Advanced Group Accounting (RIKA)

Block 2

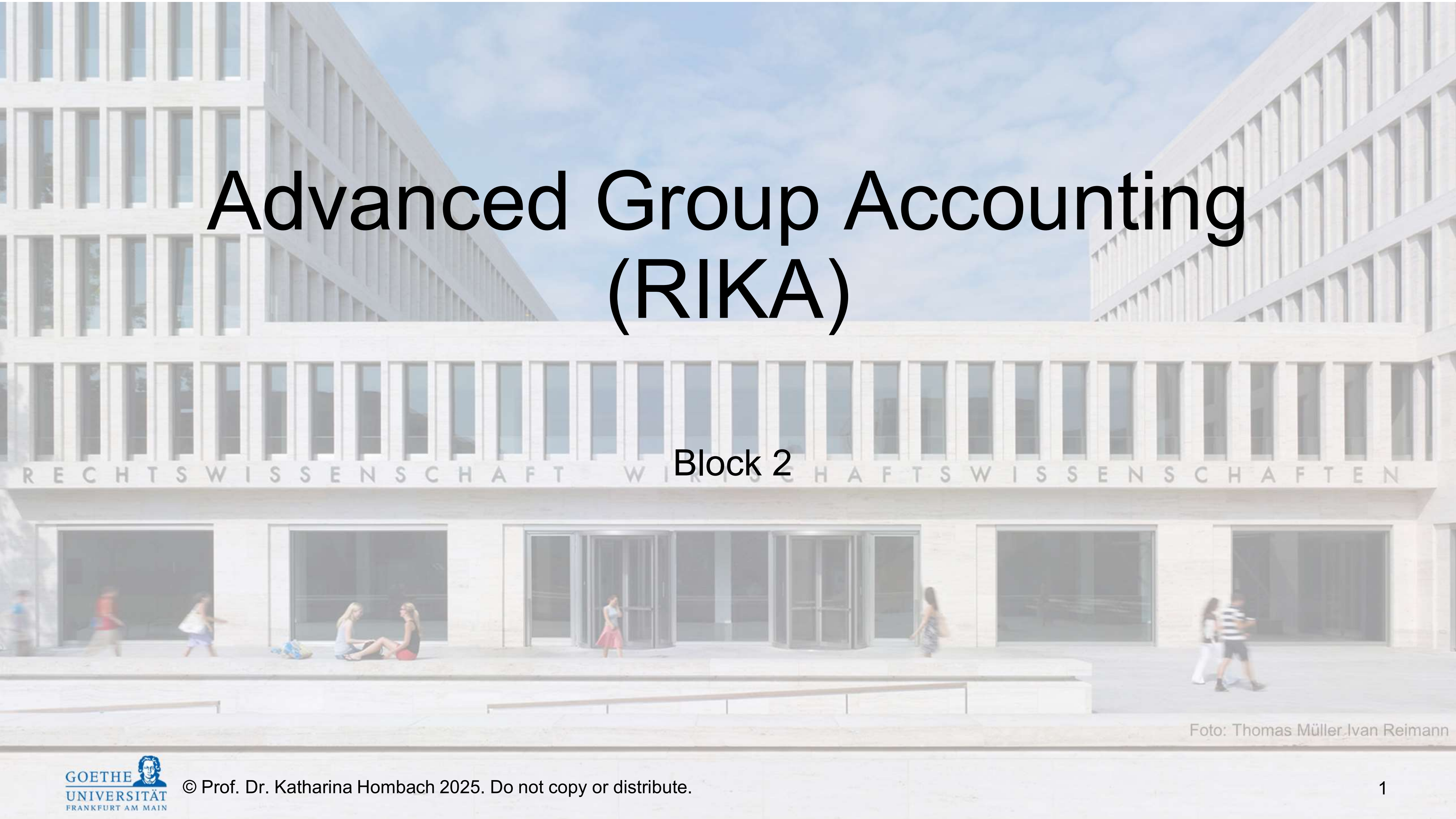


Foto: Thomas Müller Ivan Reimann

Course Structure

Block	Topic
	Preparation: recap double-entry bookkeeping (online, self-study)
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

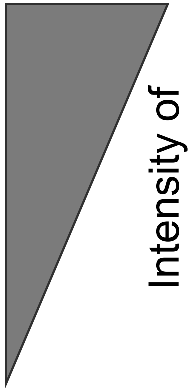
Course Structure

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

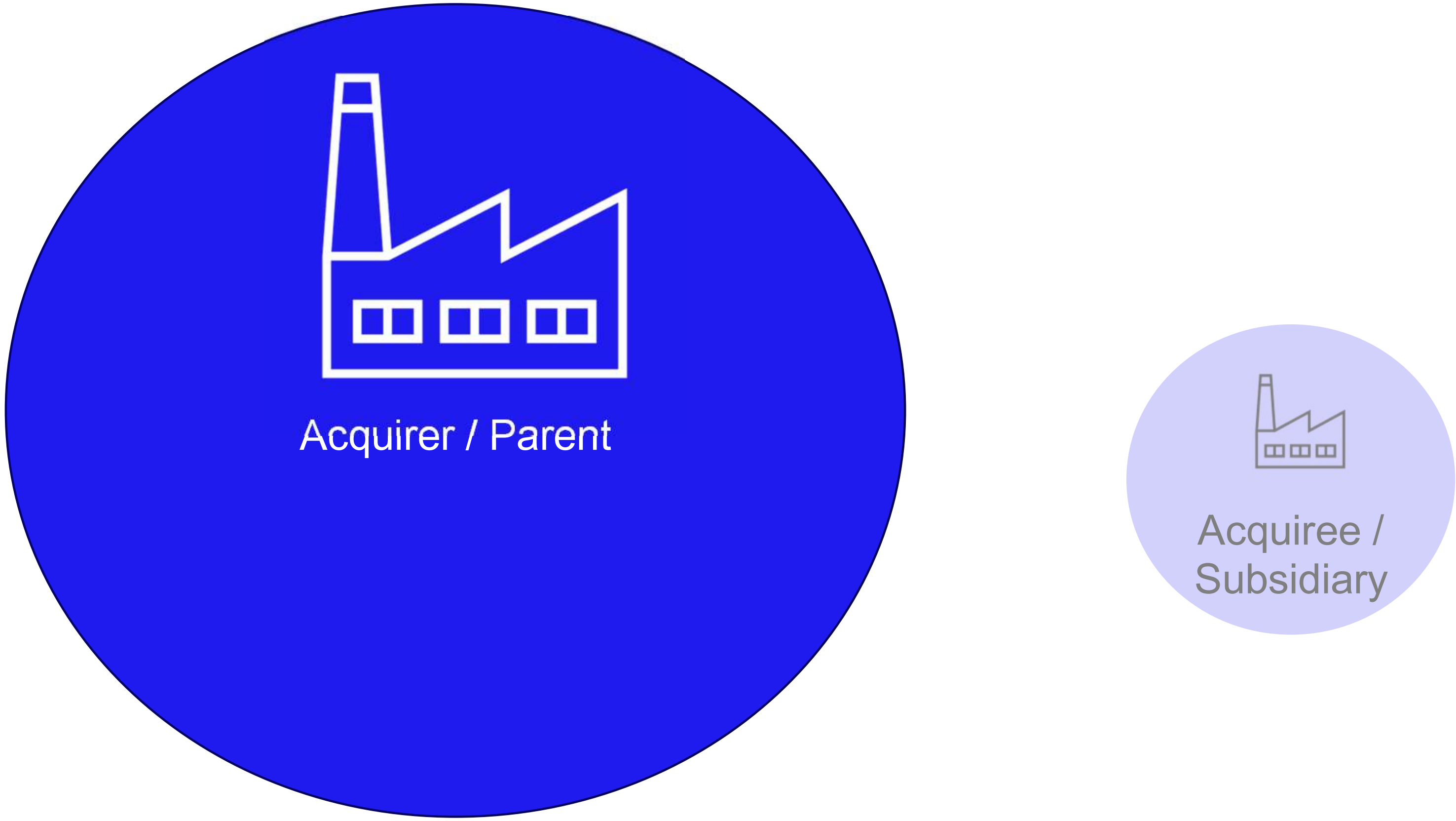
- What is the acquisition method?
- How does application of the acquisition method matter for consolidation?

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

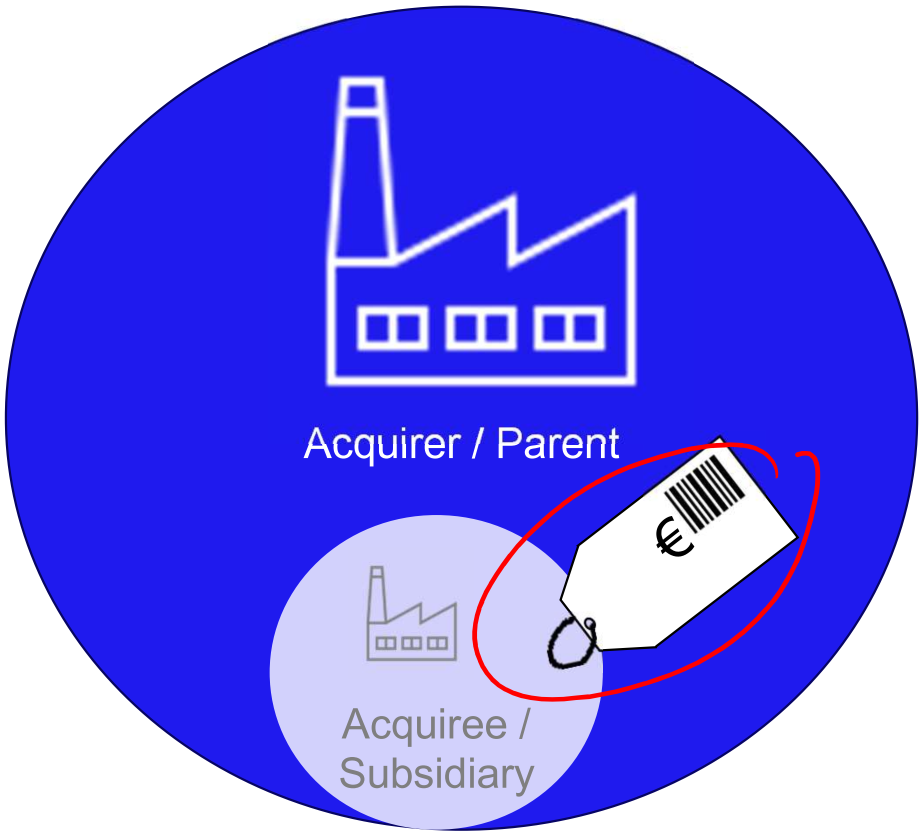
Type of investee	Relation	Accounting implication
Subsidiary	**Control**	**Full consolidation / acquisition method**
Joint arrangement	Joint control	Equity method (mostly) Partial consolidation (special cases)
Associated entity	Significant influence	Equity method



Acquisition method: basic idea



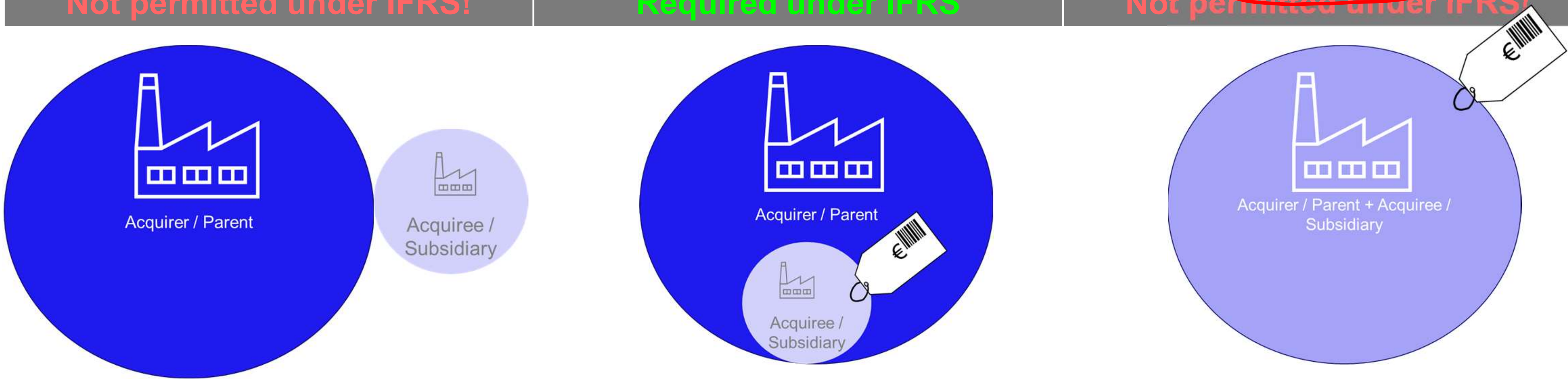
Acquisition method: basic idea



- 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?

Pooling	Acquisition	Fresh Start
Not permitted under IFRS!	Required under IFRS	Not permitted under IFRS!



Pooling

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

Acquisition

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

Fresh Start

- 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

Home > IFRS Accounting Standards Navigator > IFRS 3 Business Combinations

IFRS 3 Business Combinations

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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

1. Identifying the **acquirer**
2. Determining the **acquisition date**
3. **Recognizing and measuring** the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
4. Recognizing and measuring **goodwill** or a gain from a bargain purchase

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- Who is the acquirer in a business transaction?

Step 1: Identifying the Acquirer

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IFRS 3 Business Combinations

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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

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- 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

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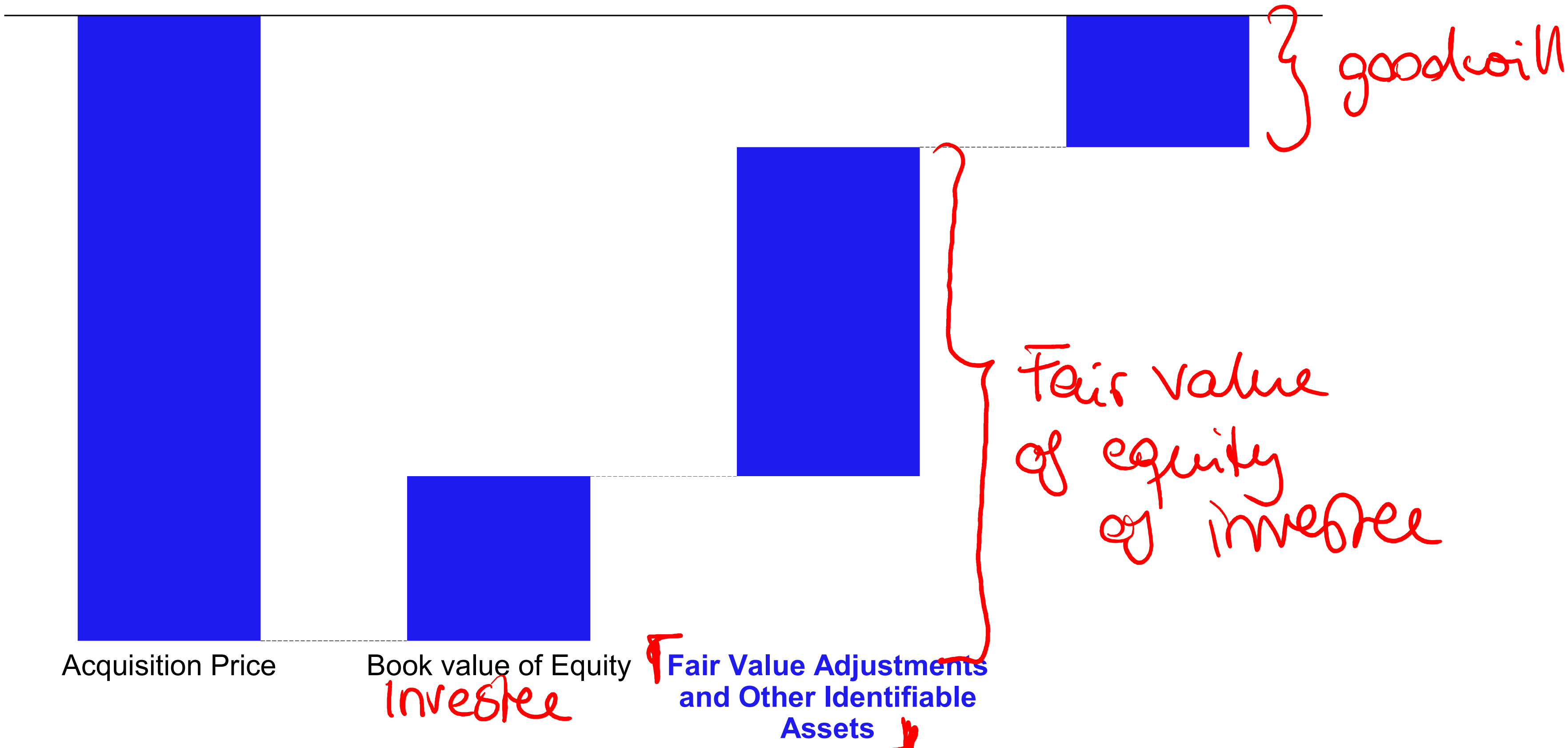
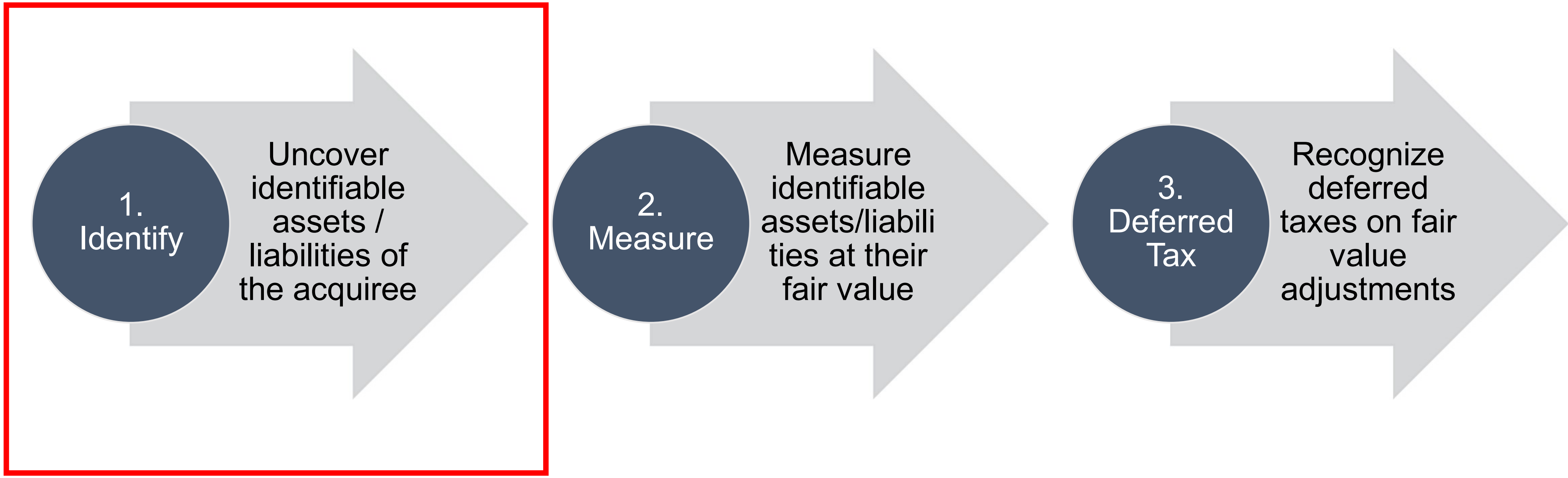
- How are assets/liabilities of the acquiree revaluated at the acquisition date?

Step 3: Measure and Recognize identifiable Assets/Liabilities



What do we need to do?



Recognizing identifiable Assets/Liabilities

Home > IFRS Accounting Standards Navigator > IFRS 3 Business Combinations

IFRS 3 Business Combinations

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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.

Yes

b) As in a), but the machine is a highly specialized equipment that can only be used in Target's operations.

Yes

c) Buyer expects that Target's employees will negotiate significant pay raises after completion of the transaction.

No (because no liability)

d) Target owns a license to operate a technology patent. The license cannot be transferred or sold.

Yes (contractual right)

- self-generated brand value
  customer lists; in-process R&D

Two Pharmaceutical Companies

organic growth

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 f

	Group
Sales [2, 3]	56,846
Royalties and other operating income [2, 3]	2,651
Revenue [2, 3]	**59,497**

external growth

NOVARTIS

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:

	Goodwill	Intangible assets other than goodwill						
(USD millions)	Total	In-process research and development	Alcon brand name	Technologies	Currently marketed products	Marketing know-how	Other intangible assets	Total
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.

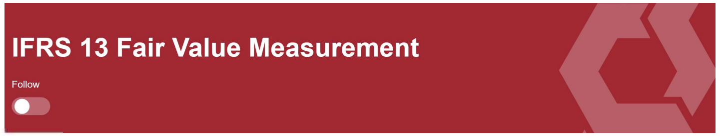
Growth Strategies and Accounting Implications

Organic growth (internal R&D)	External growth (M&A)
▪ Not all intangibles can be capitalized on the balance sheet (e.g., prohibited according to IAS 38: self-generated brand, customer lists)	▪ Acquiree's intangibles "uncovered" via M&A transaction / purchase price allocation
▪ Innovation/marketing efforts charged through P&L (R&D expenses, marketing expenses)	▪ Purchase price allocated to identifiable intangible assets (capitalization on consolidated financial statements)
▪ Subsequent periods: no amortization expense (no asset)	▪ Subsequent periods: amortization expense and/or impairment testing

What do we need to do?

1. Identify — Uncover identifiable assets / liabilities of the acquiree
2. Measure — Measure identifiable assets/liabilities at their fair value
3. Deferred Tax — Recognize deferred taxes on fair value adjustments

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

Level 1	• Quoted prices in active markets for identical assets/liabilities
Level 2	• Other, directly or indirectly observable prices for identical assets/liabilities
Level 3	• Unobservable factors (e.g., proprietary data) which might need to be adjusted

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?

1. Identify — Uncover identifiable assets / liabilities of the acquiree
2. Measure — Measure identifiable assets/liabilities at their fair value
3. Deferred Tax — Recognize deferred taxes on fair value adjustments

3. Deferred Tax

Recognize deferred taxes on fair value adjustments

Considering Deferred Taxes

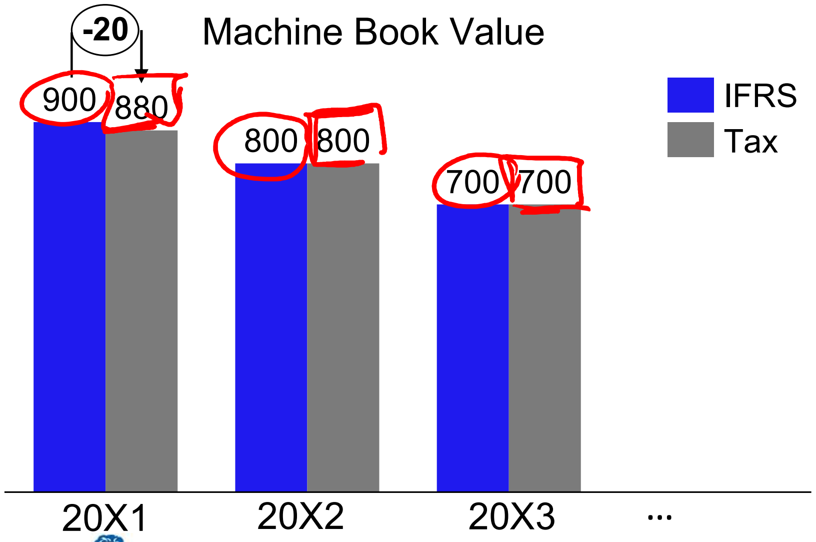
- General:
  - Deferred taxes account for differences between a reporting entity's IFRS financial statements and its tax accounting.

- 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

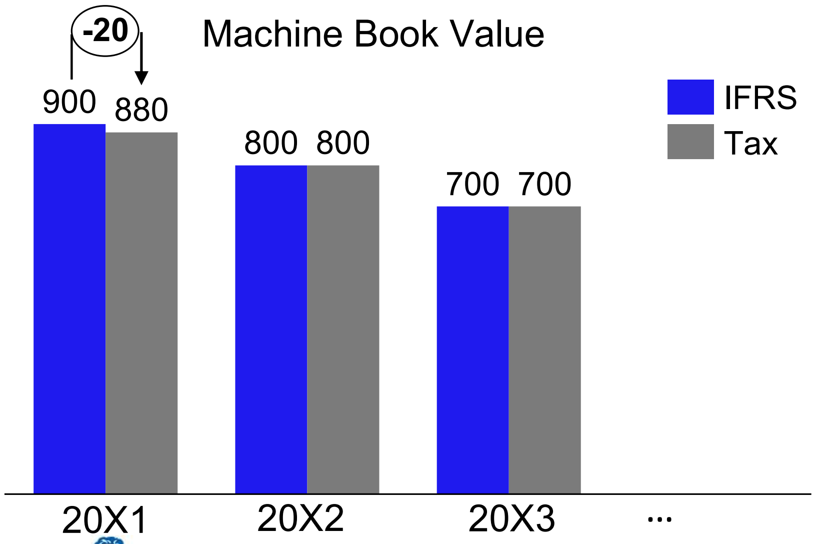
- Company X purchases a machine for EUR 1,000 at the beginning of 20X1.
- Assume that Company X pays a flat tax rate of 30% on its taxable income.
- Under IFRS, Company X depreciates its assets on a straightline basis. Under its tax rules, Company X is allowed to pull parts of its depreciation forward.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



	20X1	20X2
Revenue (IFRS = Tax)	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%

Solution

Deferred Taxes: why do we need them?



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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

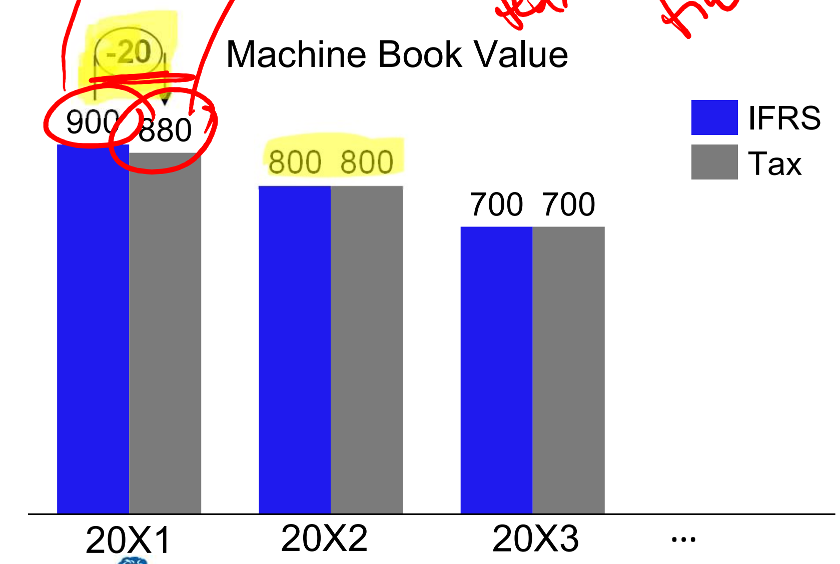
Break ends 4:05 pm

Solution

Deferred Taxes: why do we need them?

future IFRS depreciation: 900

future depreciation that is tax deductible: 880



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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)	30% $\boxed{20}$	0
Deferred tax expense/income (IFRS) = def. tax!	6 (expense)	6 (income)
Effective tax rate	(24 + 6) / 100 = 30%	(36 – 6) / 100 = 30%

Solution

Deferred Taxes: why do we need them?

- Journal entries and calculations:

Solution

Deferred Taxes: why do we need them?

Journal entries and calculations:

<u>20X1</u>:

- 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

<u>20X2</u>:

- 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

Differences between IFRS carrying amounts and tax bases of assets and liabilities

timing differences	other temporary differences	permanent differences
E.g.: Depreciation over different useful lives	E.g.: Financial assets carried at cost (tax) versus at fair value (IFRS)	E.g.: Certain donations are expense under IFRS, but are not tax deductible
→ **deferred taxes**		→ ***no*** **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: 11,800 €
  - Depreciation (tax): linear, 50 years of useful life
  - Tax rate: 30%

$10000 - (10000/50)$

$\Delta = \text{IFRS} - \text{Tax} = 11{,}800 - 9{,}800 = 2000$

DTL: $2000 \times 30\% = 600$

Dr. Deferred tax expense Cr. Deferred tax liab. 600

Solution

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: 11,800 €
  - 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):

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

Fair Value Adjustments and Deferred Taxes

- 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	10
		Debt	10

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.

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

Solution

Fair Value Adjustments and Deferred Taxes

unconsolidated

temporary difference between tax + IFRS

	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	–	10
Deferred tax liability	–	(2.4)	(2.4)
Debt	(20)	–	(20)
= Revalued equity			15.6

8

+30%

38

22.4

① Fair value of assets / liabilities

② statutory tax rate

Solution

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

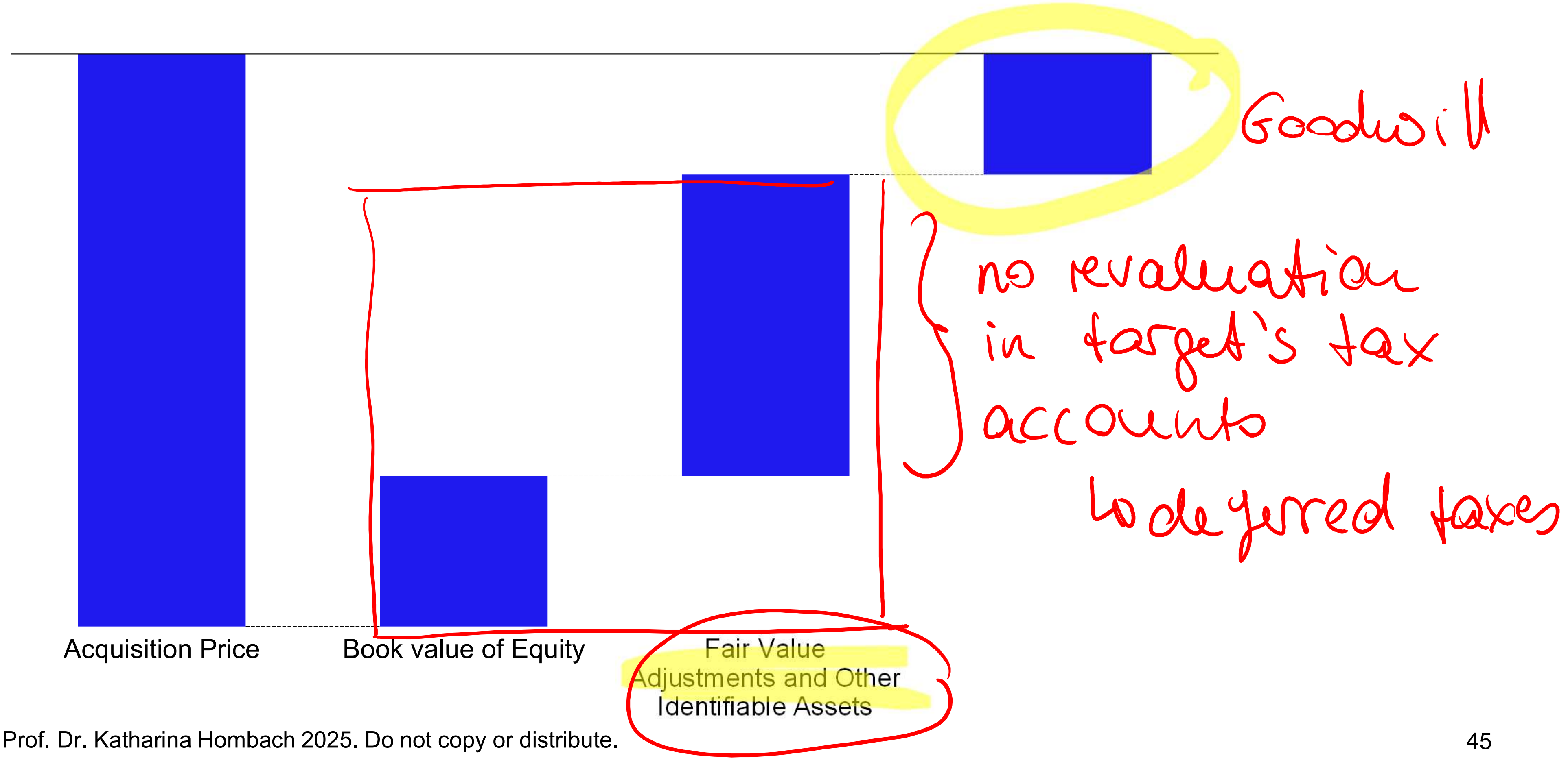
- At the time of initial consolidation, the deferred tax liability is accounted for through Other Comprehensive Income (OCI):
  - *Dr. Other Comprehensive Income (OCI)* *Cr. Deferred Tax Liability*

- 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!)

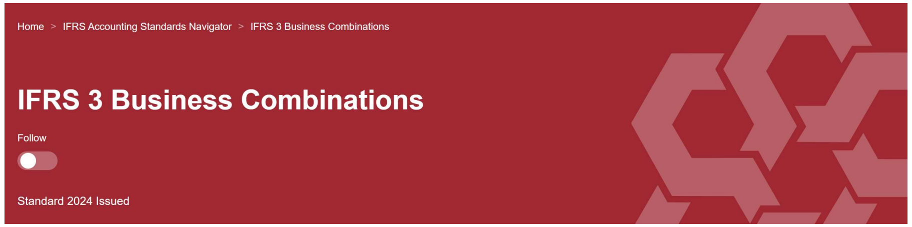
Course Structure

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

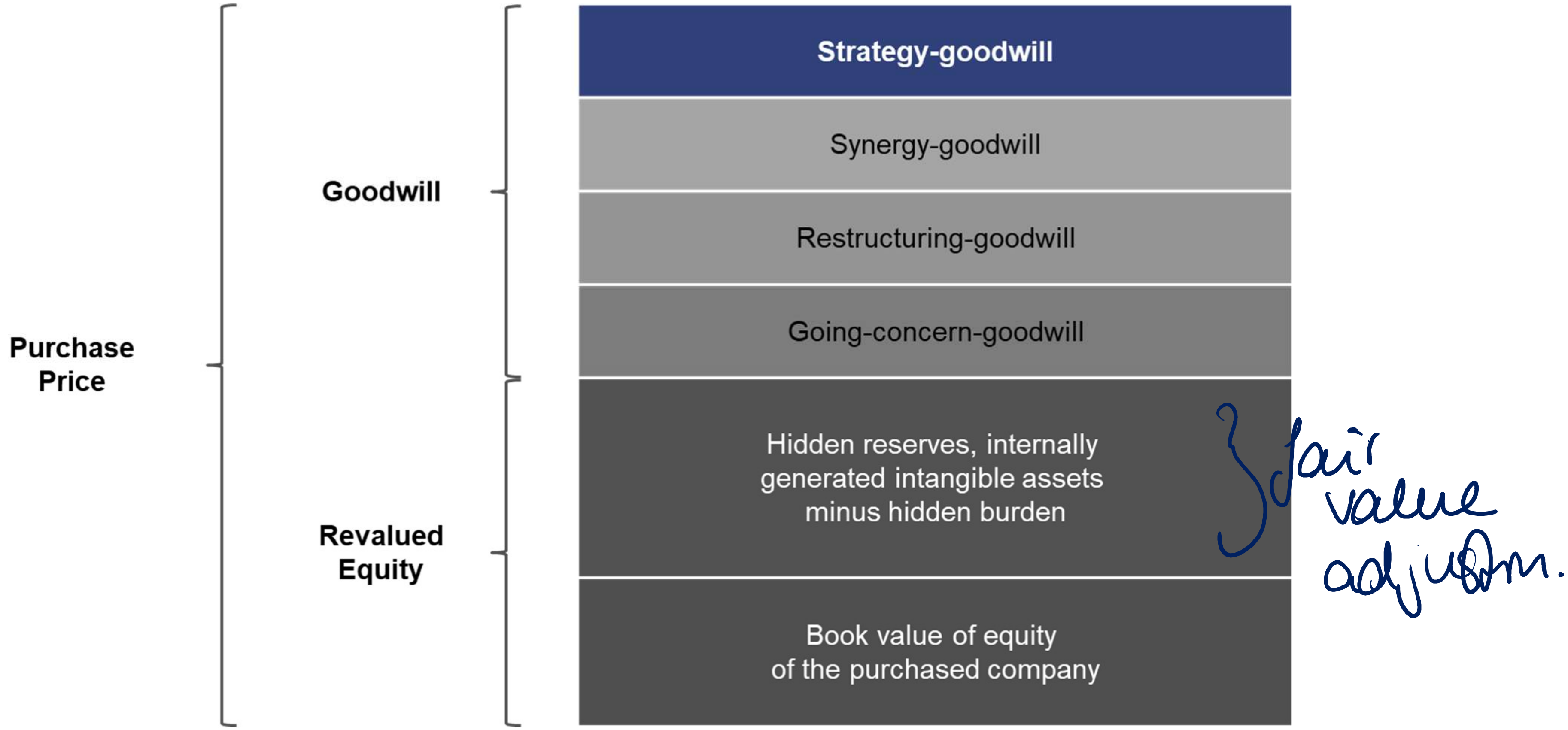


Goodwill



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.

ACQUISITIONS (DKK million)	**Total 2018**	**Total 2017**
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**

economic benefits from stronger brand value

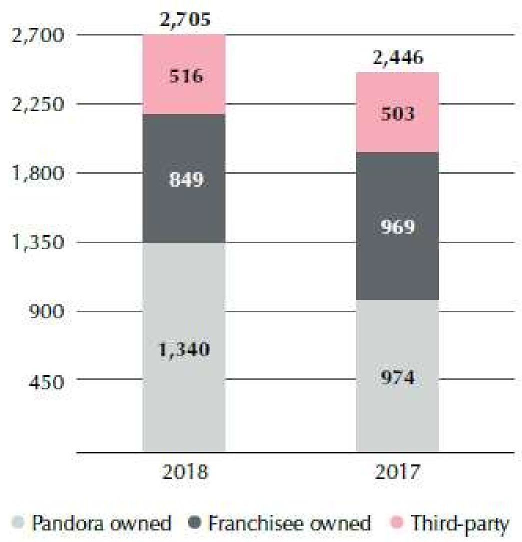
Case Study: Program NOW

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

crowding out

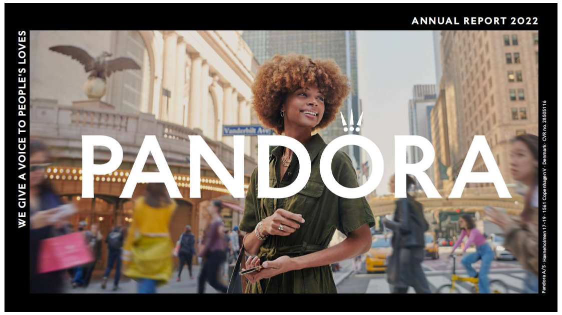
NUMBER OF CONCEPT STORES (No.)



Couple of years later…

REVENUE BY CHANNEL DKK million	2022	2021
Pandora owned[1] 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**

purchase price < $\boxed{\text{revalued equity}}$

Another example… What happened?

UBS Group AG consolidated financial statements

Primary financial statements and share information

Audited |

Income statement

		For the year ended		
USD m	Note	**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's sharply discounted takeover of Credit Suisse led to a paper gain that gave it the biggest quarterly profit by a bank in history.

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

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

reduced revalued equity

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

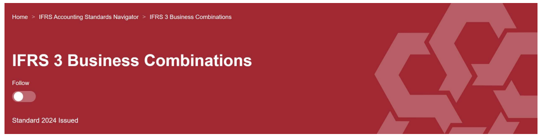
Recognising and measuring goodwill or a gain from a bargain purchase

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	10
		Debt	10

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.

Solution

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**		

Solution

Measuring Goodwill: Example without Non-Controlling Interests

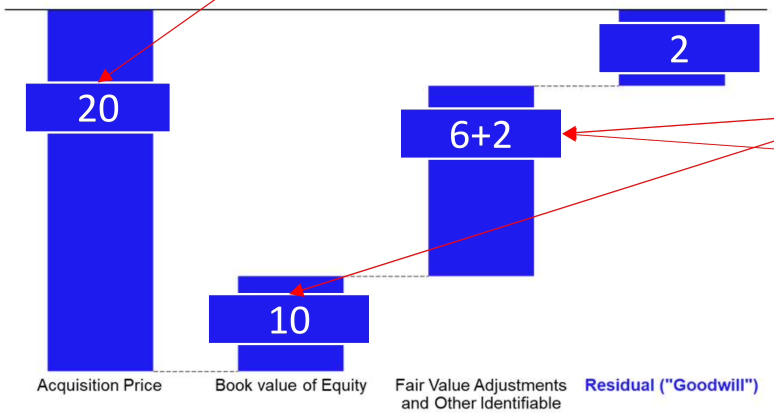
- Buyer acquires 100% equity stake in Target for 20 CU.
- Balance sheets (unconsolidated) *after acquisition:*

Buyer (Unconsolidated)

Assets		Equity &Liabilities	
Investment in Target	20	Equity	10
		Debt	10

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

Solution

Measuring Goodwill: Example without Non-Controlling Interests

Buyer (Unconsolidated)

Assets		Equity &Liabilities	
Investment in Target	~~20~~	Equity	10
		Debt	10
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	10
Other assets	22	Debt	30
Brand	6		
Goodwill	2		
Total	40	Total	40

Solution

Measuring Goodwill: Example without Non-Controlling Interests

Buyer (Unconsolidated)

Assets		Equity &Liabilities	
Investment in Target	20	Equity	10
		Debt	10
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	10
Brand	6	Debt	30
Other assets	22		
Goodwill	2		
Total	40	Total	40

(*) DTL = Fair value adj. x tax rate = (6+2) x 30%

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:*

Purchase price:	20
./. revalued equity:	15.6
Goodwill	4.4

Buyer (Unconsolidated)

Assets		Equity & Liabilities	
Investment in Target	20	Equity	10
		Debt	10

Target (revalued)

Cash	10	Equity	15.6
others	22	Debt	20 (*)
d	6	DTL	2.4

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.

Solution

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:

Solution

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

Solution

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

Buyer (Unconsolidated)

Assets		Equity &Liabilities	
Investment in Target	20	Equity	10
		Debt	10
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	10
Brand	6	Debt	30
Other assets	22	Deferred Tax Liability	2.4
Goodwill	4.4		
Total		Total	

GOETHE UNIVERSITÄT FRANKFURT AM MAIN

Solution

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

Buyer (Unconsolidated)

Assets		Equity &Liabilities	
Investment in Target	20	Equity Debt	10 10
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	10
Brand	6	Debt	30
Other assets	22	Deferred Tax Liability	2.4
Goodwill	4.4		
Total	42.4	Total	42.4

Solution

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			

Solution

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

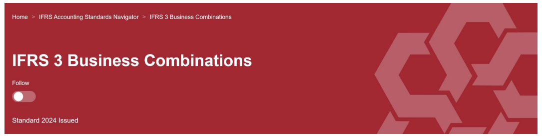
What would happen if the tax rate was 50%?

	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:

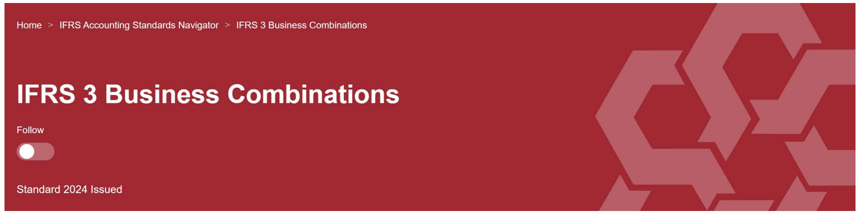
(i) the consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);

(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	10
		Debt	10
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	10
Cash	5	Debt	10

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+5	Equity (Parent)	10
Brand	6	Equity (NCI)	?
Other assets	22	Debt	30
Goodwill	?		
Total	?	Total	?

Target (Fair Value)

Cash	10	EQ	18
other	22	Debt	20
Brand	6		
Σ	38		

Solution

Measuring NCI at Fair Value (Full Goodwill Method)

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

20 CU
100%
Fair Value Target (incl. Goodwill implied by transaction)

→ 100% of revalued net assets
+ 100% of goodwill

15 CU
75%
Buyer

5 CU
25%
NCI

IFRS 3 Business Combinations

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.

- Goodwill:

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

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

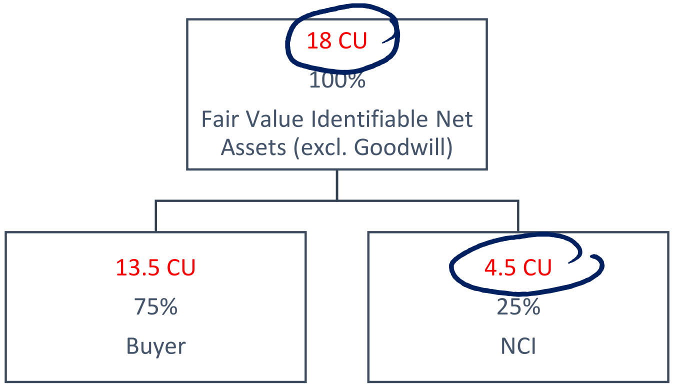
(iii) in a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.

Solution

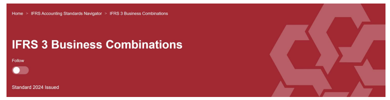
Measuring NCI at Proportionate Share in Net Assets (Partial Goodwill Method)

- 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:

(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.

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.

Solution

Measuring Goodwill: Comparing Full and Partial Goodwill Method

Buyer (Unconsolidated)

Assets		Equity &Liabilities	
Investment in Target	15	Equity	10
		Debt	10
Cash	5		

Buyer (Consolidated)
Full Goodwill Method

Assets		Equity &Liabilities	
Cash	15	Equity (Parent)	10
Brand	6	Equity (NCI)	5.0
Other assets	22	Debt	30
Goodwill	2.0		
Total	45	Total	45

Buyer (Consolidated)
Partial Goodwill Method

Assets		Equity &Liabilities	
Cash	15	Equity (Parent)	10
Brand	6	Equity (NCI)	4.5
Other assets	22	Debt	30
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