

New IFRS for Acquisitions (M&A)

What impacts on your financial statements and communication?
How should your acquisition strategies and terms be adapted?



A Pocket Guide

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on “New IFRS for Acquisitions (M&A)”
see insert...**



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PRICEWATERHOUSECOOPERS 

New IFRS for Acquisitions (M&A)

Acquisitions and disposals represent a core growth strategy for companies.

In January 2008, the IASB (International Accounting Standards Board) released a **new version of IFRS 3**, which will have substantial – and frequently counter-intuitive – consequences on financial statements.

Even if the new standard will mandatory apply to transactions dating from 2010, it could widely **influence acquisition strategies from now**.

This Pocket Guide is very practically oriented for deal-makers and preparers.

It provides **practical advice** for **optimising decision-making** with regard to:

- acquisition and disposal **strategies**;
- due diligence work and contractual **clauses**;
- the use of expert **valuations**; and
- the presentation of financial performance and **financial communication**.

It also contents an **exclusive interview** with Philippe Danjou, member of the IASB, who explains and defends the advantages afforded by the new standard.

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EXECUTIVE SUMMARY

Why is it important to look at the new IFRS standard now?

Acquisitions and disposals represent a core growth strategy for many companies. In January 2008, the IASB (International Accounting Standards Board) released a new, ground-breaking standard on business combinations. The standard:

- highlights the importance of the existence or absence of control over another company, and exacerbates the disconnection between cash flow and accounting earnings;
- results in more fair value measurement particularly in the post acquisition period, this is likely to add to earnings volatility.

The resulting impact on financial statements of the new standard may be substantial and may also be counter-intuitive. For example gains arising on step acquisitions will be recognised in the income statement and transaction costs will be expensed as incurred (and no longer included in goodwill), etc.

Buyers and sellers alike would be well advised to anticipate the accounting consequences on deals, by possibly:

- adapting their acquisition strategies,
- amending contractual clauses, and
- increasing their valuation capabilities.

The new standard will apply only to transactions dating from 2010, but could be applied on an anticipatory basis to transactions conducted in 2009 as soon as it is endorsed. Although deals completed prior to adoption will not be restated, acquisition and disposal strategies are likely to be affected straight away.

Disconnection between cash & earnings-equity

IFRS 3R - a disconnection between cash and earnings-equity?

Consolidated financial statements under the new version of IFRS 3 are now prepared as those of a single “economic entity” with majority and minority owners rather than from the perspective of the parent company’s shareholders. All transactions between an entity’s owners are reflected solely in equity. Only step acquisitions or disposals that involve change in control trigger the recognition of gains or losses in the income statement.

A consequence of the economic entity approach is that it produces an apparent disconnect between cash flow and earnings or equity movements. A challenge for management will be to explain the impact of transactions accounted for under the new standard.

Some examples of the impact of the new standard:

- the purchase of non-controlling interests will reduce equity and can appear to be value destruction;
- the sale of 30% of a 100% owned subsidiary with a fair value substantially higher than book value with no disposal gain; and
- control of a company is obtained by acquiring 13% on top of the 38% already owned, the 38% that the entity still owns gives rise to a substantial (yet unrealised) gain in the income statement.

Fair value measurement and volatility

IFRS 3R - more fair value and more volatility in earnings and equity

Fair value is already the standard valuation basis for the measurement of identifiable assets and liabilities when preparing the acquisition date balance sheet. However, the new IFRS 3 goes further by prescribing wider use of fair value and by fixing the amount of goodwill at the date at which control is obtained. Illustrations of this point:

- earn-out clauses (contingent consideration) are included in the measurement of consideration at the acquisition date and thus the initial measurement of goodwill;
- goodwill on non-controlling interests is not subsequently adjusted, even in a buyout context; and
- the fair value measurement of identifiable assets and liabilities has been expanded to include more intangible assets, as well as re-assessment and potential reclassification of some financial instruments.

The 12-month period for finalising the business combination accounting has, however, been retained. Accordingly, any subsequent changes in fair value are recognised in the income statement (or in equity, in the case of the buyout of non-controlling interests), rather than some adjusting goodwill as today.

This may well result in greater volatility for several years following the acquisition, in addition to the income statement impact expected in the year of acquisition arising from expensing transaction costs and recognition of gains related to previously held interests (step acquisitions).

Full or partial goodwill method

Considerations on choosing between “partial” and “full” goodwill under IFRS 3R

Today, in a less than 100% acquisition, a buyer recognises 100% of the identifiable assets and liabilities acquired and goodwill calculated as a residual comparing the consideration paid to the acquirer’s interest in identifiable assets and liabilities. IFRS 3R introduces an option for the buyer to value the non-controlling (minority) interest at either the minority’s proportionate share of the net identifiable assets (residual method as today or “partial goodwill”) or to value the non-controlling interest at fair value, thus recognising goodwill on the non-controlling share (“full goodwill”).

What would influence an acquirer to choose between the partial goodwill method and the full goodwill method?

The recognition of full goodwill increases equity at the acquisition date. It would also reduce any potential decrease in controlling (parent) equity resulting from a subsequent buyout of the non-controlling interest. Full goodwill might be best suited to companies with a weak equity base and/or a high level of gearing.

However, the full goodwill method also has a number of drawbacks:

- The fair value measurement of the non-controlling interest may require the use of complex valuation techniques;
- Any subsequent impairment charge is higher than under the partial goodwill method, with a negative impact on reported operating results.

Buyers are allowed to decide which method is more appropriate on a transaction-by-transaction basis – an area of flexibility allowed by the new standard.

Adaptation of acquisition strategies

Why should decision-makers anticipate the new version of IFRS 3 and adapt acquisition and disposal strategies and terms accordingly?

Acquisition and disposal decisions should not be driven by accounting considerations. Moreover, the exact time frame for deal-making and negotiations is seldom known in advance. However, decision makers like to be able to develop their own strategy, be that:

- purchasing an equity stake in the target company prior to pursuing control, in order to test the water;
- purchasing a minimum controlling interest at first and buying out NCIs (NCI, previously minority interest) at a later date;
- acquiring 100% control from the outset, increasing the value of the acquired business and then disposing of shares without, however, giving up control; or
- acquiring control, increasing the value of the acquired business, then disposing of shares and retaining only a NCI.

The terms of transactions under IFRS 3R could have very different and potentially counter-intuitive effects on earnings and equity. Management should consider if the previous strategy for business acquisitions is the right one under the new accounting requirements.

The best way to avoid surprises is to anticipate the consequences of the proposed transaction terms and the new accounting standard on the financial statements at an early stage and to model potential outcomes.

Adaptation of contractual clauses

IFRS 3R - how might it change contracts for business combinations?

Managers are already taking a close look at the contractual clauses associated with acquisitions, particularly with regard to the cash component of earn-outs, post-acquisition payments to selling shareholders and indemnity clauses. Depending on the terms of the arrangement, fair value adjustments related to these items might need to be recognised in the income statement, rather against goodwill as today. Good planning and hard negotiating may reduce or eliminate earnings volatility in the wake of an acquisition. There are some significant areas that merit consideration to meet this challenge:

- expand the scope and extent of due diligence work and either replace earn-out arrangements by a definitive acquisition price (“locked box” mechanism) or shorten the duration of earn-outs;
- pay earn-outs in a fixed number of equity instruments;
- use valuation experts and benchmarking techniques to assess the fair value of earn-out clauses as accurately as possible.

However, to reduce or eliminate earnings volatility, companies should:

- negotiate for robust liability indemnification clauses and better monitor related compliance; and
- carefully word clauses governing payments due to former owners retained in the business after the acquisition date.

These changes should be made before contracts are signed to avoid problems further down the road.

Use of expert valuations

How does IFRS 3R increase the use of valuations in acquisitions and disposals?

Accurate fair value measurements of acquired assets and liabilities in a business combination can present real challenges to companies today. The wider use of fair value under IFRS 3R may increase both the number and complexity of valuations.

There is an incentive for assessments to be even more precise and reliable, given that re-measurements after the acquisition date will be recognised in the income statement.

The main consequences on the valuation front are likely to relate to:

- estimates of earn-outs, including the modelling of the probability of pre-defined performance objectives being achieved;
- the analysis and quantification of control premiums, with a view to measuring non-controlling interests;
- the measurement of unusual intangible assets or indemnities concerning liabilities, such as environmental risks; and
- the reassessment of financial assets and liabilities, notably hedging instruments and embedded derivatives.

The challenges ahead may see companies seeking additional input from experts armed with a strong knowledge of valuation techniques and of the sectors in which their clients operate.

Interview with Philippe Danjou

What improvements does the new IFRS 3 bring to international accounting regulatory governance, to competition between companies and to transaction management ?

Acquisitions and disposals are of strategic importance to companies. This importance was brought to the fore in January 2008 with the new IFRS 3. The new version of the standard represents a significant improvement from previous guidance and will produce new effects on financial statements as from 2009 onwards. With this in mind, we urged companies in our previous contributions to consider the implications of the new standard now (see Q1 to Q3).

Our presentation of the difficulties associated with applying the standard and the counter-intuitive consequences relative to current practice has struck a chord with readers. This is especially pertinent since the adoption of the standard by the European Union in the coming months is a crucial step for the IASB.

Philippe Danjou, member of the IASB, here explains and defends the advantages afforded by the new guidance in his responses to the following questions.

How does the new IFRS 3:

- improve international accounting regulatory governance?
- level the playing field for European and American companies?
- enhance transaction transparency?
- live up to the simplification of guidance announced by the IASB?
- facilitate the management of acquisitions?

WHY IS IT IMPORTANT TO LOOK AT THE NEW IFRS STANDARD NOW?

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at the new IFRS standard now?**

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Why is it important to look at the new IFRS standard now?

Acquisitions and disposals represent a core growth strategy for many companies. Accounting considerations should not drive transaction decisions but accounting can have a real impact on deal structure and planning, contractual clauses and communications with the marketplace.

In January 2008, the IASB (International Accounting Standards Board) released a new standard on business combinations, accompanied by a revised standard on consolidated financial statements that requires the use of the economic entity model.

A number of significant changes are looming. In particular, the new standard:

- reinforces the importance of the existence or absence of control over a company, and exacerbates the disconnection between cash flow and accounting earnings;
- prescribes the wider use of fair value measurement particularly in the post acquisition period, which is likely to add to earnings and equity volatility.

The resulting impact on financial statements may be substantial and counter-intuitive. This means that buyers would be well advised to anticipate the accounting consequences on deals, by possibly:

- adapting their acquisition strategies,
- amending contractual clauses, and
- increasing their valuation capabilities as these skills may be needed more frequently and for more complex issues.

Q1. *In what way is the new standard on acquisitions and disposals ground-breaking?*

The new standard gives pride of place to two major concepts: control and fair value

Control as a key determinant

The majority of companies have been preparing their consolidated financial statements from the perspective of the parent company exercising control over another entity. The new standard requires the adoption of the “economic entity” model. Under this approach, consolidated financial statements are treated as those of a single entity and are prepared from the perspective of both categories of shareholder – majority and minority. Only a handful of IFRS companies are using economic entity today.

Two noteworthy consequences of this new approach are as follows:

- The assumption or loss of control changes the economic entity. Therefore, a change in control conditions the recognition of a gain (or potentially a loss) in the income statement; and
- Where acquisitions or disposals of equity interests do not result in a change in control, the economic entity is perceived as intact. Such transactions are treated as having no impact on the income statement and are reflected only in equity.

These effects may seem counter-intuitive. The economic entity approach may also be seen by some to exacerbate the disconnection between the cash paid for acquisitions (or received for disposals) and fluctuations in earnings or equity. Specifically, the

prescribed accounting treatment could lead to depicting a step acquisition as wealth-enhancing and the acquisition of a non-controlling interest as wealth-destroying. This may well be hard to explain to analysts and users.

Ever-wider application of fair value measurement, leading to increased earnings volatility

Fair value measurement is increasingly present throughout the process of acquiring control and the related consequences will be felt in the year of acquisition and beyond. For example:

- In the context of a step acquisition, any previously-held equity interest in the acquiree is required to be re-measured to fair value and the resulting gain or loss is recognised in the income statement in the year of acquisition. This was previously recorded in equity;
- Transaction costs will no longer be included in the acquisition price and are expensed as incurred;
- Any earn-out must be recognised at fair value at the date of the transaction (regardless of probability) and any subsequent re-measurements (after the measurement period) are recognised in the income statement (and no longer in goodwill);
- The requirement to recognise all of the identifiable assets and liabilities of the acquiree at fair value will cover a larger number of intangible assets, given that the reliable measurement criterion is now deemed to be met for all intangible assets;
- The new standard requires that deferred tax assets be treated in the same manner as other assets; adjustments relative to the business combination accounting on day 1 must be recorded in the

income statement as part of tax expense in subsequent years; and

- There is no requirement to measure non-controlling (minority) interests at fair value (including related goodwill). However, under the optional “full goodwill” method, non-controlling interests may be measured at fair value on a transaction-by-transaction basis (see Q18).

Major implications to take into account in the early stages of acquisition and disposal strategies

The new standard has some significant implications. The accounting consequences might be counter-intuitive and potentially unmanageable for an acquirer that doesn't pay attention to the new requirements. Buyers and sellers alike should look now at acquisition structures and plans with a view to eliminating transaction terms that result in volatility. Management should also consider the impact of transactions on earnings and equity.

Actions could include:

- changing acquisition and disposal strategies. For example, where possible, buyers should weigh the benefits and drawbacks of acquiring control of a company in one or several stages and whether it is necessary to buy 100% of the shares;
- the enlargement of the scope and extent of due diligence prior to and at the acquisition date;
- the amendment (or replacement) of certain contractual clauses, notably those around earn-outs or other contingent payments; and
- increase access to valuation expertise. Complex models may be required and more valuations may be needed for an entity active in acquiring and disposing of businesses.

Q2. *Why look ahead now to the new standard?*

The standard is required for financial years beginning on or after 1 July 2009

For example, a company with a 31 December financial year-end will have to apply the new standard to acquisitions and disposals occurring from 1 January 2010. However, the compulsory compliance date for a company with a 31 October financial year-end, for example, will be 1 November 2009.

However, the standard may be applied earlier for transactions occurring as soon as 2009

European companies may indeed opt for earlier adoption once the standard has been endorsed by the European Union, i.e. probably for transactions conducted as soon as 2009.

Compliance from 2009 will be compulsory for American companies. There has been muted reaction to the new standard in USA, despite the relatively greater impact for them. Acceptance of the standard on the other side of the Atlantic may overshadow the criticism aroused by the new standard elsewhere and persuade the European Union to endorse it (see QI and QII, interview with Ph. Danjou).

Probable impact on transactions in 2008 and 2009, ahead of the application of the standard

The new standard may not be applied retrospectively to earlier or current acquisitions and disposals. However, it is likely to have a strong influence on forthcoming transactions, such as:

- if a company has full control over the timing of a transaction, it may want to advance or postpone the deal depending on whether the current or new version of the standard is more favourable;
- likewise, if a company does not have full control over the timing of a transaction, it may consider the benefits versus the drawbacks of the early application of the new standard.

This analysis can be applied to all types of transactions (acquisition of an interest, acquisition of a controlling interest, step acquisitions, purchase of a minority or a disposal).

Thus, there is much food for thought and reason to reflect upon the accounting consequences of the new standard as of now.

Q3. *A new standard on common control? ...*

Common control transactions are business combinations in which the same party controls the combining entities. Transactions involving entities and activities under common control remain outside the scope of the new standard. The IASB is currently working on this issue, but a new standard is not expected soon. In the absence of explicit guidance, companies may elect to apply fair value measurement by reference to the current standard or the historical book values of the acquired assets and liabilities, without recognising goodwill.

In conclusion, given the implications of the new standard and its major accounting consequences, potential buyers should focus on preparing for the application of the standard (see Q20 to Q24).

IMPACTS ON FINANCIAL STATEMENTS AND FINANCIAL COMMUNICATION

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► **Disconnection between cash & earnings-equity**

IFRS 3R - a disconnection between cash and earnings-equity?

Today, consolidated financial statements under IFRS are prepared (almost exclusively) using the “parent company approach”, i.e. they present the financial situation of the parent company’s shareholders only. The revised standard on consolidation (IAS 27R) requires that consolidated financial statements instead be treated as those of a single “economic entity” and be prepared from the perspective of both categories of owner – majority and minority or controlling and non-controlling interests using the new terminology.

Transactions between the controlling and non-controlling shareholders do not change the composition of the economic entity. They are transactions between the company’s owners and, therefore, are reported only in equity. The replacement of the parent company’s perspective by the entity’s global perspective represents a ground-breaking change. The related accounting consequences will be significant, but also may be counter-intuitive for those accustomed to the parent company approach.

The new approach creates or increases an apparent disconnection between cash movements and fluctuations in earnings or equity. A buyout of non-controlling interests has a negative impact on equity and the disposal of a non-controlling interest in a company whose shares have appreciated in value does not, any longer, trigger the recognition of a gain in the income statement.

This “disconnection” will be apparent in the year of the acquisition or disposal and will affect earnings and equity in an unexpected manner.

Companies will need to:

- anticipate the accounting consequences at a very early stage of the acquisition strategy process and adapt their strategies accordingly, where appropriate;
- explain to the marketplace the impact of transactions on financial health and performance ratios, and the cash consequences of acquisitions and disposals.

Q4. *How does the disconnection between cash and earnings already exist in the current standard?*

The current standard, IFRS 3, requires a buyer to recognise an intangible asset once the item in question meets the definition of such an asset and its fair value can be measured reliably. This provision has resulted in the recognition of many more intangible assets. Many of these are internally generated by the acquiree and include trademarks, customer lists, order backlogs and, in some circumstances, research and development projects. Recognition is mandatory even if the items are not shown in the acquiree’s pre-transaction balance sheet. The buyer’s income statement is impacted by hefty amortisation charges related to such acquired intangible assets during the years following the acquisition.

The two companies' combined cash flow remains the same before and after the acquisition but the consolidated income statement will include the additional amortisation charges.

The resulting apparent decline in profitability measures like EBITDA and P/E is often stripped out by many analysts looking at a company's results. A business combination is intended to generate synergies and the prospect of a deterioration of performance ratios is inhibitive... and has even scuttled some deals !

IFRS 3R may make some transactions even more difficult to explain, as discussed below.

Q5. How does the new IFRS 3 exacerbate the existing, intangible asset-related disconnection between cash and earnings?

The new IFRS 3 will result in an increase in the number of intangible assets carried on the balance sheet for acquisition purposes. This will increase the disconnection between cash movements and fluctuations in earnings or equity (see Q32). The gains and losses arising from step acquisitions and partial disposals are one element of this, the absence of gains and goodwill from transactions with non-controlling interests is another.

Q6. *How does obtaining control through a step acquisition exacerbate the disconnection between cash and earnings?*

Recognition of a gain on the previously-held equity interest, although there is no cash inflow, but rather a cash outflow to pay for the additional stake leading to the assumption of control

When a buyer achieves control through successive share purchases (thereby increasing its interest from, say, 30% to 60%), the previously-held equity interest in the acquiree must be re-measured to fair value and the resulting gain recognised in the income statement (rather than in equity as today). This treatment is applicable irrespective of whether the previously-owned shares were accounted for under the equity method or as available-for-sale (AFS) financial assets.

The trigger for the recognition of the gain in a step acquisition is the change in control within the economic entity. The buyer, previously only a shareholder in a company, now controls the individual assets and liabilities of the target company. The new standard treats a step acquisition as two transactions:

- the disposal of the previously-held equity interest (30%), leading to the recording of “proceeds” or gain in the income statement; and
- the subsequent acquisition of control (60% interest in our example) over the target company.

There is, obviously, no cash inflow for the buyer, but rather an outflow of cash to pay for the additional shares.

Q7. *How does a partial disposal with loss of control exacerbate the disconnection between cash and earnings?*

Recognition of a gain on the interest retained and on the shares disposed of, although cash is received solely for the shares sold

Consider the case of a company which owns a 51% controlling interest in a subsidiary and decides to sell 5% of the shares owned. Under IFRS 3R, a gain arises not only on the shares sold, but also on the 46% interest retained. The 46% interest is re-measured to fair value and any resulting gain or loss is recognised in the income statement (together with the gain or loss on the shares sold).

How may one explain the recognition of a gain on the 46% interest retained when cash is received only for the 5% of shares sold?

The trigger for the recognition of the gain under the new standard is the loss of control (i.e. the reduction in the seller's previous controlling interest to an equity stake), that changes the economic entity. The treatment of the partial disposal of shares with loss of control reflects two transactions:

- the disposal and de-recognition of the individual assets and liabilities of the subsidiary, leading to the recognition of a gain on the shares retained and the shares sold; and
- the subsequent acquisition of shares corresponding to the retained stake.

In practice, cash is received only for the 5% stake effectively sold.

Q8. *How does a partial disposal without loss of control exacerbate the disconnection between cash and equity?*

Recognition of a disposal gain or loss in equity and not in the income statement, despite the existence of a cash inflow

Where a company has 100% control over a subsidiary and decides to sell 30% of the shares, after having increased their value, IFRS 3R requires that the disposal gain be credited to equity. The controlling interest (seller) has created value and will receive a cash inflow, but no disposal gain will be recognised in the income statement. Under the new standard, a disposal of shares is treated as a transaction between a single economic entity's two categories of owners. Accordingly, the impact of the transaction must be reflected in equity and not in the income statement as today. In other words, the treatment is the same as that applied to treasury shares.

Q9. *How does the buyout of non-controlling interests after the assumption of control exacerbate the disconnection between cash and equity?*

Reduction in equity despite the contribution to its increase in value paid in cash

Under current practice, if a company acquires the 49% non-controlling interest of an entity already 51% controlled by it, it records the difference between the acquisition price and the book value of the non-controlling interest as additional goodwill. The buyout of non-controlling interests under IFRS 3R is treated as a transaction between a single economic entity's two categories of owners. The marketplace may see that the acquisition of non-controlling interests in a profitable company results in a reduction in equity and value destruction.

Would it have been more advantageous for the buyer to acquire 100% of the shares in one stroke? Regardless of the option selected for the treatment of goodwill ("partial goodwill" or "full goodwill" method), the buyout of non-controlling interests will reduce equity if the fair value of the acquiree has increased since the assumption of control (see Q16 à Q19).

Q10. Given the counter-intuitive consequences on financial ratios, how may companies best rise to the increasing challenge of communicating with the marketplace?

The disconnection between cash movements and fluctuations in earnings or equity is bound to have significant consequences, both during the year of acquisition and beyond. Companies will need to anticipate lack of understanding on the part of investors and be ready to explain to financial analysts and the investment community the impact of acquisitions and disposals on:

- the buyer's various performance indicators, including EPS, P/E and, where appropriate, operating result and EBITDA ratios;
- the buyer's financial health ratios, notably the debt-to-equity ratio and, where appropriate, financial covenants compliance.

Companies may want to realign their performance ratios with the new standards.

They will also have to explain the real value of acquisitions or disposals and the associated business benefits over a short- to long-term horizon.

For help with strategy and communication policy, companies may refer to the explanations provided above and to those hereinafter (see Q20 to Q24).

► Fair value measurement and volatility

IFRS 3R - more fair value and more volatility in earnings and equity

Fair value is already the standard valuation basis for the measurement of identifiable assets and liabilities when preparing the acquisition date balance sheet. However, the new IFRS 3 goes further by prescribing wider use of fair value and by fixing the amount of goodwill at the date at which control is obtained. Illustrations of this point:

- earn-out clauses (contingent consideration) are included in the measurement of consideration at the acquisition date and thus the initial measurement of goodwill;
- goodwill on non-controlling interests is not subsequently adjusted, even in a buyout context; and
- the fair value measurement of identifiable assets and liabilities has been expanded to include more intangible assets, as well as re-assessment and potential reclassification of some financial instruments.

The 12-month period for finalising the business combination accounting has, however, been retained. Accordingly, any subsequent changes in fair value are recognised in the income statement (or in equity, in the case of the buyout of non-controlling interests), rather than some adjusting goodwill as today.

This may well result in greater volatility for several years following the acquisition, in addition to the income statement impact expected in the year of acquisition arising from expensing transaction costs

and recognition of gains related to previously held interests (step acquisitions).

Q11. Under the new standard, what is entailed by the measurement of shares at fair value at the date of obtaining control?

All newly acquired or previously held interests in an acquired business are measured at fair value at the date control is obtained. The resulting value of consideration – and, therefore, the related goodwill – is not adjusted subsequently. Any immediate or subsequent change in value of assets, liabilities, contingent liabilities or contingent consideration is recognised in the income statement, rather than in goodwill or equity for some transactions as allowed under IFRS 3 today.

The consideration given to obtain control of the acquiree must be measured at fair value

This calculation excludes transaction costs such as fees paid to intermediaries, consultants, lawyers, and valuation experts. These costs are not part of the acquiree's intrinsic value and are expensed as incurred under IFRS 3R.

The current standard treats transaction costs as a component of the acquisition price and therefore they fall into goodwill.

Earn-out clauses are measured at fair value at the date at which control is obtained

The value of earn-out clauses and other forms of contingent consideration is usually driven by the post-acquisition performance of the acquired business.

Earn-outs are routinely based on, for example, growth in turnover, operating result or the share price.

Earn-out clauses under IFRS 3R are measured at fair value at the date at which control is obtained. The probability of payment does not impact recognition but will affect the valuation of the contingent consideration. Any subsequent re-measurement is recognised in the income statement. Earn-out clauses under the current standard are recognised only if payment is probable and reliably measurable. However, even when these are recorded at the acquisition date any subsequent adjustment is recorded against goodwill and not in the income statement.

Previously owned interests in the acquired business must be re-measured to fair value (for example, the acquisition of a 40% interest on top of an existing 15% or 25% stake). The re-measurement of the existing 15% or 25% stake is performed at the date at which control is obtained and any gain is recognised in the income statement, rather than in equity as today.

Q12. Under the new standard, how should non-controlling interests be measured at the date of obtaining control?

Will it still be possible to adjust goodwill after the date at which control is obtained?

IFRS 3R provides the option to measure non-controlling interests at fair value at the acquisition date (“full goodwill method”) or to record only the controlling interest’s share of goodwill (“proportionate share method”). Where companies elect to apply the

full goodwill method the non-controlling interest is recorded at fair value as a component of equity.

Companies may also elect to measure non-controlling interests at the fair value of net identifiable assets (as per current practice) on a transaction-by-transaction basis (see Q16).

The goodwill recognised is not adjusted subsequent to the acquisition date whichever method is chosen to value non-controlling interests at the acquisition date. Any subsequent purchase of the non-controlling interest is reported solely in equity first eliminating the non-controlling interest and then reducing the equity of the controlling interest. Current practice is to let companies choose between adjusting the previously-recognised goodwill (the norm) or recording a reduction of equity.

Q13. When control is obtained, which additional items acquired must be measured at fair value?

Fair value adjustments applied to identifiable assets and liabilities (and, therefore, recognised separately from goodwill) must be recorded within a period of 12 months from the date control is obtained. After this period, any adjustments must be recognised in the income statement. The scope of this guidance, already included in the current version of IFRS 3, has been extended to a larger number of assets and liabilities.

New intangible assets will be recognised separately from goodwill and measured at fair value as the reliable measurement criterion is deemed to be met for all intangible assets. This contrasts with

current guidance that allows buyers to consider that the condition is not met in some cases. More intangible assets might be recognised separately under the new standard instead of being included in goodwill.

Deferred tax assets will continue to be measured based on the perceived probability of recovery, but any subsequent increase in the recoverable amount must be treated in the same manner as fair value adjustments to other assets.

If the recovery of a deferred tax asset is assessed as probable more than twelve months after the acquisition date, the recoverable amount is recognised in tax expense. This is a change from current guidance.

Buyers are required to reassess all contracts and arrangements based on the facts at the acquisition date except for the classification of leases and insurance contracts. Specifically, they must:

- classify items in different categories of financial assets and liabilities based on their intended use;
- re-designate hedge relationships; and
- re-examine all embedded derivatives.

The facts at the acquisition date are likely to differ from those at the time of contract issuance, an assessment may be reached that is different from that made by the acquiree (separation or otherwise of the embedded derivative). Current guidance allows buyers to choose between conducting reassessments and retaining the accounting treatment applied by the acquiree.

Q14. How does the new IFRS 3 add to earnings volatility in the year of acquisition but also in subsequent years?

Effects on the income statement in the year of the acquisition

The changes in IFRS 3R may have the following effects on the income statement in the year of acquisition:

- a reduction in earnings from expensing transaction costs (these are typically substantial); and
- an increase in earnings in the event of a step acquisition, resulting from the re-measurement to fair value of the previously-held interest and the recognition of the resulting gain in the income statement.

Effects on the income statement in the years following the year of acquisition

The changes in IFRS 3R may have the following effects on the income statement in the years following the year of acquisition:

- a reduction or increase in earnings depending on the nature of re-measurements concerning earn-out clauses. The volatility of earnings in subsequent years will be driven by the buyer's ability to assess, at the acquisition date, the probability of the achievement of the pre-defined performance objectives on which additional payment is based. An accurate estimate will reduce subsequent changes and volatility;
- an increase in earnings if the assessment of the acquiree's deferred tax assets at the acquisition date proves to have been too conservative;

- a reduction in earnings resulting from the recording of additional amortisation charges related to the larger number of intangible assets recognised;
- a reduction in earnings resulting from the recognition of impairment losses under the “full goodwill” method (where applicable). The recognition of goodwill on non-controlling interests will increase any impairment charges recorded in subsequent years; and
- an increase in earnings in the event of a partial disposal of a subsidiary with loss of control. A holding gain (unrealised) is recognised in the income statement on interest retained as well as on the interest that has been sold.

Q15. How does the new IFRS 3 add to equity volatility?

An increase in equity in the year of acquisition if the acquirer chooses the “full goodwill” method

An acquirer may choose the “full goodwill” method, and goodwill attributable to controlling and non-controlling interest is recognised. The non-controlling interest is measured at fair value, resulting in an increase in equity and goodwill. This additional goodwill is not adjusted if the non-controlling interest is subsequently acquired by the controlling interest.

Effects on equity on purchase or disposal of non-controlling interests

The changes contained in IFRS 3R will have the following effects on equity in the years following the year of acquisition:

- a reduction in equity on purchase of the non-controlling interests. The difference between the

- acquisition price of the shares in question and the equity attributable to the non-controlling interest reduces controlling interest (parent) equity. The application of the full goodwill will have a cushioning effect on controlling interest (parent) equity (see Q16 to Q19);
- an increase or reduction in equity in the event of the disposal of a non-controlling interest (i.e. the acceptance of shareholders in a subsidiary) with a gain or loss on disposal. The difference between the value of the shares and the share of book value of net assets attributable to the new non-controlling interest is reported in controlling interest equity.

In conclusion, the new standards will have a significant impact in the year of acquisition and in subsequent years. Buyers are encouraged to model the accounting consequences of different acquisition strategies and contract terms to avoid surprises (see Q20 to Q24).

► Full or partial goodwill method

How to choose between partial goodwill and full goodwill under the option available in the new standard?

Today, in a less than 100% acquisition, a buyer recognises 100% of the identifiable assets and liabilities acquired and goodwill calculated a residual comparing the consideration paid to the acquirer's interest in identifiable assets and liabilities. IFRS 3R introduces an option for the buyer to value the non-controlling (minority) interest at either the minority's proportionate share of the net identifiable assets (residual method as today or "partial goodwill") or to value the non-controlling interest at fair value, thus recognising goodwill on the non-controlling share ("full goodwill").

What would influence an acquirer to choose between the partial goodwill method and the full goodwill method?

The recognition of full goodwill increases equity at the acquisition date. It would also reduce any potential decrease in controlling (parent) equity resulting from a subsequent buyout of the non-controlling interest. Full goodwill might be best suited to companies with a weak equity base and/or a high level of gearing.

However, the full goodwill method also has a number of drawbacks:

- The fair value measurement of the non-controlling interest may require the use of complex valuation techniques;
- Any subsequent impairment charge is higher than under the partial goodwill method, with a negative impact on reported operating results.

Buyers are allowed to decide which method is more appropriate on a transaction-by-transaction basis – an area of flexibility allowed by the new standard.

Q16. What is the choice under the new standard with regard to the treatment of goodwill?

Companies may choose between two methods for the measurement of goodwill under IFRS 3R:

- **The existing partial goodwill method**, with goodwill representing the difference between the consideration paid and the buyer's share of the fair value of the identifiable net assets acquired. Goodwill is said to be partial because it is calculated solely by reference to the buyer's acquired interest and does not include any goodwill related to the non-controlling interest.
- **The new full goodwill option**, which involves the recognition of goodwill on both the controlling interest and the non-controlling interest, with a corresponding increase in equity attributable to the non-controlling interest. Thus, when less than 100% of a company is purchased, goodwill is given the same treatment as the other assets and liabilities acquired: the buyer recognises 100% of goodwill, i.e. the goodwill that may be said to relate to the majority shareholder as well as that portion that relates to the shares held by the non-controlling interest. The non-controlling interest is measured at fair value for this purpose.

The impact of the full goodwill method is different from that of the partial goodwill method only if less than 100% of a company is acquired. The option offered by

IFRS 3R to choose between the two methods may hinder the comparability of acquisition-related accounting treatment, given that:

- A single buyer could apply a different method to each of two transactions;
- Two companies could each use a different method for the recognition of goodwill;
- The ability to use the partial goodwill method represents a divergence from US GAAP: under the equivalent US standard, applicable from end-2008, the use of the full goodwill method is mandatory.

Q17. Why does the full goodwill method result in a permanent increase in equity, even in the event of the buyout of the non-controlling interest?

The selection of the full goodwill method in comparison to the partial goodwill method, triggers an increase in equity commensurate with the goodwill related to the non-controlling interest. 100% of goodwill on the acquired company is recognised in assets in the buyer's balance sheet under the full goodwill method. The non-controlling interest is recorded at fair value, thus insuring that the goodwill related to the non-controlling interest increases equity. The full goodwill method may be most attractive to companies with a thinner equity base and/or a high level of gearing.

The increase in equity will be very useful in that it cushions the decrease in parent equity resulting from the subsequent buyout of non-controlling interest.

The difference between the consideration paid and the book value of the acquired non-controlling interest is

charged against controlling interest equity. The application of the full goodwill method:

- lessens the impact of the buyout of non-controlling interest, provided that the fair value of the non-controlling interest has remained stable between the acquisition date and the buyout date; and
- limits the decrease in controlling interest equity when the fair value of the non-controlling interest has increased between the acquisition date and the buyout date.

Use of the full goodwill method can be said to strengthen equity at the acquisition date and cushion controlling interest equity in the context of subsequent non-controlling interest buyouts. This may offer advantages when the acquisition of an initial 51% controlling interest is to be followed by significant non-controlling interest buyouts.

Q18. Why does the full goodwill method entail the use of more complex valuation techniques?

Partial goodwill in an less than 100% acquisition is calculated as the difference between the consideration paid and the acquirer's interest in the fair value of the acquiree's identifiable assets and liabilities. The non-controlling interest is measured at its proportionate share of the net identifiable assets.

However, the non-controlling interest must be measured at fair value at the acquisition date under the full goodwill method. Buyers are expected, in practice, to determine this fair value based on the market value of the shares not owned at the acquisition date. However, in the absence of a reference market value, it may not always be possible

to extrapolate the price per share paid by the buyer to acquire a controlling interest in order to measure the non-controlling interest. The consideration paid might have included a control premium, for example. Valuation experts may be necessary to assess the existence and amount of any premium. Alternative valuation techniques may be required (market-based data, similar transactions or models based on future earnings or cash flows) if a straightforward approach is not appropriate.

Q19. Why does the application of the full goodwill method result in a higher charge in the event of impairment?

Application of the partial goodwill method, when less than 100% of a company is acquired, results in any goodwill impairment charge being allocated solely to the controlling interest.

Any impairment charge under the full goodwill method is based on 100% of goodwill and, therefore, is higher than that resulting from the partial goodwill method. Impairments should not occur more frequently under full goodwill because of the impairment testing requirements for partial goodwill, but they may be larger. Full goodwill also results in a requirement to allocate the impairment charge between the controlling and non-controlling interests. This can be a complex process depending on the level at which a company tests goodwill and how it groups its CGUs.

Therefore, the increase in equity upon the acquisition of a controlling interest under the full goodwill method could be followed by a negative earnings impact in subsequent years if an impairment occurs.

The choice of full goodwill method might prove unfavourable for cyclical industries or where there is a risk that initially identified synergies will not materialise.

However, with non-controlling interests as part of equity, related impairment losses will be apportioned between profit/loss attributable to the group and profit/loss attributable to non-controlling interests at the foot of the income statement. Thus, any increase in the impairment charge would have a neutral impact on earnings per share as calculated based on profit/loss attributable to the group.

Impairment testing under the full goodwill method may be less complex than under the partial goodwill method although this will differ from company to company. This is because for the purpose of impairment testing, partial goodwill must be increased by the amount of goodwill allocated to the non-controlling interest in order to derive the carrying amount of the cash-generating unit (CGU) or group of cash-generating units and to compare it with the ascribed value in use or market value. Any impairment loss is then reduced by the amount related to the non-controlling interest. Such restatements are eliminated during impairment testing under the full goodwill method. However, the application of the full goodwill method means that the impairment must be allocated between the controlling and non-controlling interests. This allocation can be a complex process.

In conclusion, the full goodwill option may be more favourable in practice from an equity perspective notwithstanding the possibility of higher impairment charges. Entities might consider use of the full goodwill method particularly in the following cases:

- sizeable acquisitions;
- acquisitions to be followed by significant non-controlling interest buyouts; and
- companies with a weak equity base and/or a high level of gearing.

STRATEGIC AND OPERATIONAL IMPACTS

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► Adaptation of acquisition strategies

Why should decision-makers anticipate the new version of IFRS 3 and adapt acquisition and disposal strategies and terms accordingly?

Acquisition and disposal decisions should not be driven by accounting considerations. Moreover, the exact time frame for deal-making and negotiations is seldom known in advance. However, decision makers like to be able to develop their own strategy, be that:

- purchasing an equity stake in the target company prior to pursuing control, in order to test the water;
- purchasing a minimum controlling interest at first and buying out NCIs (NCI, previously minority interest) at a later date;
- acquiring 100% control from the outset, increasing the value of the acquired business and then disposing of shares without, however, giving up control; or
- acquiring control, increasing the value of the acquired business, then disposing of shares and retaining only a NCI.

The terms of transactions under IFRS 3R could have very different and potentially counter-intuitive effects on earnings and equity. Management should consider if the previous strategy for business acquisitions is the right one under the new accounting requirements. The best way to avoid surprises is to anticipate the consequences of the proposed transaction terms and the new accounting standard on the financial statements at an early stage and to model potential outcomes.

This chapter considers the impact of IFRS 3R on common transaction structures.

Q20. You are used to taking control in steps...

In future, why will there be a positive impact on earnings at the date at which control is obtained?

Successive share purchases (with the buyer's interest increased from, say, 30% to 60%) under the current standard result in the previously-held equity interest in the acquiree (30% in our example) re-measured to fair value and the resulting gain recognised in equity.

The gain will be recognised in the income statement under IFRS 3R. This will have a positive impact on earnings in the year of acquisition, losses are also theoretically possible but are not expected to occur in practice.

If the buyer has a choice, does the accounting look more attractive for a successive share purchases (step acquisition) or to acquire a controlling interest at a stroke?

A step acquisition will entail the recognition of a gain in the income statement, corresponding to the unrealised gain on the previously-held equity interest.

Yet, there will be no cash inflow for the buyer. In contrast, where control is achieved in a single stage, no gain will be recognised in the income statement. Instead, the increased value of the acquired business is reflected in goodwill, but there will also be an outflow of cash.

Q21. You are used to acquiring a minimum controlling interest (51%) and subsequently buying out the non-controlling interest...

In future, why will each buyout transaction have a negative impact on equity for the year in question?

Another common approach is the acquisition of a minimum controlling interest (51%) and subsequent purchase of the NCI: under the new standard, each purchase of a further interest past control will reduce the equity of both the controlling and NCIs.

Current practice in a buyout of a NCI is to record the difference between the acquisition price and the book value of the NCI either in goodwill or as a charge against equity. The additional goodwill approach is most widely used in practice although a handful of large IFRS preparers apply a form of “economic entity” that results in the excess of the consideration paid over book value of the NCI is a reduction of controlling interest equity.

The new guidance requires the adoption of the economic entity model and the difference, above the NCI, is a reduction of controlling interest equity. Equity is reduced by the acquisition of a NCI.

This impact may be mitigated by the application of the “full goodwill” method for the business combination accounting on day 1. Goodwill, under this method, is recognised on both the controlling interest and the NCI. This results in a “gross up” in goodwill and a corresponding increase in equity for the NCI. The decrease in equity resulting from a NCI buyout is offset by the higher value of the NCI at the date of obtaining control

as included in “full goodwill” and equity. The application of the “full goodwill” method limits the reduction in controlling interest equity on the buyout of a NCI to the amount by which the fair value of the purchased shares has increased between the date of obtaining control and the buyout date. The “full goodwill” method cushions the impact on controlling interest equity.

The news is not all good, though. The “full goodwill” method increases the amount of any impairment charges that are included in the operating result (See Q19).

Q22. You are used to acquiring 100% control from the outset, increasing the value of the acquired business and then partially disposing of shares without losing control...

In future, why will the related disposal gain never impact the income statement?

It is also common for a business to acquire 100% of another, increase the value of the acquired business and then dispose of an interest without losing control. Under the new standard, no disposal gain is recognised in the income statement on this transaction.

Current practice sees two main approaches to account for disposal of an NCI: the difference between the disposal price of the shares and the carrying amount of the corresponding NCI is reported either in equity or in the income statement. Most companies recognise the gains in the income statement.

IFRS 3R requires the recognition of gains on partial disposals of shares in a subsidiary without loss of control in equity and prohibits recognition in the income statement.

In future, why will there be a positive impact on earnings in the year of disposal?

Q23. You are used to acquiring control, increasing value of the acquired business and then reducing the equity investment to a non-controlling interest...

In future, why will there be a positive impact on earnings in the year of disposal?

A gain on disposal, under present standards, is recognised in the income statement and:

- if the equity method is applied to the retained shares, the interest is stated at the consolidated carrying amount at the disposal date; or
- if the retained shares are treated as available-for-sale (AFS) financial assets, they are re-measured to fair value, with a corresponding impact on equity.

Accordingly, no gain is recognised on the retained interest in either case.

The requirement to recognise a gain or loss on the shares disposed of in the income statement when control is lost stays under IFRS 3R. However, the retained interest must be re-measured to fair value and any related gain or loss is also recognised in the income statement. This treatment is applicable irrespective of whether the retained shares are subsequently accounted for under the equity method or as a financial asset.

Accordingly, disposals resulting in a loss of control increase earnings by the amount of the unrealised gain on the retained interest – as if the interest in question has, indeed, been sold.

Q24. How best way to anticipate the accounting consequences of the new guidance and realigning acquisition/disposal strategies?

The different scenarios illustrate the potentially powerful accounting impact of the prescribed changes under the new standard. The information should provide some insight for companies into possible changes to their transaction strategy. Any company considering a transaction would be well advised to consider some of the specific aspects of the standard as described in this section.

Modelling different outcomes of proposed acquisitions and disposals will give insights into the impact on earnings and equity of planned acquisitions and disposals

The effects of the new guidance should be considered in the light of the state of the company's financial position (for example, a thin equity base), planned growth and restructuring strategies, and essential financial communication content (impact on financial position and performance ratios).

This analysis should not be confined to the impact in the transaction year alone. Projections should also be made for subsequent years, notably in respect of any increase in the volatility of earnings and equity (see Q11 to Q15).

Companies should look at their available valuation resources and the increased demands under the new standards and fill any gaps

The modelling described about, together with transaction accounting requirements, will expand the

need for valuation expertise. This will embrace, for example, the revaluation of assets and liabilities owned prior to the acquisition of control, the re-measurement to fair value of NCIs (which may not necessarily be correlated to the price paid to acquire control) and the re-measurement to fair value of a NCI retained following the loss of control.

Management might look to pull forward or postpone transactions planned for 2008 and 2009

If a company has full control over the timing of acquisitions and disposals planned for 2008 or 2009, it should compare the related accounting consequences under the current standard with those under IFRS 3R.

- If the current standard is deemed to have more favourable consequences, transactions could be carried out prior to the compulsory application of the new IFRS 3, i.e. before 2010 in the case of companies with a 31 December financial year-end.
- Conversely, if the new guidance is deemed to be more favourable and if circumstances permit, transactions could be postponed until the application date of the new standard.

An alternative to altering the time frame for deals could be early adoption of the new standard

Early adoption is not available to European companies until the standard has been endorsed by the European Union but could be early adopted by others.

In conclusion, the impact of IFRS 3R on future acquisitions and disposals need to be anticipated now.

► Adaptation of contractual clauses

IFRS 3R - how might it change contracts for business combinations?

Managers are already taking a close look at the contractual clauses associated with acquisitions, particularly with regard to the cash component of earn-outs, post-acquisition payments to selling shareholders and indemnity clauses. Depending on the terms of the arrangement, fair value adjustments related to these items might need to be recognised in the income statement, rather against goodwill as today. Good planning and hard negotiating may reduce or eliminate earnings volatility in the wake of an acquisition. There are some significant areas that merit consideration to meet this challenge:

- expand the scope and extent of due diligence work and either replace earn-out arrangements by a definitive acquisition price (“locked box” mechanism) or shorten the duration of earn-outs;
- pay earn-outs in a fixed number of equity instruments;
- use valuation experts and benchmarking techniques to assess the fair value of earn-out clauses as accurately as possible.

However, to reduce or eliminate earnings volatility, companies should:

- negotiate for robust liability indemnification clauses and better monitor related compliance; and
- carefully word clauses governing payments due to former owners retained in the business after the acquisition date.

Q25. How will the new accounting treatment of earn-out clauses affect post-acquisition earnings?

Uncertainty might exist about the value of the acquired business or of some of its significant assets at the acquisition date. This is why earn-outs are routinely contingent on the post-acquisition earnings performance (as reflected in growth in the acquiree's turnover, operating result or share price) or on the success of a significant uncertain project.

Earn-out clauses and contingent consideration under current IFRS 3 are valued at the acquisition date only if payment is deemed probable and reliably measurable. Any subsequent re-measurement is recorded in goodwill and, therefore, has no immediate impact on the income statement.

Under the new IFRS 3, earn-out clauses must be measured at fair value at the acquisition date and recorded as part of consideration. Probability enters into the measurement of the liability but does not impact recognition. The new guidance prohibits the recording of any subsequent re-measurement in goodwill (unless the adjustment results from circumstances that existed at the acquisition date and occurs within the 12-month time limit for finalising the business combination accounting).

- Any earn-out paid in cash or in a variable number of shares is a financial liability and fair value re-measurements are recognised in the income statement.
- An earn-out that is financed by an equity instrument and provides for the delivery of a fixed number of

shares to the seller, regardless of the fair value of the shares, is an equity instrument and no subsequent re-measurement through the income statement is required.

Q26. How may earn-out clauses be amended to reduce post-acquisition earnings volatility?

Earn-out clauses are typically paid in cash or in a variable amount of shares. Re-measurements of earn-outs to fair value through the income statement, under IFRS 3R, may lead to earnings volatility in the years following the acquisition.

Buyers might consider the following (limited) opportunities when formulating transaction provisions.

Extending due diligence work, eliminating earn out clauses by achieving an accurate valuation of the acquiree at the acquisition date or shortening the duration of the earn-outs

Elimination of earn-out clauses and contingent consideration is the best way to reduce volatility, however it significantly limits flexibility in transaction structures. This approach would also eliminate the ability to adjust the cash consideration for the transaction. The scope and extent of pre-transaction due diligence work would therefore have to be expanded substantially to achieve an accurate valuation of the acquiree at the acquisition date. This solution would be most suited to companies operating in very mature markets. However, it would not be appropriate, for example, for start-ups operating in fast-growing markets.

Financing earn-out in a fixed number of equity instruments

Earn-outs financed by equity instruments are included at fair value in the acquisition price at the acquisition date and are not subsequently re-measured through the income statement. This reduces volatility and to the extent the buyer's share price is impacted by the performance of the acquired business – it may be an acceptable proxy for a cash earn-out.

This solution is economically feasible only if the buyer's share price is unlikely to increase very significantly. Otherwise, the possible share-price growth would have to be taken into account in the determination of the number of shares to be delivered to the seller. Where applicable, a hedge should be taken out in the form of an immediate or fixed-price forward purchase of the quantity of shares that might have to be handed over.

Using valuation experts and benchmarking techniques to assess the fair value of earn-out clauses as accurately as possible to reduce post acquisition volatility

A probability-based fair value approach, for example, would reduce the likelihood and amount of subsequent re-measurements of the amount (see Q30).

Reducing the duration of earn-out clauses likewise would limit the number of subsequent fair value re-measurements as well as allow for inherently more accurate forecasting.

Q27. Why will the new IFRS 3 prompt the extension of the protection provided under liability indemnification clauses and better monitoring of related compliance ?

Indemnities are usually granted in relation to environmental risks, ongoing lawsuits, customer warranty liabilities, tax risks and so forth.

Such contingent liabilities, under current guidance, are recorded as liabilities in the acquisition balance sheet. Subsequent adjustments after the 12-month time limit for finalising the business combination accounting are charged to the income statement.

With the new standard, the seller's commitment to discharge (provide refunds for) these contingent liabilities is recorded as an asset of the buyer. The asset is measured based on the contractual provisions and is limited to the amount of the indemnified item. Any reassessments after the acquisition date are reflected in both assets and liabilities, with no net impact on the income statement if the buyer is indemnified for the whole amount of the risk.

Buyers may also wish to negotiate extended liability indemnification. However, the new accounting treatment requires the inclusion of a formal reimbursement clause for each type of guarantee provided. The indemnity payable by the seller is measured using the same assumptions applied to the related contingent liability.

Unless each risk covered is precisely identified, the liability indemnification clause is likely to generate accounting mismatches, as under the current standard.

Q28. How do the new refined requirements increase the ride of mandatory expensing of contingent payments to former owners retained in the business?

A contingent payment made to a former owner retained in the business after the acquisition may be construed as compensation for future services and, therefore expensed in post-acquisition earnings. Former owners often continue to work in the company after the completion of the acquisition as their professional skills and relationships can contribute to the future success of the acquired business.

Payments made by the buyer to the former owners in their capacity as the selling shareholders are considered to be part of the consideration paid for the shares and, therefore, are included in goodwill. Payments made by the buyer to the former owners in their capacity as retained employees providing services are expensed as incurred. The latter type of payments serve to lock in the former owners and reward them for future services, rather than as consideration for the acquired business.

Previously, no explicit guidance was provided to indicate whether such payments to former owner-managers were to be treated as part of the consideration paid for the business or as compensation for future services.

Q29. Which precautions should be taken to ensure that contingent payments to former owners retained in the business qualify for inclusion in goodwill, as opposed to being expensed?

IFRS 3R follows the example of US GAAP and provides a list of criteria to consider when determining the appropriate accounting treatment. Buyers will have to scrutinise the proposed wording of clauses governing contingent payments to former owners retained in the business with a view to substantiating the classification of such payments in goodwill and avoiding expensing them in the income statement in subsequent years.

For example, as a general rule, payment to a former owner-manager should be treated as compensation and expensed, when it is stipulated that:

- the contingent payment is forfeit if the individual leaves the company; or
- the contingent payment is granted only to selling shareholders who remain in the company's employment and not to other selling shareholders.

However, this is not the sole accounting issue to be considered when formulating contingent payment clauses. The classification of a payment as compensation for services rather than as part of the purchase consideration also poses the risk of reclassification under company and tax law. This would concern not only the buyer, but also the employee as it may have consequences for social security, employment charges and income tax.

In conclusion, it is possible to limit volatility in the income statement following an acquisition, provided that the contractual clauses have been revisited on a timely basis.

Once the acquisition agreement is signed, however, there will be no going back.

► Use of expert valuations

How does IFRS 3R increase the use of valuations in acquisitions and disposals?

Accurate fair value measurements of acquired assets and liabilities in a business combination can present real challenges to companies today. The wider use of fair value under IFRS 3R may increase both the number and complexity of valuations.

There is an incentive for assessments to be even more precise and reliable, given that re-measurements after the acquisition date will be recognised in the income statement.

The main consequences on the valuation front are likely to relate to:

- estimates of earn-outs, including the modelling of the probability of pre-defined performance objectives being achieved;
- the analysis and quantification of control premiums, with a view to measuring non-controlling interests;
- the measurement of unusual intangible assets or indemnities concerning liabilities, such as environmental risks; and
- the reassessment of financial assets and liabilities, notably hedging instruments and embedded derivatives.

Q30. What is the best way to approach the measurement of earn-out clauses at fair value at the acquisition date?

As specified in Q11, the new IFRS 3 requires that earn-out clauses be measured at fair value at the date at which control is obtained, with probability of payment built into the measurement of the liability. If the earn-out is paid in cash or in a variable number of shares, which is the most common practice, any later re-measurements must be recognised in the post-acquisition income statement.

Accordingly, the more the acquired business exceeds the performance projections underpinning the initial fair value, the greater the charge against the post-acquisition income statement. It is, therefore, essential to obtain a reliable measurement of the fair value of earn-out clauses at the acquisition date.

For companies, this will mean refining the analyses performed to assess the probability at the acquisition date of the achievement of performance objectives related to earn-out clauses.

A detailed analysis of projections may provide insight into the determinants of earn-out payment and contribute to more reliable measurement. The analysis should cover both market-related factors (derived, for example, from market surveys or sector benchmarking reports) and factors specific to the company. Application of a sophisticated valuation method which includes models to assess the probability of performance objectives being achieved may also add to increased accuracy. Different scenarios might be identified for each objective, together with the related probability of occurrence.

Consider, for example, an earn-out clause concerning the launch of a new product. The valuation expert will assess the probabilities of the various possible scenarios:

- success of the product launch;
- success of the product launch in the retail sector, but not in the wholesale sector; and
- failure of the product launch.

By applying a probability-based approach, the valuation expert hopes to arrive at more accurate assessment of the fair value of the earn-out liability at the acquisition date, thereby reducing the risk and hopefully the amount of any subsequent re-measurements.

Q31. How does the new IFRS 3 increase the use of fair value measurement for non-controlling interests?

Fair value measurement is also required to measure non controlling interest:

- Fair value measurement will be mandatory in the following situations:
 - If the buyer acquires control through successive share purchases (increasing its interest from, say, 30% to 70%), the previously-held interest in the acquiree (30%) must be re-measured to fair value;
 - In the case of a partial disposal of shares with loss of control (decrease in interest held from, say, 51% to 49%), the retained interest is re-measured to fair value;

- If the buyer uses the “full goodwill” option under IFRS 3R, the non-controlling interest is measured at fair value at the acquisition date (see Q16 to Q18).

The difficulty with regard to the measurement of non-controlling interests at fair value lies in the determination of the control premium (or non-controlling discount). Where control is achieved through successive share purchases, the buyer should assess if there is a control premium and how much might be attributable to the non-controlling interest at the date of the business combination.

The estimation of the control premium should be approached on a transaction-by-transaction basis. Control premiums vary markedly from one sector to another and from one acquisition to another, reflecting the circumstances specific to each buyer and to each transaction.

One component of a control premium might be the amount of synergies that the transaction is expected to deliver over time. However, the premium also reflects the conditions surrounding the negotiation and execution of the transaction, including, for example, the signing of a draft agreement or of an agreement in principle governing subsequent share purchases, or the introduction of operational co-operation to facilitate the generation of specific synergies.

The control premium may also vary depending on the liquidity of the purchased shares (hence the disparity observed in some markets between control premiums for listed vs unlisted shares) or on the shareholder structure (for example, the control premium paid to a single owner is likely to differ from that paid in the context of multiple owners).

The valuation process can be complex and depends on the nature of the transaction. However, a detailed assessment of non-controlling interests is essential.

Q32. How does IFRS 3R increase the use of more complex valuation methods for the measurement of identifiable assets and liabilities?

Intangible assets

An acquired intangible asset, under the current guidance is recorded separately from goodwill if it is reliably measurable. This requirement has reduced the number of recognised intangible assets particularly unusual assets. However, the reliable measurement criterion is deemed to be met for all intangible assets under IFRS 3R. Those intangible items previously recorded in goodwill because of the lack of reliable measurement will now be recognised separately.

Some companies have included non-compete clauses in goodwill on the assertion that these are difficult to measure reliably. More sophisticated analyses may be required to measure these assets*.

The preliminary analyses will have to cover competition risk and might include:

- a market analysis: the buyer will have to consider the potential competition in the sector concerned;
- an analysis of the seller's capacity to act as a competitor (based on his or her age and qualifications, for example); and

*Warning: in some countries, non-compete clauses were not separately recognized as it was considered that they did not meet the reliable measurement criterion under existing IFRS 3. But in many other places, non competes are routinely enforced by the courts and thus valued.

- an understanding of factors related to will and desire that could motivate the person to act as a competitor.

The accurate capture of the consequences of competition (loss of business, possibly leading to loss of profit) is also vital. A valuation approach like the "Lost Profit Approach" or approaches based on option modelling might be appropriate.

Assets and liabilities arising from seller indemnities

A seller's commitment to discharge or refund contingent liabilities, an indemnity, is recorded as a receivable by the buyer under IFRS 3R. The amount of the receivable is measured using assumptions that are consistent with those applied to the related contingent liability. It is expected that increasing attention will be paid to environmental risks as these can present measurement challenges. Due diligence work in the sphere of environmental risks is likely to include:

- future investments to bridge the gap between regulatory requirements and actual operating conditions at sites. This might include the need to estimate compliance costs;
- the measurement of liabilities related to ground pollution. These can be difficult to quantify because of the numerous parameters involved, including cost and time (analysis of ground pollution can take up to several months); and
- the estimation of cash flows resulting from strategic scenarios planned by the company over the medium term with a view to sustainable development.

Q33. Why will IFRS 3R require re-measurements of financial instruments to fair value?

The current guidance does not stipulate whether buyers should or should not re-examine the classification of financial instruments in the balance sheet, or whether re-designation of the hedge relationships entered into by the acquiree is necessary. The IFRIC declined to comment on the obligation (or lack thereof) to reassess embedded derivatives in a business combination context. Companies were required to develop an appropriate accounting policy for reclassification, re-designation and reassessment. Few companies in practice chose to reassess.

IFRS 3R requires that the buyer reassess the accounting treatment of the financial assets and liabilities of the acquired business. The buyer may be required to:

- reclassify financial assets and liabilities, based on how the buyer intends to manage them, in the following categories – fair value through profit or loss (FVTPL), available-for-sale (AFS) and held-to-maturity (HTM);
- re-designate hedge relationships (re-designation of hedged items, hedging instruments and of the intended nature of the hedge relationship, and the preparation of new associated documentation with new effectiveness tests). Effectiveness testing will be particularly challenging, since the tests involved are more difficult to conduct when the hedging instrument has an initial value (premium, discount, equalisation payment) than when it has a nil value;

- re-examine all embedded derivatives, and the facts at the business combination date may differ from those at the time of contract issuance, an assessment may be reached that is different from that initially made by the acquiree.

In conclusion, the challenges ahead call for greater vigilance and for the input of experts armed with a strong knowledge of valuation techniques and of the sectors in which their clients operate.

INTERVIEW WITH PHILIPPE DANJOU, MEMBER OF THE IASB

What improvements does the new IFRS 3 bring to international accounting regulatory governance, to competition between companies and to transaction management?

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What improvements does the new IFRS 3 bring to international accounting regulatory governance, to competition between companies and to transaction management?

Acquisitions and disposals are of strategic importance to companies. This importance was brought to the fore in January 2008 with the new IFRS 3. The new version of the standard represents a significant improvement from previous guidance and will produce new effects on financial statements as from 2009 onwards. With this in mind, we urged companies in our previous contributions to consider the implications of the new standard now (see Q1 to Q3).

Our presentation of the difficulties associated with applying the standard and the counter-intuitive consequences relative to current practice has struck a chord with readers. This is especially pertinent since the adoption of the standard by the European Union in the coming months is a crucial step for the IASB.

Philippe Danjou, member of the IASB, here explains and defends the advantages afforded by the new guidance in his responses to the following questions.

How does the new IFRS 3:

- improve international accounting regulatory governance?
- level the playing field for European and American companies?
- enhance transaction transparency?
- live up to the simplification of guidance announced by the IASB?
- facilitate the management of acquisitions?

Q1. Governance: how does the new IFRS 3 improve international accounting regulatory governance?

PwC: The request for comments on the exposure draft of proposed amendments to IFRS 3 (referred to as “BC2”) triggered criticism on a range of issues. These included the increased use of fair value, the adoption of the “economic entity” model for the preparation of consolidated financial statements, the counter-intuitive effects resulting from the proposed guidance and the absence of field tests concerning ground-breaking proposals.

Few of these concerns are addressed in the final version of the new IFRS 3.

Furthermore, despite the IASB’s endeavours over more than 15 years to reduce the number of accounting options available, a new option with major implications, the “full goodwill” method (i.e, the measurement of Non Controlling Interests at Fair Value), has been added.

P. Danjou: The issuance of the new version of the standards (IFRS 3 and IAS 27 and FAS 141 and 160) shows that convergence is not a one-way process – towards US GAAP. The preparation of the new standard provided a breakthrough opportunity for the formulation of common positions by the world’s two leading standard-setting bodies, the IASB and the FASB.

These common positions:

- are the result of three years’ work by a joint IASB/FASB team;
- represent a true departure from current practice under US GAAP and to a lesser extent under IFRS;
- were decided separately, but in an almost identical manner, by the IASB and FASB.

As for the “full goodwill” method, which is more accurately described as the measurement of non-controlling interests at fair value, it is optional under IFRS and mandatory under US GAAP. This compromise was adopted because the IAS Board was unable to reach a majority agreement on a single final solution. The Board was divided on the assessment of the costs and benefits of this change to the standard. It takes heed of the criticism voiced in Europe while allowing for the application of the same treatment under the two accounting frameworks.

Q11. Competition: how does the new IFRS 3 level the playing field for European and American companies?

P. Danjou: Some of the counter-intuitive accounting consequences, which were extensively covered in your preceding questions, could put companies off at first.

The new IFRS 3 is nevertheless the first international standard that permits a common assessment of a key component of financial reporting, namely accounting for acquisitions and disposals.

Thanks to the revised guidance:

- if two companies – say a US firm and a European based one – are competing to acquire the same target, neither of the bidders will gain an advantage from its accounting framework;
- even when there is no such competition, it will be possible to compare the impact on the respective financial statements if the two companies involved have a similar external growth record.

We are proud of what has been achieved so far with convergence – and there is more to come.

PwC: Yes, but the provisions of the new standard may not be applied retrospectively to earlier transactions and there is an exemption upon first-time adoption of IFRS. This means that the full comparability of earnings is many years off. This situation favours American companies, which have long benefited from the “pooling of interests” method, which has been a catalyst for business combinations.

QIII. *Transparency: how does the new IFRS 3 enhance transaction transparency?*

P. Danjou: As explained in your previous questions, the new guidance may in some cases increase the volatility of earnings and equity because of the extended use of fair value.

However, by requiring the recognition in the income statement of transaction costs and the re-measurement of any previously-held interest upon gaining control and of the retained interest upon losing control, it enhances transparency and gives companies the opportunity to:

- better justify the residual goodwill;
- provide better disclosure of transaction costs and of existing unrealised gains related to acquisitions and disposals, thereby making the information more readily visible.

PwC: But given the particularly counter-intuitive accounting consequences of the new standard for market practitioners, there will be no simplification of financial communication in the initial years.

QIV. Simplification: how does the new IFRS 3 live up to the simplification of guidance announced by the IASB?

P. Danjou: Some of the consequences of the new guidance may seem counter-intuitive relative to current practice.

However, this is always the case when changes are introduced. People need time to get used to the new rules.

That aside, the approach underpinning the new IFRS 3 is highly logical one and gives precedence to two key events – the obtaining and the loss of control. These events justify re-measurements to fair value and the recognition of the resulting gain or loss in the income statement. Conversely, transactions not entailing a change in control do not alter the economic entity and are not perceived as significant. Accordingly, the related dilution/accretion is recorded in equity.

Admittedly, the logic has been taken to the extreme, but the treatment is rigorous and straightforward. Furthermore, no exemptions are allowed other than the option to apply the “full goodwill” method under the compromise reached by the IASB.

And so, yes, the new version of the standard is an initial example of the revision of IFRS guidance in the direction of simplification. The simplification is even greater relative to US GAAP, as there will no longer be fair value remeasurements for step acquisitions.

PwC: Did simplification have to be taken so far? The logic pursued is the result of the balance sheet approach under IFRS taken to the extreme. If we continue along this road, fears will continue to arise concerning the introduction of full fair value over the long term and other innovations regarding framework concepts.

Wouldn't an arbitrary agreement be preferable in some cases to logic taken to the extreme ?

QV. *Transaction management:*
how does the new IFRS 3 facilitate the management of acquisitions?

P. Danjou: The “economic entity” approach is useful here for the financial analysis, for example, because of its treatment of non-controlling interests:

- For the purposes of the debt-to-equity ratio, non-controlling interests are included in consolidated equity, as the debt calculation includes 100% of subsidiaries' debt.
- For the purposes of the net profit margin ratios, non-controlling interests are included in the calculation of consolidated profit, which arises out of the consolidation of 100% of subsidiaries' turnover.

PwC: Change represents an opportunity to take a fresh look at how we do things and improve the effectiveness of procedural and management approaches. Our previous questions have provided some essential advice in this vein:

**Adapt acquisition/disposal strategies
(see Q20 to Q24):**

Acquisition and disposal decisions quite rightly are not and should not be dictated by accounting considerations. However, the consequences of the new IFRS 3 on earnings and equity are such that the impact of proposed transaction terms on the financial statements should be anticipated and simulated in order to avoid unwelcome surprises.

Contain costs:

- Transactions costs will no longer be included in goodwill, but instead will be clearly visible in the income statement (see Q11).
- The newly-introduced possibility to recognise specific liability-related indemnities granted by the seller as assets will prompt companies to extend the protection provided under liability indemnification clauses and better monitor related compliance. The aim here is to achieve a neutral impact on the income statement (see Q27).
- The desire to avoid the expensing of payments due to former owners retained in managerial positions after the acquisition date will prompt companies to word the clauses governing such payments carefully (see Q28).

Mitigate risks (see Q11 to Q15):

- The requirement to measure earn-out clauses at fair value at the acquisition date and to recognise subsequent re-measurements in the income statement (rather than in goodwill as today) will prompt companies to expand the scope and extent of due diligence work and adapt the related clauses;
- The wider use of fair value and of more complex valuations will necessitate greater vigilance and the input of experts armed with a strong knowledge of valuation techniques and of the sectors in which their clients operate;
- The full reassessment of the acquiree’s financial instruments upon first-time consolidation will give companies more insight into the underlying financial risks.

Strengthen the equity base (see Q16 to Q19):

The “full goodwill” method, which may be applied on a transaction-by-transaction basis at the buyer’s discretion, is more favourable from an equity perspective. However, it entails a complex re-measurement of the non-controlling interest to fair value at the acquisition date. As such, the option should be applied mainly to large acquisitions or by companies with a weak equity base.

Realign financial communication quality (see Q4 to Q10):

Given the counter-intuitive consequences on financial health and performance ratios, companies will have to exercise even greater care with regard to transaction-related disclosures.

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**For contact details
on “New IFRS for Acquisitions (M&A)”
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April 2008

PRICEWATERHOUSECOOPERS 

New IFRS for Acquisitions (M&A)

What impacts on your financial statements and communication?
How should your acquisition strategies and terms be adapted?



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