IFRS CREATES A TOUGHER WORLD FOR M&A

Accounting changes have dramatically altered the way mergers and acquisitions are analysed. This is the first of two articles based on a report by Dimitris Karydas and Kenneth Lee of Citigroup.

By Dimitris Karydas and Kenneth Lee

The high level of M&A - or ‘business combinations’ - over the past two years has made analysis of deals vital for investors. However, accounting rules in this area have been subject to huge changes with the transition to IFRS. The first changes, made in 2005 and known as phase 1, were significant but not controversial. Phase II, however, is causing a great deal of concern.

Let’s first look at what has already changed as this is what investors will have to cope with when analysing 2006 deals.

Elimination of merger accounting

It was already difficult for a combination to qualify as an accounting merger under IFRS due to the strict criteria. The elimination of this approach to M&A accounting seemed a sensible bit of housekeeping. Having only one business combination accounting approach should also enhance inter-company comparability. This change will apply prospectively: previous poolings will not have to be ‘unpooled’. As merger accounting has been eliminated, the attraction of using share consideration has diminished.

Change in the definition of goodwill

Goodwill is now defined as the ‘future economic benefits arising from assets that are not capable of being individually identified and separately recognised’. This is a distinct change from the previous approach whereby goodwill was merely a residual difference between the purchase consideration and the fair value of the net assets. The onus is on the company to split out any separately identifiable intangible assets on future acquisitions. This should provide a more detailed and useful breakdown of these assets. However, this will reduce the amount allocated to goodwill on future acquisitions. There is some initial evidence that companies are allocating very low levels of the purchase cost to other intangibles and goodwill is still dominant. This is despite the clear expectation in IFRS 3 that this would change.

No more goodwill amortisation

There is no longer any systematic amortisation of goodwill. However, amortisation of other intangibles is required. Goodwill will instead be subject to an annual impairment test. Most companies have applied this change prospectively so that existing goodwill has, in essence, been frozen at its current value (see footnote 1) and then subject to impairment tests.
Figure 1. Changed Definition of Goodwill

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Net asset value of target</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>60</td>
</tr>
<tr>
<td><strong>+40</strong></td>
<td></td>
</tr>
<tr>
<td>Analysed into</td>
<td></td>
</tr>
<tr>
<td>Brands</td>
<td>Trademarks</td>
</tr>
</tbody>
</table>

Source: Citigroup Investment Research.

**Less opportunity to manipulate post-acquisition results**

Restructuring provisions on acquisitions has been severely restricted. This should provide fewer opportunities for management to manipulate post-acquisition results.

**The verdict on these changes**

The headline change was the elimination of goodwill amortisation. We have always seen this as a positive step. Given the ‘autopilot’ nature of goodwill amortisation it was largely ignored as having no economic relevance. Impairment testing is a more meaningful approach under which management will be forced to think through the value of goodwill using a cash-flow-based methodology. Also, the disaggregation of intangibles should provide more useful information.

From a valuation perspective goodwill impairment should continue to be examined in a similar way to amortisation. This is because, unlike depreciation which relates to tangible fixed assets that must be replaced, impairments relate to goodwill that need not be explicitly replaced. Therefore impairment charges would be expected to have little discernible impact on investor sentiment. Of course an unexpected impairment or an impairment that is larger than expected may indicate a problem. A reaction would then be no surprise (see footnote 2).

The introduction of an impairment regime does have two further possible implications. First, it will make profits less predictable. Second, it may well increase management discretion in relation to earnings. There may be little to stop management overestimating impairments to increase future profits and
returns on book equity at the expense of short-term earnings.

Finally, in the absence of impairments, eliminating annual amortisation has resulted in a step-up in earnings. As this is likely to be relatively higher than the increase in equity due to non-amortisation, returns on book equity should increase.

Let’s look now at the proposed Phase II changes and their likely effects.

Full, not partial, recognition of goodwill

Currently goodwill is measured on a partial basis. In essence we only recognise the part of goodwill that has been purchased. So if 60% of the business is acquired then only 60% of goodwill is recognised. This is inconsistent with the treatment of other assets where, once control is achieved, we consolidate 100% and back out the minority interests.

Acquisition costs to be expensed

The theory is that such costs are not assets so they should be expensed within goodwill, rather than subsumed as is currently the case.

Contingent consideration

The new standard will distinguish between contingencies that relate to uncertainties existing at the acquisition date (for example, what is the fair value of receivables?) and those uncertainties that will only be resolved as the target conducts its business (for example, earn out provisions). The standard suggests that the former are dealt with by adjusting the price and the latter are recognised as items unrelated to the original acquisition.

So what are the implications for acquisitions of these proposed accounting changes? Earnings will certainly be more volatile: the elimination of techniques such as restructure provisioning will make it more difficult to smooth earnings after the acquisition. In most cases redundancy and similar costs will be recognised as period expenses. It will also be harder to show a post-acquisition uplift: this follows on from the restrictions on provisioning.

On a positive note, there should be improved transparency. Extra disclosures are required about the makeup of the purchase price, the adjustments to asset values and the determination of the residual goodwill number. However, in the UK the new disclosures appear more limited than UK GAAP.

Finally, troubled acquisitions will be revealed more quickly.

Investor Q&A on business combinations accounting

Q. The elimination of goodwill amortisation will result in an increase in earnings per share (EPS). Has this caused higher valuations?

It shouldn’t have. From an investment perspective goodwill amortisation is not relevant because companies do not have to replace the goodwill.

This contrasts with depreciation which relates to operating assets that must be replaced. Many investors and sell-side analysts have long been using Ebitda (earnings before interest, taxes, depreciation and amortisation) as an operating profit measure or a quasi cash-based EPS number where the major adjustment was to add back goodwill amortisation. However, remember that some investors do look at unadjusted EPS numbers and not all investment houses ignored goodwill amortisation.
Q. Many countries allowed companies to write goodwill off direct to reserves (equity) under local GAAP. Has IFRS required reinstatement of this goodwill?

There is no requirement to reinstate this goodwill and it is unlikely that companies would choose to do so.

This goodwill will not be recognised in the income statement as part of the calculation of any profit/loss on disposal. This may well significantly increase profits on disposals for those companies that have written off goodwill against equity.

Q. The standard includes rules about restructuring provisions. What will be the impact of these rules?

This is an area of major change by IFRS 3. Essentially the opportunity to make provisions on an acquisition is often exploited by acquirers to manage the earnings profile of a combined entity after acquisition. It allows companies to channel operating costs through goodwill, or at least to avoid recognition of certain expenses in the income statement. The rules have been tightened up so that many of the standard approaches to managing earnings in an acquisition have been eliminated.

Q. Can an acquirer recognise a restructuring provision which is dependent on the acquisition taking place?

This is crucial. According to the detail in IFRS 3 the possibility, or even near certainty, of an acquisition is an insufficient recognition event. Therefore an acquiree cannot recognise such a provision in its financial statements.

Q. Has amortisation disappeared as a concept altogether?

We need to be careful here. The prohibition on amortisation in IFRS 3 relates solely to goodwill. Other intangibles such as brands, patents, development costs and so on will continue to be amortised. This ties in with the change in the definition of goodwill which means that other separable intangibles will be recognised and amortised as normal.

Footnotes

1. For cross-border deals under IFRS, goodwill will have to be restated to take into account shifting exchange rates. This is a departure from many other GAAPs that allowed goodwill to be recorded at the historical rate. This may well cause much larger foreign exchange movements in equity on the re-translation of foreign subsidiaries.

2. There is some evidence that impairments do matter and are negatively correlated with the firm’s post-acquisition return performance (Li, Shroff and Venkataraman, 2004).
REPORT DEBUNKS MYTHS ABOUT SUCCESSFUL MERGERS

In the second of two articles based on a report by Citigroup, Dimitris Karydas and Kenneth Lee propose a framework for analysing mergers and acquisitions

By Dimitris Karydas and Kenneth Lee

There are three areas of analysis that are particularly important when it comes to understanding merger and acquisition (M&A) deals. They are:

• financial analysis: what accounting issues/disclosures may be particularly interesting to examine?
• valuation issues: the common valuation errors to avoid
• empirical evidence: what factors have historically indicated successful M&As?

Figure 3 below puts these into a framework.

Figure 3. M&A analysis framework

Source: Citigroup Investment.
Four points of analysis

Last month’s article in Insight looked at the accounting rules governing M&A accounting. Here we examine four areas that may receive less attention but that are worthy of analysis.

1. Fair value adjustments

The fair value exercise is a major component of any M&A analysis process and it can be revealing. Establishing an estimate for the fair value of an asset and then any subsequent adjustment can have important implications for key performance indicators (KPIs). For example, if an initial fair value estimate for a property was conservatively biased then depreciation would be understated with goodwill overstated (but no amortisation under IFRS). Therefore investors should be sensitive to the fair value exercise and especially to any changes from the initial estimates.

2. Allocation of value to separable intangibles and subsequent amortisation

The crucial questions here relate to:

- What separable intangibles have been recognised? Does this reveal extra value in the target? Are the recognised amounts unexpectedly high or low?
- What amortisation period has been chosen? How does this compare with peer companies?
- Are the separable intangibles maintained? If these assets do not have to be replaced, is amortisation a real economic cost or merely double counting?

3. Impairment disclosures

There is a huge amount of disclosure required in this area that may have significant relevance for value. However, based on anecdotal evidence, we believe it is rarely addressed in detail. For example, the disclosures for un-amortised goodwill would include:

- key assumptions underpinning any value in calculation of use
- the period over which cash flows have been forecast
- the discount rates used.

If a change to a particular assumption causes an impairment to be recognised then a form of sensitivity analysis must be disclosed. Many investors and analysts would find these audited disclosures of interest as another way to access management thinking.

4. Taxation

Often the tax aspects of a deal are particularly important motivators. Indeed an acquisition may open opportunities for acquirers to unlock tax value. In addition deferred taxation aspects can be most confusing. The tax disclosures post-acquisition are well worth studying carefully: any recognition of previously unrecognised deferred tax assets indicates the creation of value in the deal. It is likely that new deferred tax liabilities, especially those on goodwill and other intangibles, are actually instruments of ‘matching’ rather than true economic liabilities. Therefore it may well be that most investors choose to ignore these.

Allocation of purchase price to goodwill versus intangibles - evidence from the UK

A recent report by Intangible Business examined the proportion of the purchase price that had been allocated to goodwill as against intangible assets. The overall split is illustrated in Figure 4 below. Clearly goodwill has maintained its dominance.
The question is whether such a heavy allocation to goodwill is actually evidence of companies making biased decisions about the disaggregation. Why might companies be motivated to allocate more to goodwill?

There may be a concern among corporates that the amortisation of non-goodwill intangibles will not be added back to earnings by the market in the same way that goodwill amortisation was. Therefore a large allocation to goodwill preserves earnings.

Also, dividing up assets into smaller units can expose the company to a higher risk of an impairment. For example, when assets are grouped together strong cash flows from one may offset weaker cash flows from another. However, if assets are split out then this compensating offset may not happen and an impairment is more likely.

If the assertion in the Intangible Business report is correct then IFRS 3 would appear to have failed to give investors materially enhanced information on intangibles in the context of acquisitions. However, we feel that more time is required before a final verdict can be delivered. The quality of disclosures for 2006/2007 will be the start of the acid test.

**Valuation issues**

There are certain valuation issues on M&A deals that cause confusion when assessing what constitutes a successful or unsuccessful acquisition.

The most common include:

1. **Earnings accretive deals are a good thing.**

   It is not uncommon to read in the press that a company could afford to pay up to a particular amount for something ‘without diluting its earnings per share’, as if this represented an economically meaningful statement. The maths may well be right. It is just that the answer does not matter. This is easiest to see if we think of an acquisition financed by borrowing. Suppose that a company can borrow money at a gross interest cost of 6%, and that it has a 33% marginal rate of tax.

   Interest will cost it a net four cents in the euro. So if it buys an asset, or a company, on a multiple to earnings of less than 25 times [see footnote 1], the result will be earnings accretive. Suppose it pays a multiple of 20 times, then the earnings yield on the acquisition will be an
immediate 5%, with an uplift of 1% on its return on capital.

Readers should not have difficulty thinking of acquisitions that would be very poor value on a multiple of 20 times current earnings. Now take an acquisition funded with new shares. If the earnings multiple of the acquirer is higher than that of the target then the result will be earnings accretion. If you do deals on this basis regularly enough you will sustain a high rate of growth in earnings per share, apparently justifying the high multiple — until you run out of large enough targets to maintain the pretence.

There is some evidence that in fact it is dilutive deals that do best. Why? Perhaps because they are the ones that get thought about more carefully before management takes them to the market.

2. **Return on capital employed must exceed the cost of capital for a deal to be a good thing.**

How many times have we read in the financial press that ‘if you take the projected synergies, tax them, and add them to the ongoing earnings of the target company, then the implied return on the transaction value — the price paid for the equity and the debt that is being assumed - is less than the cost of capital, so it is a bad deal’?

Most acquisitions destroy value for the bidder’s shareholders, but this calculation simply does not work. By this logic if you want a return on your equity investment of 8% or more then you would never buy a share on a multiple to earnings of more than 12.5 times. Investors happily pay more than that because they are capitalising upside from future growth opportunities. Why shouldn’t corporate bidders do the same?

This point is illustrated in Figure 5 below. While the acquirer achieves a Return on Invested Capital (ROIC) lower than the Weighted Average Cost of Capital (WACC) in the early years of the post-merger integration, it generates returns over and above the cost of capital in later years. Any transaction judged on the basis of any single year’s comparison of return and cost of capital would give the wrong conclusion about the value creation potential.

Instead, a holistic approach is required that explores whether the value creation in the later stages of the transaction integration (ROIC > WACC) outweighs the initial value loss.

3. **Acquirers’ share prices underperform because promised synergies don’t happen.**

Not so. It is true that historically the share prices of most bidders underperform the market for a long time after the transaction, and the bigger the transaction, the worse the damage. It is not true that the profitability of merged companies is lower than that of their competitors who have not made acquisitions - rather the reverse.

So how do we square this circle? Because when companies make acquisitions the price that they pay generally includes an element that relates to expected synergies. The problem is not that the synergies don’t happen. It’s just that they are not generally large enough to justify what was paid for them. If a company pays for 150 per cent of the achievable upside from a deal, the target’s shareholders will be very happy. The acquirers will not and may come to regret the deal.
4. Whose cost of capital?

A company that has paid what seems to observers to be a relatively high price for an acquisition often justifies it by saying ‘we have a very low cost of capital so can pay more’, to which the unkind response might be ‘not any more, you don’t!’

The first and most basic rule relating to the application of discount rates to acquisitions is that the discount rate applies to the target, not the acquirer. But there are more subtle issues. What if the target has an inefficient balance sheet and the acquirer argues that by funding the acquisition more effectively, it can cut the cost of capital? And how much of this upside should it be prepared to pay for?

One starting point is to question whether the tax shelter could have been created by the acquirer through the purchase of its own shares, rather than by borrowing money to pay for someone else’s. If the answer to this question is ‘yes’ then that in no way justifies paying up for the target. One could imagine a situation in which the bidder already had an optimally financed balance sheet, the target did not, and the refinancing element of the bid was part of the addition of value created by the deal - but probably not outside the world of private equity. If a bidder funds an acquisition with cash then it is clearly not justifiable to value the target using a cost of debt.

Why? Because the bidder is only able to fund the acquisition by virtue of having equity in its balance sheet. What is happening is a cross-subsidy of the target by the previously owned assets, which clearly does not in itself add value. So most of the time the prudent course is to allocate no value to the effect of refinancing.

5. Analyst models that have steadily rising returns on capital employed in them are overly optimistic.

Usually, but not when the company being analysed has lots of goodwill in its balance sheet. This is an extension of the point made under item 2. When companies make new investments they do not install a pile of goodwill on top of
them. It is the return that the company makes on its existing capital — excluding goodwill — that presumably provides the best indication of the returns that can be expected on new capital. This explains Figure 5 under item 2 above. As the balance between existing assets and new ones shifts towards the new, so the weighted return on capital shifts upwards towards the underlying level, excluding the goodwill.

6. **Control premiums and synergies — avoiding double counting.**

Acquirers generally pay a premium over the previously prevailing market price. This is what is generally known as a premium for control. It is justified by synergies of one sort or another, and these should be carefully divided into two categories.

The first relates to the possibility that the market value of the company was depressed — perhaps because of a perception of poor management. In this case, the uplift in value that the acquirer expects derives entirely from its expected ability to achieve a higher value from the existing assets. This is either by managing them better or by financing them more efficiently, or both. This is what private equity funds are designed to exploit.

The second relates to the possibility that putting two operations together will result in either lower costs or higher revenues. Here the benefit is not stand-alone. It is the direct consequence of economies of scale, cross-marketing, technology transfer, and so on.

Clearly when assessing deals it is essential to differentiate between the expected justifications for the control premium. It is also essential not to pay a control premium over and above the expected synergies.

**Footnotes:**

1 A price-to-earnings multiple of 25 implies an earnings yield (the reciprocal) of 4%. Any PE of less than 25 would have a larger earnings yield and so the increase in earnings would be greater than the incremental borrowing cost of 4% in our example. So by default earnings per share would rise.