M&A:
New Norms in a New World

Tax accounting and valuation, both pre- and post-merger, are key facets of any M&A deal

The ability of companies to stay relevant and build scale in today's environment demands a heightened ability among CFOs to navigate inorganic growth paths. M&A as a route to international expansion, or indeed, to acquire unique capabilities or product portfolios, will see greater activity, but in ways markedly different from the last phase of India's growth. Assessments of valuations and funding structures will become more rigorous, and more robust mechanisms will be needed for post-M&A complexities in areas such as earn-outs, IP R&D, intangibles, assembled workforces, and deferred revenue. Elements such as stock options will also demand a much keener understanding in terms of their tax, accounting and valuation implications. This is not just on account of a fast changing business environment, but also because of changing policy frameworks – in countries like the US, but also at home.

PRE-M&A: ASSESSING TAX IMPLICATIONS

The different financing arrangements use for M&A – whether cash, debt, or equity – can have varying tax implications, potentially impacting the feasibility of the investment. Each comes with its own costs and risks, varying also by company, its debt liabilities, the value of its assets, its ownership status, and the prevailing regulatory framework. For instance, an Indian company acquiring a US-based firm through its US subsidiary might prefer debt financing owing to its interest deductibility. However, if the Indian parent already holds high levels of debt, this may trigger provisions on thin capitalisation, debt-equity reclassification, or even BEPS, which imposes permanent limits on the deductibility of interest. Such a disallowance can impact the firm's incremental tax cost. However, if the same Indian parent company guarantees the debt, the Indian tax authorities will charge an arm's-length guarantee fee, which is subject to tax in foreign jurisdictions. Companies operating in international locations should also take into account the timing difference in claiming domestic and foreign tax credits, which can severely impact cash flows and disrupt tax planning.

> In any M&A deal, the unique mix of cash, debt, and equity deployed can have key tax implications, even impacting the feasibility of the investment

Tax treaties between two tax jurisdictions impact cross-border acquisitions. However, many companies structure themselves in a foreign location to take advantage of favourable tax treaties (which is also known as 'treaty shopping'). An Indian firm, for example, may try to incorporate a shell company in Switzerland, which has a favourable tax treaty with the US, solely for the purpose of receiving a lower withholding tax rate on the distribution of dividends from the Indian subsidiary in the US. It is advisable to avoid such exotic

tax structures, because a resultant scrutiny can lead to the denial of treaty benefits, thereby disrupting tax planning. Employee stock options (ESOPs) are another area that creates tax complications for Indian MNCs operating in foreign jurisdictions. If the Indian parent company issues ESOPs to employees of its US subsidiary, it will trigger tax liability in the US at the time of vesting the options, rather than at the future exercise date.

POST-M&A: EVALUATING ACCOUNTING AND VALUATION IMPLICATIONS

More and more companies require post-M&A tax accounting owing to heightened scrutiny and new reporting standards. The transition from Indian GAAP to Ind-AS, for example, requires a shift from the general approach of accounting, which was based on legal form rather than commercial substance. Financial reporting requirements for acquisitions have become more comprehensive, and often have far-reaching implications for the transaction itself. For instance, under Ind-AS, intangible assets like customer relations, trade names, or favourable leases, are treated as identifiable, non-monetary asset without physical substance. The identifiability criterion is met when the intangible asset is separable (i.e., when it can be sold, transferred or licensed), or where it arises from contractual or other legal rights. Ind-AS even establishes a 'single framework' for measuring the fair value of assets and liabilities that is based on market data, rather than on the company's internal assessments. A fair value measurement requires management to determine the value of a particular asset or liability in its 'highest and best' use through an established valuation premise. Illustratively, an entity that is interested in acquiring another company will value the assets by discounting the future cash flows derived from the asset to reflect the time value of money and the risks specific to the asset. Next, all assets, including intangibles, will be tested for impairment by considering both external indicators (changes in technology, markets, or the economic or legal environment) and internal factors (physical wear-and-tear of assets or evidence of performance), to understand the highest and best use of a non-financial asset from the perspective of market participants.

> **Post-M&A tax accounting has become an imperative, especially with a rash of new reporting standards globally, including, for India specifically, the transition from Indian GAAP to Ind-AS**

An assembled workforce (AWF) is a critical intangible asset in most acquisitions, enabling the acquirer to continue operating the business. For valuation purposes, AWF will be considered as an intangible asset if it meets the identifiability criterion, i.e., the workforce has a contractual agreement with the acquiree, or can be sold or transferred separately without causing disruption to the acquiree's business. The multi-period excess earnings method (MPEEM) is one of the commonly used techniques to assess the value of assembled workforce.

The accounting treatment of assets and liabilities under a 'business combination' is different from that in an outright asset acquisition. In the case of the former, intangible assets are always recognised and systematically amortised over their useful life. Ind-AS has clear guidelines to identify if the deal is classified as a business combination or an asset acquisition. To illustrate, a pharmaceutical company with a large sales force acquired certain assets in another company, including the rights to a drug compound and related testing and development equipment. Even though certain elements of the business were not acquired – including manufacturing capabilities, management and sales personnel – the deal was termed as a business combination. In another case, in order to enhance its inventory distribution system, a consumer retail company purchased several warehouses from a shipping company. Since the acquirer purchased only inputs (i.e., the physical assets) and no accompanying processes, the deal was classified as an asset acquisition.

During acquisition, when the buyer and seller are in disagreement over the purchase price, both parties can agree to an additional payment or a 'contingent consideration/earn-out' that is linked to future events. Typically, such payments are related to revenue or earning targets that the acquired company must meet after the acquisition date. Accounting for such arrangements under the new rules represents a significant change from past practice. Earlier, earn-outs were generally accounted for as part of the cost of the acquisition when settled. Now, buyers must recognise such considerations on the acquisition date. Therefore, even though the buyer and seller have not agreed on the total purchase price, the buyer is required to determine the fair value of the consideration, and recognise that amount in the purchase price on the acquisition date. ■

This article is based on discussions with Rajesh Khairajani, Lead Valuation Partner, KNAV and Shishir Lagu, Mumbai Lead Partner, KNAV