Planning for the future?

Recent accounting standard changes will impact your acquisitions and disposals

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For financial years beginning on or after 1 July 2009, business combinations accounting is changing. We expect the new IFRS 3 standard to result in greater earnings volatility, particularly for transactions involving earn-out arrangements, taking control of an existing investment or those with contingent consideration, pre-existing trading relationships with the target or indemnities.

M&A specialists need to be familiar with these changes – earnings, EPS, management incentive plans, covenants, and distributable reserves are all likely to be affected, and the greater emphasis on the use of fair value is likely to increase the visibility of whether certain deals have provided a return for shareholders.

Red flags

If your transaction involves any of the following, these accounting changes will impact you:

Acquisition costs	Acquisition costs such as finder's fees, advisory, legal, accounting, valuation and other professional or consulting fees will now be an immediate expense to the income statement rather than being part of the cost of acquisition as previously.	**Increase in accounting costs of transactions**
Share-based payments	For the first time, guidance is provided on whether replacement share-based payment awards form part of the cost of acquisition or are part of the ongoing remuneration cost to be recognised in the income statement. Only where the acquiree or the employee has the ability to enforce replacement of existing share-based awards will the cost of replacement awards be treated as part of the cost of acquisition.	**Increase in possible accounting costs of transactions**
Contingent consideration	Your best estimate of contingent consideration has to be determined at the time of the acquisition. Thereafter any changes to that consideration are recognised immediately in the income statement rather than being adjusted through goodwill as previously. Remeasurement takes place at each balance sheet date until the final payout is made.	**Increase in volatility and possibly charges, in the income statement**
Acquisition of a controlling interest in a non-subsidiary investment (i.e. so that an entity becomes your subsidiary)	If you increase your stake in a business so that you take control (usually >50% ownership), you will have to re-measure the stake already held, at fair value at the date on which control is gained. Any difference between this amount and the existing carrying value of the investment now has to be recognised immediately in the income statement, resulting in a gain or loss.	
Increasing stake in an existing subsidiary	If you already control a non-wholly owned subsidiary, increasing your stake will not result in additional goodwill or intangible assets being recognised. This means that an increase in stake does not increase amortisation charges for intangibles and similarly, does not increase the amount of goodwill that has to be considered for impairment. Increasing your stake in an existing subsidiary is accounted for entirely in equity.	**No likely impact on the income statement**
Disposal of non-controlling stake in a subsidiary	If you sell part of your investment in a subsidiary (i.e. so that you have control both before and after the transaction), the gain or loss on the partial disposal is recorded in equity, i.e. does not impact your income statement.	
Disposal of controlling stake in a subsidiary	If you sell a stake in a subsidiary such that you no longer have control, the remaining stake is required to be recognised at fair value at the date control is lost with the gain or loss arising impacting your income statement.	**Increase in volatility in the income statement as a result of gains or losses arising on partial disposal**

Acquisition of a non wholly-owned subsidiary	If you acquire control of an entity but take less than 100% of the equity, when determining goodwill, you have to take account of the value of the other party's non-controlling stake. This can be measured either at fair value at the acquisition date or as the non-controlling party's share of net identifiable assets of the entity acquired. This choice can be made on a transaction by transaction basis. Whilst this does not directly impact the income statement on day one, it does affect the value of goodwill which will be assessed for impairment in future periods. Impairment losses are always charged to the income statement.	**Choice of accounting on an acquisition-by-acquisition basis which may impact the income statement**
Indemnities	Indemnification assets (i.e. where a vendor has indemnified the acquirer, for example, the seller may indemnify the acquirer against losses above a specified amount on a liability arising from a particular contingency) must be accounted for at each reporting date on the same basis as the asset or liability to which the indemnity relates. Any movements in value will be taken to the income statement, resulting in a gain or loss.	**Increase in volatility and possibly charges, in the income statement**
Re-acquired rights	As part of a business combination, you may reacquire a right that you had previously granted to the acquiree (e.g. a right to use your trade name under a franchise agreement or a right to use your technology under a licensing agreement). You will need to recognise the reacquired right as an intangible asset which is amortised over the remaining contractual period of the contract in which the right was granted. If the terms of the contract giving rise to a reacquired right are favourable or unfavourable relative to the terms of current market transactions for the same or similar items, you will have to recognise a gain or loss in the income statement.	**Increase in volatility in the income statement for gains and losses relative to market values**

Key considerations

The changes highlighted above pose some new challenges for M&A specialists.

Consider:

- How does the deal impact on your earnings forecasts? Immediate recognition of deal costs, fair valuing existing equity stakes where you are taking control and fair valuing contingent consideration will all affect earnings.
- Will you need to revise the financial terms in your debt covenants as a result of these changes, for example, if EBITDA will be reduced as a result of additional costs in your income statement?
- How do these changes impact your ability to pay dividends?
- How will these changes impact the tax you owe or your ability to use losses?
- How will you communicate to investors and analysts about the impact of these changes?
- Is your sale and purchase agreement fit for purpose in light of these changes?
- Have you considered how to structure your transactions to take account of these new rules?
- For step-acquisitions, what does the requirement to use fair value for your existing stake indicate about the historic acquisition cost, and more importantly, the acquisition cost for the remaining stake?
- Is the acquisition of partially-owned subsidiaries now a more attractive proposition as earnings will not be diluted by amortisation expense?

Deloitte can help you

Deloitte LLP offers a range of M&A services including:

- Transaction structuring accounting advice.
- Sale & Purchase Agreement services.
- Acquisition and vendor due diligence.
- Debt advisory.
- Vendor assistance.

We also run a workshop session on the impact of IFRS3 changes on M&A.

If you are interested in finding out more please contact your normal M&A contact, visit www.deloitte.co.uk/manda or email mailto:deloittema@deloitte.co.uk

International Financial Reporting Standards are rapidly becoming the global standard and they are being revised as part of a process of converging with US GAAP. IFRS 3, which governs the accounting and financial reporting of business combinations, has been revised and will be effective for financial years beginning on or after 1 July 2009.

This document forms part of a series of periodic bulletins for M&A professionals produced by our functional and industry experts within Deloitte focussing on hot topics that impact our clients businesses and deal related activities.

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