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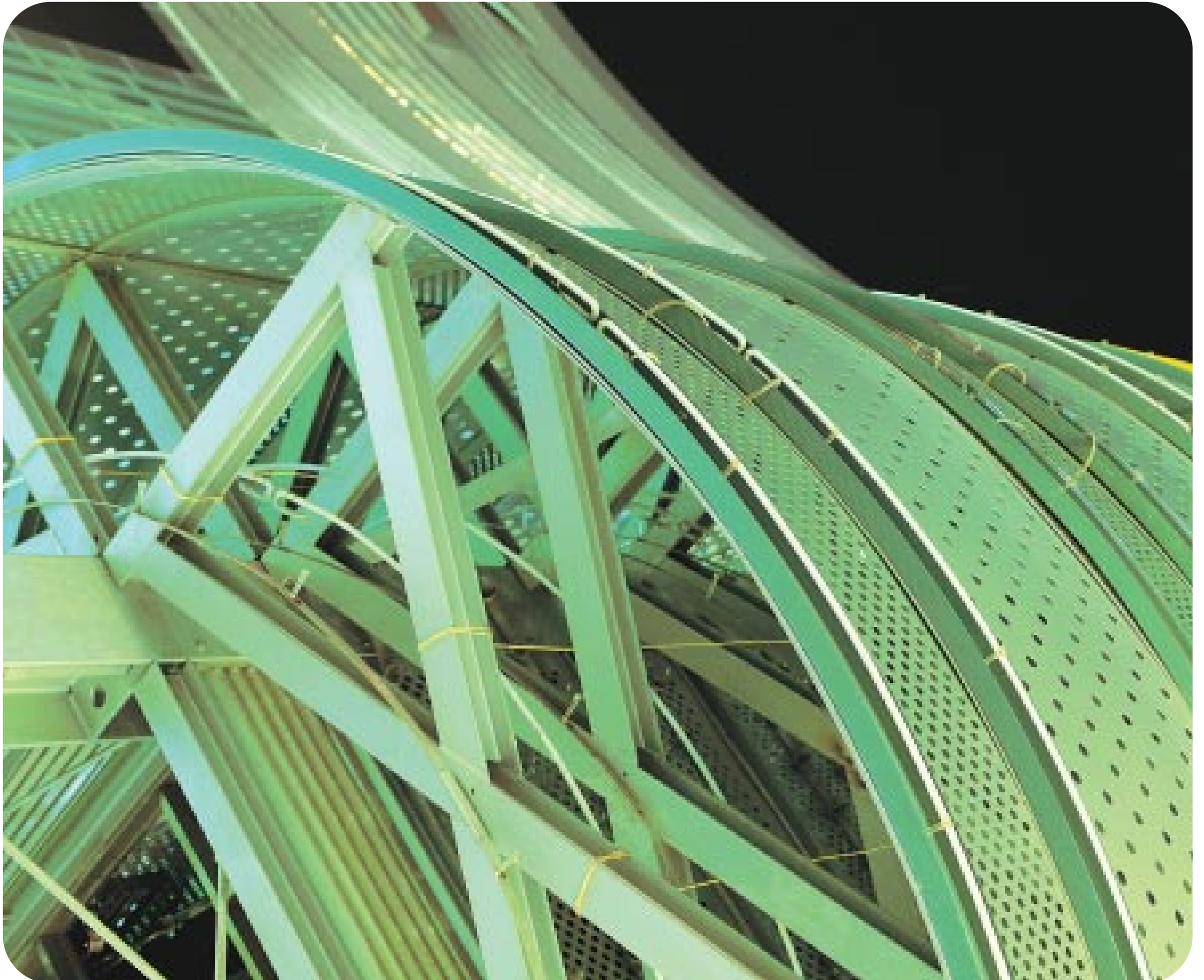
The new deal

Financial services M&A in an IFRS environment*



IFRS – Global Reporting Revolution

July 2005

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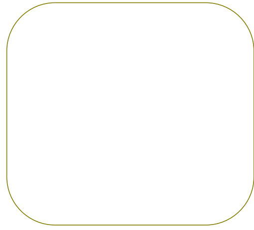
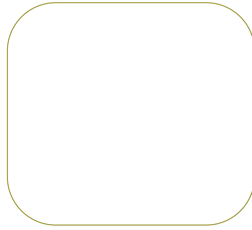
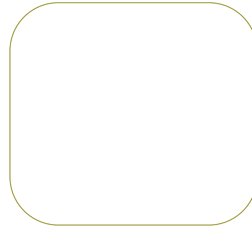




The IFRS Revolution

Welcome to the 17th in a series of papers dedicated to discussing International Financial Reporting Standards (IFRS) and their impact on financial services institutions and the users of their accounts.

IFRS went live in January 2005 and it is already clear that the new regime is leading to some significant changes. Recognising this, the Global Financial Services Leadership Team has been sponsoring a series of briefing papers focusing on the key commercial and technical challenges, aimed at delivering the information the industry needs to respond to the IFRS revolution.

This paper discusses the main challenges for companies when doing deals under IFRS and highlights the potential for additional complexity in M&A activity in the short term. In the long run, the more revealing IFRS information will make it easier to judge whether a takeover has been a success or failure, and lead to more probing questions from the market. Companies will therefore need to increase evaluation and due diligence and look more closely at how to justify any deals.

I hope that you find this paper thought-provoking and insightful. If you would like to discuss any of the issues addressed in more detail, please speak to your usual contact at PricewaterhouseCoopers or those listed at the end of this paper. We would also appreciate your feedback, as this helps us to ensure that we are addressing the issues that you are most focused on.

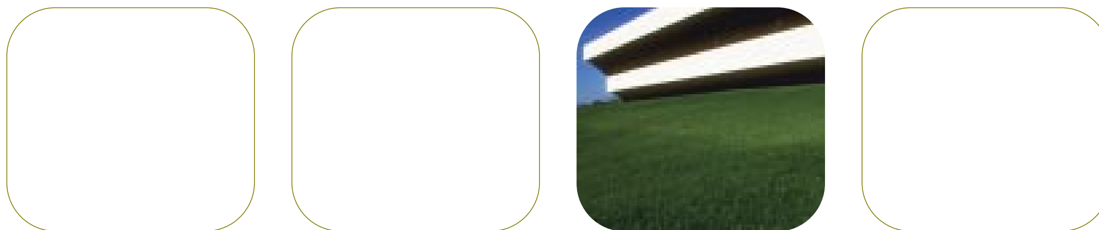
Ian Dilks
IFRS Conversions Leader

The new deal

Financial services M&A in an IFRS environment

Overview

- The move to International Financial Reporting Standards (IFRS) in Europe is adding to the complexity of M&A transactions and, in the short term, may delay or, in a few cases, prevent their completion;
- The main challenges are the need to translate the target's historical and projected performance into IFRS to assess the viability of the transaction and to understand the impact on the acquirer's earnings per share ('EPS') from the recognition of new intangible assets;
- There will be diversity in IFRS accounting and reporting practices across the European financial services sector, making comparison difficult. In addition, there is a particular issue for the insurance sector, with IFRS set to change in Phase II which will alter the way deals are looked at. On a positive note, however, convergence between IFRS and US GAAP no later than 2009 is looking more likely;
- Tax and financing implications arise from the introduction of IFRS which will impact the way transactions are structured;
- There will be increased deal scrutiny for senior management, as financial statements will contain more detailed information about acquisitions, which will make it easier for the market to judge the real success or failure of takeovers, in particular as a result of the potential need to book impairment charges against goodwill;
- Financial services organisations will therefore need to look closely at how to evaluate, execute and then justify their transactions under new and more exacting IFRS criteria; and
- Once the initial upheaval subsides, the enhanced level of pre-deal analysis and spotlight of IFRS scrutiny could well lead to better deals.



Introduction: M&A under the spotlight

The impact of the move to IFRS on M&A deals requires a recalibration of the measures used to evaluate transactions, and could be likened to switching from the old currencies to the Euro. The transition period to the new measures will create a period of some uncertainty, as was experienced with the currency changes.

Acquisitions are firmly back on the agenda across the European financial services sector. Latest research from PricewaterhouseCoopers has found that FS M&A volumes increased in all major European markets in 2004. Deal activity in banking and investment management has been steadily rising over the past two years. Interest in acquisitions in the insurance sector has also now picked up after a long period of relative inactivity. As margins continue to tighten across the FS sector, the impetus for further consolidation is likely to strengthen as organisations seek to improve scale, build volume and exploit the potential for cost-saving synergies.

In theory, IFRS should not affect the overriding economic and strategic rationale that is driving the increased focus on M&A. In practice, however, the reverberations of the new regime may increasingly reach into the deal market, especially as the information available to potential buyers, and indeed to analysts and commentators looking at completed deals, is different, deeper and potentially more revealing.

In particular, fundamental changes to the timing and trajectory of revenue recognition under IFRS are affecting tax, financing and the key measures by which transactions are priced, justified and rewarded. In fact, we have seen some deals founder as a result of new criteria for the recognition and amortisation of intangible assets, under which the planned takeovers would have failed to enhance earnings in the short term. This is illustrated in the example on page 6.

During the continuing transition to IFRS, these changes could raise the uncertainty and complexity of M&A transactions as companies and the users of their accounts endeavour to make sense of an unfamiliar and largely untested system. Once IFRS has bedded down, however, the information it provides may allow a greater level of insight into a bidding company's view of value.

Additional disclosures are required for each acquisition, especially on the intangible assets acquired and what the residual goodwill in the deal represents. This may make the M&A costs and returns more immediately transparent and so enhance analysts' and investors' ability to judge and compare takeover deals.

Acquiring companies will therefore need to strengthen the rigour of valuation, due diligence, market education and communication in anticipation of more probing questions from the market. While this is clearly a challenge, greater preparation for transactions and improved articulation of the rationale could lead to better deals and ensure that more acquisitions enhance rather than erode shareholder value.

This paper outlines the key implications of IFRS for the planning and execution of FS M&A. In particular, it looks at the importance of closer integration between the finance, business development and investor relations teams in providing a solid platform for successful acquisition in an IFRS environment.

Impact on deal evaluation

Changes to presentation, revenue recognition and asset designation will affect the criteria for determining a transaction's viability, price and incentive arrangements.

The impact of IFRS on financial services is in many ways more pervasive than any other sector, not least because of the high level of financial assets on the books. It includes significant changes to the timing of revenue recognition, the impact of the changes to the hedging rules and the related potential for greater earnings and equity volatility as more assets are marked to market (see 'Earnings impact').

Over time, the accounting differences need not change the underlying economic value generated by an acquisition. However, they can affect projections of 'maintainable earnings', along with the key measures such as the price/earnings multiple (P/E) and price/book value (P/BV) by which the market judges the price and viability of transactions.

In practice, it is important to ensure that the market multiples and key performance indicators (KPIs) used in assessing a potential target are applied on a consistent IFRS basis. While the overall aim of IFRS is greater comparability, significant choices do exist and important measures could therefore vary as a result. An example would be whether to present the income from associates or joint ventures in total revenues or below expenses, which could affect the cost-income ratio. Similarly, comparisons of net interest income, for example, could be affected by the choice of where to include the income from investments recorded at fair value. Acquirers will need to take account of, and where possible correct, the impact of these choices in their comparisons with other targets and industry norms.

Moreover, experience from other sectors suggests that FS companies should not underestimate the impact on M&A of writing off pension deficits against equity and the resulting reduction in prices. Last year, for instance, concerns over pension liabilities contributed to the collapse of the planned takeovers of UK retailers WH Smith and Marks & Spencer. Companies will also need to look at how to avoid potential dividend blocks in the light of any pension deficits.

The fundamental considerations for acquirers include a new set of criteria for measuring goodwill and intangible assets (see 'Acquirer impact'). This represents an end to merger accounting which will

Earnings impact

- The recognition of more financial assets at fair value, including derivatives;
- More prescriptive rules on hedge accounting;
- Tougher rules on the consolidation of special purpose vehicles (SPV);
- More rigorous asset impairment reviews than under some legacy GAAPs (generally accepted accounting principles), including new provisioning rules;
- New intangible assets with varying amortisation periods (usually shorter than 20 years);
- Changes in the profit recognition profile for some products; and
- Pension shortfalls may be written off against equity.

Source: PricewaterhouseCoopers

eliminate the anomalies between the 'purchase' and 'pooling-of-interest' methods previously used in different parts of Europe.

The remaining goodwill will no longer be amortised and therefore, in some instances, goodwill may effectively become permanent if the annual impairment test is continually passed. Companies may initially benefit from a windfall in operating profit from the elimination of the amortisation charges. However, the gains may be negated in the short-term by fresh amortisation charges from newly designated intangibles. In particular, brands, technology and customer relationships that had previously been accounted for within goodwill now need to be identified and separately valued as intangible assets (see 'Impact on financials' overleaf). In turn, the annual goodwill impairment test will improve users' ability to judge whether the amount allocated to goodwill is appropriate, as any overpayment is more likely to attract a charge in the early years.

In the short term, the valuation of a new set of intangible assets could prove challenging and will, of course, have to withstand market and audit scrutiny. In particular, there is as yet no precedent in Europe to underpin market-wide benchmarks for the valuation of assets such as customer relationships, apart from the experience in the US, where transactions have been accounted for in a similar way under US GAAP since 2001. We analysed a representative sample of 100 transactions that took place in the US between 2001 and 2003. One of the key findings was that the proportion of the purchase price allocated to intangible assets rose from 15% in 2001 to over 20% in 2003. This suggests that the more companies come to understand the new criteria, the higher the level of recognition and valuation of acquired intangibles.

The different tax treatment of acquired intangible assets and goodwill in different European countries and in different deal structures (asset or share deal) also provides challenges and opportunities.

Acquirer impact

- All business combinations need to be accounted for as acquisitions and not mergers;
- Brands, technology, customer relationships and other specified assets are taken out of goodwill and fair valued as intangible assets on acquisition;
- Goodwill is no longer amortised, but subject to an annual impairment test. Goodwill could potentially become virtually a permanent item;
- Negative goodwill is recognised immediately in income; and
- First-time adopters can choose whether or not to restate past deals on an IFRS basis – few have, in our experience.

Source: PricewaterhouseCoopers

Real measure of value

Some companies believe the new criteria will actually have a negligible impact, as analysts will simply continue to focus on profit before amortisation of intangibles, in the same way they added back the goodwill amortisation under previous accounting regimes. However, the intangible assets now subject to amortisation represent more concrete elements of value than the 'balancing figure' of previous

Impact on financials

The example below illustrates the potentially negative impact on short-term EPS from the recognition and amortisation of intangible assets and application of the goodwill impairment test as opposed to the current practice of goodwill amortisation, which is a key change from many legacy GAAPs. In this example, the deal would have been earnings-enhancing in year one, but under the new regime is earnings-dilutive in the first year. The change will clearly have significant implications for investor relations.

Company A buys Company B for 600

Balance sheet recorded under old GAAP	
Price paid	600
Fair value of net tangible assets	200
Goodwill	400

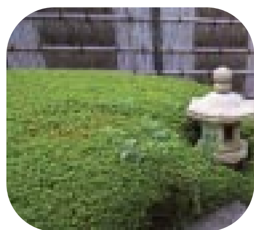
Income statement impact	
Operating profit	50
Amortisation of goodwill[1]	-20
PBT	30

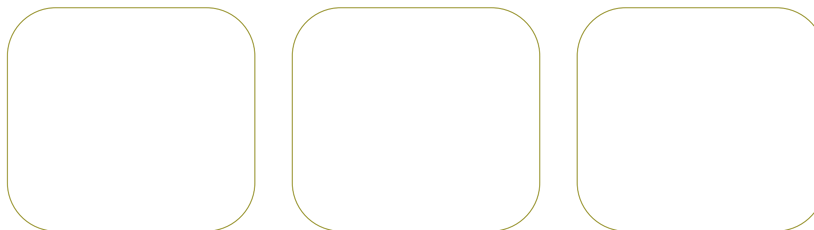
Balance sheet recorded under IFRS	
Price paid	600
Fair value of net tangible assets	200
Fair value of intangible assets	
– trademark	50
– customer relationships	250
Goodwill	100

Income statement impact	
Operating profit	50
Amortisation of goodwill[2]	0
Amortisation of intangibles[3]	-53
Goodwill impairment[4]	Variable
PBT	-3

1 Assumes goodwill amortisation over 20 years under old GAAP
2 Goodwill is not amortised under IFRS
3 Assumes 20 year useful life for trademark and five year useful life for customer relationships
4 New annual impairment test may result in an impairment

Source: PricewaterhouseCoopers





goodwill and it is now more transparent what the acquirer believes they were paying for.

As a result, analysts may opt to include the amortisation in their performance evaluation at an operating profit level. This could be seen as enhancing their ability to evaluate the deal in a number of important ways as:

- Return on invested capital is a post-amortisation measure that is used by many companies and analysts as a benchmark for assessing companies' performance;
- The amortisation of intangible assets may be viewed on a similar basis to tangible assets (where the depreciation charge is not added back) and may be viewed as providing greater insight into whether the acquisition price is appropriate.

Further considerations

Financing

Some commentators believe that IFRS could render certain forms of financing unviable. For example, the current absence of a fair value option for liabilities under IFRS could make it more difficult to deal with income statement volatility arising from certain structured financing arrangements. Particular instances include arrangements that contain significant fee components and/or embedded derivatives, or those that fall within an equity classification and have been hedged with a derivative. Careful structuring will therefore be required.

Tax

The tax-efficiency implications are key considerations for the structuring of cross-border deals, especially when IFRS is applied for tax purposes in one jurisdiction while local GAAP is used in another. In some circumstances, for example, acquirers may no longer be able to deduct the interest charges from certain 'debt push-down' arrangements. Additionally, the use of certain SPV arrangements may no longer be possible.

Companies may choose to retain existing GAAP at the entity level for tax purposes and confine IFRS to the consolidated accounts rather than embedding it throughout the group. Acquiring companies will therefore need to take account of the basis for tax returns and the possible impact of changes to revenue recognition and asset designation on the trajectory of the liabilities.

Further headaches could arise from the requirement under the EU merger directive for acquirers to track the value of assets for tax purposes according to the principles that had previously applied before the merger took place. In other words, acquirers may have to maintain accounting records for tax purposes in local GAAP.

Accounting

Inconsistencies arise from the variations in different countries' accounting practices that will continue to be used, for example, under Phase I for insurance companies, though European Embedded Value could help to provide greater comparability. Insurers also face continuing uncertainty over the timing and outcome of the eventual Phase II solution, which will have an impact on key areas of accounting and value, including policyholder liabilities, deferred acquisition costs and the profit profiles of certain lines of business. There are encouraging signs that reconciliations between IFRS and US GAAP will not be required in the medium term. The SEC recently agreed to eliminate the need for companies using IFRS to reconcile to US GAAP by 2007, or 2009 at the latest.

The bottom line

So why does IFRS matter to M&A? The change in accounting is likely to affect EPS, which our research indicates is still the key criterion for transaction incentives and executive remuneration generally. Indeed, our assessment of a recent typical transaction provides some indication of why it is so important to understand the potential impact before closing the deal. In this case, we found that the high-level identification of intangibles had failed to provide a reliable guide to the likely amortisation charges and effect on EPS. As a result, a takeover that had been expected to be earnings accretive in 2004 would not actually prove to be so until at least 2007.

Tougher due diligence

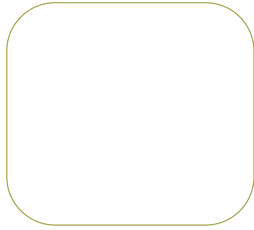
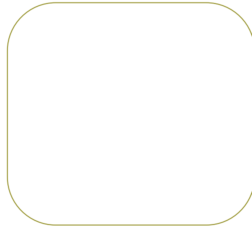
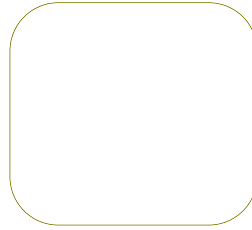
Comparability and consistency in the application of IFRS across countries and companies could vary markedly, and most unlisted companies will not prepare IFRS accounts. Acquirers will need to assess the implications as part of strengthened due diligence.

IFRS aims to create a compatible basis for users of accounts to assess performance and profit potential across different sectors and countries. Initially, however, the switch from local GAAP to IFRS could make it difficult to reconcile the numbers from previous years and prepare meaningful performance and working capital projections. Further disparities could arise from how IFRS is interpreted and how rigorously its principles are applied from one country to another.

These potential disparities are likely to heighten the demands on due diligence. Key areas for consideration include financial instruments, business combinations and share and pensions options. Acquirers may also need to devote far more time and resources to scrutinising how the target's numbers have been produced, including the quality and consistency of the underlying data and the quality of the calculations of fair value, including the estimate of useful lives.

Particular difficulties could arise when buying a subsidiary, private company or other non-IFRS reporting entity. Reliable conversion of numbers can be tricky and potentially expensive. Moreover, the potential cost of bringing the target's reporting systems up to group-wide standards, and the time required to do this, could be a significant factor in transition planning. We are finding that quite a few newly acquired companies are struggling with the data and disclosure requirements of IFRS.

These considerations will be especially critical for companies that are subject to 'Sarbanes-Oxley'. Senior managers will be required to sign-off on what could be unfamiliar IFRS financials. New standards are also currently before the European parliament and will soon be applied across the EU.

Contract negotiations, completion accounts and deferred consideration

The move from previous GAAP to IFRS will affect the basis for debt covenants and earn-outs. Contract negotiations will need to reflect the changes. Creditors, staff and other key stakeholders will need to understand the implications.

Any change in the valuation criteria of assets, liabilities and earnings will clearly affect key aspects of the completion accounts such as the net asset completion mechanism. In the short term, sale and purchase agreements may require greater planning and analysis to take account of the additional complexity.

Companies will also need to take account of the impact of these changes on covenant and incentive arrangements. In particular, a likely shift in companies' debt/equity ratios following the switch to IFRS may affect financial institutions as both issuers and holders of covenants. Companies may therefore need to re-negotiate past agreements to translate the old GAAP terms onto an IFRS basis. Similarly, earn-out clauses will need to be adjusted to take account of changes to the earnings and other measures.

The viability of such negotiations and re-negotiations will depend to a great extent on how well staff understand the dynamics of IFRS, including how it will impact on reported earnings. Basing incentives on IFRS metrics could in turn help to foster such understanding.

Market communications

IFRS offers new insights into what has been bought, the price paid and how it performs. Directors will therefore need to be prepared for more probing questions.

Under IFRS, the earnings profile of the business may be subject to heightened volatility as a result of the increased application of the fair value model, the requirements for effective hedging and the potential recognition of structures previously held off-balance sheet.

In some cases amortisation charges may also be higher in the early years, depending on the level of and amortisation period associated with intangible assets. Accordingly, deals may be potentially less earnings enhancing (or dilutive) in the initial period.

Companies will therefore need to anticipate and explain any variations in the profit forecasts or P/E multiples from previous accounting principles to IFRS, including the potential impact of earnings volatility, amortisation and impairment charges.

In the short term, IFRS may therefore lead to a certain amount of uncertainty in the M&A market as users of accounts endeavour to get to grips with the new 'numbers'. In the long run, however, the new regime will improve the visibility, granularity and comparability of M&A disclosure and so make it quicker and easier for analysts and investors to judge whether the price paid is justified.

Educating stakeholders and managing their expectations are therefore critical. Companies will need to ensure that the entire deal team, including corporate development and investor relations, understands the dynamics of IFRS in an M&A environment and how it affects the key measures by which deals are judged. They will also need to consider the impact of more immediate and exacting scrutiny of acquisitions under IFRS. Ultimately, greater transparency will raise the bar for FS M&A, forcing purchasers to look more closely at the true value of what they are buying and how to justify the deal to a better-informed market.

Conclusion: A sure-footed approach to M&A

IFRS will have an impact on every aspect of the deal continuum, as shown in Figure 1. From planning to execution, the acquisition process will need to become more rigorous in an IFRS environment:

- Stricter evaluation of targets to withstand greater market scrutiny;
- Need to uncover, analyse and address potential accounting-related issues early in the process; and
- Understanding how IFRS affects the numbers is crucial to the market perception of the transaction.

Before taking the deal forward, companies will therefore need to be able to answer these fundamental questions:

Valuation

- Do you know how the target's cost/revenue projections have been put together (previous GAAP or IFRS)?
- Do you know what choices have been made in the target's application and presentation of IFRS?
- Have you taken account of any IFRS differences in your comparisons with other targets and industry norms?
- What market transactions can provide a reliable guide to value (P/E) and under which accounting regime are they valued?
- What criteria will be used to value the target's brands, technology and customer relationships as intangible assets?
- What does the residual goodwill represent (workforce, synergy value etc)?

Due diligence

- Will your evaluations/asset designations stand up to market scrutiny?
- How well is IFRS embedded in the target and how credible and consistent are its numbers?

Contract

- What will the completion accounts look like under IFRS?
- How will the earn-out be calculated?
- How will the debt covenants be re-negotiated?

Communication

- What will be communicated about the impact on EPS and other KPIs influenced by IFRS?
- Do the IFRS projections take account of any differences in accounting policies?
- What justification will be given for residual goodwill?

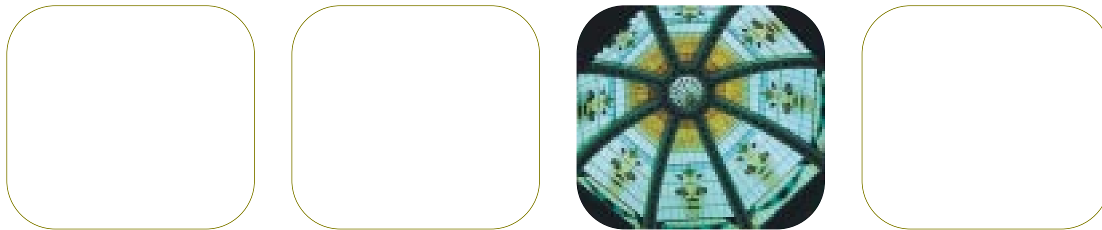
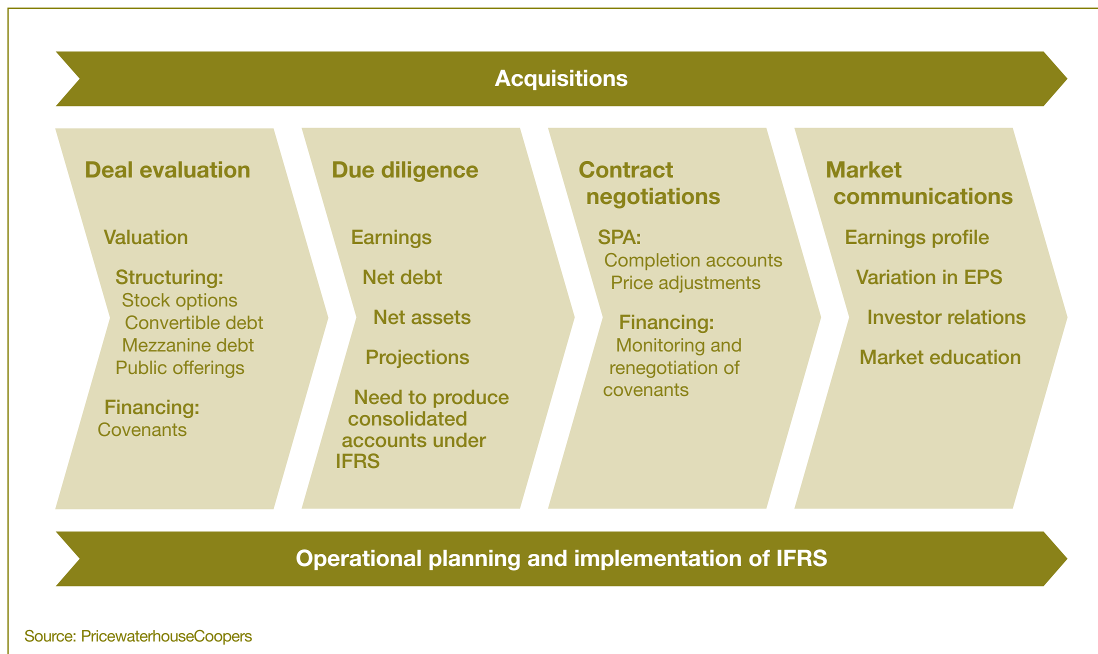


Figure 1 | Impacts throughout the deal continuum



Source: PricewaterhouseCoopers

IFRS is unlikely to affect the growing impetus for M&A in the European FS sector. In the short term, however, it could give rise to deal assessment complications in areas ranging from earnings projections to the valuation of acquired intangible assets, as well as adding to the time required to complete deals if target companies' financials need to be converted to IFRS. Moving forward, benchmarks for valuation, amortisation and impairment charges are likely to emerge, paving the way for what is likely to be a more transparent and insightful approach to M&A.

IFRS replaces limited historical profit measures with a more multi-dimensional approach to M&A accounting capable of providing more detailed, reliable and forward-looking insights into what has been bought, for how much and why. As consolidation continues to gather pace across the FS sector, acquisition decisions will therefore be subject to an ever more intense spotlight of transparency. The challenge for the sector is how to ensure that targeting, pricing, due diligence and market communications are strong enough to stand up to this scrutiny. In our view, the foundation for success is a well-informed and integrated deal team capable of carrying out rigorous and wide-ranging evaluation of targets, negotiating a tightly structured deal and communicating confidently with stakeholders.

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If you would like to discuss any of the issues raised in this paper, please speak to your usual contact at PricewaterhouseCoopers.

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