Mergers & acquisitions—a snapshot
Changing the way you think about tomorrow’s deals

Stay ahead of the accounting and reporting standards for M&A¹

Alliances: Innovative transaction structures in a changing economic environment

The accelerated globalization of businesses, technological breakthroughs, and demographic and social changes in the 21st century have had a dramatic impact on the way companies and industries operate. This has resulted in a shift in M&A strategy and execution.

Increasingly, corporations and investors are moving beyond the traditional acquisition/disposal model and using joint ventures and strategic business alliances to achieve their business development objectives. More and more, companies are turning to alliances to step up growth and to benefit from a partner’s complementary skills and capabilities. Each alternative for expanding your business (build it, buy it, or partner for it) has its own accounting and operational implications that should be considered.

This edition of Mergers & acquisitions—a snapshot, is the first in a series focused on joint ventures and strategic alliances. Throughout this series, we will refer to joint ventures and strategic alliances as “alliances.” The series will discuss various aspects of an alliance, including when to consider an alliance, how to structure and govern the alliance, and how to ultimately exit the alliance. This snapshot highlights when to consider an alliance, who to consider partnering with, and the relevant accounting implications that should be considered.

¹ Accounting Standards Codification 805 is the US standard on business combinations, Accounting Standards Codification 810 is the US standard on consolidation (collectively, the “M&A Standards”).
Alliance: a significant global trend

Today’s economic environment is having a significant impact on the way businesses operate and compete. Megatrends of unprecedented population growth, shifting economic power to emerging economies, rapid urbanization, resource scarcity, and technological breakthroughs are having pervasive impacts on businesses globally and across all sectors.

This changing economic environment is driving companies to look at alternative structures for expanding their business to be more nimble and flexible. Rather than spending significant capital to invest in new locations or develop new products, businesses are partnering together. In the most recent PwC Annual U.S. CEO Survey, 59% of CEOs indicated that they will enter into an alliance in the coming 12 months.

Alliances play a key role in a corporate growth strategy. They are an alternative to the organic option of building a new business from the ground up or the inorganic option of making an acquisition. Although each option has its benefits, each also has its drawbacks.

Under a build it model, companies generally go it alone – this can lead to higher rewards due to the ability to control the decision making and economics. However, under this model, companies need the requisite knowledge to develop the product or service. In addition, it generally takes a longer period of time and usually is more costly to build it yourself.

Under a buy it model, capability gaps can be quickly filled and the goals of expanding into new markets or products can be rapidly achieved. However, it can often be difficult to find an appropriate target and execution is a long-term business decision; although not necessarily permanent, it can be costly if you change your mind.

Compared to the build it or buy it models, alliances have become an increasing part of the deals landscape as companies are looking to access emerging technologies and strengthen innovation. Capability gaps can be filled through alliance structures and can provide significant benefits to businesses, often with limited capital outlay. In addition, alliances may be the only option based on foreign ownership laws.

Figure 1 highlights where strategic alliances sit along the continuum between building it yourself and traditional acquisitions in certain key areas.

Benefits of alliances

The benefits to growth through alliances, rather than through the traditional acquisition model, are plentiful. Access to new and emerging technologies and innovation capabilities are top reasons for partnering, allowing CEOs to complement their company’s strengths. In addition, given the increased competition in their traditional markets, companies are looking to expand their business through alternative sources, often through partnerships, which provide access to different customers and geographies. Further, the ability to share costs and leverage knowledge from companies is blurring the lines between different industries as CEOs look to leverage expertise from companies outside of their traditional realm. Lastly, the capital outlay required for alliances is more limited than the traditional M&A model.

Figure 2 highlights the new and traditional drivers for entering into an alliance as depicted in PwC’s Annual Global CEO Survey.
Types of partners

Companies are developing a diverse and far reaching network for collaboration. While many still partner with traditional stakeholders, such as suppliers, many are looking to grow and diversify their network through non-traditional partners, both within and outside of their industry.

For example, two major competitors within the automotive industry are sharing knowledge and reducing costs by partnering to develop a transmission. Automotive manufacturers are also partnering outside of their industry, with technology companies, to react to changes in their traditional customer due to the success of car-sharing networks and the expected growth in mega cities.

Pharmaceutical companies are partnering with technology companies as a result of the emergence of new types of healthcare data. Technology companies are able to assist in converting “big data” into more useable and impactful information to assist with the development of healthcare solutions.

Non-traditional alliances are becoming more common with governmental agencies, academia, start-up companies, business networks, and trade organizations. Many companies are also partnering with customers through “crowd sharing” concepts, utilizing the power of social media to create ideas for innovation. Figure 3 highlights the types of alliance partners according to a recent PwC global CEO survey.
Types of structures

Alliances are often created through a variety of complex structures as companies are looking for flexibility and options that balance the benefits of new opportunities with the risks, costs, complexity, and lack of control that often exist with alliances. Alliances may be structural (where a new entity is created) or contractual (where a new entity generally is not created and a series of contracts are used). This series will focus on both types.

Examples of common alliance structures include the following:

<table>
<thead>
<tr>
<th>Alliance Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint venture</td>
<td>A structure in which two or more parties contribute assets to a legal entity (“NewCo”) and share in the profits and losses</td>
</tr>
<tr>
<td>Majority investment</td>
<td>A structure in which the partner contributes funds, IP, or other property to an existing entity and takes back a majority ownership stake</td>
</tr>
<tr>
<td>Minority investment</td>
<td>A structure in which the partner contributes funds, IP, or other property to an existing entity and takes back a minority equity stake</td>
</tr>
<tr>
<td>Long-term contract/virtual joint venture</td>
<td>A contractual arrangement to collaborate with a partner for a specific task (e.g., purchase or supply of products or services) or a business goal (e.g., joint launch of a new product) that provides a mechanism to allocate risks and rewards</td>
</tr>
</tbody>
</table>

Structural alliance (new entity is created)

If a new entity is created, the entity generally is either consolidated into a company’s financial statements or treated as an equity-method investment. New entities may be created for joint ventures, majority investments, or minority investments.

If the new entity is consolidated, the consolidating company includes the results of the newly created entity (including all of the assets, liabilities, revenues, and profits/losses) in its financial statements. The consolidating company would also need to consider whether noncontrolling interests exist (e.g., if any other investors own a portion of the newly created entity), which would also impact reporting on the balance sheet and income statement.

If the company maintains “significant influence” over the new entity, but does not control the new entity, it would account for its investment as an equity-method investment. This would include a “true joint venture,” in which neither party has control. Under equity-method accounting, the company would recognize its proportionate share of the net assets of the equity-method investee on one line on its balance sheet and its proportionate share of the earnings or losses on one line in its income statement. This is often presented outside of operating income in the income statement, even if the alliance is very strategic to the company.

Contractual alliance (new entity is not created)

Many alliances are created through contract alone and do not result in the creation of a new legal entity. For example, entities may participate in a joint operating activity to develop and commercialize intellectual property (e.g., the development and commercialization of a new drug, software, computer hardware, or a motion picture) through long-term contracts. For arrangements when a separate legal entity does not exist, costs incurred and revenue generated from transactions with third parties would generally be reported by the participant in the collaborative arrangement pursuant to the revenue recognition and research and development guidance. For many companies, the income statement presentation of recording revenues and costs arising from transactions with a collaborative arrangement may be preferable to that of recording equity-method income/loss arising from an investment in a joint venture.

Accounting implications

Some of the structures result in the creation of a new legal entity whereas others would not. Governance, profit allocation, and exit mechanisms can vary significantly. Each type of structure may impact financial metrics that should be considered prior to the execution of an agreement. This is especially true when companies in different industries collaborate as the key metrics in their respective industries may be different.
Key financial metric implications for the reporting entity’s financial statements by type of alliance are summarized as follows:

<table>
<thead>
<tr>
<th>Financial statement metrics</th>
<th>Structure</th>
<th>Revenue</th>
<th>Liabilities</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint venture</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Majority investment</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Minority investment</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Long-term contract/virtual joint venture</td>
<td>Yes</td>
<td>It depends</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

In summary

The competitive environment has shifted in a way that is creating new and unique challenges. Companies are working to stay ahead of the curve by collaborating with partners in various industries to share ideas, knowledge, experience, and costs. The globalization of the economy has also created a shift in overseas ventures and alliances as companies are looking to expand into new markets.

These alliances can be structured in different ways, each with unique accounting considerations and resulting impact on financial metrics. As each company and its investors view the importance of certain accounting and financial reporting metrics differently, the various impacts of the different structures should be carefully considered.

A company’s consideration of the impact on corporate governance, compensation arrangements, and tax compliance and reporting, as well as considerations of an exit strategy are critical to ensure the ultimate success of an alliance. Stay tuned for future editions in our series on alliances, which will highlight some of these considerations.

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The following M&A Snapshots (all available on cfodirect.com) address topics related to business combinations and noncontrolling interests and are relevant to a broad range of constituents.

- How timing your transactions in light of the new standards will impact your business and communication with stakeholders
- Goodwill impairment testing: What’s old is new again
- Deal or no deal: Why you should care about the M&A Standards
- Even your tax rate will change
- Accounting for partial acquisitions and disposals—it’s not so simple!
- Doing a deal? Be careful about employee compensation decisions
- Acquired assets not intended to be used: You may need to record them, even if you don’t use them!
- Accounting for contingent consideration—Don’t let earnouts lead to earnings surprises
- The Consolidation Standard—determining who consolidates is just the beginning
- Carve-out Financial Statements—A challenging process
- Noncontrolling interests—why minority shareholder rights matter
- Market participants: how their views impact your values

Did I buy a group of assets or a business? Why should I care?
Don’t let push-down accounting push you around
Financial risk management considerations in an acquisition
We’re in the process of acquiring a company with significant in-process research and development (IPR&D) activities. What’s next?
Cross-border acquisitions – Due diligence and pre-acquisition risk considerations
Cross-border acquisitions – Navigating SEC reporting requirements
Cross-border acquisitions – Accounting considerations relating to income taxes
Cross-border acquisitions – Post-acquisition considerations
Companies in distress: A successful turnaround requires decisive action
Companies in distress: Bankruptcy process and reporting considerations
Companies in distress: Emerging from bankruptcy
Companies in distress: Tax planning and accounting considerations

Coming soon: PwC’s Deals Practice monograph, covering topics relevant to a broad range of alliance considerations.

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