Thinking of acquiring a business? Are you ready to risk?

In today's rapidly evolving world, strategic business acquisitions capitalising on growth opportunities and market penetration, are proving to be more evident across a variety of industries. Very often, such transactions are moulded with little consideration to the underlying accounting implications, only to face unpleasant surprises as the acquirer accounts for the acquisition in the succeeding financial statements in accordance with the requirements of International Financial Reporting Standards (IFRS). This article summarises some of the main points which, from our experience, tend to steer the accounting for business acquisitions in different directions if overlooked.

Under IFRS acquirers account for most business combinations following the acquisition method under IFRS 3. In simple terms, acquirers need to measure the consideration transferred and the identifiable assets and liabilities taken over at fair value, and account for the difference between the two measures as goodwill or gain on a bargain purchase (so called 'negative goodwill').

Determining what is part of the consideration transferred to acquire a business, and measuring that consideration at fair value, will directly affect the amount of goodwill or gain recognised upon acquisition. While the treatment of cash consideration is often straightforward, measuring other forms of consideration may require effort and expertise. However, this is often not a major obstacle. What is critical at this stage is clarity on what is being exchanged as consideration payable by the buyer to the seller, when, and if contingent upon future outcomes or circumstances, clarity on those future contingencies.

For instance, when part of the consideration depends on future earnings before interest, tax, depreciation and amortisation (EBITDA), it is extremely important to define EBITDA and what should be included or excluded in the determination of such. For example when determining EBITDA for this purpose one has to be clear as to whether one-off non-recurring items are to be included or not and whether certain expense items, such as currency fluctuations should form part of the equation. IFRS do not define EBITDA – clarity and agreement between the parties in that respect is therefore paramount so as not to find oneself in situations which would result in unintended consequences. An exhaustive list of such inclusions/exclusions, attached to the Sale and Purchase Agreement (SPA), would probably mitigate potentially contentious issues.

Payments to employees who are former owners of the acquiree could also form part of the consideration transferred, depending on the circumstances and conditions underpinning such payments.

Identifying and measuring at fair value the assets acquired and liabilities assumed (including those that are off the acquiree's balance sheet) upon the acquisition of a business, can be a laborious process, especially in certain industries which depend heavily on assets that are intangible in nature. When acquiring businesses operating in such industries, identifying and attributing a measure to the following could be particularly challenging:

- Customer lists. A customer list consists of information about customers, such as names, contact information, order histories and demographics. A customer list that is separable might meet the definition of an intangible asset, however not all customer lists are separable. For example local regulations or terms of confidentiality may prevent an entity from selling, leasing or exchanging the information in such a list.
- Internally generated intellectual property (IP). Very often the acquiree is allowed to capitalise only a certain portion of R&D costs incurred on generating IP, where the cost in the books of the acquiree of that IP is insignificant when compared to its fair value.
- Contingent liabilities. In view of their off-balance sheet nature, identifying and measuring contingent liabilities often requires careful analysis and attention.
- Deferred revenues, loyalty points and similar items. These may be common in certain industries. Like any other obligation assumed in a business combination, these must be measured at fair value. In fact, the fair values attributed to all of the above identifiable assets and liabilities, also directly affect the amount of goodwill or gain recognised upon acquisition.

The above is by no means an exhaustive list of potentially contentious issues and there are many other stones often left unturned in the process of sealing a deal. The concluding message is one – while accounting should not dictate business doings, it merits at least due consideration to avoid unintended consequences and unpleasant surprises in financial statements through which an entity ultimately communicates to the outside world.

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