Transaction Accounting

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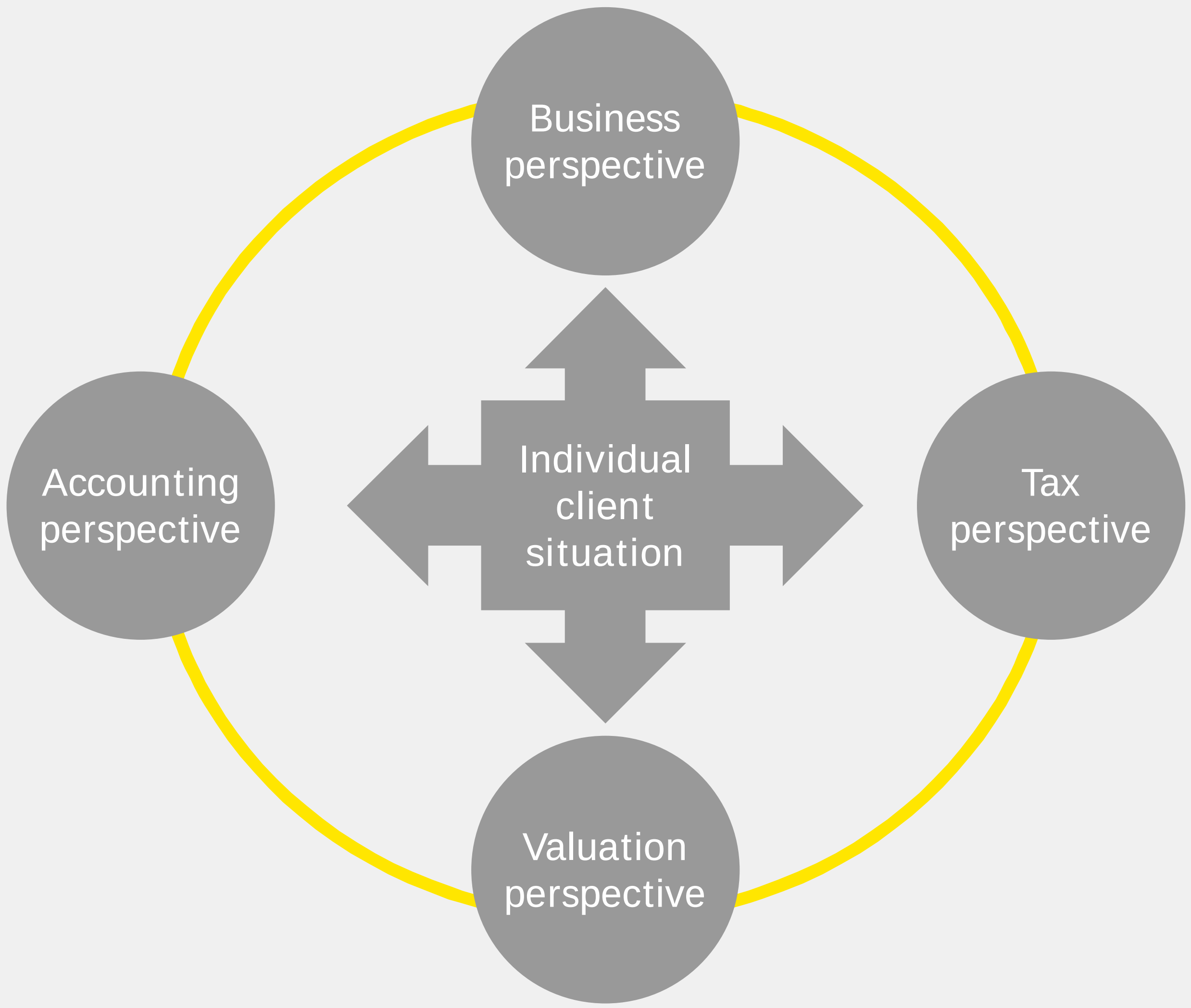
Agenda

- A Overview Transaction Accounting/PPA
- B Earn-out arrangements
- C Further Considerations
- D Reorganisations/ Spin-offs

Overview Transaction Accounting/PPA –
What is Transaction Accounting?

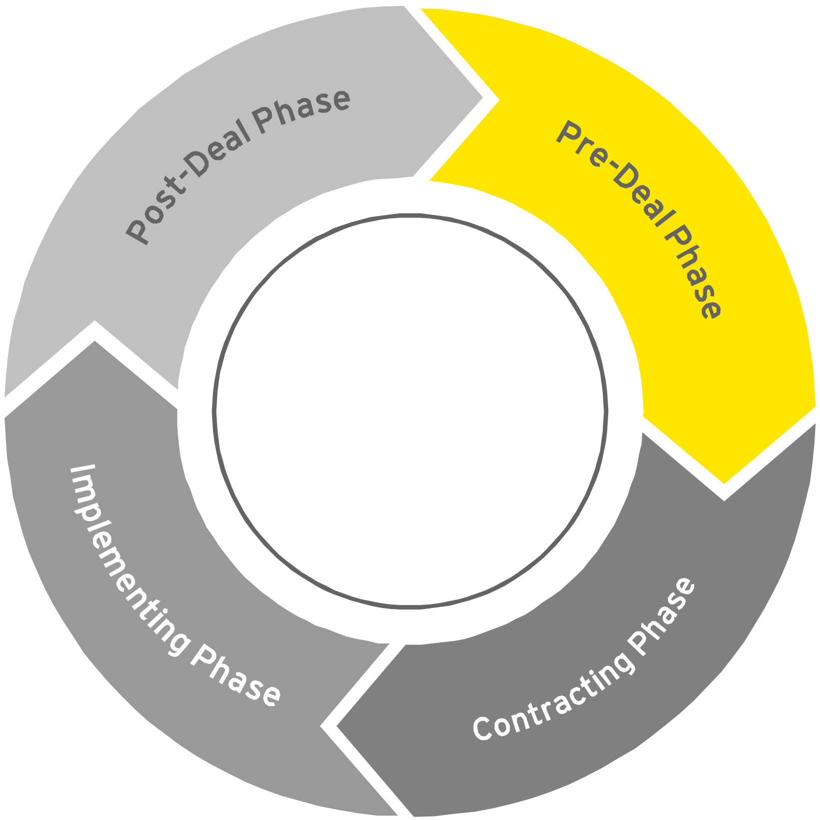
"Transaction Accounting involves the appropriate presentation and reporting of complex business transactions (like acquisitions, divestitures, financing, IPO, joint venture creation, reorganizations) in the consolidated financial statements of a buyer or seller including advice of the respective business implications."



Overview Transaction Accounting/PPA – Transaction Accounting Process

- Purchase price adjustments and final calculation of goodwill including non-controlling interests
- Harmonizing accounting rules at the acquired entity
- Integrating the acquiree in the standardized group reporting and consolidation processes
- Transactions with minority shareholders
- Set up a group aligned impairment process for the acquired entity

- Preparing acquisition accounting/ identifying/setting the acquisition date
- Reviewing closing accounts
- Performing the purchase price allocation
- Advice on setting covenants for the deal financing
- Conclude on all relevant accounting issues (such as effect of accounting for employee share based payment plans on future earnings, impact of put/call options and other potential rights on consolidation entries etc.)
- Analyze the impact of restructuring activities

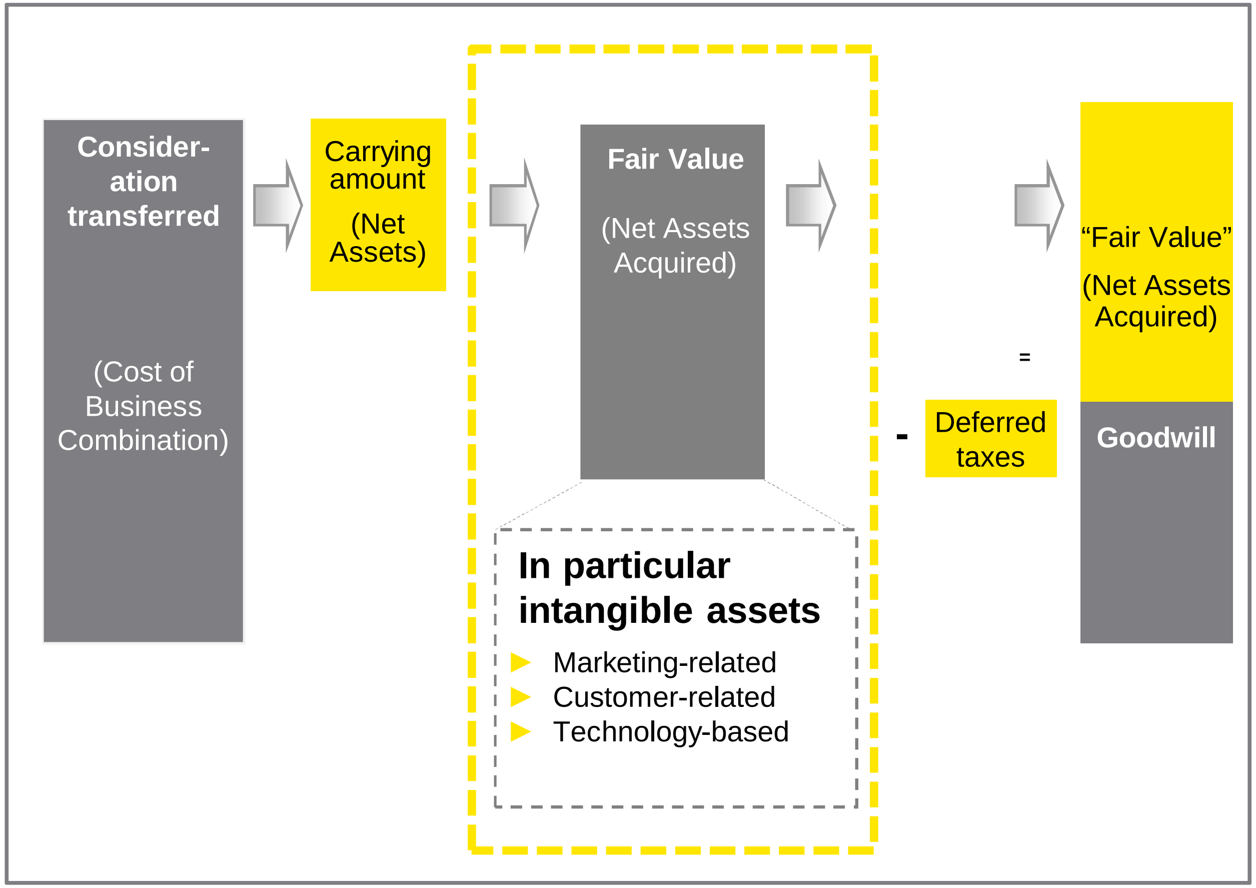


- Clarifying accounting, tax and legal objectives and identifying restrictions
- Accounting buy side due diligence (including assessing all critical accounting issues)
- Analyzing various scenarios for the acquisition structure
- First indicative assessment of post-Transaction Accounting consequences including the impact on distributable reserves

- Ongoing assessment of the accounting consequences based on the progress of negotiations
- Analyzing aspects relevant to account-ing (especially earn-out arrangements/ contingent considerations, put/call options, control issues, indemnity clauses, purchase price hedging, interest rate swaps)
- Analyzing financing structures from an accounting and tax perspective
- Forecasting future business developments and their impact under various alternative contractual arrangements

Overview Transaction Accounting / PPA
PPA Process (I)

“Transformation” into an asset deal



Overview Transaction Accounting / PPA
PPA Process (II)

General

Within a Purchase Price Allocation, a transaction is „**transformed“** into an asset deal – regardless whether the transaction is conducted as share deal or asset deal. Acquired assets and liabilities are thereby measured at **Fair Value.**

1 Initial situation

- Transaction (acquirer, acquisition date, consideration transferred, acquirer‘s intention, transaction details, Fair-value-test)
- Analysis of target company („Understand the business“)

2 Identification

- Recognition criteria for intangible assets
  - Contractual/legal?
  - Separable?

3 Valuation

- Commonly income approach, often:
  - Relief from Royalty Method (RfM)
  - Multi Period Excess Earnings Method (MEEM)
- Discount with risk-adjusted interest rate (WACC „market-view“)

4 Goodwill

Fair value of consideration transferred („Purchase Price“)

\+ Value of non-controlling interest (NCI, „minorities“)

\+ Fair Value of the acquirer‘s previously held share (business combination achieved in stages)

\- Acquired net assets measured at Fair Value

= Goodwill (Badwill)

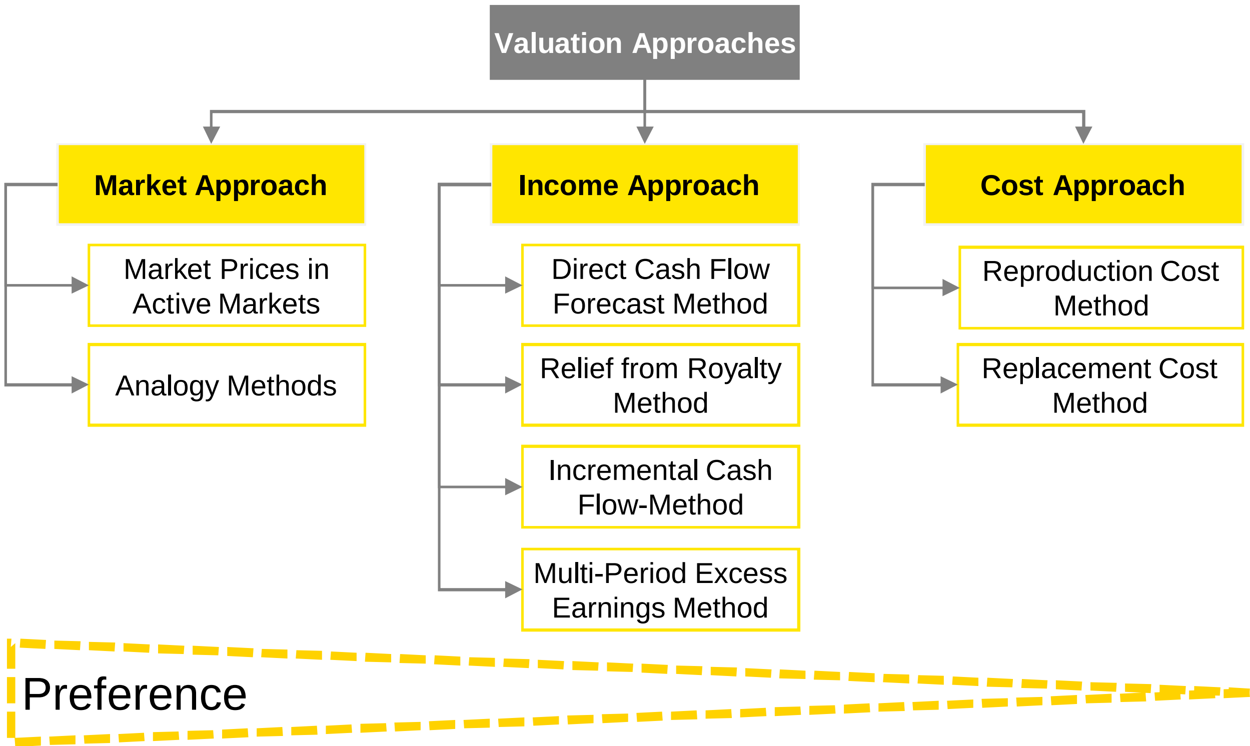
Fair value

„Fair Value“ means the amount for which an asset could be exchanged, or a liability settled between

- knowledgeable,
- willing parties
- in an arm‘s length transaction.

(IFRS 3 Appendix A)

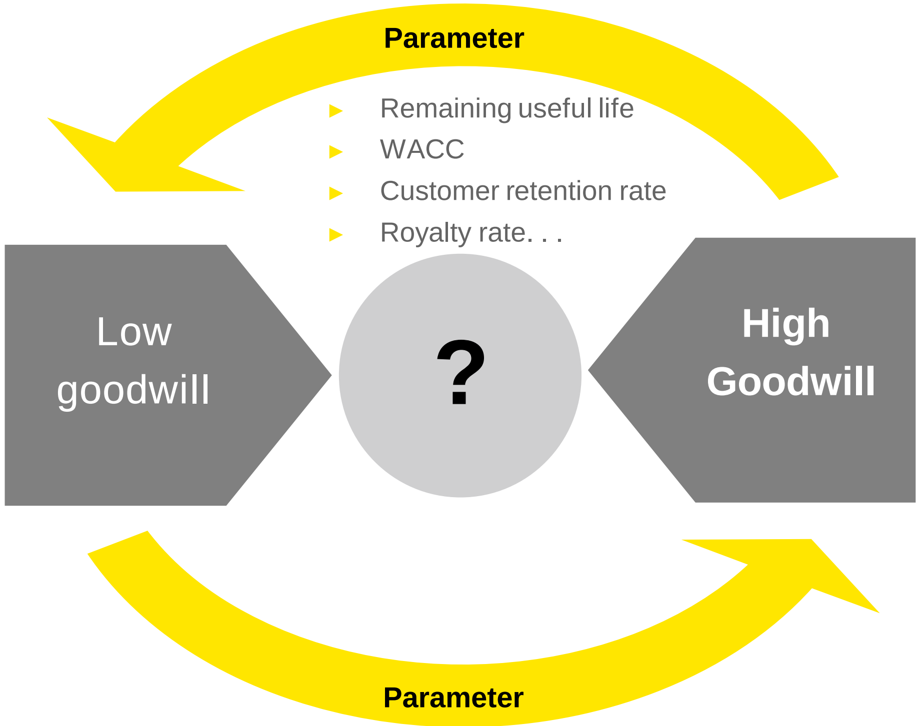
Valuation approaches



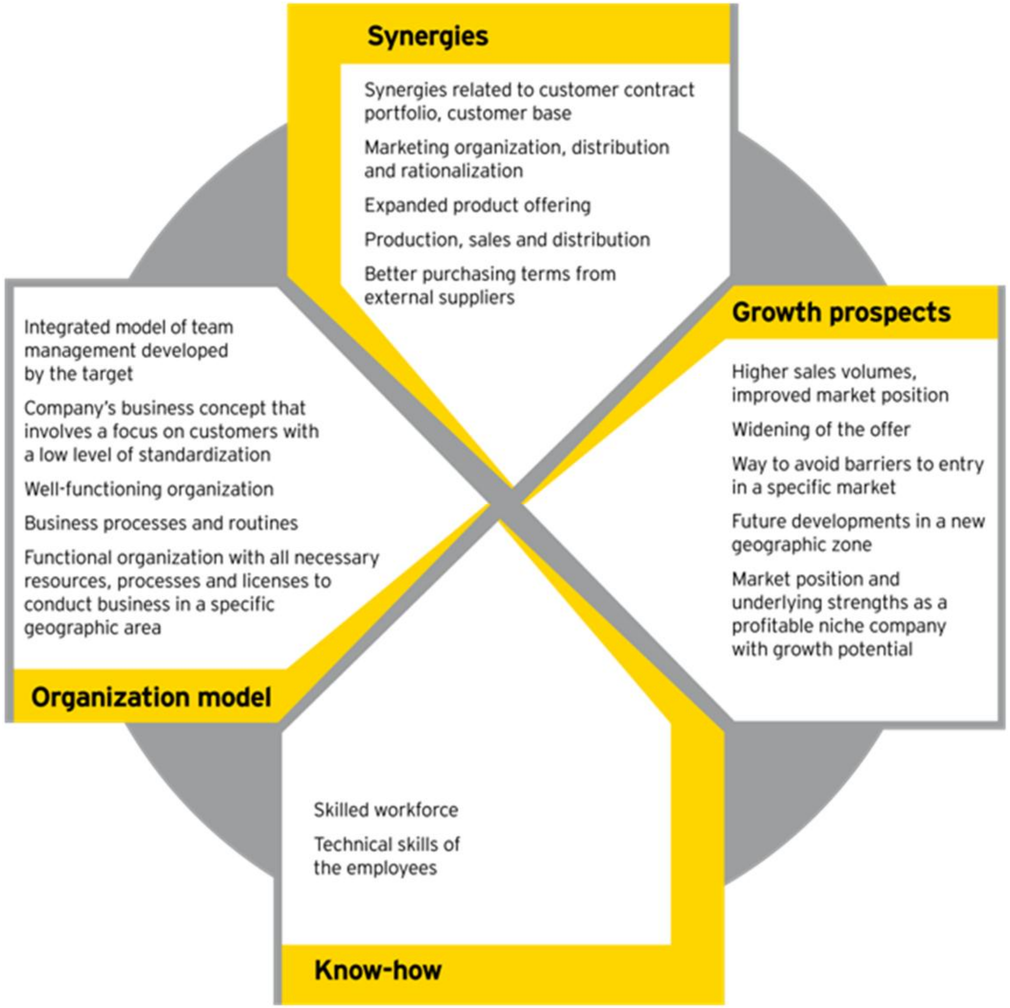
Intangible assets are generally measured using the Income Approach, since market-oriented approaches are hardly applicable

Overview Transaction Accounting / PPA
Explanation of goodwill

Accounting policies



Explanation of goodwill, examples



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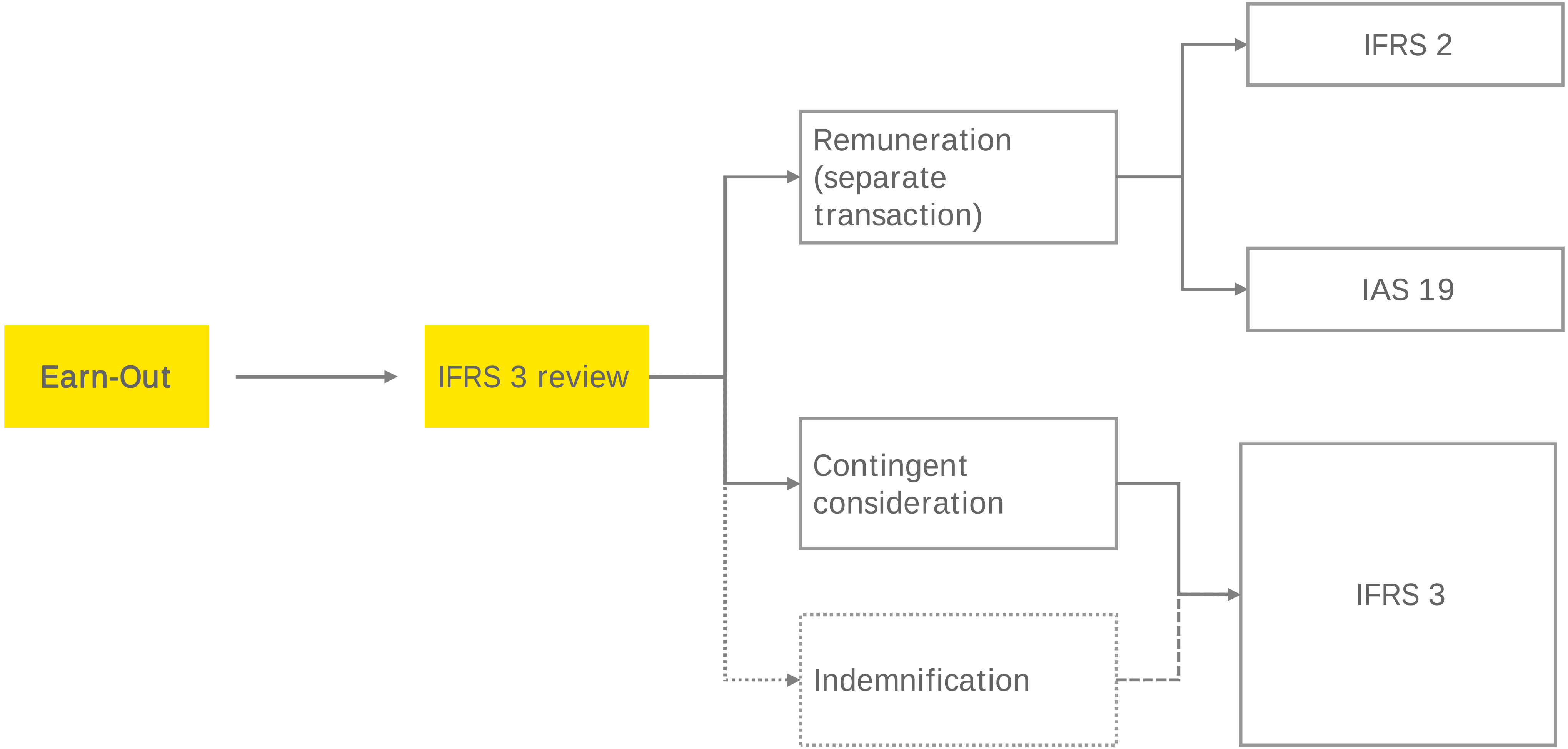
Earn-out arrangements –
Reasons

- The buyer and seller cannot agree on a final purchase price
- Market volatilities create uncertainty about future economic developments and conditions
- Information asymmetry between the buyer and seller is reduced, thus enhancing the seller's credibility
- The transaction risk is divided between the buyer and seller/better control of the risks in a business transaction
- Future factors (e.g., successful patent application, key employees) are fundamental to the future earnings potential of the business
- The buyer and seller have different expectations as to future earnings prospects

Earn-Out-arrangements

(variable contingent future payment)

Earn-out arrangements –
Structuring options



Earn-out arrangements –
Remuneration vs. contingent considerations

What are the reasons for the earn-out?/Who initiated the earn-out and when? Other indicators

- Continuing employment
- Duration of continuing employment
- Level of remuneration
- Incremental payments to employees

Contingent consideration

Separate transaction

- Number of shares owned
- Linkage to the valuation
- Formula for determining consideration
- Other agreements

Earn-out arrangements –
Contingent consideration: Overview

	Remuneration (separate transaction)	Contingent consideration
Acquisition date	▶ Not recognized	▶ Included in purchase consideration/goodwill ▶ Recognized as a liability or equity
After acquisition	▶ Recognized as an expense in profit or loss	▶ Settlement of liability/equity ▶ Changes in FV of liability recognized in P&L

Impact on the financials

Earn-out arrangements –
Contingent consideration as liability: Accounting

Initial recognition at fair value (as part of transferred consideration/**purchase price)**

Subsequent measurement at fair value

Changes in value are recognized in **profit or loss**

As contingent consideration is measured at fair value, recognized liabilities and reported results can be subject to considerable volatility

This, in turn, can have implications for corporate ratios, debt covenants, remuneration systems, etc.

Agenda

Step acquisitions –
Reasons

Initial strategic investment as a part of a long term strategy leading to control

Acquire part of a business and leave part owned by the vendor executives for a period of time to ensure that they are committed to the continued success of the business they are selling

Acquire first a significant influence in a growing company and transfer to control when the results of the entity are improving

Market price opportunities to increase the current ownership by a further share purchase without directly acquiring control

Majority ownership is currently not available in the market, but maybe for sale in a later period and current acquisition offers the investor a good opportunity to acquire control at a later date

Step acquisition

(purchase of a minority share first and increase of share ownership to control in one or several additional share acquisitions)

Put/Call options –
Overview

In a business combination, call and put-options can be agreed in a number of different ways with very different accounting consequences

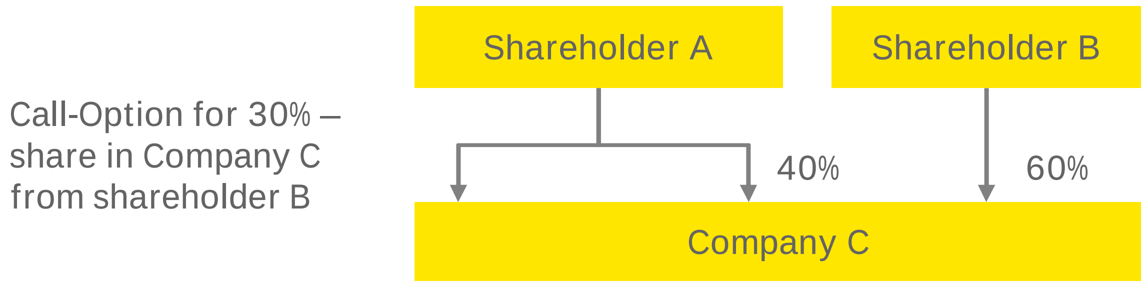
- Timing alternatives: issuing of options at the time the parent acquires the controlling interest or at some later date
- Pricing alternatives: fixed price, fair value or formula based (for example multiple of EBITDA)
- Call/put combination: either individual call or put options or a combination of both (either fixed price based or at fair value)

Different implications

- Structuring alternatives for the acquirer
- Structuring alternatives for the seller

Put/Call options –
Example

Example



Guidance in IFRS 10

- Call options have to be considered as potential voting rights in the determination of control, if the option is substantive based on the following criteria:
  - Exercise price relative to market terms:
    - Option is only substantive if either the option is priced with a fair value or is "deeply in the money" or
    - Is currently "out of the money", but still valid expectation that option will turn "in the money" (or the option has strategic importance to the option holder)
  - Financial ability to exercise the option, assumed to be the case for "in the money options"
  - Timing and length of exercise period: the option has to be either "currently" exercisable or is exercisable before the next (special) shareholder meeting

Put/Call options –
Structuring thoughts (I)

Structuring thoughts

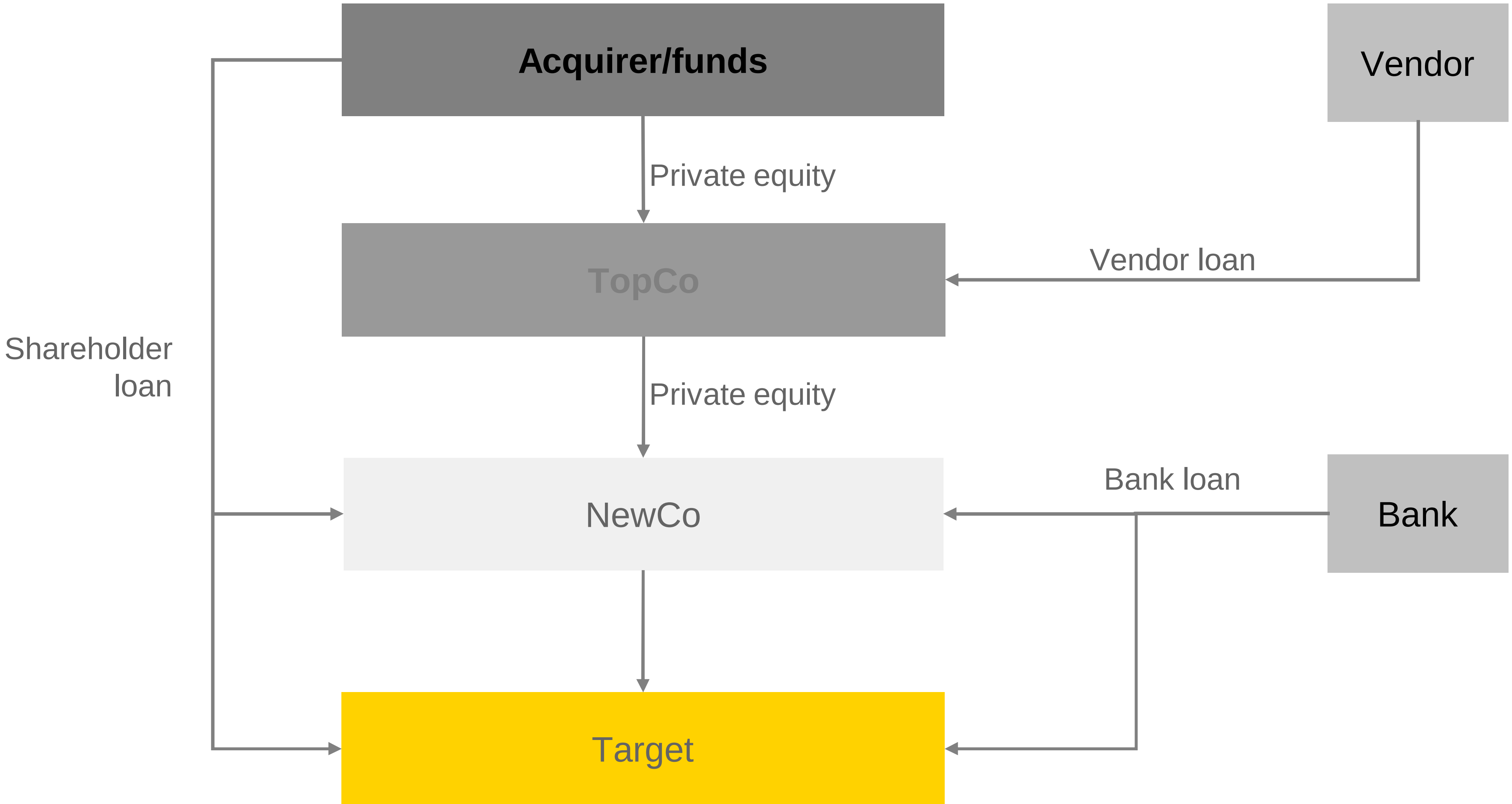
- Realizing consolidation with call options only in favourable situations
  - Agree on current exercisable call options directly with the acquisition of a non-controlling interest
  - Call option only “in the money” or “not deeply out of the money” with positive expectations, if the target company performs at least in line with forecasted results
  - Compared to a direct acquisition of a share majority the use of a call option reduces the economical risk
  - No consolidation requirement until the target shows positive performance (means the call option turns “into the money”)
- Realizing consolidation with call options at a specific future date:
  - Interesting scenario if the forecasted results will improve over time and turn the call option into the money at a future date (only consolidation during positive periods)
  - Avoid with the pricing of the option consolidation until reaching a certain result level
  - When the call option turns into the money, remeasurement of non-controlling interest with the fair value will have positive impact on consolidated P&L

Put/Call options –
Structuring thoughts (II)

Structuring thoughts

- Avoiding consolidation using call options:
  - In all “deeply out of the money” scenarios consolidation and therefore reflection of potential negative results is avoided
  - Determining a later exercise date for call options in scenarios with start up losses
  - Defining key future contingent events as the exercise date for a call option (for example achieving certain approvals in the pharmaceutical industry, reaching certain result levels by the target company)

Financing and loan covenants
Overview



Financing and loan covenants
Shareholder Loans

Structuring options in the case of non-interest bearing or below-market interest-bearing shareholder loans

...Scenario 1:
Callable at any time

- Recognition as a current financial liability
- Initial recognition at fair value (in the amount of cash received)
- Date of repayment: derecognition of the liability against cash

...Scenario 2:
Callable if liquidity available

- Recognition as a current or non-current liability
- Recognition depends on the expectations regarding when liquidity will be available
- E.g., if the result is “3 years,”→ see scenario 3

...Scenario 3:
Callable after 3 years

- Fair value recognized as a non-current liability
- Difference between the fair value and the nominal amount is an equity contribution
- Recognition of interest expenses during the term at the market interest rate

Financing and loan covenants
Transaction costs (I)

Transaction costs are incremental costs that are directly attributable to the acquisition of a financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired the financial instrument.

- Bank charges
- Arrangement fees
- Legal costs

- Acquisition vehicle/operating units
- Credit lines/revolving credit facilities
- Documentary credit facilities

- Unscheduled repayments
- Credit facility outstandings
- Early repayment
- Refinancing arrangements
- Modifications
- Prepayment options

Scope for judgment regarding the determination of the amount, allocation and amortization

Financing and loan covenants –
Consequences lease accounting

	Operating lease	Finance lease	Right-of-use concept
Statement of financial position	Neither an asset nor a liability is recognized	Leased asset and liability are recognized	► Right-of-use asset (value in use) ► Financial liability
Income statement	Operating lease expense (EBITDA effect)	► Amortization ► Finance charges (no EBITDA effect)	► Amortization ► Interest expense (no EBITDA effect)
Notes	Future payment obligations under the lease	Future payment obligations under the lease	Additional disclosures in the notes

Pre-existing relationships –
Overview

Pre-existing relationships

Contractual or non-contractual relationships

- Contractual (supply or service contract): gain or loss recognized at lesser of
  - Amount of any stated settlement provisions and
  - Amount by which terms differ from current market terms
- Non-contractual: gain or loss recognized at fair value

Remuneration to employees or former owners for future services

- Remuneration
  - IFRS 2
    Equity or cash-settled
  - IAS 19
    In cash without link to company shares
- Contingent consideration
  - IFRS 3

Reimbursement of acquisition-related costs

- Payment by seller followed by reimbursement by acquirer, or
- Acquiree pays before acquisition by acquirer and does not recognize a liability, such that acquisition-related costs increase the consideration

Restructuring plans

- A liability is only recognized if acquiree had an obligation when control was obtained and restructuring would still make sense even if acquisition did not go ahead
- Who initiates the restructuring?
- Who benefits from the restructuring?

Pre-existing relationships –
Contractual vs. non-contractual (I)

At the acquiree	At the acquirer
Receivables from/liabilities to the acquirer	Extinguished due to confusion of rights
Interests in the acquirer	Acquisition of treasury shares
Interests in subsidiaries of the acquirer	Acquisition of non-controlling interests
Interests in associates of the acquirer	Step acquisition of an associate
Contractual right of use	Reacquired right

Example: contractual relationship

- Contract to supply electronic components; 12-month term; price per component EUR120
- Current price now only EUR100 per component; fixed purchase quantity of 100,000 components per year
- Acquirer purchases the entity for EUR5m
- The amount which differs from market terms (EUR20 per component x 100,000 components = EUR2,000,000) is not part of the consideration transferred. It is therefore not included and is recognized as an expense in profit or loss

Example: non-contractual relationship

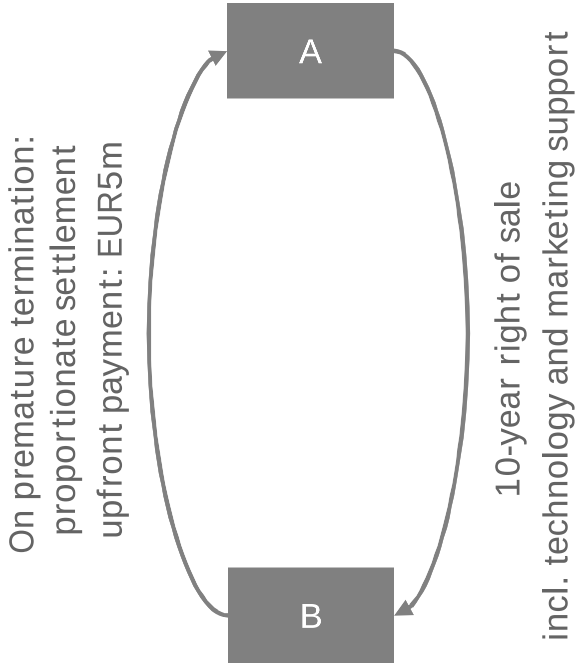
- A sues B for damages due to an alleged patent infringement; B recognizes a provision for the damages
- B acquires A. The consideration implicitly includes an amount for the settlement of the lawsuit; the fair value of this settlement amount must be deducted from the consideration
- The difference between the provision and the settlement amount is recognized in profit or loss

Pre-existing relationships –
Contractual vs. non-contractual (II)

Special aspects relating to reacquired rights

- Reacquired rights are intangible assets that are recognized separately; they are measured on the basis of the remaining contractual term of the related contract without considering potential contractual renewals, rather than at fair value
- A separate assessment is required to determine whether a settlement gain or loss needs to be recognized

Example



- A acquires B for EUR10m
- The remaining contractual period of the right of sale is four years; a third party would currently pay EUR6m for the remaining four years
- From A's perspective the right of sale is thus unfavorable, by an amount of EUR4m (EUR6m–EUR5m x 4/10)

- The right of sale is recognized at EUR6m during the PPA
- A settlement loss of EUR2m is recognized (proportionate settlement of 4/10 x EUR5m)
- The adjusted consideration is therefore EUR8m (EUR10m–EUR2m)

Pre-existing relationships –
Critical factors

	Separate transaction	Part of the combination
General	► Transaction arranged primarily for benefit of acquirer ► Transaction initiated by acquirer and not so much by acquiree or its former owners ► Transaction was arranged during the negotiations of the terms of the combination or upon closing	► Transaction is primarily for the benefit of the acquiree or its former owners ► Transaction initiated by acquiree or its former owners ► The transaction and the combination do not take place close together
Remuneration	► Entitlement forfeited upon premature termination ► Payment based on a specified percentage of earnings ► Change of control bonus arranged in a document separate to employment contract; acquirer is initiator	► Entitlement not forfeited upon premature termination ► Payment based on a business valuation ► Change of control bonus already set out in employment contract; not initiated by acquirer
Restructuring	► Restructuring in order to leverage synergies ► Adopted in connection with the combination	► Restructuring must be independent of the combination and must make economic sense even without the combination ► Announcement prior to closing the combination

Restructuring activities – Introduction

- Synergies in a business combination commonly result in a reduction of headcount in the combined operations
- Entities in an intense business situation in general have a need for restructuring activities realized commonly after a business combination
- Key question: timing of the recognition of a restructuring provision
  - Recognition before or at acquisition date: restructuring provision reduces the net asset balance at acquisition date and therefore indirectly increases the goodwill balance
    - No P&L impact from the recognition of the restructuring provision
    - Increased impairment risk due to the higher goodwill balance
    - Potential future release of provision classifies as operating income
  - Recognition after acquisition date: restructuring provision has a direct impact on the operating result of the group, also potential future release of provision classifies as operating income
- Therefore timing of recognition may have a material impact on the performance of the group, target is to recognize the provision before or at the acquisition date

Agenda

Reorganisations/ spin-offs –
Carve-out and combined financial statements?

Transaction

- OldCo – one group two companies announced in December 20#5
- Legal Reorganization under common control of OldCo AG into 2 separate groups (OldCo AG + New SE)
- IPO of New SE in late 20#6

Relation between IPO, Legal Reorg and CFS

- The requirement for the preparation of the CFS is fixed due to Prospectus
- The overall basis for the preparation is the legal reorganization itself
    - The Combined financial statements are dependent on the final step plan for the legal reorganization
- Carving out a new sub-group and establishing a new sub-group parent company leads to a wide range of challenges from the Accounting and Tax perspective

IPO / Prospectus

Requirement for preparation of combined financial statements (comparative data for prior periods, auditable, etc.)

Legal Reorganization

Basis for preparation of combined financial statements (new legal structure of New SE sub-group as a basis for new consolidation of historical data)

Combined Financial Statements

Wide range of practical issues to be handled during preparation of combined financial statements (IFRS questions, technical questions on consolidation system, Tax challenges, Reporting Issues, etc.)

Reorganisations/ spin-offs –
Carve-out and combined financial statements?

Combined / Carve-out financials

- No IFRS guidance
- No existing “group” under IFRS 10
- Specific occasion at one point in time
- Based on historical financial information
- Auditable

Preparation requires

- Alignment and consistency with strategic and operational objectives of the transaction
- Alignment with transaction timeline
- Flexible structure that can be adjusted quickly during preparation process
- IT concept for simultaneous consolidation of OldCo AG consolidated financials and New SE combined financials
- Buy-in from OldCo management taking ultimate responsibility for the financial statements of New SE
- Close communication with auditor

Audited/Auditable

Reconcile | *Input*

Existing OldCo audited financial statements

- Consolidated financial statements
- Group audit at group materiality

New SE Combined financial statements

- Combined financial statements for 20#5, 20#4, 20#3
- Challenge/restate historical cost allocations
- Define appropriate materiality

Prospectus

- Incorporation of combined financial statements
- Additional interim financial information
- MD&A type information
- Comfort letter by auditor

Spin-off report

- Spin-off and take-over contract
- Pro-forma financial information
- Additional financial KPIs and other MD& type information
- Court appointed auditor

Guest lecturer

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