

# Formation of Inter-Entity Relationships

## Overview of Types of Inter-Entity Relationships

### *Reporting Entities*

- SAC 1, Definition of the Reporting Entity, para. 6:
  - Entity means any legal, administrative or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives
- Reporting entities could be:
  - Individual entities
  - Groups of related entities
  - (Also not impact of Corporations Act)
- One economic entity exists (no matter how many individual entities) if there is control
  - Overarching principle is that the economic reality of control is that there is really only one entity for financial reporting purposes

### *Summary of Inter-Entity Accounting*

| <b>Nature of Relationship between Investor &amp; Investee</b> | <b>Name given to Investee entity</b> | <b>Name given to Investor entity</b> | <b>Accounting method for recording investee relationship</b>  | <b>Basic accounting method</b>   |
|---|--------------------------------------|--------------------------------------|---|--|
| No special relationship                                       | Investment                           | Investor                             | AASB 139, AASB 9  | At cost or amortised cost or fair value  |
| Significant influence   | Associate                            | Investor                             | Equity method – AASB 128                                      | Proportional share of associate's profits  |
| Control   | Subsidiary                           | Parent                               | Consolidation – AASB 10                                       | Combination of all entities' financial statements                                    |
| Joint Control   | Joint Arrangement                    | Venturer                             | Proportionate consolidation or equity method – AASB 11 or 128 | Proportional share of JA's assets, liabilities, revenues & expenses or equity method |

### *No Special Influence of Control – Investment*

- Accounting treatment for these kinds of relationships are governed by several standards – AASB 139 or 9, 127, 132

- Ordinary shares are a type of financial instrument
- Definitions: (AASB 132 para. 11)
  - Financial instrument – any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity
  - Equity instrument – any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities
  - Financial asset – includes an equity instrument of another entity
- So an ordinary share is an equity instrument for the entity that issues it and a financial asset for the entity that holds (buys) it (i.e. the two sides of the same contract)

#### Equity Instruments as Investments:

- Two alternative standards:
  - AASB 139 – currently operative but to be replaced by AASB 9
  - AASB 9 – operative from 1 January 2015 but can early adopt (use this one)
- Relevant extracts:
  - Recognise financial asset when entity becomes a party to the contract (para 3.1.1)
  - Initial measurement at cost (FV of acquisition) + direct acquisition costs (para 5.1.1.)
  - After acquisition, financial assets classified as either ‘measured at amortised cost’ or ‘measured at FV’ depending upon the entity’s business model for financial instruments and the contractual cash flow characteristics of the financial asset (para 4.1.1)
  - Financial asset is classified as measured at amortised cost if business model is to hold the asset to collect the contractual cash flows and the contractual cash flows arise at specified dates and are payments solely for principal and interest (para 4.1.2) (e.g. a debenture)
  - If the financial asset is not classified as ‘measured at amortised cost, the measure at FV (para 4.1.4)
  - As equity instruments do not satisfy the requirements of para 4.1.2(b), they must be classified as measured at FV
  - Para 5.7.1 – subsequent movements in FV of equity instruments (financial assets recognised in current period’s profit and loss unless the entity makes an irrevocable choice to take the movements through OCI provided the equity instruments are not held for trading (para 5.7.5 and Appendix A)

#### Example 1

Alto Ltd purchased 5% of the ordinary shares of Tenor Ltd on 3rd June, 2014 for \$125,000. Brokerage costs of \$2,500 were paid on 4th June. At 30th June, 2014 the fair value of the investment was \$131,200. The investment is not held for the purpose of trading and Alto has not elected to take fair value changes through OCI.

*Provide the relevant journal entries in the books of Alto Ltd*

3 June 2014

|                        |         |         |
|------------------------|---------|---------|
| DR Shares in Tenor Ltd | 125,000 |         |
| CR Bank                |         | 125,000 |

4 June 2014

|                       |       |       |
|-----------------------|-------|-------|
| DR Brokerage Expenses | 2,500 |       |
| CR Bank               |       | 2,500 |

30 June 2014

|                                |       |       |
|--------------------------------|-------|-------|
| DR Shares in Tenor Ltd         | 6,200 |       |
| CR Gain on Investments (P & L) |       | 6,200 |
| (131,200 – 125,000)            |       |       |
| (para 5.7.1)                   |       |       |

## *Importance of Correctly Identifying & Accounting for the Reporting/Economic Entity*

- It is useful in decision making – if entities operate as one, the it should reflect that in the financial statements
- Shows impact of control – e.g. assets ultimately available to parent; collective responsibility (e.g. liabilities/guarantees)
- Controls naughty behaviour
  - Inflation of sales – economic entity cannot make a profit by selling to itself
  - Hiding non-performing members of the group
  - Off-balance sheet financing
  - Transfers of risk (derecognition)
  - Special purpose entities (SPEs); securitisation (sub-prime mortgage instruments)

### **Example 2**

Overstatement of Profits:

- A controls B by owning all of B's voting shares
- A makes B buy inventory from A with a cost to A of \$100 (and a market value of \$130). A makes B pay \$3,000 for this inventory

Extracts from financial statements:

|              | <b>A Ltd</b> | <b>B Ltd</b> |
|--------------|--------------|--------------|
| Sales        | 3,000        | -            |
| Less COGS    | (100)        | -            |
| Gross Profit | 2,900        | -            |
| Inventory    | ↓ 100        | 3,000        |

## *Special Purpose Entities (SPEs)*

- SPEs are entities created by another entity to achieve a specific objective. For example:
  - Take debt off-balance sheet (e.g., debt defeasance arrangements; James Hardie obligations for asbestosis claims)
  - Effect a securitisation of financial assets (e.g., sub-prime mortgages)
  - Shift risk from one party to another (e.g., sub-prime mortgages)
- Typically take the form of a trust or company
- Can make good business sense, but also open to abuse
- Debt Defeasance – Hooker Corporation able to:
  - Take the debt off-balance sheet and borrow more money
  - Recognise a profit on the transfer to the SPE because the carrying amount of assets transferred was less than the carrying amount of debt transferred
  - Ultimately, despite this (and other arrangements) Hooker went bankrupt
  - This is not possible under AASB 9 (para B3.3.3)
  - Accounting issues:
    - Amount of assets transferred
    - Quality of assets transferred
    - Who controlled the SPE
- Securitisation
  - SPEs very popular means of implementing securitisation arrangements

- Securitisation is the process by which specific financial instruments with similar characteristics are bundled together into ‘securities’ that can then be sold to investors
- Securitisation improves liquidity; turns non-tradeable instruments into tradeable ones; allows entities to shift risk (e.g. credit risk)
- Accounting issues:
  - Is the transfer of assets/liabilities to the SPE a true transfer?
    - Has the entity (e.g., the originator) transferred its rights to receive cash flows?
    - If the entity has assumed an obligation to pay the cash flows from the assets to the SPE, do these payments meet the “pass-through” criteria? (para. 3.2.5, AASB 9)
    - Have substantially all the risks and rewards been transferred? (para. 3.2.6, AASB 9)
  - Should the SPE be consolidated with the entity that created it (i.e., who controls the SPE)?
    - Consolidated (collective) financial statements prepared for all entities that are part of the group – basic test is whether one entity “controls” the other
    - If SPE has to be consolidated with originator entity, then nothing will be achieved – i.e., transfer will not be off-balance sheet as far as the ‘group’ is concerned
- Imperative that entity which created the SPE does not control it or the transfer of assets/liabilities and risks/rewards will be ineffective
- Methods for distancing the creating entity from the SPE include:
  - No ownership interest (or interest below 50% in the US)
  - SPE runs on auto pilot
  - Independent management/trustee of SPE

#### SPE Control – AASB 112 (Replaced by AASB 10 from 1/1/13) para 8-10:

- A SPE must be consolidated when the substance of the relationship between an entity and the SPE indicates that the entity controls the SPE
- Use normal identifiers of control (e.g. ownership, composition of SPE management/board)
- Autopilot arrangements indicate control where those arrangements are in substance for the benefit of the entity

## Due Diligence & Takeover Law

### *Business Combinations*

- Mergers – two companies combine to form a new company
  - E.g. Adelaide bank and Bendigo bank = Bendigo & Adelaide Bank
- Acquisition & Takeover – one entity gains ‘control’ over another
  - E.g. Facebook and WhatsApp

### *Why Merge or Acquire?*

- Protective value – protect market competition
- Synergistic value – value chain, economies of scale
- Growth value – access new markets

- Underperformance value – remove poor management
- Risk management – diversification

Most M&A activity is motivated by the desire to achieve sound commercial goals (ATO).

## *Due Diligence*

### *Transaction Life Cycle:*

- Opportunity
- Transaction strategy and bid development – objectives, value, risks, SWOT and options
- Transaction analysis and due diligence – earnings, net assets, cash flow, forecasts, quality of data
- Final negotiation and execution
- Stakeholder sign-off

### *Role of due diligence*

- To identify risks to enable the purchaser to make an informed decision
- Risks may impact:
  - Go or no go decision
  - Transaction value
  - Warranties
- User's of DD include purchaser's board, management, cornerstone investors and financiers
- **Purchaser DD** – number of DD teams looking at same data
- **Vendor DD** – target appoints DD team to produce one set of results from data
- About 50:50

### *Degree of info available:*

- Publicly available info
- Data rooms – making data available to specific people
- Access to financial and other records

### *Forms of DD:*

- Financial and tax
- Legal
- HR/people
- Engineering
- Environmental

### *Transaction value*

- There are many ways to guide the ultimate value of a transaction, including:
  - Multiples of earnings e.g.
    - Adjusted EBITDA 100m
    - Transaction multiple 6x
    - Enterprise value 600m
    - Less net debt (200m)
    - Equity value 400m
  - Discounted cash flows
  - Share market prices, plus a premium
- Ultimately value is a very judgemental manner and may not reflect any of the above valuation principles – DD helps guide this judgement

### *Technical aspects*

- Most often looks at both historical and forecasts with respects to earnings, BS and CF

- Historical DD considers:
  - Conformity with GAAP
  - Conformity with purchaser's accounting policies
  - Abnormal income, expenditure and capex
  - Trends in consumption of working capital
  - Related party transactions
  - Tax
  - Contingencies, commitments and liabilities
- Forecasts
  - Revenue and price assumptions
  - Expenditure assumptions – opex and capex
  - Working capital assumptions – how WC changes with a change of earnings
  - Consistency with historical performance
  - What are the synergistic/carve out assumptions
  - What assumptions are there around transaction costs, redundancies, integration plans

**Working capital** is a financial metric which represents operating liquidity available to a business, organization or other entity, including governmental entity. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. Gross working capital equals to current assets. Net working capital (NWC) is calculated as current assets minus current liabilities.<sup>[1]</sup> It is a derivation of working capital, that is commonly used in valuation techniques such as DCFs (Discounted cash flows). If current assets are less than current liabilities, an entity has a **working capital deficiency**, also called a **working capital deficit**.

#### *Commercial aspects: negotiation and execution*

- Confirmation of DD findings
- Confirmation of offer
- Negotiation of key terms
  - Pricing
  - Representations and warranties
  - Settlement
  - Conditions precedent
- Finalisation of sale and purchase agreement
- Financial close and execution

Purchase price (PP) accounting – PP must be allocated between:

- Identifiable assets and liabilities
  - Cash, a/c rec, land PPE, hedges at FV, taxes
- Identifiable intangibles
  - Patents, licenses, databases, customer contracts, mining interests
- Goodwill – the last option
  - Does the good will actually exist or have you paid too much therefore impairment on first day
- All of this is directed by AASB 3R

#### *Australian Takeover Regulation*

Legal considerations:

- Corporations Act 2001
  - Procedures and ensuring fairness
- ACCC
  - Competition & Consumer Act 2010

- Protecting competition in markets
- ASIC
  - Regulatory guidance and administering Corporations Act
- FIRB
  - Foreign Acquisitions & Take Overs Act 1975
  - Protecting national interests
- ATO
  - Concerned with corporate and investor taxation issues
  - The courts/Australian takeover panel

### *Corporations Act 2001 – Chapter 6*

- A takeover gives rise to control – 20% or greater shareholding is deemed control
- s 602
  - Efficient, competitive and informed market for takeover
  - Target's shareholders and directors know the identity of the bidder, have reasonable time to consider bid; and have enough info to make decision
  - All shareholders have reasonable and equal opportunity to participate
  - Shares acquired compulsorily are treated fairly
- S 606
  - Prohibits an entity acquiring a relevant interest in a company's voting shares if it results in someone's voting power in that co increasing:
  - From 20% or below to more than 20%
  - From a starting point that is above 20% and below 90%
  - An entity has a relevant interest if:
  - They are on a company's register of members as the holder of those shares
  - They have power or control over the voting rights attached to those shares; or
  - They have the power (or control the power) to sell those shares
  - Exemptions include:
  - General prohibition does not apply to a formal takeover bid
    - Types of bid:
    - Off market bid
    - Market bid
  - 3% creep in 6 months (condition: existing ownership >19%)

**Voting Power** includes that of associates:

- Companies controlled by bidder
- Companies that control the bidder
- Entities with whom the bidder has formal/informal agreements re control of the target

Bidder statement:

- Identity of bidder
- Details about the bidder's current relevant interest
- Details about consideration to be paid
- Details about the bidder's intentions for the target entity post-takeover
- Other disclosures

Target's statement:

- All info relevant to the decision to accept or reject the offer
- A statement from each director making a recommendation as to the offer and providing reasons for that recommendation

### Australian Competition & Consumer Commission (ACCC)

- Ensure M&A do not have anti-competitive effects

- S 50 prohibits mergers that would have the effect, or likely to have the effect, of substantially lessening competition in a market
- ACCC has power to pre-authorise a M or A
- Accept or reject – or may apply to court for injunction
- Considerations:
- Comp theories of harm and the effects of constraint
  - Actual and potential level of import comp
  - Barriers to entry
  - Levels of market concentration
  - Countervailing power in the market
  - Likelihood acquirer could significantly increase profits – would they increase price with monopolistic power
  - Substitutes in the market
- Notification
  - Voluntary notification threshold:
    - The products of the merger parties are either substitutes or complements; and
    - The merged firm will have a post-merger market share of greater than 20% in the relevant markets

#### *Australian Securities & Investment Commission (ASIC)*

- Administers Chapter 6 of Corporations Act
- Provides regulatory guidance on interpretation s 606 and 611
- Actively reviews and monitors acquisitions
- Can modify exceptions set out in s 611:s655A on a case by case basis

#### *Australian Taxation Office (ATO)*

- M & A transactions raise complex tax issues
- Pre transaction guidance on taxation issues required – for example:
  - CGT for seller and shareholder of seller
  - Possible scrip for scrip rollover relief
  - Future shareholder distribution may be considered return of capital rather than dividend

#### *Foreign Investments Review Board (FIRB)*

- Concerned with non resident acquirers
- Can block if contrary to national interest
- Monetary threshold \$231m total assets or business value
- Mandatory notification under s 25, 26, 26A of FATA for:
  - All foreign government investment (no min)
  - All urban land corp/trusts (no min)
- Different rules/threshold for the USA

## Formation of Inter-Entity Relationships

### *AASB 3 – Business Combinations*

#### Application:

- This standard does not apply to the acquisition of an asset of a group of assets that are not a business
- Nor does it apply to joint ventures or common control scenarios

#### Definition of a ‘**Business Combination**’ (para. 3 & Appendix A)



- ‘A transaction or other event in which an acquirer obtains control of one or more businesses’
- A business is not just a group of assets – it is an ‘integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return...’

What is a ‘**Business**’? (para. B7-B12)

- Three elements:
  - **Input** – any economic resources that create, or has the ability to create outputs when processes are applied to it.
    - Non-current assets
    - IP
    - Ability to obtain access to necessary materials or rights
    - Employees
  - **Process** – a system, standard, protocol, convention or rule
    - Strategic management processes
    - Operational processes
    - Resource management processes
    - Accounting and other administrative systems are typically not processes that lead to outputs
  - **Output** – results of inputs and processes applied to those inputs that provide or have the ability to provide results in form of:
    - Dividends
    - Lower costs
    - Other economic benefits to investors or other owners and participants
- Exception: where an integrated set of activities and assets is in its development stage
  - Have planned principal activities begun?
  - Are there employees, IP and other inputs and processes?
  - Is a plan to produce outputs being pursued by these inputs and processes?
  - Will they be able to obtain access to customers that will purchase the outputs?
- The presence of goodwill could be an indicator of a business (but is not essential)

#### Summary of difference in accounting for BCs vs Asset Acquisition

| <b>Impact on:</b>   | <b>Business Combination</b>                    | <b>Asset Acquisition</b>                |
|---|--|---|
| <i>Goodwill</i>   | Goodwill or gain on bargain purchase may arise | No goodwill recognised                  |
| <i>Initial measurement of assets acquired and liabilities assumed</i> | Fair value                                     | Allocated cost (on a relative FV basis) |
| <i>Directly attributable transaction costs</i>                        | Expensed                                       | Capitalised                             |
| <i>Deferred tax on initial recognition</i>                            | Recognised (in some cases)                     | Not recognised                          |
| <i>Disclosures</i>  | More extensive                                 | Less disclosures required               |
| <i>Consideration in the form of shares</i>                            | AASB 2 Share Based Payment does not apply      | AASB 2 Share Based Payment does apply   |

#### *Forms of Business Combination*

1. Buying a collection of individual assets/liabilities that operate together as a business (**Assets less liabilities**)
  - a. Entity A separately records fair value of each asset/liability acquired from Entity B in its own records
2. Buying enough equity (e.g. voting shares) to gain control over the net assets of another entity (**Equity**)

- a. Entity A records one asset (investment in subsidiary) but then separately prepares consolidated financial reports made up of the financial statements of A and B together

#### Key Terms: (Appendix A)

- **Acquirer** – entity that obtains control of acquire
- **Control** – an (acquirer) controls an (acquiree) when it is exposed, or has rights, to variable returns from its involvement in the acquiree and has the ability to affect those returns through its power over the acquire (AASB para. 6)
- **Non-controlling interest** – the equity in a subsidiary not attributable to a parent

#### *Alternative Accounting Methods*

##### **Acquisition (or purchase ) method:**

- Assumes a collective purchase of the net assets of an acquired entity by the acquirer
- Acquiree's net assets restated at fair value
- Recognition of goodwill on acquisition
- Balance sheet of combined entity reflects 'mixed' asset values (acquire at fair value and acquirer at historical cost)

##### **Pooling of interests method:** (now outlawed)

- Assumes the combined entity is a continuation of two or more constituent entities (not a new entity)
- Combined entity's net assets measured at the historical book values of the constituent entities
- No goodwill recognised by combined entity
- Traditionally popular in the USA – understated costs of acquisitions; tended to boost future profits; and effectively hide the effects of 'bad' acquisitions

#### *Basic Principles of Accounting for Business Combinations*

1. Identify the acquirer
  - a. The business combination is viewed from the perspective of the acquirer
  - b. The acquirer is the entity that obtains control of the acquiree
  - c. Importance of identifying acquirer relates to deciding which entity's assets will be measured at fair value
  - d. C is not the acquirer where A and B combine and a new entity (C) is formed to acquire all the shares of the existing entities
  - e. Indicative factors: (para. B13-B18 Appendix B)
    - i. Entity that transfers cash or other assets
    - ii. Entity that issues its equity instruments
    - iii. Entity which is the largest relative to other constituent entities
  - f. Reverse acquisitions – entity issuing equity instruments is not the acquirer
2. Determining the acquisition date
  - a. This is the date that the acquirer obtains control of the acquiree
  - b. Determining the correct acquisition date is important as the following are affected by the choice of acquisition date:
    - i. The fair values of the net assets acquired
    - ii. Consideration given, where the consideration takes a non-cash form
    - iii. Measurement of the non-controlling interest
3. Identification and recognition of net assets acquired & calculation of fair value of net assets acquired
  - a. Fair value allocation occurs at acquisition date and requires the recognition of: