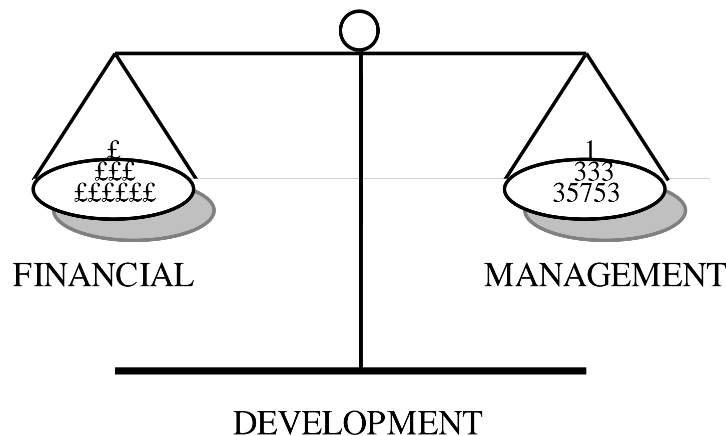
FINANCIAL MANAGEMENT DEVELOPMENT

Financial Accounting

Acquisitions

NO 152

ACCOUNTING FOR AN ACQUISITION



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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ACCOUNTING FOR AN ACQUISITION

Once an acquisition has been made the accounting is largely a matter of common sense. This paper sets out the impact on the published data of the acquiring company A, highlighting the differences between the treatment of investments, associates, partly owned and wholly owned subsidiaries. The balance sheet is considered first, then the profit and loss account.

The Balance Sheet

1. The Base Case

Figure 1 sets out the base company - Company A.

Figure 1

Company A	£
Fixed Assets	100
Net Current Assets	200
	300
	===
Shareholders Funds	300
	===

2. Investment

In Figure 2 it has purchased 10% of the share capital of B for £20. The investment is shown at cost. It would be imprudent of A to revalue it upwards if it gained in value e.g. if it was a 10% share in a quoted company and the share value increased. If A receives any dividend from the investment arising from profits made after it acquired its shareholding it will treat that as income. In most respects an investment is similar to cash on deposit account. It stays in at cost and only income received is taken to profit. The only difference is that an investment may reduce in value and in that case the prudent owner would normally make a provision against the carrying cost in the balance sheet, just as for any other asset which loses part of its value.

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Figure 2

Company A plus an Investment in B	£
Fixed Assets	100
Investment (at cost)	20
Net Current Assets	180
	300
Shareholders Funds	300

3. **Associate**

Figure 3 shows Company A having purchased not 10% of the shares in B but 30%.

Figure 3

Company A plus B as an Associate	£
Fixed Assets	100
Investment (at cost)	60
Net Current Assets	140
	300
Shareholders Funds	300

B is now an Associate of A. A does not have a controlling interest but it does have a "significant" stake. Because of the fact that it has a holding greater than 20% it can "equity account" for B. Thus 30% of any profits that B makes from its activities after the acquisition by A can be included in A's Accounts. Figure 3a shows the Consolidated Balance Sheet for the A group after one year when Company B has made a profit of £10. The carrying cost of B in the Consolidated Balance Sheet has increased by A's share of that profit i.e. £3 and there has been a commensurate increase in shareholders' funds of £3.

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For simplicity it has been assumed that A itself made no profit for the period. Notice that this is the Group's Balance Sheet. The Balance Sheet of the Holding Company alone i.e. A Limited, would still show the numbers in Figure 2 unless any of the profit from B was physically paid to A as a Dividend. If that were the case the A Limited would account for the dividend income as its own profit but the total Group figures for assets would not change as the payment would have reduced the assets of B and increased the assets in A. The total shareholders funds for the A Group would also be unaffected by such a payment, all that would have happened is that the amount of the dividend has moved from B to A. The Group retained profits would stay the same.

Figure 3a

A Group including profit in Associate B	£
Fixed Assets	100
Investments	63
Net Current Assets	140
	303
Shareholders Funds	303

4. **100% Acquisition**

Figure 4 shows the balance sheet of A Limited if it buys the whole of the share capital of B Limited for £200. Apart from the size of the numbers, the treatment is indistinguishable from the case when B was an investment. The difference only arises in the Consolidated Accounts for A Group. Because A now has control over the assets of B it is reasonable for the Group Accounts to show those assets and any liabilities. For the purposes of this example we will assume that B has £50 Fixed Assets and Net Current Assets of £150. These are matched by shareholders' funds of £200.

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Figure 4

Company A plus Subsidiary B	£
Fixed Assets	100
Investments	200
Net Current Assets	-
	300
Shareholders Funds	300

Figure 4a

A Group including B as a subsidiary	£
Fixed Assets	150
Net Current Assets	150
	300
Shareholders Funds	300

Figure 4a shows the Consolidated Balance Sheet on acquisition. Notice the Group's shareholders' funds figure has not changed. All that the consolidation process has done is to replace the cost of investment with the underlying assets. This is designed to help the user of published accounts who wishes to know the assets being controlled by the Directors - not simply a cost of investment figure.

Because the Group Balance Sheet shows the underlying assets the treatment of any profit made by B will be different from the situation when B was an associate. When B makes a profit its net assets will increase and so will its retained earnings. Similarly in the Group Accounts the net assets will increase and so will Group shareholders' funds. Figure 4b shows the Group after a year when B has made a profit of £10, all of which has been reflected in an increase in Net Current Assets. The shareholders of A now own assets with a value of £310 and this is reflected in the Group accounts even though part of that value is held by B. They own all of B and therefore they own its assets.

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Figure 4b

A Group including profit in subsidiary B	£
Fixed Assets	150
Net Current Assets	160
	310
Shareholders Funds	310

5. Partial Acquisition

Figure 5

Company A plus part owned subsidiary B	£
Fixed Assets	100
Investment	160
Net Current Assets	40
	300
Shareholders Funds	300

The last Balance Sheet to examine involves A buying 80% of the shares of B for £160. This is shown in Figure 5. Because A owns more than 50% of the shares of B it can be said to control B and should therefore treat the assets of B as its own because B is still a subsidiary company. The Balance Sheet of A is shown in Figure 5 and apart from the values the treatment of the cost of investment is the same as before. The main difference comes on consolidation. A has bought an 80% share of B's assets. The dilemma facing the accountant is that because of the size of the shareholding A can be said to control 100% of the assets. To include 100% of the assets would seem to be appropriate but the Balance Sheet would then not Balance! **The concept of an unbalanced Balanced Balance Sheet is enough to unbalance even the sanest accountant.**

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Fortunately in 1978 there appeared a standard solution in the form of Statement of Standard Accounting Practice Number 14 now encapsulated in Financial Reporting Standard 2. The solution was simple: show ownership of 100% of the assets but bring in the amount owned by the other shareholders of B to make the balance sheet balance. Figure 5a shows the result. The net current assets of the Group are now £190. They consist of the £40 remaining in A and the £150 in B. However the Group is now apparently larger than it was when A owned 100% of B. This is because holders of 20% of B shares have continued to hold their shares. They own 20% of B's assets which are worth a total of £40 cash and therefore the total assets under the control of the Group are £340. The figure of £40 for Minority interests shows the value of the shareholding held by the continuing shareholders at the time of acquisition. Their position is an "interesting" one. They do not control B and yet they have no shares in A.

Figure 5a

A Group including B as part owned subsidiary	£
Fixed Assets	150
Net Current Assets	190
	340
Shareholders Funds	300
Minority Interest	40
	340

There are certain things which Company law prevents the Directors of A doing. For example the Directors of A may consider it a good idea for B Limited to lend all its assets to A Limited at a low interest rate. The end result is a loss of value of B in favour of A. Since the outside shareholders of B share 20% of the loss in B the A Group gains value. Whilst such blatant activity is a "fraud of the minority" and illegal, it can be imagined that the position of the holders of minority interests is often not a happy one.

Figure 5b shows the Balance Sheet of the Group after a year when B makes a profit of £10. The effect of B making a profit is to increase the assets available to the Group as a whole by £10. However, only 80% of this is due to the shareholders of A. The remaining 20%, i.e. £2 is due to the outside shareholders of B and is therefore added to the minority interest figure in the Balance Sheet.

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Figure 5b

A Group including profit in part owned subsidiary B	£
Fixed Assets	150
Net Current Assets	200
	350
Shareholders Funds	308
Minority Interest	42
	350

At this point we can leave the various Balance Sheets of A Limited, B Limited and the A Group. In summary; the Balance Sheet of A Limited shows the cost of investment no matter how large its shareholding in B. It is only the Group Balance Sheet which changes. If a shareholding is below 20% the investment is left at cost. With a shareholding of between 20% and 50% the investment is treated as an associated company and therefore the Group's share of any profits made after acquisition is shown as adding value to the carrying cost of the investment with a commensurate increase in the Group's shareholders funds. Once A Limited owns more than 50% it can show the assets and liabilities of B Limited as Group assets and liabilities. Where it owns less than 100% this will involve the inclusion of a figure to represent the shareholding of the minority.

The Profit and Loss Account

The Profit and Loss Account treatment of the various levels of investment mirrors the Balance Sheet treatment. Connoisseurs of accounting will not be surprised by this since the profit and loss account is merely the statement which analyses the movement in the shareholders' funds line in the Balance Sheet. In Company A's own accounts the only impact of having an investment will be that it will show any dividend income in the profit and loss account. However, the Published Accounts of any Group will not show the Profit and Loss Account for the Holding Company as a separate entity. Unlike the Balance Sheet, there is no legal requirement for it to be shown. There will merely be a brief statement of the amount which has been earned by the Holding Company for the period. It is the Group Profit and Loss Account which shows the results of the Group as a whole.

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Figure 6 shows part of a typical published Group Profit and Loss Account for a Group which has investments, associated companies (called in Companies Act Legislation "Related Companies"), partially and wholly owned subsidiaries. Notice that where changes take place in the composition of the Group during the accounting period the Profit and Loss Account will only show the results during the period of the Group's ownership.

In summary; where the Group owns a controlling interest the results are included. If that interest is less than 100% the amount due to the minority should be shown. Where the interest is substantial but below 50% the pre-tax profit and the associated tax charge are shown. Where the interest is less than 20% only dividend income is accounted for.

Figure 6

Group Profit and Loss Account	Note	£ millions
Turnover	1	1,000
Cost of Sales		700
Trading Profit		300
Other Operating Income	2	50
Share of Profits of Related Companies	3	100
Operating Profit		450
Taxation - Holding Company and Subsidiaries		100
- Share of Related Companies		35
Profit after Taxation		315
Minority Interests	4	15
Profit for the Financial Year		300

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Notes

1. The Group Accounts include the results of the Holding Company and its subsidiaries. Where companies have been acquired or disposed of during the year the results are included from the date of acquisition or the date of sale. The results exclude any inter-group trading.

2. Other Operating Income includes dividend income receivable from investments held by the Group.

3. A related company is a company, other than a subsidiary, over which the Group exercises significant influence and/or in which it owns more than 20% of the share capital with voting rights. The Group profit and lost account includes the Group's share of the profits and losses of its related companies.(Note for most purposes the Companies Act definition of Related Companies is synonymous with the accounting term "associated company").

4. Minority interests include that part of the post-tax results of subsidiaries which is due to holders of shares in those subsidiaries where the Group has less than 100% of the share capital. The Group does therefore not have ownership of those profits.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

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