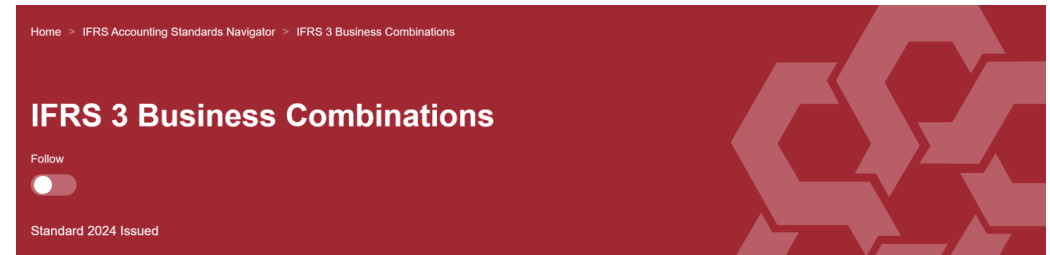
Block	Topic
2	Acquisition Method and Capital Consolidation
2.1	Step 1: Identify the Acquirer
2.2	Step 2: Determine the Acquisition Date
2.3	Step 3: Measure and Recognize Assets / Liabilities
2.4	Step 4: Measure and Recognize Goodwill

Step 4: Measure and recognize goodwill

Purchase Price Allocation



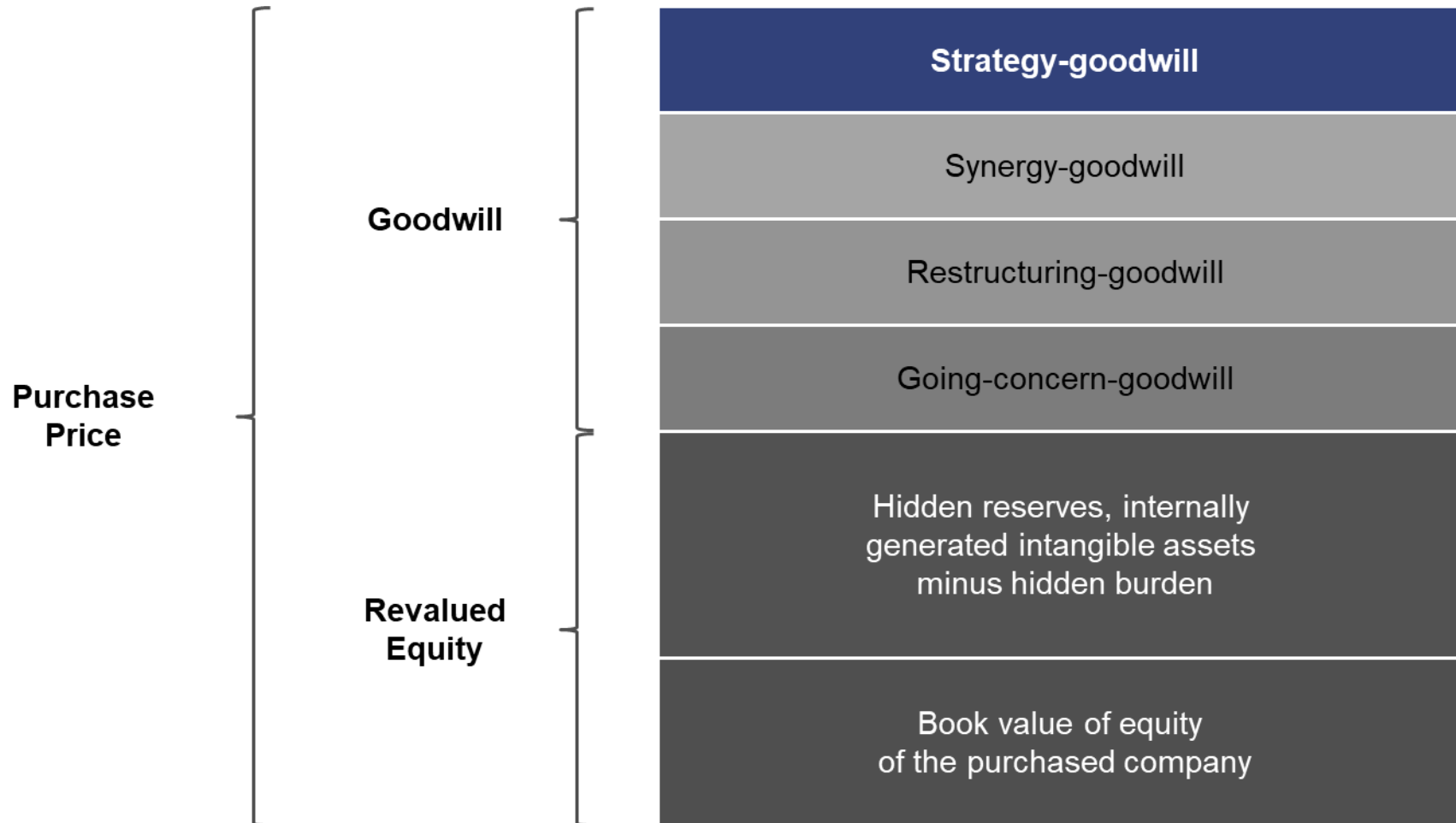
Goodwill



goodwill

An asset representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised.

Types of Goodwill



Case Study: Program NOW

Consolidated balance sheet

(At 31 December)

ASSETS (DKK million)	Notes	2018	2017 ¹
Goodwill		4,278	3,522
Brand		1,057	1,057
Distribution network		124	154
Distribution rights		1,047	1,153
Other intangible assets		1,272	1,113
Total intangible assets	3.1	7,778	6,999
Property, plant and equipment	3.2	2,634	2,324
Deferred tax assets	2.5	1,050	884
Other financial assets		323	289
Total non-current assets		11,785	10,496



Case Study: Program NOW

NOTE 3.3

Business combinations

The total purchase price for the acquisitions made during 2018 was DKK 1,108 million. Based on the purchase price allocations, goodwill was DKK 739 million. Goodwill from the acquisitions is mainly related to the synergies from converting the stores from wholesale to Pandora owned retail.

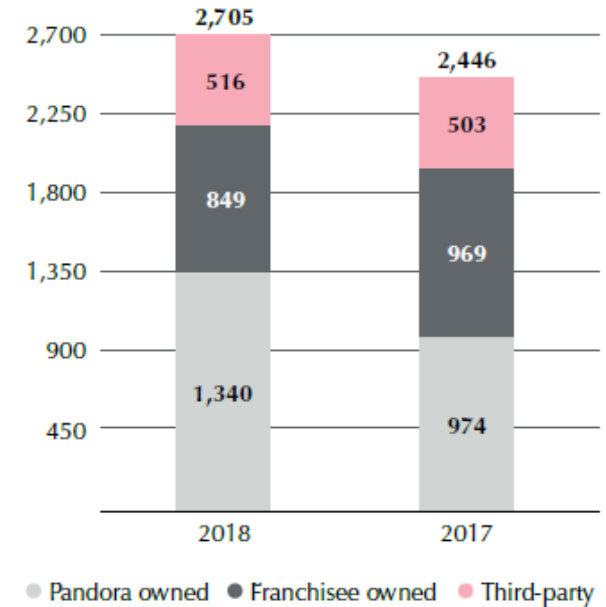
<u>ACQUISITIONS (DKK million)</u>	<u>Total 2018</u>	<u>Total 2017</u>
Distribution rights	-	131
Other intangible assets	26	17
Property, plant and equipment	109	152
Other non-current receivables	2	6
Trade receivables and other receivables	38	111
Inventories	302	470
Cash	4	10
Assets acquired	481	897
Non-current liabilities	23	17
Payables	31	94
Other current liabilities	58	35
Liabilities assumed	112	146
Total identifiable net assets acquired	369	751
Goodwill arising on the acquisitions	739	1,109
Purchase consideration	1,108	1,860

Case Study: Program NOW

REVENUE BY SALES CHANNEL (DKK million)	2018	2017
Pandora owned retail*	12,895	9,782
Wholesale	8,633	11,470
Third-party distribution	1,278	1,529
Total revenue	22,806	22,781

* Including revenue from Pandora eSTOREs

NUMBER OF CONCEPT STORES (No.)



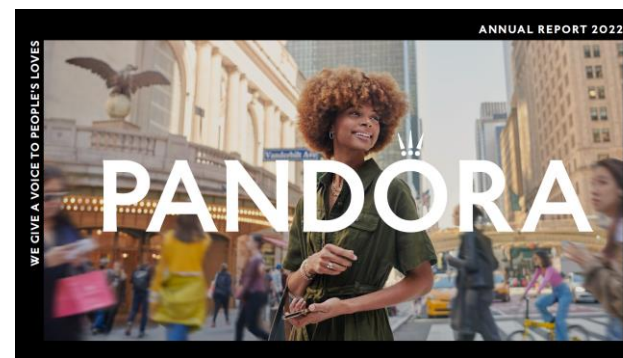
Couple of years later...

REVENUE BY CHANNEL DKK million	2022	2021
Pandora owned¹ retail	19,115	15,922
- of which concept stores	12,150	9,133
- of which online stores	5,612	5,977
- of which other points of sale	1,353	812
Wholesale	6,628	6,705
- of which concept stores	3,508	3,737
- of which other points of sale	3,120	2,968
Third-party distribution	721	767
Total revenue	26,463	23,394

Margins



CONSOLIDATED INCOME STATEMENT (DKK million)	Notes	2018	2017
Revenue	2.1, 2.2	22,806	22,781
Cost of sales	2.3, 3.1, 3.2	-5,864	-5,815
Gross profit		16,942	16,966
Sales, distribution and marketing expenses	2.3, 3.1, 3.2	-8,222	-7,045
Administrative expenses	2.3, 3.1, 3.2	-2,289	-2,137
Operating profit	2.2	6,431	7,784
Finance income	4.6	533	198
Finance costs	4.6	-382	-315
Profit before tax		6,582	7,667
Income tax expense	2.5	-1,537	-1,899
Net profit for the year		5,045	5,768



CONSOLIDATED INCOME STATEMENT DKK million	Notes	2022	2021
Revenue	2.1	26,463	23,394
Cost of sales	2.3, 3.1, 3.2	-6,273	-5,590
Gross profit		20,190	17,803
Sales, distribution and marketing expenses	2.3, 3.1, 3.2	-11,322	-9,939
Administrative expenses	2.3, 3.1, 3.2	-2,125	-2,026
Operating profit	2.1	6,743	5,839
Finance income	4.6	412	152
Finance costs	4.6	-622	-613
Profit before tax		6,533	5,378
Income tax expense	2.5	-1,504	-1,218
Net profit for the year		5,029	4,160

Another example... What happened?

UBS Group AG consolidated financial statements

Primary financial statements and share information

Audited I

Income statement

<i>USD m</i>	Note	For the year ended		
		31.12.23	31.12.22	31.12.21
Interest income from financial instruments measured at amortized cost and fair value through other comprehensive income	4	31,743	11,782	8,533
Interest expense from financial instruments measured at amortized cost	4	(28,216)	(6,564)	(3,259)
Net interest income from financial instruments measured at fair value through profit or loss and other	4	3,770	1,403	1,431
Net interest income	4	7,297	6,621	6,705
Other net income from financial instruments measured at fair value through profit or loss	4	11,583	7,517	5,850
Fee and commission income	5	23,766	20,789	24,372
Fee and commission expense	5	(2,195)	(1,823)	(1,985)
Net fee and commission income	5	21,570	18,966	22,387
Other income	6	384	1,459	452
Total revenues		40,834	34,563	35,393
Negative goodwill	2	27,748		
Credit loss expense / (release)	20	1,037	29	(148)

Another example... What happened?

The New York Times

<https://www.nytimes.com/2023/08/31/business/dealbook/ubs-billion-credit-suisse-deal.html>

DEALBOOK NEWSLETTER

UBS Gets a \$29 Billion Bump From M.&A. Accounting

The Swiss bank
gave it the bump

↓ XLSX

USD m

Purchase price consideration, after consideration of share-based compensation awards			3,710
Credit Suisse Group net identifiable assets on the acquisition date			
		As previously	
Fair value of net assets acquired	32,771	(1,177)	31,594
Settlement of pre-existing relationships	135		135
Provisional negative goodwill resulting from the acquisition	28,925	(1,177)	27,748

¹ Refer to Note 10 for information about credit quality of financial assets, including purchased credit-impaired positions.

Gain on bargain purchase

- In accounting for M&A, companies must compare the purchase price with the fair value of the (net) identifiable assets and liabilities.
- The difference is accounted for as
 - goodwill (if positive), or
 - As a gain on bargain purchase (if negative)

Positive difference	Negative difference
The common situation is when the purchase price exceeds the acquirer's interest in the net fair value of identifiable assets and liabilities	This arises where the fair value of assets and liabilities exceeds the purchase price. This suggests that a bidder has either acquired the target company cheaply or that it will incur future operating losses or restructuring charges.

UBS: Why?

Additional provisions and contingent liabilities

Included in *Provisions and contingent liabilities* is USD 5.4bn for additional litigation provisions and contingent liabilities, which includes USD 1.6bn for litigation provisions, in addition to the existing USD 1.3bn provision previously recorded by the Credit Suisse Group to reflect management's assessment of the associated probability, timing and amount considering new information, and USD 3.8bn contingent liabilities for certain obligations in respect of litigation, regulatory and similar matters identified in the purchase price allocation. The timing and actual amount of outflows associated with litigation matters are uncertain. UBS has continued to assess the development of these obligations and the amount and timing of potential outflows. The USD 3.8bn contingent liabilities reflects an increase of USD 0.8bn from the previously reported USD 3.0bn, with an additional USD 45m increase in litigation provisions recognized, following publication of the UBS Group fourth quarter report as detailed in the table on the following page.

↓ XLSX

<u>USD</u> m	31.12.23	31.12.22
<i>Provisions related to expected credit losses (IFRS 9, Financial Instruments) 1</i>	350	201
<i>Provisions related to Credit Suisse loan commitments (IFRS 3, Business Combinations) 2</i>	1,924	
<i>Provisions related to litigation, regulatory and similar matters (IAS 37, Provisions, Contingent Liabilities and Contingent Assets)</i>	4,020	2,586
<i>Acquisition-related contingent liabilities (IFRS 3, Business Combinations) 2</i>	3,832	
<i>Restructuring, real-estate and other provisions (IAS 37, Provisions, Contingent Liabilities and Contingent Assets)</i>	2,123	456
Total provisions and contingent liabilities	12,250	3,243
<i>of which: Credit Suisse 2</i>	9,681	

1 Refer to Note 10 for more information. 2 Refer to Note 2 for more information about the acquisition of the Credit Suisse Group.

UBS: Critical Audit Matters

Purchase price allocation over Credit Suisse acquisition

Description of the Matter As described in Note 2 to the consolidated financial statements, the Group acquired Credit Suisse Group AG (CS) on 12 June 2023. The transaction has been accounted for as a business combination under IFRS 3 and accordingly, the assets acquired, and liabilities assumed from CS were recorded at fair value as of the acquisition date, resulting in the recognition of negative goodwill of USD 27.7 billion. Purchase price allocation (PPA) adjustments were recognized on financial instruments and other asset and liability categories, including litigation provisions and contingent liabilities to derive the fair values. Additionally, the Group has begun to recognize the accretion of fair value adjustments applied to certain financial instruments that will be recognized over their expected lives in the income statement.

Auditing the Group's fair value estimate of certain assets and liabilities, particularly financial instruments and litigation provisions and contingent liabilities, was complex due to the significant judgment required by management in developing the estimates due to illiquid instruments with unobservable market inputs, uncertain expected future cash flows, complex underlying collateral, and the uncertain amount and probability that an outflow of resources will be required for certain litigation matters. Additionally, auditing the Group's calculation of accretion of certain fair value adjustments was complex due to judgments around the appropriate methodology applied (including whether certain assets/liabilities should be subject to accretion), operational challenges and changes in credit conditions or maturity of an underlying in terms of treating defaults or repayments, in part or in whole. These factors contributed to a high degree of auditor judgment and effort in performing procedures and evaluating audit evidence obtained.

UBS: Execution Risk

RATING ACTION COMMENTARY

Fitch Downgrades UBS and Upgrades Credit Suisse on Closing of Acquisition; Outlooks Stable

Mon 12 Jun, 2023 - 05:58 ET

The rating actions reflect the completion, announced on 12 June 2023, of Credit Suisse Group AG's acquisition by UBS Group AG.

We have also downgraded UBS Group AG's and UBS AG's Viability Ratings (VR) to 'a' from 'a+', as we expect the enlarged group's (UBS) business and risk profiles to be exposed to execution risk from the complex and lengthy integration of Credit Suisse into UBS. UBS will need to stabilise and restore Credit Suisse's franchise and ensure its business is aligned with UBS's more conservative risk appetite. UBS's management will also have to swiftly regain the confidence of Credit Suisse's key stakeholders, in particular wealth management clients and depositors, to prevent a further deterioration in Credit Suisse's franchise and contagion to the rest of the UBS group.



UBS

Annual Report 2023 – UBS Group

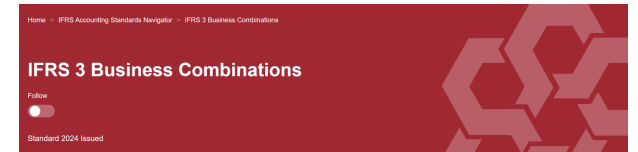
Pro forma financial information

From the date of acquisition until 31 December 2023, the Credit Suisse Group contributed USD 7.6bn of net revenues and an overall net loss of USD 3.5bn to the net profit of the UBS Group. For illustration purposes, the pro forma net revenues and net loss for the UBS Group for the year ended 31 December 2023 if the business combination had taken place on 1 January 2023 are estimated as USD 46.1bn and USD 2.1bn, respectively.

Measuring Goodwill

Recognising and measuring goodwill or a gain from a bargain purchase

- 32 The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:
- (a) the aggregate of:
 - (i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see **paragraph 37**);
 - (ii) the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and
 - (iii) in a business combination achieved in stages (see **paragraphs 41 and 42**), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
 - (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.



Measuring Goodwill: Example without Non-Controlling Interests

- Buyer acquires 100% equity stake in Target for 20 CU.
- Balance sheets (unconsolidated) after acquisition:

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	20	Equity	20

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

Measuring Goodwill: Example without Non-Controlling Interests

	Carrying amount at the date of acquisition	Adjustment to fair value	Fair value at the date of acquisition
Intangible assets (brand)	-	6	6
Other assets	20	2	22
Cash	10	0	10
Debt	(20)	-	(20)
= Revalued equity	10	8	18
Purchase Price	20		
- revalued equity	18		
= Goodwill	2		

Measuring Goodwill: Example without Non-Controlling Interests

- Buyer acquires 100% equity stake in Target for 20 CU.
- Balance sheets (unconsolidated) after acquisition:

Buyer (Unconsolidated)

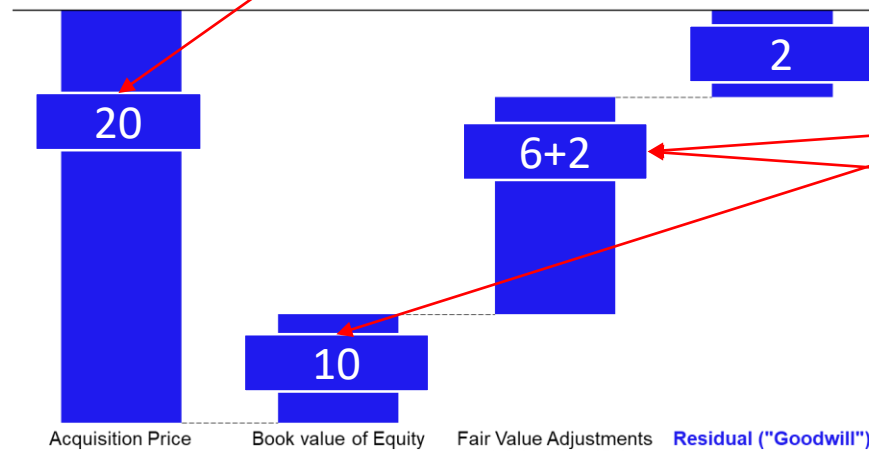
Assets		Equity & Liabilities	
Investment in Target	20	Equity	20

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.



- Revalued equity is $10 + 6 + 2 = 18$
- Goodwill is $20 - 18 = 2$

Measuring Goodwill: Example without Non-Controlling Interests

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	20	Equity	20
Total	20	Total	20

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

Buyer (Consolidated)

Assets		Equity & Liabilities	
Total		Total	

Measuring Goodwill: Example without Non-Controlling Interests

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	20	Equity	20
Total	20	Total	20

Buyer (Consolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	20
Brand	6	Debt	20
Other assets	22		
Goodwill	2		
Total	40	Total	40

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

Measuring Goodwill: Example without Non-Controlling Interests, plus Deferred Taxes

- Buyer acquires 100% equity stake in Target for 20 CU.
- The tax rate is 30% (from earlier example). (Version 2: 50%)
- Balance sheets (unconsolidated) after acquisition:

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	20	Equity	20

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

Measuring Goodwill: Example without Non-Controlling Interests, plus Deferred Taxes

	Carrying amount at the date of acquisition	Adjustment to fair value	Fair value at the date of acquisition
Intangible assets (brand)	-	6	6
Other assets	20	2	22
Cash	10	0	10
Deferred tax liability:			
Debt	(20)	-	(20)
= Revalued equity			

Goodwill:

Measuring Goodwill: Example without Non-Controlling Interests, plus Deferred Taxes

	Carrying amount at the date of acquisition	Adjustment to fair value	Fair value at the date of acquisition
Intangible assets (brand)	-	6	6
Other assets	20	2	22
Cash	10	0	10
Deferred tax liability: 30% * (6+2)	-	(2.4)	(2.4)
Debt	(20)	-	(20)
= Revalued equity	10	5.6	15.6

Goodwill:

Purchase price	20 CU
- Revalued equity	15.6 CU
= Goodwill	4.4 CU

Measuring Goodwill: Example without Non-Controlling Interests, plus Deferred Taxes

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	20	Equity	20
Total	20	Total	20

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

Buyer (Consolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	20
Brand	6	Debt	20
Other assets	22	Deferred Tax Liability	
Goodwill			
Total		Total	

Measuring Goodwill: Example without Non-Controlling Interests, plus Deferred Taxes

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	20	Equity	20
Total	20	Total	20

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

Buyer (Consolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	20
Brand	6	Debt	20
Other assets	22	Deferred	2.4
Goodwill	4.4	Tax Liability	
Total	42.4	Total	42.4

Measuring Goodwill: Example without Non-Controlling Interests, plus Deferred Taxes – Version 2

What would happen if the tax rate was 50%?

	Carrying amount at the date of acquisition	Adjustment to fair value	Fair value at the date of acquisition
Intangible assets (brand)	-	6	6
Other assets	20	2	22
Cash	10	0	10
Deferred tax liability:			
Debt	(20)	-	(20)
= Revalued equity			

Measuring Goodwill: Example without Non-Controlling Interests, plus Deferred Taxes – Version 2

What would happen if the tax rate was 50%?

	Carrying amount at the date of acquisition	Adjustment to fair value	Fair value at the date of acquisition
Intangible assets (brand)	-	6	6
Other assets	20	2	22
Cash	10	0	10
Deferred tax liability: 50% * (6+2)	-	(4)	(4)
Debt	(20)	-	(20)
= Revalued equity	10	4	14

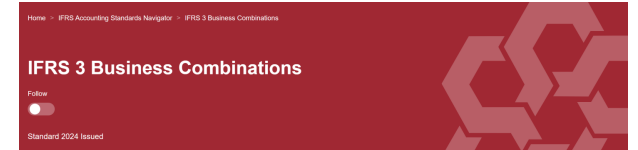
Goodwill:

Purchase price	20 CU
- Revalued equity	14 CU
= Goodwill	6 CU

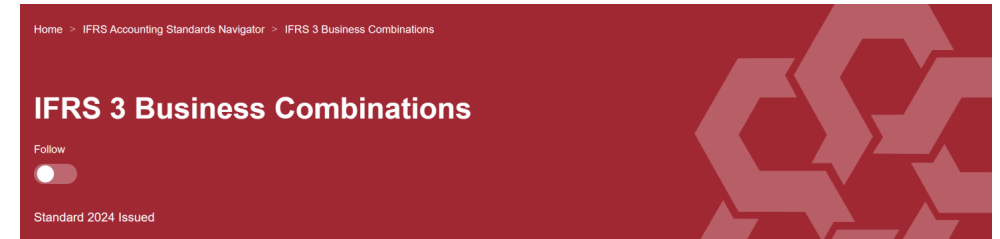
Non-Controlling Interests Affect Goodwill

Recognising and measuring goodwill or a gain from a bargain purchase

- 32 The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:
- (a) the aggregate of:
 - (i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see **paragraph 37**);
 - (ii) the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and
 - (iii) in a business combination achieved in stages (see **paragraphs 41 and 42**), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
 - (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.



Measuring Non-Controlling Interests



Measurement principle

- 18 The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.
- 19 For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:
- (a) fair value; or
 - (b) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.
- All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

Measuring Goodwill: Example with Non-Controlling Interests

- Buyer acquires **75%** equity stake in Target for **15 CU**.
- Balance sheets (unconsolidated) after acquisition:

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	15	Equity	20
Cash	5		

Target (Unconsolidated)

Assets		Equity & Liabilities	
Cash	10	Equity	10
Other assets	20	Debt	20

Notes:

- Target has a brand (not recognized); fair value: 6 CU.
- The other assets contain hidden reserves of 2 CU.

Measuring Goodwill: Example without Non-Controlling Interests

Buyer (Unconsolidated)

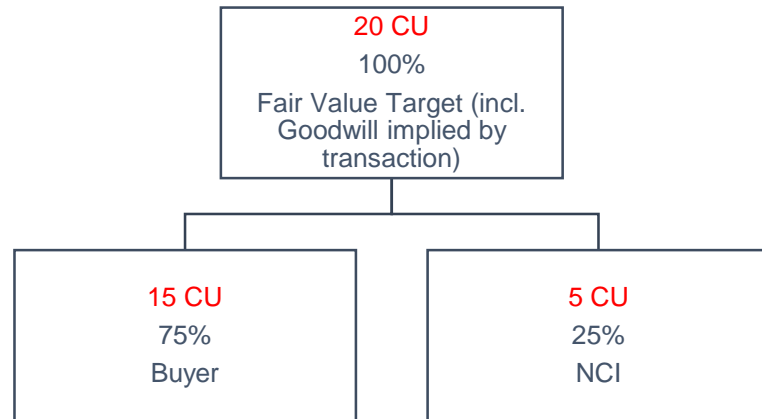
Assets		Equity & Liabilities	
Investment in Target	15	Equity	20
Cash	5		

Buyer (Consolidated)

Assets		Equity & Liabilities	
Cash	10+5	Equity (Parent)	20
Brand	6	Equity (NCI)	?
Other assets	22	Debt	20
Goodwill	?		
Total	?	Total	?

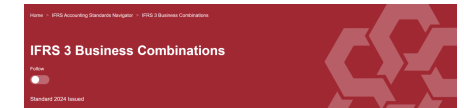
Measuring NCI at Fair Value (Full Goodwill Method)

- Buyer acquires **75%** equity stake in Target for **15 CU**.



- Goodwill:

Purchase price	15
+ Equity attributable to NCI	5
- Revalued equity target (100%)	-18
= Goodwill	2



Measurement principle

18 The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

19 For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:

- fair value; or
- the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

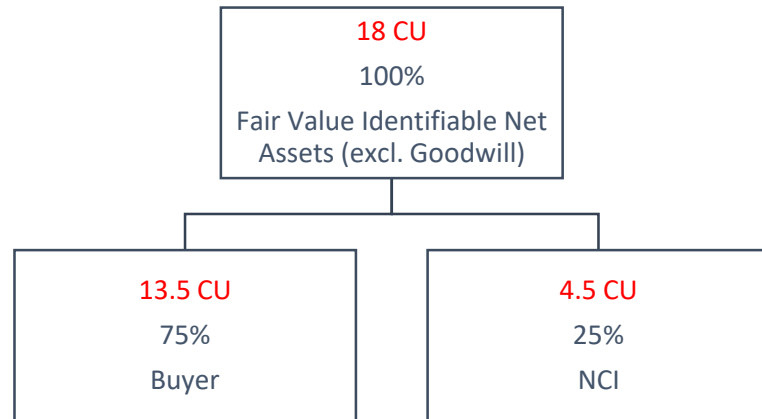
Recognising and measuring goodwill or a gain from a bargain purchase

32 The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:

- the aggregate of:
 - the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);
 - the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and
 - in a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
- the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

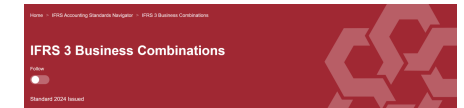
Measuring NCI at Proportionate Share in Net Assets (Partial Goodwill Method)

- Buyer acquires **75%** equity stake in Target for **15 CU**.



Goodwill:

Purchase price	15
+ Equity attributable to NCI	4.5
- Revalued equity target (100%)	-18
= Goodwill	1.5



Measurement principle

- 18 The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.
- 19 For each business combination, the acquirer shall measure at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation at either:
- fair value; or
 - the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.
- All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

Recognising and measuring goodwill or a gain from a bargain purchase

- 32 The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:
- the aggregate of:
 - the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);
 - the amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and
 - in a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
 - the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

Measuring Goodwill: Comparing Full and Partial Goodwill Method

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	15	Equity	20
Cash	5		

Buyer (Consolidated) Full Goodwill Method

Assets		Equity & Liabilities	
Cash	15	Equity (Parent)	20
Brand	6	Equity (NCI)	5.0
Other assets	22	Debt	20
Goodwill	2.0		
Total	45	Total	45

Buyer (Consolidated) Partial Goodwill Method

Assets		Equity & Liabilities	
Cash	15	Equity (Parent)	20
Brand	6	Equity (NCI)	4.5
Other assets	22	Debt	20
Goodwill	1.5		
Total	44.5	Total	44.5

Block 2: Key take-aways



- The acquisition method uncovers the fair value of the identifiable assets of an acquiree, including assets that have not previously been recognized on the acquiree's unconsolidated statements.
 - Mix of fair value (acquiree) and historical cost (acquirer) on consolidated balance sheet
 - Consolidated balance sheet reflects company's growth strategy (organic versus external growth)
- Fair value of acquiree's assets/liabilities are based on the price determined by knowledgeable market participants (might differ from acquirer's actual intended use).
- Fair value adjustments lead to differences to tax accounts and, hence, deferred taxes.
- Goodwill is the residual that is left over after the purchase price has been allocated to revalued equity (considering deferred taxes).
- Under the full goodwill method, the company recognizes goodwill at its full fair value (including the share attributable to non-controlling interests).

Further Readings

- For further readings see also:

Picker et al. (2016): *Applying IFRS Standards*. Fourth Edition.

- The nature of a business combination: starting p. 380 (especially on the steps of a business combination)
- Calculation of deferred tax: starting p. 133 (p. 143)
- Consolidation: Controlled entities: starting p. 561
- Consolidation: non-controlling interest: starting p. 635