Impact of IFRS on the Valuation of Mergers and Acquisition of Banks in India

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ABSTRACT

International Financial Reporting Standards (IFRS) convergence, in recent years, has gained momentum all over the world. As the capital markets become increasingly global in nature, investors feel the need for a common set of accounting standards. India being a key global player, migration to IFRS will enable Indian entities to have access to international markets without having to go through the cumbersome conversion and filing process. It will lower the cost of raising funds, reduce accountants’ fees and enable faster access to all major capital markets. It is going to be a game changer in the M&A deals. Since the valuation approach is going to change which will take into consideration the points like valuation based on fair value, calculation of goodwill, inclusion of contingent liability for calculation of goodwill, consolidation of group accounts.

The impact has to be studied to see whether IFRS will provide more synergy to the acquisition of banks in India or not. The research suggests that the Cost of Merger will increases because of fair value adoption; hence the synergy of acquisition of banks also increases.

Key Words: M&A, IFRS,

Introduction:

Globalization of financial markets has meant an increased focus on international standards in accounting and has intensified efforts towards a single set of high quality, globally acceptable set of accounting standards. Converging to global accounting standards i.e. IFRS has conceptual differences with the Indian Accounting Standards (IAS). Keeping in view the extent of difference between existing IAS and the corresponding IFRSs, conversion process would need careful handling. By introducing a new company law, the Indian Government has initiated the process to amend the legal and regulatory framework, much needed to adopt IFRS.

The Institute of Chartered Accountants of India is laying down the strategy for IFRS convergence and adoption. The major focus of IFRS is on getting the balance sheet right. This can bring significant volatility in the income statement. The valuation approach is also going to change which will take into consideration the points like valuation based on fair value, calculation of goodwill, inclusion of contingent liability for calculation of goodwill, consolidation of group accounts.

So it is really necessary to study the impact of IFRS on the valuation of Mergers and Acquisition of Banks in India.

Reviews of Literature:

John Ammer, Nathanael Clinton, Greg Nini (2004) conducted a study titled “Accounting Standards and

Information: Inferences from Cross-Listed Financial Firms”. The objective of the study was to test whether U.S. GAAP reconciliation effectively enhances disclosure, to examine several measures of transparency for the cross-listed firms, relative both to pre-listing measures and to a control sample of firms that have not cross-listed. The researchers found substantial evidence that the mandatory reconciliation to U.S. GAAP accompanying a U.S. equity listing has engendered a significant improvement in the transparency of European financial firms, at least in some cases. Moreover, firms currently using IFRS appear to have a similar degree of transparency to those firms already cross-listed.

Chris Armstrong, Marv E. Barth, Alau D. Jagolinzer (2006) in the study titled “Market Reaction to the Adoption of IFRS in Europe” wanted to examine European stock market reactions to 16 events associated with the adoption of International Financial Reporting Standards in Europe. The authors concluded that there is an incrementally positive reaction for firms with lower quality pre-adoption information, which is more pronounced in banks, and with higher pre-adoption information asymmetry, consistent with investors expecting net information quality benefits from IFRS adoption.

Cong Wang and Fei Xie (2007) conducted a study titled “Corporate Governance Transfer and Synergistic Gains from Mergers and Acquisitions”. The objective was to find the relation between the strength of the acquirer’s shareholder rights and the synergy created by the acquisition. The author concluded that there was evidence supporting the hypothesis that acquisitions of poorly managed targets by well-run acquirers create more value than other acquisitions. In other words, the stronger the acquirer’s shareholder rights relative to the targets, the higher the acquisition synergy. Further analyses show that the shareholder rights difference has significantly positive effects on both target shareholder gains and bidder shareholder gains, indicating that targets and acquirers share the valuation effects of corporate governance transfers.

Vedran Capkun, Anne Cazavan Jeny, Thomas Jeanjean and Lawrence A. Weiss (2008) did a research titled “Earnings Management and Value Relevance During the Mandatory Transition from Local GAAPs to IFRS in Europe”. The objective of the study was to analyze a sample of 1,722 European firms during their mandatory transition from local country accounting rules (Local GAAP) to International Financial Reporting Standards in 2004 and 2005 using the same set of firm-year observations. The authors concluded that this unique transition period is used to examine the impact of a change in accounting standards on the quality of firms' financial statements. The
transition to IFRS appears to have a small but significant impact on firms' reported total assets and book equity, as well as on their reported goodwill, intangible assets, property plant and equipment, long term debt and current assets and liabilities.

Lantto and Sahström (2009) in the study titled “Impact of IFRS on financial ratios” studied the impact of International Financial Reporting Standard adoption on key financial ratios and revealed increase profitability ratios and decrease in price to earnings ratio; decrease in liquidity ratio; increase in gearing ratio and decrease in equity ratios. The results of the study indicated that the adoption of IFRS changes the magnitudes of the key accounting ratios of Finnish companies by considerably increasing the profitability ratios and gearing ratio moderately, and considerably decreasing the PE ratio and equity and quick ratios slightly.

Julie Cotter, Ann Tarca, Marvin Wee in (2010) in the study titled “IFRS Adoption and Analysts Earnings Forecasts: Australian Evidence” studied 145 large listed Australian firms to explore the impact of IFRS adoption on the properties of analysts’ forecasts and the role of firm disclosure about IFRS impact. They found that analyst forecast accuracy improves and there is no significant change in dispersion in the adoption year, suggesting that analysts coped effectively with transition to IFRS. The results question the timeliness and usefulness of financial statement disclosure, even in a setting where disclosure was mandated by accounting standards (AASB 1047 and AASB 1) and firms had strong incentives to provide information to analysts.

Research Methodology:
Statement of the problem
Although many studies have been conducted on the capital structure, still there is a gap of satisfactory, comprehensive and positive explanation for firms’ capital structure observed behaviour. Most of the research on capital structure has focused on public, nonfinancial corporations with access to U.S. or other international capital markets. The study on the determinants of capital structure of SME’S in the developing countries like India has been overlooked and therefore a study on testing the hypotheses based on Pecking Order Theory by examining the most important factors that influence the capital structure decisions of SMEs in India is an important research area that needs to be explored.

Objectives of the study
The present study has been undertaken with the following objectives:

I. To study the impact of IFRS on the banks.
II. To study the difference between IFRS and Indian GAAP.
III. To study the synergy created in bank mergers under IFRS valuation method.

Variables of the study
Dependent variable
The dependent variable in the study is the Synergy creation.
Independent variable
Independent variables used in the study are Purchase method, Valuation of Goodwill, Accounting under fair value basis, Reverse acquisition - accounting based on substance (Anti-Takeover defense), Potential voting rights, Deferred tax, Minority interest (Equity), Performance indicators after merger.

Hypotheses
Primary Hypothesis:
Hypothesis 1: IFRS will create less synergy in the mergers and acquisition of banks in India.

Secondary Hypothesis:
Hypothesis 2: Purchase method under IFRS-3 will not maintain uniformity instead of no guidance.
Hypothesis 3: Valuation of Goodwill will show less value under IFRS-3.
Hypothesis 4: Accounting under fair value basis is not better than Indian GAAP.
Hypothesis 5: In Reverse Acquisition cost to initial acquire will be more under IFRS-3.
Hypothesis 6: Power given to potential voting rights will affect merger decision of banks.
Hypothesis 7: Recognition of deferred tax under IFRS-3 will lower the cost of acquisition.
Hypothesis 8: Inclusion of minority interest within equity under IFRS-3 will affect cost of acquisition.

Sampling procedure
The primary research instrument used in this study was the questionnaire. Based on the proportionate sampling method the researcher has selected 200 Chartered Accountants from Bangalore for the current study.

Data Analysis:
Seven secondary hypotheses (hypotheses 2 – 8) have been tested using the t-Test. If more than 5 secondary hypotheses will be disproved then the main hypothesis will be rejected and the alternate hypothesis will be accepted.

Testing of Hypotheses (2 to 8):
The summarized results of the hypothesis tested by t test are given below. As in all the cases (except Synergy Fair value basis) the p value is less than the significance level (.05) so all the Hₐ (except Synergy Fair value basis) is rejected. As 6 of the secondary hypothesis is disproved (Hₐ rejected) so the main hypothesis i.e. IFRS will create less synergy in the mergers and acquisition of banks in India is rejected and can be concluded that IFRS will create not less synergy in the mergers and acquisition of banks in India.

Insert Table 1: Paired Sample Test

Findings:
- Purchase method under IFRS-3 will maintain uniformity instead of no guidance.
- Valuation of Goodwill will not show same value under IFRS-3.
- Accounting under fair value basis is not better than Indian GAAP as far as synergy is concerned.
- In Reverse Acquisition cost to initial acquire will not be more under IFRS-3.
- Power given to potential voting rights will affect merger decision of banks.
- Recognition of deferred tax under IFRS-3 will not lower the cost of acquisition.
The Bank Merger Wave: The rd meeting. Mergers and Acquisitions in, 60, 285

ing depreciation. Secondly inclusion of minority interest holders under equity will increase the cost of acquisition because the minority interest holders will not allow the acquisition to happen if they do not want and they will vote against it in the board meeting. Also the cost of the merger increases because of fair value adoption; hence the synergy of acquisition of banks also increases. Calculation of goodwill under IFRS 3 takes contingent liability into consideration; it leads to decrease in the value of goodwill and under Anti-takeover defense the cost will remain same to the initial acquire under IFRS 3.

Conclusion:
The study is with the aim of contributing to the search of impact of IFRS on the valuation of mergers and acquisition of banks in India. The study concludes with many positive points, but there are some loopholes which need to be improved on, like from the study it was revealed that the fair value basis is not better than the Indian GAAP as far as synergy of acquisition of banks also increases. Calculation of goodwill under IFRS 3 takes contingent liability into consideration; it leads to decrease in the value of goodwill and under Anti-takeover defense the cost will remain same to the initial acquire under IFRS 3.

References:
### ANNEXURE

**Table 1: Paired Sample Test**

<table>
<thead>
<tr>
<th>Paired Differences</th>
<th>95% Confidence Interval</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>S.D</td>
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<tr>
<td>Synergy Purchase Method</td>
<td>-0.34375</td>
<td>0.65300</td>
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<tr>
<td>Synergy Goodwill</td>
<td>-2.78125</td>
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<tr>
<td>Synergy Fair Value Basis</td>
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<td>0.67725</td>
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<td>Synergy Anti Takeover Defense</td>
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<td>Synergy Voting Rights</td>
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<td>Synergy Deferred Tax</td>
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<tr>
<td>Synergy Minority Interest</td>
<td>-0.65625</td>
<td>0.65300</td>
</tr>
</tbody>
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