The importance of being financially bilingual
How financial reporting differences can affect perspectives on cross-border deal value

May 2017
Deals
At a glance
Identifying potential financial reporting differences is critical to evaluating deal value
Efficient execution hinges on understanding how financial reporting and regulatory requirements interact
Embedding GAAP changes and managing multi-GAAP reporting post-acquisition requires careful planning
Executing deals in a connected world

Globalization is not dead, and in a world increasingly connected through cross-border deals, differences in accounting, tax and regulatory practices remain.

With cross-border deal activity making up an increasing percentage of global M&A activity, we are in a new era of globalization. It is no longer just US investors looking overseas. Despite political uncertainty, US-bound volumes from Europe and China are robust.

While “numbers” may seem to be a universal language, the stories they tell can convey very different meanings. The “era of convergence” between US GAAP and IFRS has ended. While new accounting standards may be closer aligned, there remain potentially significant differences in both the bottom-line impact of accounting conventions and disclosure requirements.

Understanding these differences and their impact on key deal metrics, as well as both short- and long-term financial reporting requirements, will lead to a more informed decision-making process. It can also help minimize last-minute surprises that can significantly impact deal value or completion.

To fully realize the anticipated value of a cross-border transaction, stakeholders require comprehensive knowledge of the accounting differences. They must also understand differences in tax requirements, M&A conventions, market regulations, and legal practices. They also need to anticipate the implications of existing and evolving geopolitical sentiment.

Finding the best target or right buyer requires careful assessment of these complex issues to determine the potential of companies or the expectations of buyers that may be thousands of miles apart.

Shareholders are no less demanding or forgiving in today’s uncertain economic environment. To meet their expectations, companies need to navigate the financial, tax, and regulatory nuances of cross-border transactions.
Connecting the dots across different financial languages

Preparing for the deal

Whether buying, selling, or raising capital, cross-border transactions are complex, demanding disciplined and well-executed preparation. Given the myriad of scenarios for M&A in today’s market environment, companies should carefully consider what information will be required by potential buyers or investors, what information is available from potential sellers, and how financial information can best be presented and analyzed to achieve maximum value and deal efficiency. In many transactions, financial or regulatory reporting issues demand that buyers receive audited financial statements. Often, stand-alone financial information does not exist and must be “carved out” of another entity. At the same time, statutory financials need to be maintained. Depending on the nature of the carve-out, development of the financial statements can be complicated and time-intensive. It may require judgments and estimates, corporate allocations, debt and purchase accounting push-downs, the creation of stand-alone data that may not have previously existed, and conversion to a different GAAP basis.

Financial information a buyer can understand

Buyers outside the US will likely expect to understand how the seller’s financial position and results look on an IFRS basis. When financial statements must be converted or reconciled to IFRS, or conversely from IFRS to US GAAP, the complexity of the deal is sure to intensify.
Understanding how GAAP and regulatory requirements mesh

**US buyers**

Public US buyers should understand how a target’s historical IFRS financial information differs from US GAAP, and how that may impact post-acquisition financial reporting and metrics. It is also essential to plan for the SEC reporting requirements resulting from the transaction.

Key questions should include:

- Will the target meet the definition of a foreign business?
- Will audited historical financial statements be available and will they need to be reconciled to US GAAP?\(^1\)
- How difficult will it be to calculate the S-X Rule 1-02(w) significance test and prepare combined pro forma financial information based on US GAAP?

Companies will need to determine as early as possible whether they have the expertise to convert IFRS to US GAAP in-house or whether they need to engage outside advisors.

**US sellers**

Understanding the potential non-US buyer’s regulatory reporting requirements is critical and will be dictated by the specific territory in which the buyer resides. Regulatory rules may stipulate the number of fiscal and interim periods required, and whether reporting is audited or unaudited.

If audited, companies must know whether the auditing standard is international or US. It will be necessary to determine whether pro forma information must be prepared in conformity with the buyer’s IFRS or local GAAP policies, and whether Management’s Discussion and Analysis or Operating and Financial Review must be presented.

Finally, buyers must understand the traditional expectations and legal requirements of investors, bankers, and analysts in the territory. This could include prospective financial information, a concept that may be uncomfortable to many US capital market participants.

Sellers should be prepared to tell their story in the financial reporting language and format spoken by buyers. That may require a greater level of disaggregated information and disclosures than currently prepared using US GAAP.

**Transparency**

Both buyers and sellers may also need to consider their tolerance for transparency because certain countries make statutory filings (including director information and remuneration) available online, even if the company is privately held. This information may not be available from the current information technology reporting environment.

**EBITDA**

Differences between IFRS and US GAAP accounting principles, as well as diversity in application and judgments, can lead to notable differences in reported earnings. While enterprise value, in theory, should not be affected by accounting policies, valuation techniques like EBITDA multiples can be impacted due to earnings variations resulting from accounting policy differences.

---

\(^1\) Reconciliation of IFRS to US GAAP is not required if the financial statements of the foreign business are prepared in accordance with IFRS as issued by the IASB and audited in accordance with PCAOB standards. However, target financial statements prepared using local GAAP or a local variant of IFRS will require reconciliation to US GAAP under SEC regulations.
Figure 1 illustrates the impact on EBITDA of IFRS to US GAAP accounting differences. Example A demonstrates how implied EBITDA multiples may be impacted on conversion to new accounting standards, even if there is no actual change in the underlying cash flows. In certain circumstances, these same GAAP differences can be the difference between positive earnings and breakeven results (Example B).

**Figure 1: Example of possible EBITDA adjustments in a quality of earnings exercise due to change in GAAP or accounting policy**

<table>
<thead>
<tr>
<th>Example A</th>
<th></th>
<th>Example B</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Adjustments (’000s)</strong></td>
<td><strong>EBITDA</strong></td>
<td><strong>Implied EBITDA Multiple</strong></td>
<td><strong>Enterprise Value</strong></td>
</tr>
<tr>
<td>EBITDA (IFRS)</td>
<td>100</td>
<td>10</td>
<td>1,000</td>
</tr>
<tr>
<td>Accounting differences</td>
<td>(20)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDA (US GAAP)</td>
<td>80</td>
<td>12.5</td>
<td>1,000</td>
</tr>
</tbody>
</table>

To further illustrate differences in EBITDA multiples, consider the Figure 2 summary of multiple averages for transactions announced over the last three years in key industries.

**Figure 2: Differences in EBITDA multiples**

<table>
<thead>
<tr>
<th>Industry</th>
<th>Average EBITDA multiple in recent transactions*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US GAAP</td>
</tr>
<tr>
<td>Entertain, media &amp; communications</td>
<td>9.82</td>
</tr>
<tr>
<td>Financial services</td>
<td>17.61</td>
</tr>
<tr>
<td>Industrial products</td>
<td>12.46</td>
</tr>
<tr>
<td>Pharmaceuticals &amp; life sciences</td>
<td>19.08</td>
</tr>
<tr>
<td>Retail &amp; consumer</td>
<td>11.44</td>
</tr>
<tr>
<td>Technology</td>
<td>17.06</td>
</tr>
</tbody>
</table>

*Data derived from data on CapitalIQ.com, selected transactions from the past three years.
Beyond EBITDA

Corporate buyers concerned about post-transaction earnings per share (EPS) dilution, should carefully consider the impact of other line items below EBITDA. For example, GAAP differences in hedge accounting and deferred taxes can significantly impact interest expense, other gains/losses, tax expense, and potentially even cash taxes.

Such accounting differences are incremental to the expected impact from additional depreciation and amortization from purchase accounting fair value step-ups, as well as from earnings volatility generated by operating in different currencies. It is also worth noting that, depending on the region, investor focus may vary.

US corporate entities tend to be EPS-focused while European corporations tend to emphasize trading trends.

IFRS and US GAAP: So close and yet so far

Differences in required accounting principles can significantly impact a company’s modeling and post-acquisition forecasts.

Layering fundamental accounting policy differences on top of purchase accounting impacts makes analysis of post-deal accretion or dilution a challenging exercise.

See Figure 3 for a summary of common accounting differences.

Again, the application of accounting policies should not affect cash flows or a company’s ability to service its debt. But interest-coverage ratios, earning targets and classification of debt—for instance, mezzanine treatment under US GAAP is not available under IFRS—can vary under different GAAPs. These types of bank covenants will likely need to be “reset” post-transaction to adjust for accounting differences.

A company operating in a highly regulated industry will need to consider the impact of accounting differences on regulatory requirements. For instance, a foreign buyer of a US-based insurance company would need to consider converting the target’s financial results into the GAAP of the acquirer as well as report under local GAAP for state insurance divisions.

Often, a US acquiree continues to keep its books on US GAAP and makes adjustments to reconcile to IFRS and non-US statutory GAAP, which could lead to inefficiency prospectively. For example, debt securities under US GAAP and IFRS are valued according to their classification (US GAAP and IFRS employ different classification categories), and statutory GAAPs often require debt securities to be recorded at amortized cost.

Thorough financial due diligence can help identify accounting differences, quantify the potential impact on earnings profiles and valuation comparability, and focus on potential post-deal efficiencies around conforming accounting practices or frameworks.

Disparities in accounting policies should also be considered when establishing post-transaction debt covenants and regulatory requirements.
### Figure 3: Common differences between IFRS and US GAAP

<table>
<thead>
<tr>
<th>Topic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research and development</td>
<td>Development costs are capitalized under IFRS if certain criteria are met, but are expensed as incurred under US GAAP.</td>
</tr>
<tr>
<td>Stock-based compensation</td>
<td>Although the US GAAP and IFRS guidance in this area is similar at a high level, significant differences exist at the detailed application level. The measurement, timing and pattern of expense recognition can vary depending on award features and recipients. The timing of recognition of social charges associated with awards generally will be earlier under IFRS than US GAAP, and cash-settled awards are more likely to be liability classified under IFRS, resulting in increased income statement volatility.</td>
</tr>
<tr>
<td>Inventory</td>
<td>IFRS prohibits the use of LIFO, so companies that utilize that costing methodology under US GAAP might show significantly different operating results under IFRS. Regardless of the inventory costing model used, IFRS companies might experience greater earnings volatility because IFRS requires reversals of inventory write-downs when there are recoveries in values previously written down.</td>
</tr>
<tr>
<td>Impairments</td>
<td>The impairment models are very different between the two accounting frameworks, with write-downs generally taken earlier under IFRS. IFRS also requires impairment charges to be reversed if there is a recovery in value, something not allowed under US GAAP.</td>
</tr>
<tr>
<td>“Converged” standards</td>
<td>The IASB and FASB coordinated their standard-setting efforts for business combinations, revenue, and leasing. However, differences remain baked into the accounting details. We also expect that additional differences will develop in the practical application of the new revenue and leasing guidance once fully adopted by both US GAAP and IFRS users. Even transition to the new guidance drives complexity. For example, US GAAP companies will have a staggered adoption timeline for the new revenue standard but IFRS has a single adoption date.</td>
</tr>
</tbody>
</table>

Many other accounting areas are similar, but significant differences can still arise. For a more complete summary of differences between the two accounting frameworks, we refer you to our *IFRS and US GAAP: Similarities and Differences* publication.
Both buyers and sellers must conduct a rigorous due diligence to ensure that cross-border risks are identified and included in the purchase agreement.

Deal terms

In any M&A transaction, the Sale and Purchase Agreement (SPA) represents the outcome and documentation of all commercial and pricing negotiations. Both buyer and seller should ensure that significant cross-border risks identified during due diligence are properly addressed in the SPA.

Companies should also assess the potential cross-border value considerations arising from the financial issues discussed during negotiation. These may include:

**Working capital accounting policies**
Accounting treatments under local statutory GAAP (and sometimes IFRS) will vary by territory. Even within territories, practices may differ. It is critical to have staff or advisors who understand local statutory GAAP or IFRS in order to evaluate historic trends and define the treatment of key items in the SPA, particularly those related to working capital adjustments.

**Debt and debt-like items**
Buyers will attempt to identify debt and debt-like items in order to reduce purchase price. Items identified during diligence may or may not be treated as debt in the seller's financial statements. US GAAP, for example, has a higher threshold for recognition of certain liabilities. The treatment of these items should be carefully prescribed in the SPA to ensure both parties agree on the appropriate deal treatment.

**Warranties and indemnities**
Warranties and indemnities for judgmental items, such as tax, legal or environmental provisions, are often contentious issues. The legislative environment in each territory may give rise to varying degrees of risk. In addition, GAAP disparities could drive different book liabilities. For example, IFRS, unlike US GAAP, requires recording a liability for executory contracts if the unavoidable costs of meeting the obligations exceed the expected economic benefits.

Journey from enterprise value to transaction price: Under current guidance, lease classification under IFRS is less “bright-lined” than US GAAP guidance. Accordingly, more leases may be classified as finance leases under IFRS. Similarly, there is a higher threshold for recognition of certain liabilities under US GAAP, which could lead to more provisions being recognized under IFRS.

The treatment of such items in the SPA as either debt or working capital could have a significant impact on the transaction price if not defined or clearly understood:

<table>
<thead>
<tr>
<th></th>
<th>US GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise value</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Bank borrowings</td>
<td>(20)</td>
<td>(20)</td>
</tr>
<tr>
<td>Finance leases</td>
<td>(30)</td>
<td></td>
</tr>
<tr>
<td>Provisions</td>
<td>-</td>
<td>(10)</td>
</tr>
<tr>
<td>Transaction price</td>
<td>$50</td>
<td>$70</td>
</tr>
</tbody>
</table>
Reporting the deal

**US regulatory reporting**
Time pressures are a critical factor in cross-border M&A. US public companies must file a Form 8-K within four business days after the completion of an acquisition. Rule 3-05 financial statements (if required) and Article 11 pro formas must be filed by amendment to the Form 8-K no later than 71 days after the due date of the original 8-K.

Material differences will need to be adjusted to convert the target’s financial information to US GAAP for the Article 11 pro forma presentation. SEC guidance requires a significance test to determine how many years of the target’s audited historical financial statements are required to be included in the 8-K. This must be calculated using US GAAP financial information.

If the result of the US GAAP significance test requires the filing of the target’s audited financial statements, they need to be prepared in accordance with IFRS as issued by the IASB, or reconciled to US GAAP for all periods presented.

Management will also need to develop a plan to make conversion to new US GAAP policies sustainable and well controlled post-acquisition.

**Overseas requirements**
Certain territories require additional information to be prepared, filed, and in some instances opined on by local auditors. Some exchanges, such as London and Hong Kong, require that profit forecasts and working capital reports be prepared and opined on in advance of certain transactions, such as a capital-raising. Those territories may also require confirmation of appropriate corporate governance and internal controls, in addition to any Sarbanes-Oxley compliance required for the US reporting environment.
Reporting after the deal

Each territory will need to maintain its books and records in a manner that allows reporting under multiple GAAPs and/or regulatory frameworks (banking, insurance, and utilities, for instance). Implementing systems and methodologies that allow such complex reporting can be a time-consuming, costly, and difficult task. Planning, investment, and training can greatly minimize the pain.

Many banking arrangements do not contain the required flexibility to allow for the adoption of a new GAAP basis and the reset of banking covenants. This may result in significant fees being incurred to amend banking agreements or complex covenant reporting going forward, as reported results under the old GAAP would need to be restated for bank reporting.

Other forms of legislation in overseas territories may dictate additional reporting requirements. For example, financial institutions may require separate reporting under local GAAP or IFRS. In addition, many non-US governments require statutory reporting for all companies located in their jurisdiction (whether publicly listed or not), and statutory reports typically follow local GAAP. These filing requirements usually continue post-acquisition. Consequently, it is essential to ensure that formal processes are in place and that systems and controls are capable of handling multi-GAAP reporting.

Staff at both parent and subsidiary levels will need to be trained to understand and evaluate the differences between the various reporting requirements. Robust and clearly written group accounting policies and internal controls documentation will need to be created to ensure knowledge and guidance is transferred to acquired companies.

Any knowledge of IFRS and overseas reporting held by the existing finance team should be leveraged for strategic conversion to group reporting principles. With the widespread use of IFRS outside the US, there may be wide-spread opportunities to streamline financial reporting under IFRS.

Multiple territories, many GAAPs: A US-listed group acquires a listed IFRS preparer in Hong Kong

The acquired business may have operations across multiple territories, each with their own local GAAP for statutory reporting purposes. In addition to the significant effort involved in the initial conversion to US GAAP, the ongoing reporting requirements for each subsidiary must be considered.

<table>
<thead>
<tr>
<th>External reporting basis</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group reporting for US registrant</td>
<td>US GAAP</td>
</tr>
<tr>
<td>Hong Kong listing requirements</td>
<td>IFRS</td>
</tr>
<tr>
<td>Subsidiary reporting requirements</td>
<td>Local GAAP (e.g., Hong Kong GAAP, Thailand GAAP, UK GAAP)</td>
</tr>
<tr>
<td>Local tax reporting</td>
<td>Local tax basis</td>
</tr>
</tbody>
</table>

The complexities of maintaining significant volumes of accounting records under multiple GAAPs has far-reaching consequences, from employee training to IT platforms and internal controls.
Understanding the impact of cross-border complexities

It is easy to underestimate the time, effort, and cost of preparing for a cross-border M&A transaction. You’ll need a comprehensive understanding of international differences in order to accurately measure the costs and value of the transaction.

These differences can impact the bottom line and balance sheet classifications, financial reporting requirements, regulatory requirements, cash tax and tax accounting. They also can affect deal valuation benchmarks, investor expectations, and post-deal efforts to support future international regulatory requirements. All of these must be added to an already complex range of diligence assessments necessary for a domestic deal.

While buyers often anticipate some of these cross-border considerations, sellers generally do not focus on these issues. In cross-border deals, sell-side due diligence and M&A support could dramatically enhance the marketability, messaging, and negotiating platform of the seller. Value erosion begins well before the deal closes, so preparation and positioning are critical.

Many of the topics discussed are applicable beyond the M&A window. In the last few years, more companies have looked abroad to seek more welcoming regulatory environments for capital-raising, redomiciling, or initiating legal-entity restructurings. Though typically different in their end goal, many of the considerations are similar to those encountered in a cross-border M&A transaction.

No matter the objective, any cross-border deal will require heightened expertise, well-informed advice, and plenty of advance preparation.
Authors

David Schmid
Partner, US Firm IFRS Leader
973 236 7247
david.schmid@pwc.com

Paul Sheward
Partner, Deals – Accounting Advisory Leader
312 298 2232
paul.sheward@pwc.com

Christopher Chung
Director, National Professional Services Group
973 236 7755
christopher.chung@pwc.com