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Looking to aquire a business?

Don't forget the accounting!

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Business acquisitions

Business acquisitions are often significant strategic decisions to improve a business that can also have a material impact on financial statements.

In particular, business acquisitions often involve earn-out payments, post-acquisition payments to selling shareholders, indemnity arrangements and other terms which can all create accounting complexity and/or introduce earnings volatility in the financial statements.

Acquisitions may also involve the need for complex valuations in respect of assets and liabilities being acquired, or where equity or other financial instruments are exchanged.

While accounting should not drive decision-making, early consideration of the accounting choices available and possible accounting consequences may identify terms that could be adapted to remove earnings volatility or other complexities. It also supports transparent decision making and up front communications with investors so that there are no surprises after the deal has been completed.

Considerations and challenges

The acquisition method is used when an entity (the 'acquirer') obtains a controlling interest in one or more businesses (the 'acquiree') – referred to as a business combination.

The acquisition method involves seven steps, as shown opposite, each of which can present challenges for entities undertaking an acquisition.

Examples of some of the challenges are as follows:

Is control of a business being acquired?
Acquisition accounting only applies when the acquirer obtains **control** of a **business**. Sometimes this determination will be obvious, for example where control is exercised by means of ordinary shares and the acquirer obtains a majority of the ordinary shares in an established business which has inputs, processes and outputs. In other cases, judgement may be required in order to determine if control is obtained, or if there is a business to acquire.

There are important differences between accounting for an asset acquisition and a business combination (e.g. in relation to the treatment of transaction costs, deferred tax, contingent liabilities) so this assessment is critical.

Who is the acquirer? Usually the entity that transfers cash or other assets is the acquirer. However, there may be situations where further analysis is required, such as when newly formed entities are set up to acquire another entity through a share exchange, or where two entities of a similar size exchange shares or merge to effect a combination.

What is the acquisition date? The acquisition date is the date on which the acquirer obtains control of the acquiree. It is a matter of fact and cannot be retrospectively altered. Typically, control passes on the settlement/closing date however, facts and circumstances may indicate that control passed on a date that is earlier or later than the settlement/closing date. When this occurs, there may need to be adjustments to the purchase price, for example to take into account where profits accrue to the acquirer from a different date.

Reassessment of the acquiree's contractual arrangements at the acquisition date

In most cases, assets acquired and liabilities assumed are classified or designated as necessary based on contractual terms, economic conditions, accounting policies, and other pertinent conditions that exist at the acquisition date. In particular, for financial instruments:

- items must be classified based on their intended use
- hedge relationships need to be redesignated, which could lead to ineffectiveness
- contracts need to be re-examined for embedded derivatives.

Steps to consider when there is a business combination

Determine whether the transaction or event is a business combination

Identify the acquirer

Determine the acquisition date

Recognise and measure the identifiable assets acquired, liabilities assumed and any non-controlling interests

Measure consideration and determine what is part of the business combination

Recognise and measure goodwill or a gain from a bargain purchase

Subsequent measurement and accounting

Fair value calculations Fair value calculations, supported by specialist valuation advice, may be required in order to value:

- assets acquired and liabilities assumed, including contingent liabilities and intangible assets (such as brands and customer relationships) not previously recognised by the acquiree
- equity instruments provided as part of the acquisition consideration
- contingent consideration ('earn-out' arrangements) entered into
- previously held interests - in a 'step-acquisition' where an existing interest is increased to take control of the acquiree, the previous interest is re-measured to fair value with a resulting gain/loss being recorded in profit or loss.

Valuation adjustments may also require the recognition of additional deferred tax assets or liabilities, with a corresponding impact on the amount of goodwill recorded.

Accounting policy choice for the measurement of non-controlling interests

Non-controlling interests (NCI) can be measured at either their share of identifiable net assets in the acquiree, or at fair value (including goodwill).

The decision to use fair value adds complexity, as the valuation needs to be based on what a third party would pay for a non-controlling interest (i.e. without a "control premium) and is not simply a mathematical exercise using the acquirer's consideration. The decision may also impact future earnings or equity figures, for example if all or part of NCI is subsequently reacquired, or if there are impairment charges to be recognised.

Contingent consideration clauses

Contingent payments are included in the measurement of consideration at the acquisition date at their fair value, with subsequent changes in the fair value being recorded through profit or loss. Initial valuation and modelling of the probability of earn-out objectives being achieved should be included as part of the due diligence process.
In addition, careful analysis of clauses involving contingent payments to former owners who stay on in some capacity will be required. There is a risk that such payments could represent compensation for future services and therefore would have to be expensed as services are delivered. Such payments are automatically considered to be compensation where they are forfeited if the individual leaves the company, but other indicators may also lead to treatment as compensation.

Consideration for the acquisition

When measuring the consideration being provided to obtain control over the acquiree, the acquirer is required to separate amounts that are not in relation to obtaining control, such as payments for non-compete arrangements and amounts to settle pre-existing arrangements (e.g. rights under supply, franchise or licensing agreements, or settlement of disputes between the parties). Transaction costs are expensed.

As consideration is measured at fair value, complexity will arise where there are contingent consideration arrangements (refer above), where consideration is deferred, or where it involves the exchange of assets, shares or other financial instruments (such as options or warrants).

Summary

If you are looking to acquire a business, we recommend you extend your due diligence analysis to include early consideration of the likely accounting outcomes and their impact on other aspects of the business.

For example:

- tax treatment, such as thin cap calculations
- banking covenants
- distribution policies
- remuneration arrangements such as share-based payments or bonus schemes where they include financial targets.

How we can help

Further information on accounting for business combinations under International Financial Reporting Standards (IFRS) is available on Deloitte's global IFRS website:
http://www.iasplus.com/en/standards/ifrs/ifrs3

We also have an experienced team of professionals who can help you address issues that arise through the acquisition process including:

- accounting or tax advisory services
- valuation and purchase price allocation expertise
- help with the monthly closing process to consolidate the new business and other process and controls requirements, and
- other matters.

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