TEN WAYS TO MATERIALLY MISSTATE YOUR FINANCIAL STATEMENTS…

THE 'BLIND FREDDY' PROPOSITION CONTINUED - PART 6 – BUSINESS COMBINATIONS

This month we continue our 'Blind Freddy' series with a discussion on business combinations. There are potentially numerous issues that an accountant can get wrong when accounting for a business combination. These include:

- Incorrectly treating an asset acquisition as a business combination
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- Incorrectly identifying the acquirer
- Incorrectly applying 'fresh start accounting'
- Not identifying embedded share-based payments or post acquisition service-based arrangements
- Not identifying all acquired intangible assets
- Incorrectly valuing acquired intangible assets
- Incorrectly valuing acquired inventory
- Incorrectly accounting for 'puttable minority interests'
- Incorrectly determining purchase consideration
- Incorrectly determining date on which control was achieved.

In this article we will specifically consider:

- Date of determining control
- Fair valuing inventory
- Allocating appropriate fair value to work in progress (WIP) and order backlogs
- Allocating appropriate fair value to intangibles acquired that you do not intend to use.

Date of determining control

A common mistake when determining the date on which control was achieved is incorrectly referring to the date from which profits flow to the purchaser vs. the date when control is actually achieved. This is best illustrated by an example:

Example 1:

In late 2010, Aggregator Ltd enters into talks to acquire Company X from Old Ltd.

Talks are progressing well and the target date for acquisition is 1 January 2011. Aggregator Ltd enters into a Memorandum of Understanding (MOU) on 30 November 2010 with Old Ltd to enter into good faith negotiations to acquire Company X, with a target acquisition date of 1 January 2011. The acquisition process includes Aggregator Ltd performing due diligence on Company X and Aggregator Ltd securing financing.

Talks proceed at a slower pace than anticipated and the purchase agreement is signed on 1 June 2011. The purchase price is based on Company X's 31 December 2010 balance sheet and states that all profits and revenues earned after 1 January 2011 will go to Aggregator Ltd. Purchase price is \$100m, revenue of Company X for the five months to 31 May 2011 is \$100m and profit is \$10m.

Aggregator Ltd wants to consolidate Company X from 1 Jan 2011, recognising $100m of revenue and $10m of profit.

This proposed accounting is incorrect because the point consolidation commences is when control is achieved, which is 1 June 2011. Aggregator Ltd cannot recognise any revenue from Company X before that date. The $10 m profit is simply a purchase price adjustment and should be offset against the $100m consideration.

Fair valuing inventory

A basic requirement of AASB 3 is to fair value all assets and liabilities acquired in a business combination. This includes inventory. Thus, where inventory has appreciated over time (e.g. wine, timber, etc.) or has appreciated because of commodity price increases (e.g. gold, etc.), the fair value is very important.

The same principal applies when an acquirer acquires inventory as part of an acquisition of a manufacturer or a miner.

Example 2:

Gold Co Ltd acquires Small Co Ltd, a junior gold producer. Small Co Ltd has 1,000 oz of gold on hand, carried at its production cost of $700 per oz. Market price at date of acquisition is $1,700 per oz.

Gold Co Ltd fails to assign fair value to the inventory, and records the following entry when it subsequently sells the gold at $1,600 per oz:

Dr Cash	$1,600,000	
Cr Revenue		$1,600,000
Dr Cost of sales	$700,000	
Cr Inventory		$700,000

Net profit = $900,000

Correct accounting is:

Dr Cash	$1,600,000	
Cr Revenue		$1,600,000
Dr Cost of sales	$1,700,000	
Cr Inventory		$1,700,000

Net loss = $100,000

Example 3:

Big Manufacturer Ltd acquires Little Manufacturer Pty Ltd. Finished goods acquired is carried at cost of $10m. The expected wholesale price of these goods is $21m and fair value is $20m.

Big Manufacturer Ltd fails to assign fair value to the inventory, and records the following entry when is subsequently sells the finished goods:

Dr Cash	$21m	
Cr Revenue		$21m
Dr Cost of sales	$10m	
Cr Inventory		$10m

Net profit = $11m

Correct accounting is:

Dr Cash	$21m	
Cr Revenue		$21m
Dr Cost of sales	$20m	
Cr Inventory		$20m

Net profit = $1m

Allocating appropriate fair value to work in progress (WIP) and order backlogs

AASB 3 requires that all assets and liabilities acquired are measured at fair value. This includes WIP and order backlogs. As in the example in respect of inventory, this means that the fair value will include a significant amount of the anticipated gross profit on these contracts, with the subsequent profit recognised on the performance of the contractual obligations only being commensurate with the effort of satisfying the contract and the credit risk associated with the contract.

This situation is likely to give rise to material misstatements when buying entities with long term construction or service contracts.

Example 4:

Construction Ltd buys Small Builder Pty Ltd. Small Builder Pty Ltd is half way through a $100m construction project which is anticipated to make a 30 % gross profit. The fair value of this contract at date of the business combination is $10m.

Construction Ltd fails to fair value the contract and proposes the following entries for the completion of the contract:

Dr Cash	$50m	
Cr Revenue		$50m
Dr Cost of sales	$35m	
Cr WIP		$35m

Net profit = $15m (30% margin on $100m contract which was 50% complete at time of acquisition)

The correct accounting must also include the amortisation of the acquired contract as follows:

Dr Amortisation expense	$10m	
Cr Contract intangible		$10m

This has the effect of reducing the overall net profit by $10m.

Allocating appropriate fair value to intangibles acquired that you do not intend to use

When acquiring a business, it is very common that a purchaser acquires intangible assets that it does not require or intend to use. This is particularly common when acquiring brands that will be discontinued, or technology and intellectual property that will be abandoned. AASB 3 requires that all assets and liabilities acquired are measured at fair value and that the fair value is the value market participants would pay for the intangible, rather than specifically the fair value the acquirer assigns to the intangibles.

Example 5:

Big Pharma Ltd acquires Little Pharma Pty Ltd for $10m.

At the time of acquisition, Little Pharma Pty Ltd has four projects underway. The whole purpose of the acquisition of Little Pharma Pty Ltd by Big Pharma Ltd is to purchase Project A for further development and to abandon Projects B, C and D. Big Pharma Ltd allocates all of the purchase price of $10m to Project A.

The projects were valued in the market as:

PROJECT	FAIR VALUE ($M)
A	7
B	1.5
C	1
D	.05

Big Pharma Ltd should have assigned a fair value of $3m to the Projects B, C and D and then recognised an impairment loss on these projects as they would have no recoverable amount in future because Big Pharma Ltd intends to abandon these projects.

In next month's newsletter we will discuss failing to recognise a reverse acquisition, failing to properly apply derecognition requirements and pitfalls in capitalising items that fail the definition of an asset.