Fair Valuation under Ind AS 103 - Accounting for Business Combinations

With the adoption of Ind ASs, the fair value concept has assumed prime importance in the Indian accounting scenario. The concept of fair value has assumed significant role for companies who are planning to make an acquisition as Ind AS 103 on "Business Combinations" provides that the acquirer shall account for the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. The principles of fair valuation of assets and liabilities are provided under Ind AS 113 on "Fair Value Measurement". This article provides insights into the three valuation techniques prescribed under Ind AS 103 and deals with the challenges of these approaches in the practical scenario and the various forms of these approaches which are most common and popular among the valuation experts. Read on to know more….

A business combination is defined under Ind AS 103 as a transaction or other event in which an acquirer obtains control of one or more businesses.

A business is defined as an integrated set of activities and assets (inputs) capable of being conducted and managed (process) for the purpose of providing a return in the form of dividends, lower costs or other economic benefits (outputs) directly to investors, other owners, members or participants.

An investor controls an investee if and only if the investor has power over the investee, exposure or rights, to variable returns from its involvement with the investee; and the ability to use its power over the investee to affect the amount of the investor's returns.

If the transaction/assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition

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by recognising assets and liabilities by allocating the cost on the basis of their relative fair values. No goodwill arises in case of an asset acquisition.

In case the transaction or event is a business combination, it needs to be accounted for using the acquisition method and the following steps are to be followed in case of a business combination:-

a) Identify a business combination
b) Identify the acquirer
c) Determine the acquisition date
d) Recognise/measure identifiable assets acquired/liabilities assumed
e) Recognise/measure any non-controlling interest
f) Determine the consideration transferred
g) Recognise/measure goodwill (or gain from a bargain purchase)

Assets acquired and liabilities assumed are recognised at fair value if they meet the definition of an asset or liability in the Framework at the acquisition date and are part of what is exchanged in the business combination. The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. Under the erstwhile AS-14 on Accounting for Amalgamations, there was no provision for the fair valuation of the assets acquired and liabilities assumed. The assets and the liabilities by the acquiree were recorded at the same value, as were recorded in the books of the acquirer company. With the introduction of the fair value framework, it will now be easier to link the consideration paid for acquisition of the business, with the real worth of the assets and liabilities acquired (purchase price allocation).

The principles of fair valuation of assets and liabilities have been provided under Ind AS 113 "Fair Value Measurement" which defines fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The highest and best use of an asset establishes the valuation premise used to measure the fair value of the asset.

According to The Appraisal of Real Estate, 12th Edition (page 305), highest and best use is defined as *"the reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, and financially feasible and that results in the highest value."* Thus, the highest and the best use analysis involves the determination of physically possible uses of the item, legally permissible uses, financially feasible uses and most profitable uses.

Ind AS 103 talks about three valuation approaches or techniques for the fair valuation of assets and liabilities which are summarised below:-

Income approach

The income (income capitalisation) approach explicitly recognises that the current value of an asset (liability) is premised on the expected receipt (payment) of future economic benefits (obligations) generated over its remaining life. These benefits can be in the form of earnings, net income, cash flow, or other measures of profitability and should include the proceeds from final disposition as well as cost savings and tax deductions. Value indications are developed by discounting expected benefits to their present value at the required rate of return that incorporates the time value of money and risks associated with the particular asset. The discount rate selected is generally based on expected rates of return available from alternative investments of similar type, quality, and risk as of the Transaction/ Valuation Date.

The discounted cash flow ("DCF") method is a commonly used form of the income approach. A DCF analysis is based upon management's projections of future revenue, operating expenses, depreciation, capital expenditures, and working capital requirements. The resulting available cash flow is then discounted at a rate consistent with the inherent level of risk in the subject company asset. Available cash flow (or free cash flow) is defined as the amount that could be distributed to investors, both debt and equity, without impairing the progress of the business.

Market approach

The market approach is a technique used to estimate value from an analysis of actual transactions or

offerings for economically comparable assets/ businesses available as of the valuation date. The process involves comparison between the subject business and similar businesses that have been recently sold or is offered for sale in the market. The transaction or offering prices of the comparable businesses are adjusted for dissimilarities in characteristics including location, age, time of sale, size, and utility, among others. The adjusted prices of the comparable assets provide an indication of value for the subject business.

Cost Approach

The cost approach is based on the principle of substitution, which suggests that a market participant (buyer) will pay no more for an asset than the current cost to acquire or construct a substitute asset of equal or comparable utility (often referred to as replacement cost new). When the cost to reproduce an asset exceeds the cost to replace it, if measurable, the replacement cost new is normally the proper starting point to develop an indication of value using the cost approach. Therefore, a value indicated by the cost approach is based on the replacement cost new less depreciation allowances for physical deterioration and functional and economic obsolescence, when present and measurable.

Commonly used approaches in valuation

The assets and liabilities which are identified by the acquirer are listed out in the Sale and Purchase (SPA) agreement, which is entered between the acquirer and the acquiree in a business combination. Examples of assets that could be acquired in a business combination could include inventories, trade receivables, cash and bank balances, property, plant and equipment (PPE) and intangible assets and other short term and long term financial and non-financial assets.

In case of acquisition of trade receivables, inventories and cash and bank balances, the fair value in most of the cases equates their carrying amount in the books and hence, there is no need to appoint an external expert for the fair valuation of these assets. However, in case of acquisition of PPE, the difference between book value and the fair value can be significant and hence, the acquirer normally appoints an external expert to carry out the fair valuation of these. The expert is also required to do the fair valuation of the potentially identifiable assets that meets the contractual- legal criterion or the separability criterion under Ind AS 38 on "Intangible Assets". Hence, valuation of PPE and intangibles are the most common items which are subjected to fair valuation by external experts.

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Out of the above mentioned three techniques/ approaches on valuation, the most common and popular approach adopted by the valuation experts is cost approach due to implementation issues in the adoption of the market and income approach. Market approach is normally not adopted because the identified fixed assets are either not transacted in open market or the required comparables are not available for analysis. There are practical difficulties in the application of income approach, since it requires allocation of revenues and expenses to an individual asset or group of assets. However, income approach may be used to determine the extent of economic obsolescence of tangible assets in certain instances.

Valuation methodology for PPE

The valuation of PPE includes valuation of real property such as land and personal property such as machinery, furniture and fixtures, computers, office equipments etc. These assets are identified based primarily on the Fixed Asset Registers (FAR) maintained by the company, in electronic format, as of the valuation date. The FARs include such information as the description of each asset, its classification, its original cost and date of installation, and other descriptive information such as location, cost centre, and net book value. Additional information may be taken from management such as the physical inventory list of the major assets along with technical details, charts of accounts, and accounting lives used for depreciation purposes, and reconciliation of major assets with the physical inventory list with the FAR.

The fair value of real property is normally estimated by market approach, which includes site visit to the subject property by an external agency appointed by Management.

For the purposes of valuation of personal property, the valuer obtains the asset wise details of all the assets and creates asset categories for valuation purposes. It may be noted here that the capital work in progress includes any and all fixed asset expenditures that have not yet been capitalised as of the valuation date. For example, any monies spent for new capital purchases that have not been recorded on the fixed asset accounting system, as of the valuation date, are likely included in CWIP. As all expenditures categorised as CWIP are typically new and technologically current, the Cost of the CWIP is normally equivalent to its fair value, as of the valuation date except for projects which may be identified by the management to be cancelled before completion.

The following two methods are the most common methods of valuation used by the valuers internationally in relation to the valuation of the tangibles.

Replacement Cost New (Form of cost approach)

This method represents the theoretical cost of current labour and materials necessary to construct or acquire a new asset of similar utility to the subject asset. Similar utility refers to similar economic satisfaction. That is, the substitute is comparable in terms of its utility to the owner, but it is not necessarily an exact duplicate. Therefore, an investor would perceive an asset as an equivalent asset.

Reproduction Cost New (Form of cost approach)

This method contemplates replacing the asset with an identical asset without regard to economic and functional considerations. Reproduction cost new is the cost to reproduce the asset in like kind to obtain an asset that is nearly an exact duplicate of the subject asset.

Normally, over time, an asset becomes less than a perfect replacement for itself. In certain cases for an older asset, piecemeal changes overtime typically result in poor layout and uneconomical space utilisation.

For the purposes of valuation of personal property, the valuer obtains the asset wise details of all the assets and creates asset categories for valuation purposes. It may be noted here that the capital work in progress includes any and all fixed asset expenditures that have not yet been capitalised as of the valuation date.

Thus, replacement cost of an asset may differ from the reproduction cost of the same asset. After establishing the replacement or reproduction cost, adjustments are made to represent any losses in value resulting from physical deterioration and from functional and economic obsolescence as defined below:

Physical Deterioration- The loss in value of the property brought about by wear and tear, action of the elements, disintegration, use in service, and all physical factors that reduce the life and serviceability of the property.

Functional Obsolescence- The loss in value of the property caused by the inability of the property to adequately perform the function for which it is utilised. Functional obsolescence is thus internal to the property and is related to such factors as super adequacies (overbuilding); excess operating costs, and inadequacies (under building).

Economic Obsolescence- The loss in value of the property caused by external forces such as changes in the supply and demand relationship, legislative enactments, and other external factors which have an impact on the value of the property.

Valuation methodology for Intangibles

Intangibles could include customer related intangible assets, trade name, product and know how, non-compete agreement, software etc. The below two methods are the most common methods of valuation used by the valuers internationally in relation to the valuation of the intangibles.

Relief-from-royalty method (Form of income approach)

This method recognises that, because the company owns the intangibles rather than licensing them, a company does not have to pay a royalty, usually expressed as a percentage of sales, for their use. The present value of the after-tax cost savings (i.e., royalty relief) at an appropriate discount rate indicates the value of these intangibles.

Examples of intangibles where this methodology is used could include trademark etc.

Excess earnings method (Form of income approach)

Under this method, value is estimated as the present value of the benefits anticipated from ownership of the intangible asset, in excess of the returns required on the investment in the contributory assets necessary to realise those benefits. It is based

on the theory that all operating assets contribute to the profitability of an enterprise. Therefore, if the estimated earnings associated with a specific asset of a company rely on the use of other company assets, then the estimated excess earnings of the subject asset must include appropriate charges for the use of these contributory assets. Return-on charge would consider the interest which would compensate the owner of these contributing assets similar to a lease charge.

Examples of intangibles where this methodology is used could include order backlogs, customer relationships etc.

Common adjustments made in valuation of intangibles

In the valuation of intangibles determined using the income approach, there are certain adjustments which are to be made. These adjustments are for the allocation of the cost of the contributory assets in the valuation of the intangibles and for the tax benefit which would be available on the amortisation expense on the increase in the fair value over the book value. These adjustments are discussed in detail in the following paragraphs.

Charges for the Use of Contributory Assets

The operating earnings attributable to a specific asset, or investment, are those in excess of fair returns on all the assets that are necessary to realise the operating earnings. In other words, if the estimated earnings associated with a specific asset are dependent on the use of other assets (sometimes referred to as "contributory assets"), then the analysis should include charges, or economic rents, for the use of these contributory assets. The contributory assets include net working capital, fixed assets (or property, plant, and equipment), trademark, product and know-how, non-compete agreement, software and the assembled workforce. Surplus land is excluded from calculating the charge of fixed assets as it is non-operating in nature. These charges are deducted from each relevant asset's after-tax operating income to yield the net after-tax operating income that is solely attributable to the relevant asset(s).

If the estimated earnings associated with a specific asset are dependent on the use of other assets (sometimes referred to as "contributory assets"), then the analysis should include charges, or economic rents, for the use of these contributory assets.

Tax Benefit of Amortisation

When the indicated value of an intangible asset is derived using the income approach, it is necessary to adjust the value to include the tax benefit that would result if the assets were amortised. The value of the tax benefit of amortisation associated with an intangible asset valued through the income approach should be recognised for financial reporting purposes under Ind AS. Regardless of whether the structure of the transaction is a stock purchase or an asset purchase, the Ind AS considers the difference in tax treatment to be temporary. The transaction is treated as if it was a purchase of assets, and the basis of the assets is restated at fair value for financial reporting purposes. Any differences in the tax treatment that are temporary should be recognised for the deferred tax consequences, when accounting for business combinations using the purchase method. The estimated value of the subject intangible asset is amortised over above mentioned period, which creates a tax shield by reducing pre-tax income. Consequently, the tax shield becomes a component of the asset value. Therefore, the net present value of the estimated tax benefit created is added to the value of the intangible asset.

Conclusion

In an appraisal study, all three approaches to value (cost, market and income) must be considered, as one or more may be appropriate in valuing the subject asset. Value indications developed in applying each of the appropriate methodologies are weighted and reconciled with other facts with regard to the type of asset being appraised and the quantity and quality of the data available in order to form a conclusive opinion of fair market value. The fair valuation as determined by the valuer can have a significant impact in the books of the acquirer as the acquirer would be claiming the depreciation/amortisation on this increased fair value in the consolidated books of accounts. An auditor will also need to document the audit procedures to gather sufficient and appropriate audit evidence to support the values recorded by the management in accordance with SA 500 on "Audit Evidence".

References

- *Indian Accounting Standards*
- *Valuation report of valuer Duff and Phelps.*