IFRS news

Emerging issues and practical guidance*

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Financial reporting requirements to impact M&A deals

Yvonne Kam, partner in PwC's Accounting Consulting Services (ACS) in China, and Thierry James, senior manager in PwC's ACS in Hong Kong, look at how contingent consideration under the new business combinations standard could impact M&A deals.

The economic downturn has created opportunities for mergers and acquisitions in many industries around the world. Struggling companies have been devalued and those with healthy balance sheets are looking for bargains. The financial reporting implications are now a key consideration when formulating merger and acquisition strategies. The revisions of IFRS 3, 'Business combinations' ('IFRS 3R'), applicable to calendar year companies from 1 January 2010, has made this even more important.

Acquisition accounting under IFRS 3R may have different and even counter-intuitive effects on earnings and equity when compared with existing IFRS 3 ('IFRS 3 (2004)'). Management should avoid nasty surprises by analysing the potential impact of IFRS 3R on transactions that are in the pipeline and, if necessary, make changes to the structure of the deal.

What are earn-outs?

Earn-outs are adjustments to consideration, often arising because of uncertainties over the value of the acquired business. These adjustments relate to events or conditions that might trigger the settlement of additional consideration. For example, if an acquired business's post-acquisition earnings reach a certain level, this will trigger the payment of additional purchase consideration to the vendor – hence the name 'earn-outs'. The inverse could also happen, where consideration is 'refunded' to the acquirer if certain conditions are not met.

How will it initially impact the accounting?

Earn-outs were recognised under IFRS 3 (2004) only to the extent that their settlement was probable and the amounts reliably measureable. Under IFRS 3R, all types of purchase consideration (for example, cash, common or preferred equity instruments, warrants, options and other assets) are measured at fair value on the date the acquirer takes control of a business. This includes an estimate of contingent consideration or earn-outs, whether or not deemed probable at the date of acquisition. The probability of the earn-out will not impact whether the earn-out should be recognised or not, but it will impact how much is recognised.

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What is the impact subsequently?

Adjustments to earn-outs are made against goodwill under IFRS 3 (2004): it is only a 'balance sheet' issue. IFRS 3R prohibits the acquirer from recording subsequent changes of earn-outs through goodwill other than measurement period adjustments. There could be a significant impact to the acquirer's post-acquisition profit or and loss.

There seems to be an incentive for performing a more accurate assessment of the fair value of earn-outs, given that re-measurements after the acquisition date are recognised in the income statement for earn-outs classified as financial liabilities. The more the acquired business exceeds the performance projections underpinning the initial fair value, the greater the charge against the post-acquisition income statement. The inverse is also true, with poor performance resulting in a reduction of the recorded liability and a credit in the income statement. The results could be counter-intuitive, depending on how earn-outs are structured. It is therefore essential to measure reliably the fair value of earn-out clauses at the acquisition date. Appropriate structuring of deals and accurately fair valuing earn-outs at initial recognition may reduce or eliminate earnings volatility over the subsequent years.

Liability versus equity instruments

Earn-outs may be settled through the acquirer's additional equity securities instead of in cash. These share-denominated earn-outs will fall either within the classification of liability or equity instruments, depending on their contractual terms.

The earn-outs are classified as a liability if they fail to qualify as an equity instrument under the 'fixed-for-fixed' criteria in IAS 32. If classified as liability instruments, they are initially recognised at fair value. They are re-measured at fair value at each reporting period, with changes in fair value going through the income statement.

Earn-outs classified as equity instruments are recognised at fair value and are not subject to re-measurement. This reduces volatility and may be a more palatable alternative for all parties when compared to cash earn-outs. However, payment in shares of the acquirer may result in the transfer of more benefit to the seller than the acquirer had intended. For example, if the combination has a positive effect on the acquirer's share price the seller benefits from the market's assessment of post-combination synergies.

Earn-outs to employees or vendor-shareholders – impact

Earn-outs might be paid to the selling shareholders who remain as employees after the transaction. For example, additional payments will be made if the vendor remains employed three years after the acquisition. In another example, the acquirer may be renting property from the vendor subsequent to the transaction, and rental payments are above or below fair value. Determining whether these arrangements are part of the business combination or a separate transaction requires judgement.

An earn-out that is forfeited if employment terminates is remuneration for post-combination services. Earn-outs to employees or selling shareholders are not affected by employment termination are more likely to be consideration for the acquired business but require careful analysis.

Application challenges

IFRS 3R may have significant effects in the year of and years following an acquisition. Earnings volatility in subsequent years will be driven by the buyer's ability to assess, at the acquisition date, the probability of achieving the pre-defined performance objectives on which additional payments are based. An accurate estimate will reduce the amount of subsequent changes and volatility. This area might be a challenge for CFOs and valuers and may well result in more equity-settled arrangements or fewer earn-outs altogether.

Implications for deal restructuring

The simplest way to limit volatility is to eliminate cash earn-outs and contingent consideration. However, management will need to consider how the transactions are structured. Equity instruments eliminate volatility but may not be acceptable to the sellers or may represent too high a cost to the acquirer. Management could also ensure that due diligence is thorough and they have a full understanding of the risks before determining if contingent consideration is the right approach. Long-term volatility might be reduced by shortening the duration of the earn-out clauses, although this solution would mostly suit entities operating in mature markets; it is unlikely to be appropriate for entities operating in fast-growing markets or for start-up entities.

Structuring M&A deals requires early analysis and an in-depth knowledge of the financial reporting implications. There are few practical solutions available; management of an acquisitive entity needs to understand the financial reporting implications to reach the best possible solution for the business.

IFRS survey – your feedback needed!

PricewaterhouseCoopers is continually seeking to enhance its IFRS publications and online offering. We welcome any feedback you have to help us develop our IFRS materials. If you would like to provide input to our development process, you can complete a quick survey by following this link.

The survey should take no longer than five minutes to complete. All of the data will be analysed at a total level, and no comments will be attributed to an individual. We would be grateful for your responses by 15 April 2010. Many thanks for your contribution to help us improve our products.

Cannon Street Press

Moving closer to an ED on financial liabilities

The IASB agreed last month to retain the existing requirements in IAS 39 for financial liabilities as follows:

- financial liabilities held for trading will continue to be recognised with changes in fair value through profit or loss;
- hybrid financial liabilities will be subject to the bifurcation requirements of IAS 39 (that is, embedded derivatives should be reported separately if they are not closely related to the host); and
- 'plain vanilla' liabilities should be recorded at amortised cost.

The fair value option with three existing eligibility criteria will still be available, as noted in *IFRS news*, March 2010, p2. However, an entity that elects the fair value option will be required to separately record the amount attributable to 'own credit risk' in other comprehensive income (rather than profit or loss). Amounts will not subsequently be recycled from other comprehensive income, although if the instrument is held to its maturity, the changes would offset to zero over the instrument's life.

The Board does not expect the identification of fair value changes relating to 'own credit' to have a significant impact in practice, given that IFRS 7 currently requires this amount to be disclosed in the notes to the financial statements.

Boards publish proposals on reporting entity concept

The IASB and FASB have published an exposure draft on the concept of a 'reporting entity' as part of their joint conceptual framework project. The ED addresses some of the comments arising from the discussion paper issued last May, including proposing what a reporting entity is and when one entity controls another entity.

Comments on the exposure draft are invited by 16 July 2010.

Update on consolidation project

The consolidation project, now a joint project with the FASB, continues to wend its way through due process and further Board discussions at the IASB.

The IASB has decided to issue a single disclosure standard that will encompass all disclosures relevant for a reporting entity's involvement with other entities. It will include consolidation-related disclosures as well as those for joint activities, associates and structured entities that the reporting entity does not control. The disclosure standard is expected in Q4 of 2010.

There may be a draft of the IASB's consolidation standard available in Q2 of 2010, although it will not be finalised until much later in the year. The IASB expects to publish the FASB exposure draft on consolidation with a 'wrapper' requesting comments from its constituents. The consolidation standards are expected to be converged in key principles, although not using the same text.

One key change in the IASB consolidation standard may also require re-exposure. The IASB decided, with the FASB, that an investment company should carry all of its assets at fair value, even it some of those assets are controlled entities. The staff at both Boards are developing a definition of an investment company.

Liabilities comment deadline extended

The Board has decided to extend the comment period for the ED 'Measurement of liabilities in IAS 37' to 19 May 2010.

The extension gives respondents more time to understand the recognition requirements of the standard that will replace IAS 37 before they finalise their comments on the revised measurement proposals.

The exposure draft is expected in Q2 2010; the final standard is expected by the end of the year.

EU endorses IFRS 2 amendment and 2009 'improvements'

The EU has endorsed the amendment to IFRS 2, 'Share-based payments', on group cash-settled transactions effective for accounting periods 1 January 2010. These amendments provide a clear basis to determine the classification of share based payment awards in both consolidated and separate financial statements. The EU has also endorsed the 'Annual improvements' issued in April 2009, which amended 12 standards.

Most of the amendments are effective 1 January 2010. For more information, see *A practical guide to new IFRSs for 2010* on pwc.com/ifrs.

Korea begins countdown to IFRS in 2011

Kyung Ho Lee is a partner in PwC's Accounting Consulting Services group in Korea. He talked to *IFRS news* on his recent two-month stay in London about progress in Korea in moving to IFRS.

What are the big challenges that companies face in the move to IFRS in 2011?

One of the biggest challenges for companies in Korea is moving from the requirement to present individual financial statements to presenting consolidated financial statements. This will also involve a change to the systems capturing the data, an especially onerous task for entities in the financial services sector.

The move to fair value accounting is also a big shift for us. As more fair value measurements are required under IFRS, companies will have to be familiar with valuation techniques and use independent appraisers. It will also be a more time-consuming exercise than in the past.

What are the most significant differences between Korean GAAP and IFRS?

The issue of presenting consolidated financial statements mentioned above is a significant change. What should be consolidated and what should not? Korean GAAP is very prescriptive about this and provides bright-line rules. However, IAS 27 and SIC 12 require judgement as to who has the control, risk and reward. These different criteria mean that some entities that were consolidated under Korean GAAP will no longer qualify, and others will be consolidated where they previously were not. IFRS requires entities to be consolidated if the entity has more than 50% of ownership; under Korean GAAP it's a 30% and majority shareholder threshold. There are also more criteria to be considered under Korean GAAP that are not present in IFRS.

Another big difference is the format of the financial statements. Korean GAAP has a standard format that includes operating income. IFRS, again, provides only guidelines and requires judgement. Management will have to consider whether operating income should go in the income statement or not.

This change from a rules-based framework to principles-based is a theme that runs throughout and is a cultural shift. The regulators of course are concerned about management's use of judgement; it is a culture change for the regulators too. The regulator has not issued any official interpretations yet, but the regulator has recently set up a discussion panel in response to calls from the market. We expect to see some activity there soon.

Other significant differences between Korean GAAP and IFRS are:

- Classification of debt versus equity: for example, redeemable preference shares are in equity; under IFRS, they are in debt.
- Accounting for employee benefits: Korean GAAP looks at history and does not require the use of forward-looking actuarial methods.
- Goodwill: goodwill is amortised under Korean GAAP using the useful life method; impairment is then considered. Under IFRS there is no amortisation, just impairment testing.
- Functional currency: entities have previously used Korean won as the functional currency; the functional currency may change under IFRS.

The impact of these changes will be significant. We are talking with the investment community to communicate how the financial statements may change and raise awareness of where there may appear to be volatility in the financial statements as a result of the move to IFRS. They may struggle initially with the new format of the financial statements. They may also need to be aware of the disappearance in some reports of the operating income figure and how this will affect the apparent comparability between entities. Users will have to use judgement, as well as the preparers.

How are companies preparing for IFRS adoption in 2011?

The transition to IFRS for large companies is now nearly done, and some large companies early adopted, such as Samsung and LG in 2010. Some of the smaller companies are less well prepared; we are encouraging them in their efforts to start preparations.

Are there any lessons from the Korean experience that would be useful for other transitioning territories?

It is important to consider how company law, tax law and other regulations might need to change in order to accommodate IFRS requirements. Korea is still adapting its legislation in this regard.

I would also emphasise the importance of seeing the move to IFRS not just as an accounting change. It affect IT systems, company philosophy, staffing. It needs to be looked at holistically.

What has PwC/Samil in Korea been doing to help companies prepare?

We established IFRS Center of Excellence (CoE) in July 2005, two years before the announcement of the IFRS Roadmap, and have supported the regulators, the standard setter and our major clients. In July 2008, IFRS was diverged from IFRS CoE to focus on providing IFRS technical services.

We provide engagement teams with an IFRS toolkit. It comprises our conversion checklist and publications based on global materials but tailored for the local market, such as first-time adoption guidance based on the firm's *Manual of accounting*, hedge accounting guidance and comparison of similarities and differences between Korean GAAP and IFRS. We also issue technical updates and newsletters.

We have also been running internal and external training programmes. We have made global P2P IFRS and IFRS e-learning training in Korean available online. We provide IFRS update training and regular IFRS workshops, internally and externally, which are topic-based. We also provide 1-2 day classroom-style training sessions externally that can be tailored to clients' needs.

What do you think the impact will be for the capital markets in Korea?

Thirteen companies made the transition to IFRS in 2009. Feedback from the market shows some concern around the differing formats of the financial statements under IFRS because of the principles-based rather than rules-based approach that users are accustomed to under Korean GAAP. For example, there is some confusion around where users can now find operating income.

IFRS has also resulted in very different results for some companies – for example, because of changing the functional currency.

We are making progress and expect to have preparers and users ready for the change by 2011.

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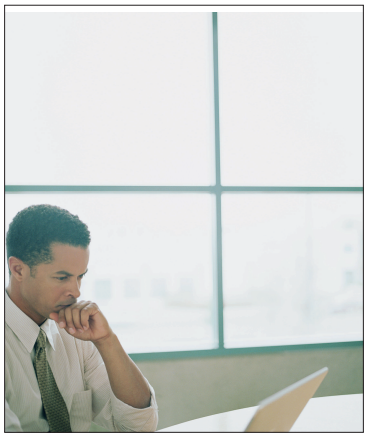

For further help on IFRS technical issues contact:

Business Combinations and Adoption of IFRS
mary.dolson@uk.pwc.com: Tel: + 44 (0)20 7804 2930
caroline.woodward@uk.pwc.com: Tel: +44 (0)20 7804 7392

Financial Instruments and Financial Services
john.althoff@uk.pwc.com: Tel: + 44 (0)20 7213 1175

Liabilities, Revenue Recognition and Other Areas
tony.m.debell@uk.pwc.com: Tel: +44 (0)20 7213 5336
mark.lohmann@uk.pwc.com: Tel: +44 (0)20 7212 4482

IFRS news editor
joanna.c.malvern@uk.pwc.com: Tel: +44 (0)20 7804 9377