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Substance over form: Hidden leases can bring post-deal surprises on domestic and overseas acquisitions

Revenue recognition and off-balance sheet transactions consume significant time during the M&A diligence process. Flying under the radar screen are certain arrangements containing embedded leases that can bring additional assets and liabilities to an acquisition candidate's balance sheet and alter P&L recognition. EITF 01-8 and IFRIC 4 are US and international accounting rules that determine whether an arrangement contains a lease which could transform a target's accounting model. These rules are quietly affecting common commercial arrangements such as supply, distribution and outsourcing contracts in many industries.

BACKGROUND

Purchase, manufacturing, service and supply arrangements are common in many commercial transactions. Historically, companies followed standard corporate policies when accounting for such transactions, with the seller recognizing revenue and the buyer either capitalizing the amount or recording an expense. However, some of these arrangements contain provisions that effectively allow the "buyer" to lease facilities or assets used to render a product or service, rather than purchasing them outright.

US GAAP and IFRS are fairly consistent in their guidance on how to identify transactions with embedded leases (EITF 01-8 and IFRIC 4, respectively). These complex rules can have a major impact on the buyer and seller's accounting—and thus the price of a deal—should transactions historically reported as purchases and sales be found to contain leases during the diligence process.

Depending on the lease classification, a seller or supplier ("lessor") may have to recognize interest or rental income instead of top-line revenue. Likewise, the buyer ("lessee") may have to report both an asset (e.g. the plant a supplier uses to produce a product) and a corresponding debt obligation as a capital/finance lease on its balance sheet.

For acquirers subject to US GAAP, EITF 01-8 is immediately effective upon the acquisition of a target.¹

¹ The target would not have applied EITF 01-8 in its stand-alone accounts to arrangements entered into prior to the effective date (typically in 2003 or

Thus it is in the buyer's best interest to examine a target's contracts during diligence in order to identify embedded leases and quantify their impact on revenue, margins, EBITDA, net assets and debt covenants. Due to grandfathering provisions of US GAAP, the seller may not have to conduct this analysis before the deal closes. This analysis will have to be done from scratch for privately held overseas targets, since it is likely that they have not yet issued financial statements reflecting IFRIC 4. Fortunately, acquirers can identify and assess embedded leases in conjunction with normal purchase accounting procedures.

Details

Under IFRS and US GAAP, an arrangement contains a lease if it meets **both** of the following conditions:

- Fulfillment of the arrangement depends on specifically identified property, plant and equipment (PP&E)
- The buyer has the right to control the use of the PP&E²

Specific PP&E—not as easy as it sounds: A distribution arrangement may explicitly name a distribution facility. However, if it is economically, legally and contractually viable for the supplier to source the product from another

2004) unless the arrangements were modified or extended after the effective date.

² Unlike US GAAP, the IFRS accounting rule for leases (IAS 17) is not limited to PP&E and may include leases of other assets, such as intangible assets, etc.

facility for the entire term of the arrangement, the arrangement is not dependent on the specified distribution facility and thus does not contain a lease.

PP&E could also be implicitly specified and identification of such an asset requires deeper analysis. Put simply, if the only practical and economically sound way for a supplier to fulfill a contract is to use a single asset, the arrangement meets the dependence criterion regardless of whether the contract explicitly identifies the asset. This often is the case in jurisdictions outside the US where cross-border restrictions, transport costs and taxes can make it economically prohibitive for a supplier to use more than one asset to fulfill a contract. Such arrangements have implicitly specified assets.

Right to control the use of PP&E—a critical nuance: An arrangement contains a lease if it gives the "purchaser" of goods or services the right to control the use of the underlying PP&E used in their manufacture or delivery, even if this was not the intent of the parties to the arrangement. According to the rules, control—and thus a lease—exists if the purchaser buys more than a minor share of the output produced **and** the answer to **any** of the questions below is "yes". The term "minor share" is not clearly defined. Some accountants consider anything at or above 10 percent to be more than a minor share when dealing with lease accounting.

- *Does the purchaser have the right to determine how the PP&E will be operated?* It is common for customers of certain manufacturing operations (e.g., chemical suppliers) to desire some control over factors like timing production, setting quality standards, and

maintaining the right to operate the assets. These types of rights indicate control. By contrast, subjecting a supplier to prudent operating standards or being able to monitor compliance with performance standards would not, by themselves, indicate control.

- *Does the purchaser have the right to control physical access to the asset?* Owners generally have the right to control and restrict physical access to their assets. But this may not be the case if the owner of an asset houses it on land a customer owns and the customer limits access for security reasons, for example. By limiting the owner's access to its asset, such a situation might give the customer the right to use the asset.

Some IT outsourcing arrangements involve dedicated equipment that runs on a customer's proprietary technology. Typically, this equipment is physically segregated so only the customer or persons authorized by the customer have access to it. If the service provider can access the equipment only at the pleasure of the customer, the outsourcing arrangement may contain a lease.

- *Will the customer take substantially all of the product produced and pay for the product on a basis other than an amount that is either (i) contractually fixed per unit of output or (ii) the current market price per unit of output at the time of delivery?* This certainly could be the case in arrangements where a single asset is used to fulfill a contract and the supplier structures the contract to recover all or part of its capital investment plus a return.

Example

A pharmaceutical company outsources drug manufacturing to a third party under an exclusive long-term arrangement. Under FDA regulations, the manufacturer must specify the equipment to be used, and cannot substitute other equipment to fulfill the contract. The pharmaceutical company contracts to buy all the output at a specified unit price with volume discounts. This arrangement contains a lease because (i) the arrangement is dependent on specific equipment and (ii) the pharmaceutical company has the obligation to take all of the output **and** pay a price that is neither fixed per unit (due to the volume discount) nor the current market price at the time of delivery.

INSIGHTS

Is your target in an industry susceptible to these arrangements? These standards are more likely to apply in industries where the customer needs to control access to or the operations of an asset used to fulfill a contract, as

such arrangements often contain leases. These include highly regulated industries (e.g. pharmaceuticals), industries where security is vitally important (e.g. technology), and industries that depend on take-or-pay arrangements (e.g. power).

Does an arrangement involve more than a lease?

Certain arrangements contain both lease elements, such as a lease of PP&E, and non-lease items such as disposables or consumables (e.g. disposable sensors for vital signs monitoring equipment). In those cases, the seller must allocate costs between lease and non-lease deliverables so the customer can account for them separately.³

Accounting should be done on a relative fair value basis which can become judgmental and challenging.

Valuation challenges

When buying a company likely to have embedded leases, an acquirer may have to apply valuation techniques to these contracts, in addition to the traditional purchase price allocation for financial reporting purposes. Valuing individual elements of an arrangement can pose unique challenges.

Extended diligence may be needed...

Determining whether arrangements contain leases under EITF 01-8 and IFRIC 4 can be a daunting task that could lengthen the diligence process. Even more challenging is the bifurcation of the arrangement consideration into lease and non-lease elements. For targets in industries susceptible to these rules, the diligence process is typically more efficient when financial and legal diligence teams work closely to identify high risk arrangements.

Acquirers must be careful to implement systems and procedures to closely monitor proposed modifications to existing contracts, and educate personnel contemplating/negotiating new contracts to make sure that there are no surprises from the embedded lease accounting rules.

...But efficiencies exist with purchase accounting

During diligence, an acquirer can analyze embedded leases in conjunction with the assessment of potential purchase accounting adjustments. For example, when reviewing contracts, an acquirer could also assess customer relationship intangibles, and favorable or unfavorable arrangements. Accordingly, it is important to coordinate the purchase accounting and due diligence work streams.

Seller considerations

Because this guidance could have a significant impact on key valuation metrics such as revenue, EBITDA, and debt/equity ratios, sellers should consider how these rules will affect the value they receive prior to putting a business up for sale. This may not have been done due to grandfathering provisions in US GAAP. Even if the seller has applied EITF 01-8 to its financial statements, it may only have used it for contracts entered into or modified after the 2003/2004 effective date.

³ Accounting guidance under EITF 00-21 or IFRIC 4, as applicable.

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