

Deal Flash!*

Volume 5 No. 2

May 23, 2006

Do you speak IFRS? Why the new accounting language matters for private equity investors

As you begin due diligence on your next overseas investment, don't be surprised if your target's financial results appear in an unfamiliar language. International Financial Reporting Standards (IFRS) has gained significant currency in the last few years as a result of the European Union's efforts to establish a single GAAP basis for all member countries. IFRS is rapidly becoming the world's global financial reporting language with China and Canada recently announcing their intent to adopt these standards. With a substantial portion of the world committed to using IFRS, US private equity funds that operate globally can no longer afford to ignore its impact. Differences between IFRS and US GAAP treatments will affect deal structuring, due diligence and post-acquisition analysis.

IMPACT ON FINANCIAL REPORTING

As a principles-based standard, IFRS relies more heavily on the judgment of senior management and their auditors than US GAAP. The relative newness of IFRS, the significance of differences between IFRS and the local GAAPs it replaced, and the complexity of business today means there is no body of well-established practices that all users consistently apply. This will have an impact on comparability and industry benchmarking efforts. However, some differences will be fairly consistent.

First, expect to see more debt on the balance sheets of targets using IFRS because:

- Off-balance sheet financing (e.g., securitization) is more difficult to achieve under IFRS.
- Many European companies elect proportional consolidation as the accounting model for jointly controlled assets. Once elected, this policy must be applied consistently and will expose debt that would otherwise be netted on the balance sheet under US GAAP.
- Consolidation guidance, though limited, can be more far reaching than under US GAAP, particularly since it requires carving out and consolidating a portion of an entity (e.g., a research and development arrangement, outsourcing contract, etc.). IFRS requirements for voting rights garnered through instruments such as currently exercisable put/call arrangements and warrants can result in consolidation, even when these instruments are priced at market or out of the money.

Second, the use of fair value accounting is more pervasive under IFRS than US GAAP. IFRS practitioners do not limit the use of fair value accounting to financial instruments, but apply it to investment property and other non-financial assets. Absent

hedging, IFRS may produce more volatility in areas that appear quite stable under US GAAP.

IMPACT ON DEAL STRUCTURING

Having to account for an overseas investment using IFRS can have an impact on a target company's balance sheet because the accounting treatment of common types of investments, such as preferred stock with an equity kicker (e.g., an embedded conversion feature, detachable warrants, or direct investment in common stock), can be very different under IFRS compared with US GAAP. For example, the conversion option in convertible preferred would have to be segregated and treated as a separate equity, while the preferred share itself is treated as a discounted security. This is likely to trigger an additional accretion charge (i.e., interest expense arising from the resulting discount).

Under IFRS, preferred shares must be treated as debt rather than equity, if redemption is beyond the control of the company, or if dividends (in kind or otherwise) must be paid on a periodic basis over the life of the security. A target company's capacity to pay such dividends depends, in turn, upon its having sufficient retained earnings or distributable reserves. Because the use of fair value accounting is more widespread under IFRS, such reserves are often more volatile and harder to forecast. This can constrain a target company's capacity to pay dividends and, under some circumstances, the amounts it can borrow.

INSIGHTS

Global reach—IFRS is not just a European phenomenon. Most major economies outside the US—including China, Japan and Korea—have or are considering adopting IFRS. In this

environment, speaking just one accounting language, US GAAP, will get you only so far.

It can hit you at home—The FASB and IASB are collaborating through joint projects on new standards (e.g., the soon to be delivered EPS standard) as well as convergence efforts to reduce differences in key areas such as business combinations and share-based compensation. These efforts, as well as those of European regulators, will affect US subsidiaries of foreign companies, as well as domestic companies that sell products or services in Europe or are listed on European exchanges.

IFRS subject to national interpretation and regulation—Prior to adopting IFRS, most countries had a legacy GAAP and regulatory regime in place. Many of these rules were tax-driven and less comprehensive than IFRS or US GAAP. Because IFRS covers virtually every area US GAAP addresses, the migration to IFRS has been a huge undertaking for regulators and the accounting profession. Companies and their auditors will be grappling with the new complexity for years to come and as they adapt, don't be surprised if "dialects" of IFRS emerge giving financial reports a local flavor, especially those of smaller companies outside the major capital markets. Until practices settle down in the post-IFRS adoption world, such inconsistencies may affect comparability and create challenges when it's time to exit and investment.

The devil is in the details—Although we've focused on IFRS concepts that affect a target's balance sheet and cash flow, IFRS also affects non-cash aspects of financial reporting IFRS

including impairment charges (which can raise or reduce distributable reserves), deferred taxes, share-based compensation and restructuring provisions. Although the guidance often seems deceptively close to US GAAP, convergence remains elusive.

CLOSING THOUGHTS

The practical impact of the adoption of IFRS by 25 legal environments in Europe and 100+ regulatory and standard-setting bodies worldwide (national standard setters as well as bank, stock market and insurance regulators) has yet to be fully felt. But four things are clear: IFRS is not US GAAP, significant differences exist, many questions remain unanswered, and the transition to IFRS will have teething problems for some time to come. As with US GAAP, there are often valid reasons for diverse accounting treatments of "similar" transactions. Although differences are not necessarily a problem, they could draw attention from regulators and financial statement users.

Expect a somewhat quiet period as a second wave of companies throughout Europe tackle the adoption of IFRS in 2006. But any respite will be brief, as standard setters on both sides of the Atlantic have critical and sensitive projects on their calendars including the accounting for business combinations, revenue recognition and consolidation. Keeping current on developments that affect the deal community and knowing where to turn for help in identifying potential issues is the best insurance against having a subtle difference in accounting models cause a major headache on your next cross-border deal.

Deal Flash!® provides late breaking news on regulatory developments that affect the deal community. Deal Flash!® is a publication of PricewaterhouseCoopers' Transaction Services Group which includes over 800 deal professionals in 16 US cities and London. Our specialists can keep you current on IFRS developments that affect your transactions and business operations. Should you require deal advice, competitive benchmarking or a full conversion, our professionals can advise on establishing appropriate processes and transferring knowledge so management remains in control, and your people operate authoritatively in the new IFRS environment. For more information, contact one of the Transaction Services professionals listed below.

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