CHALLANGES IN ACQUISITION ACCOUNTING: IDENTIFYING CONTROL AND CONTROLLERS IS TRICKY

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Abstract

This paper studies the complications embedded into identifying the existence of Control and the identity of the Controller on companies for accounting purposes. The issue appears of importance in view of the fact that, while the various theoretical definitions allow to understand the meaning of the concepts and to distinguish between Control, Influence and Portfolio Investment, still in practice recognizing whether Control exist and who the Controller is can be extremely tricky. The conundrum is relevant to more than just academic satisfaction. Indeed, those rules governing the recognition of the interest in a controlled subsidiary are different from the accounting treatment of the interest in Associates (Company over which another company has influence) and of portfolio investment (when the investor is not involved in managing the company). Hence, a proper classification of investments into categories (acquisition of Control, Influence or portfolio investment) is crucial for the preparation of proper financial statements. Investors and the general public can be easily misled otherwise. The IFRS 10, issued in 2011, provides guidance regarding the recognition of Control. Nonetheless, in reality the application of these rules can be tricky because recognizing Control(lers) is not always straightforward. We discuss the point theoretically and then we present two case-studies.

Key words: Control, Significant Influence, IFRS, Mergers and Acquisitions.

JEL Code: M40, G21

Introduction

The focus of this paper is on the difficulty regarding identification of the existence of control and the identity of the Controller as a fundamental step in the preparation of consolidated financial statements. Our aims:

1) Discussing the theoretical complexities of identifying the existence of Control and the identify of the Controller in certain cases

2) Provide practical examples of controversial cases

Existing standards (IFRS) define various concepts, like Control, Influence and Equity Investment, in theoretical terms (Long et.al., 2015; Min-Ho et.al., 2016; Fifield, 2011). However, recognizing Control and Controllers (distinguishing from holders of Influence) in practice may prove to be contentious. We discuss this problem and focus on specific cases where relationships between investors and investee can engender ambiguities.

Recent developments in Mergers and Acquisitions have resulted in differing methodologies for determination of the classical accounting classifications as to how to account for the post- transaction statements. Is the transaction a short-term investment, and therefore to be shown as an asset at fair market value? Is it a significant acquisition generating influence to be accounted for through the equity method? Or is there significant control of the acquired entity basically requiring full consolidation of the accounts including, if required, determination of goodwill? The answer is crucial for the public but often not straightoforward in practical cases.

Identification and distinction of Control and Influence can initiate consequences on the whole set of the consolidated financial statements of any group. If accountants of a given company shift, for example, from consolidation method to the equity method, it is likely to affect decisions of the general public making use of financial reports (i.e. banks, investors).

Table 1: Pepsicola

Consolidated Balance Sheet
PepsiCo, Inc. and Subsidiaries
December 31, 2016 and December 26, 2015
(in millions except per share amounts)

	2016	2015
ASSETS		
Current Assets		
Total Current Assets	27,089	23,031
Property, Plant and Equipment, net	16,591	16,317
Amortizable Intangible Assets, net	1,237	1,270
Goodwill	14,430	14,177
Other nonamortizable intangible assets	12,196	11,811
Nonamortizable Intangible Assets	26,626	25,988
Investments in Noncontrolled Affiliates	1,950	2,311
Other Assets	636	750
Total Assets	$ 74,129	$ 69,667
LIABILITIES AND EQUITY		
Total Liabilities	62,930	57,637
Total Equity	11,199	12,030
Total Liabilities and Equity	$ 74,129	$ 69,667

Source: Pepsicola financial statements 2016 (pag.79)

A look at the Balance sheet of Pepsico illustrates this point. PepsiCo is a holding company which owns many famous brands such as Lay's, Walker, Quaker and Tropicana. What is significant is that the value of goodwill, based on consolidation, is $14.4B, and equity is $11.2B. If goodwill is deducted, because it is a non-saleable asset, the Equity would be negative. In fact, PepsiCo has net tangible negative assets of $14.4B. This underlines the importance of choice of consolidation technique and the impact it can have on the balance sheets, hence investor's understanding of the financial health of the company. In fact, it could be argued that Shareholder's Equity has all been spent on acquisitions to the point that none is effectively left. If accountants of a given company shift, for example, from consolidation method to the equity method, it is likely to affect decisions of the general public making use of financial reports (i.e. banks, investors). Still identifying whether there is Control and who controls an entity can be controversial. The issue has received only scant attention in literature, which has overall only briefly touched on the theoretical aspects of the matter, without an in-depth analysis and studies of specific cases. We contribute to the rectification of these limitations, with a deeper theoretical discussion and two case-studies.

There is a dearth of research on this issue, especially in discussion of actual cases and the embedded controversies. There are some studies made on the IFRS 10 and on the IFRS, but often these few studies are not even published in impact journals. It seems that the top literature has omitted to highlight the issue we are discussing. Nonetheless, various authors have recognized, implicitly or explicitly, how the determination of the existence of Control (and Influence) /identity of Controller relies on a case-by case analysis of existing relationships among investors. As for the previous literature, Reiland (2011) has touched on the, at that time, new iFRS 10. Gornik-Tomaszevski (2014) has discussed the changes in IFRS rules occurred after the introduction of IFRS 10, focusing on the difference between IFRS and GAAP rules relevant to the determination of Control (or Influence). Nobes (2014), has provided a comprehensive analysis of the historical development of the rules on Consolidation, including also theoretical aspects. Bansal (2011) has discussed the changes in Indian accounting rules brought by the endorsement of IFRS, including IFRS 10 in his analysis. Whish and Bailey (2015) have studied the legal perspective of the issue. Nonetheless, we maintain that these previous studies have just paid a lip service to the research problem we are discussing. Additionally, there is a dearth of case studies, allowing to highlight which criteria have been followed in the classification of investment and what are the possible controversial aspects.

Marcy (2008) has discussed in greater detail some of the difficulties in identifying Control(lers). Nevertheless, his analysis is quite theoretical, with no real examples from practical and controversial cases. Kabir and Rahman (2016) also discussed the controversies which may follow an Acquisition, but they have focused on Goodwill impairment and not on the determination of Control/identity of Controller *per se*. Teutenberg and Voll (2015) published a case study on a concrete application of IFRS 10, nonetheless this appears in the form of an exam assignment.

Overall, we feel that there is room for more contribution discussing the ambiguities in the determination of the existence of Control and Controllers on a given entity. The paper is structured as follows. The next section will 1) focus on existing accounting rules (IFRS/IAS) on the determination of Control and Influence and the corresponding accounting methods which accompany the preparation of consolidated statements in either cases. The final section will analyze some cases of acquisition of Control and/or determination of the existence of Influence and comment on them. Conclusion and references will follow.

1 Existing rules

The problem of the determination of Control is object of provisions of IFRS 3 and IFRS 10. According to IFRS 10 Control indicates "An investor controls an investee when the investor 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" This entails a) the exposure to or existing rights to variable returns (in other words, the business risk(and b) the capacity to determine the conduct of a company, viz. taking those decision which are relevant to it under a business, managerial, economic, marketing, legal and human resources perspective. In other words, the Controller is the entity, in principle natural or legal person, who a) is risking his capital and has the right to obtain returns , which can be positive or negative and b) has the power to govern a company, eventually delegating part of the authority to others (i.e. managers), but still retaining the final power to revoke the delegation, replacing the top authority or finally reversing any decision.

An Acquisition is a process culminating in the shift of Control from one entity to another. This particular characteristic renders Acquisitions different from specific investments in shares of a given company which still do not lead to a change in the identity of the Controlling entity. In our globalized society, several corporations are active in the market and trade on shares of other companies on a daily basis. However, the Acquisition of another entity happens only when the investor is able to gain the capacity to govern the acquiree (company whose shares are acquired). This is a less common outcome if compared with the amount of investment in shares of listed and non-listed companies occurring on a daily basis.

There are accounting implications from the points raised above. A company acquiring or holding Control on another company needs to follow specific rules when preparing its financial statements. The controller needs to prepare consolidated statements of the whole group, including the Mother Company as well as its own Subsidiaries (Controllees). Financial Statements of the group are presented as those of a single economic entity, adjusting for intra-group transactions (otherwise the various statements would result inflated). Non-controlling interests (equity investment of non-controlling companies on the subsidiary) are also recognized. The main characteristic of the Consolidated Statements so far described is that the whole of the Assets and Claims of the Controllee are part of the statements of the whole group, also for that share that is not owned by the Parent Company (in those many cases when the Parent Company does not turn to own 100 % of the Controllee, so this latter is not a wholly controlled entity). There is also a second possibility characterising the relationship between an investor and an investee company. The former may obtain and hold “significant influence", which is defined by IFRS 28 and requires power to participate in financial and operating policy decisions of an investee (but not through having joint control or control of those polices). In this case, the investor has no legal capacity to take decisions and not even to block them (Co-control). Indeed, he has the capacity to “make his voice heard” which is far from exercising a purely passive role taking decisions discussed by others. The distinction between Control and Influence leads to a different accounting treatment of the investment in companies over which influence is exercised (these companies under influence are called Associates of the Investors) .The method used is called Equity Method.

The Accounting rules for the investment in Subsidiaries and Associates are complex, nevertheless, there is a major difference which immediately strikes the mind: the Acquisition Method prescribes the recognition of all Assets and Claims of the investee, whereas the Equity Method does not, limiting the recognition to the share owned by the Investor exercising Influence. This leads to significant different figures appearing in the relevant Statements. Classifying an investment whether either (Control/Influence) categories is a fundamental choice which definitely entail consequences for the capacity of a company to attract funds. The whole picture becomes even more complicated because accounting rules for investments which do not turn out in generating Control or Influence follows a third set of rules (Alfredson et.al., 2012)). Hence, identifying the existence of Control and Influence on another entity is a key-step in the preparation of Statements. Moreover, there are key differences in the structure of a transaction when an acquisition occurs mostly for tax purposes (dePamphilis 2015). The notions of control and influence are inherent in each of the methods below, and clearly impact taxation. Further, the method of acquisition will impact earnings per share, impact working capital, tangible net worth, and debt/equity ratios.

Existence of either Control or Influence can therefore be an extremely vital issue (Podda, 2011; IFRS, 2013; Marcy, 2008; EY, 2013; Nobes, 2014). There are cases when this can be easily done. Nevertheless, our globalised economy is characterised by an intense web of dispersed ownerships, which may include investment vehicles, funds and even hedge funds, so that identifying a majority shareholder may infact be impossible. Moreover, ownership of the majority of shares may not entail automatic Control, because it is possible that clauses in the Articles of Incorporation of a given company award decisional power to a minority shareholder or require a high qualified majority (i.e. 70% of shares). Moreover, in case the majority shareholder does not hold an absolute majority of shares (50%+1 share), he may be outvoted by a coalition of minority shareholders, which may even be unstable.

As for the determination of the existence of Control , IFRS 10 offers some assistance. The holder of a majority of shares of another entity is presumed to have Control. However, Control is possible also in absence of such an occurrence (for example, with ENRON, the conglomerate deliberately kept participation in certain *de facto* controlled entities under the threshold of 50% plus one share, to avoid full recognition of liabilities). There is an emphasis on the use of judgment in determining whether Control exists and there are various elements which should be weighted.

A key step is to determine how decisions are made. When the existing voting rights do not allow to clearly exercise decisional power, then the Controller may be identified on the basis of exposure to risk: the greater this variable is determined to be, the greater the likelihood that the exposed entity controls the investee. A further factor indicative of Control is the separability of certain Assets from the rest of the investee and the existence of specific rights and obligations on these Assets in relation to liabilities of the supposed Controller. Decisions taken about appointments and remuneration of key personnel are also relevant in the determination of the controller of an entity. More details on the criteria followed to identify the existence of Control on a company are analysed in specialised documents (www.iasplus.com, www.ifs.org). The main message is that IFRS 10, following general principles of IFRS, does not possess a precise rule. IFRS does not have a “magic formula” to determine Control. It offers advice and guidance, leaving users with some discretion regarding the application of this specific instructions to actual cases (Podda, 2016). Hence, companies are left to decide how to classify the nature of the interest they hold on another entity. There is a clear downside: companies may abuse the discretion vested on them in order to classify their interest in a way which is suitable to their strategies and aims but not in the interests of other parties. However, setting overly precise rules risks diminishing determination of Control to a purely mechanical task, which in turn may not reflect certain existing realities.

To determine existence of Significant Influence, IAS 28 provides some guidance (https://www.iasplus.com/en/standards/ias/ias28-2011). These criteria have a general validity, their application depends on a case-by- case analysis run by the Accountants of that very entity deciding whether an interest in another entity should or not should not be classified as Significant Influence (and treated according in terms of accounting rules) , as Control or as neither of them. Also, in the case of Significant Influence, the IAS does not set out a clear prescriptive rule which would lead to a mechanical classification of any given interest. Indeed, the choice is left to the declaratory entity.

2 Case studies

Case studies are used to shed light into specific phenomena as happened in a definable context (De Vaus, 2002; Remenyi et.al., 2015; Bryman, 2016). Case studies are used to reconstruct stories, identify mechanisms and patterns of interaction, decisions, application of standards. A case study should not be expected to generalize (as case studies are qualitative and not a quantitative method of research), indeed expecting generalization would reveal fundamental misunderstandings regarding the scope and aims of research based on a case-study. Actually, case studies are used as a basis for clarifying relationships emerged following a quantitative – based study or , alternatively, can be used within a strategy of exploratory research perspectives, the emerged patterns can be operationalised into statistical variable and used in further quantitative studies to generalize results. Our paper makes use of case studies in view of highlighting the mechanisms of the decisional process specific to the concrete story. A process of generalization is largely beyond the scope of our paper. We move to discuss two cases.

We refer to the Acquisition of Bulgari from LVMH group in the Spring 2011. The acquirer paid the acquiree a combination of cash and shares. According to http://www.reuters.com/article/us-bulgari-lvmh-idUSTRE7261BS20110307 LVMH issued 1.9 millions Euros worth of new LVMH shares and 2.4 millions Euros cash. Moreover, the

Bulgari family acquired the right to appoint two representatives to the Board of Directors of LVMH. At first sight it appears that LVMH can exercise control over Bulgari from the beginning. This is said in view of the fact that LVMH already owned 76 % of the capital at the moment of Acquisition. In addition, LVMH was bound to launch an offer for the residual shares still not owned at the moment of Acquisition. Clearly, LVMH obtained the large majority of the shares of Bulgari and should easily allow itself to consolidate the statements of the acquiree together with its own ones. Still, as typical in our global economy, the ownership relationship is not unilateral. Bulgari itself in the end owned a stake in LVMH, and gained the right to appoint two representatives in the Board. Hence, it may be concluded that Bulgari has obtained Significant Influence on its own Controller. Significant Influence does not entail the capacity to take decisions (otherwise it would be Control), nonetheless by definition the holder of Significant Influence has the right to be heard. The apparently paradoxical outcome is that the Controller of Bulgari is under the significant influence of Bulgari itself. These “incestuous” relationships are normal in our economy and represents quintessentially what Dunning has termed “Alliance Capitalism”(1997). The Latin proverb from Horace “Grecia capta captivam fecit” expresses a situation where Greece, the captive, caught the captor. We are not maintaining that this has really happened at the time of the combination between LVMH and Bulgari. Nevertheless, the relationship contains a symbiotic element.

Guidelines for the interpretation of IFRS/IAS assists in solving such conundra. The company which issues shares in exchange for the shares of another company is usually the acquirer, especially when it also adds cash to compensate for the remaining value of the shares. This occurrence has materialised also in the case of LVMH – Bulgari and is clearly revealing of the will of the issuer of shares to gain Control over the investee. This criterion would be helpful to assist in the identification of the Acquirer even in cases less controversial than the one we are discussing, when LVMH ended up with a large majority of shares of Bulgari. Nevertheless, even an apparently simple case reveals some tricky elements, in view of the gain of Significant Influence on the Acquirer from the Acquiree.

The case of LVMH-Bulgari allows further remarks regarding the determination of the final Controller of an entity. LVMH is itself controlled by another company, Christian Dior, which is in turn under the Control of Bernard Arnaut, who is also CEO of LVMH. In reality the real controller of the whole conglomerate seems, at least officially, to be this latter entrepreneur. One may nonetheless legitimately wonder whether he may have any sort of unrevealed agreement with further financial forces.

A second case concerns the Control of Komerční Banka (KB) by Société Générale (SG) which holds 60% of the shares of the Czech Bank, whereas the remaining part is tradable on the Prague Stock Exchnge. The Société Generale Group includes Komerční Banka in its own Consolidated Statement, however there has been a challenge by the CFA Institute, an internationally acclaimed training organization for financial analysts, based on an analysis done in the CFA Challenge.

Komercni Banka was acquired by Société Générale following approval of the Czech Government on June 28, 2001. Naturally, consolidation was shown in the accounting records of the new Parent, SG, but there were certain implications. A bank must lend the money it has on deposit, and, as no lending infra-structure existed at the time, the parent took the existing deposits and lent them through the parent (Muir, 2003), this meant, essentially that Czechs were funding loans being made through an entity in Paris. Revised regulations disallowed such loans in excess of 10%, which, in effect reduced the element of control by the parent. Hence, the doubt arose regarding the effectiveness of Control, which apparently was an issue taken for granted at the beginning. KB was using almost 50% of customer deposits of CZK 318B to lend to banks (CZK 157B) and was lending, at that time, only CZK137B to customers. Was this due to the more than significant control that SG exercised over KB? Statements and information available are silent on the topic, however, the number indicate the most likely scenario. The new parent was clearly in control. Somewhat tangential to this is the fact that the control of the parent, unable to lend adeqately in the Czech market lead to increases in banking fees. (Dubská, 2012). Subsequent banking legislation appears to have changed the situation, resulting in a significant loss of control by SG. KB is shown as a small portion of the SG group, and is listed as one of eleven Cash Generating Units (CGUs) on page 27 of the SG statements of Decenber 31, 2016. In this instance, the bank has improved its position, with Customer Loans of CZK 580.2 B, and Amounts due from Bank at CZK 51.8B against Customer Deposits of CZK 699.4 B. In the intervening period, the credit crisis of 2007-8 and Basel III forced changes which were reflected in the activities of the Czech National Bank. Control, in this case, did not turn out to be absolute.

The CFA conundrum arises over the issue of determining the value of the shares being sold on the Prague Stock exchange. In fact, the control of the Bank seems to be in the hands of SG, and such things as dividend policy, corporate strategy (as part of SG Group), expansion etc, would all be decided within the context of SG group, but KB is analysed as an independent bank in the Czech Republic. Obviosly, both situations are not possible.

The issue of control has another aspect to it. KB is itself owner and controller of several entities, one of which is Essox, in which it holds 51% of the shares. The remainder are owned by Societe Generale, which in turn owns 60% of KB. What is the controlling entity? The same question is applicable to all entities involved in the group. The reason that this is important is because attribution of benefit (profit) can have tax implications. IFRS can provide guidelines for how to report structures, but taxation authorities can, and do, contest acquisition transactions which impact the placement of profits, and therefore taxable income.

Conclusion

Identifying the existence of Control and the identity of the Control holder is an important step for many entities. Indeed, the issue is not necessarily straightforward. Existing standards provide guidance but there is still some space for discretional choices. Even cases which are apparently easy may turn out to be tricky to a certain extent. Practices in the field of accounting have not kept up with the pace of change in global finance markets. This is unfortunate because Investors need information to make informed decisions. For this reason, the nature of the financial dealings between and amongst entities must be transparent. Failure to expose the extent to which one company can influence another, and to accurately present this information in an audited and verified format appears to represent an increased risk to investors. They in turn may demand higher rreturns, which ultimately makes goods more costly for everyone. We are here to say that current Accounting rules should be improved in order the identity of Controllers is clearer. Further research may come with suggestions on how to improve current rules.

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