M&A Deals May Hit Speed Bump With New Accounting Standards

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For merger and acquisition (M&A) activity that has hit the fast lane in the past six months, the new accounting standards could put a speed bump -at least for a short while.

The new standards, called Ind-AS, would need companies to make changes in the way they account for revenue and tax. Unless they structure their deals taking this into account, the deals could put a hole in their balance sheet rather than boosting it, said accounting and tax experts.

The new rules are to come into effect on April 1, next year. An average deal takes about eight months to a year to conclude, which means if a company starts deal discussions now, the new rules would have come into effect by the time it closes it.

Companies and private equity firms have started relooking at deal structures and some have even delayed plans, said experts. “Companies are now closely looking at their inorganic growth strategies and related structures, including the way earn-outs are structured in M&As as these could potentially impact both earnings as well as their balance sheet post the transaction,“ said Sai Venkateshwaran, partner and head of accounting advisory services at KPMG.

Tax experts said in cases where companies acquire a majority stake -but not 100% -the minority shareholders' rights would impact the consolidation process. If minority shareholders have participative rights, consolidation in the parent would not be allowed under the new accounting standards. Another potential problem area is where investments are made in tranches depending on the performance of the target company. Such transactions may be treated as an expense, said Venkateshwaran. This means the investor cannot show the investment as an asset and instead record it as a cost that would weigh on the bottom line.

Another major change that investors are worried about is accounting for goodwill. According to current standards, goodwill is constant and cannot depreciate, or amortised. Due to this, the value of the company is always more than the financial value, as goodwill is an integral part of the total valuation. That is set to change.

Due to this, companies looking to restructure operations after an acquisition could face problems. “The key impact area of Ind-AS would be inability to record goodwill, which will in turn impact the claiming of tax allowance of its potential write-off, especially under the internal group restructuring,“ said Punit Shah, an expert on PE taxation and partner at Dhruva Advisors.

“Also under the new Ind AS, every year the goodwill will be tested for impairment as against standard amortisation which can have a huge impact on the profitability and tax depreciation claim of the company based on facts of each case,“ added Shah.

Apart from these issues that wipe out the value from M&As, taxation can create problems. Industry trackers said dea structures have become more important in this regards, as ignoring that could even attract minimum alternate tax (MAT).

As per Indian laws, any company is liable to pay MAT if it is paying less than 18.5% tax on its book profit in a particular year. Tax experts see PE players facing some MAT risk.

Industry experts point out that under GAAP investments in equity (including M&A) were recorded at a lower value. Under Ind-AS this has to be done at fair value. This means many investors would have to report unrealised gain on investments due to appreciation in the value of the target company (investment). When these unrealised gains are added in the income statement that would increase the income and hence tax liability, say industry trackers.

“Some companies in the private equity space may be required to do the fair value accounting for such investments or acquisitions which may result into a possible MAT exposure on the transaction after the consolidation,“ said Sandip Khetan, partner in a member firm of EY Global.

For PE players, who have invested billions of dollars in Indian companies and in the process drove up their valuation, this could become a game changer. Many PE firms are already tensed as they fear that MAT could be levied on their past investments as well. PE firms investing in the real estate sector could see more impact due to Ind-AS.

In fact, these investors could see the impact of Ind-AS on both equity level and SPV (special purpose vehicle) investments.

“Structured instruments such as convertible preference shares, etc. that are often used by PE funds will get classified as liabilities rather than equity , impacting both debt-equity ratio as well as EPS. Similarly , rights that are often given to PE investors in SPVs may lead to a conclusion that the SPVs are jointly controlled by the company and the PE, thereby precluding them from being consolidated,“ said KPMG's Venkateshwaran.

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