THE VAL STREET JOURNAL

Is Winter Coming?

Dear Professional,

In our maiden publication which was released in November 2017, to coincide with the introduction of the Companies (Registered Valuers and Valuation) Rules, 2017, we had discussed the key areas that the Rules would impact. We are now in September 2019 and while the financial markets are probably looking at a long winter, both literally and metaphorically, for the valuation profession, the sun seems to have just risen.

The demand for quality valuations has increased manifold. While, on one hand there are regular requirements by large and medium sized corporates for fair valuations under Ind-AS accounting; on the other hand there are start-ups who are getting educated every day on the mandatory requirement of a registered valuer for every new issue or transfer of shares. Similarly, for corporates not doing well, the Insolvency and Bankruptcy Code has mandated valuations.

The demand for valuers has thus increased and attracted a healthy supply with close to 2,300 registered individual valuers and 10 registered valuer entities in the country, with **ICON VALUATION LLP** being one of them. With the increasing complexities in valuations and regulations on valuers, the preference to appoint specialised valuers by clients is also increasing. Consequently, more and more individual valuers are opting for a corporate structure.

The increasing need for professional valuers has also led to an increased demand for practicing valuation professionals in the field of academics and training. This issue of our journal hence talks about the topics of Tax Amortisation Benefit for the academicians to debate and discuss and on Fair Value Measurements under Ind-AS 113 for the trainers.

Happy Reading!

We urge you to share your thoughts with us.

Thank You!

The DNA of Valuation

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Tax Amortisation Benefit ('TAB')

The term 'Tax Amortisation Benefit' has not been explicitly defined anywhere but as a concept is widely accepted by all global professional bodies. In India too, TAB is commonly applied, especially by valuers who regularly carry out valuations for the purpose of financial reporting. TAB in a layman's term is a benefit that is availed by claiming amortisation of an acquired asset as an allowable expense under tax laws. As an expert however, one would define TAB as a hypothetical benefit arising from future amortisation of an acquired intangible asset that could be available to an acquiring entity which is recording such an intangible asset in its books of accounts. The ICAI Valuation Standard 302 on Intangible Assets issued by The Institute of Chartered Accountants of India in 2018 explains TAB as a hypothetical benefit available to a market participant by way of amortisation of the acquired intangible asset, thereby reducing the tax burden.

The points below are relevant to correctly understand, apply and calculate TAB.

1. TAB is a hypothetical concept

The premise of TAB arises from the assumption that while acquiring the asset, hypothetically the acquirer would have factored in the determination of the acquisition price, such amortisation benefit that would be available on acquisition of the asset in the future. The premise of TAB is thus hypothetical and is applied irrespective of whether such amortisation is actually claimed or not. While its premise is hypothetical, its applicability is not. If there is reason to believe that the structure of a transaction or the purpose of the valuation or the tax laws are such that there may not be any amortisation benefit available, then TAB would not be available.

2. **The asset should be seen to be acquired in isolation and not as part of a business**

As TAB is based on the premise that the benefit would be available on amortisation of an asset, it is hence implied that only if the asset can be isolated and recorded separately, it can be amortised. If the asset is taken as part of a business, the asset loses its identity and cannot be recorded separately and will hence not be amortised and the question of TAB would not arise. There is hence some confusion among valuers as to whether this implies that TAB would be applicable only on asset purchase transactions and not on stock purchase transactions. However it has been settled that TAB should be applied irrespective of whether the transaction is an asset purchase or a stock purchase, as long as the asset is being accounted and recorded separately.

3. **The applicability of TAB depends on the purpose of the valuation**

Just like any other valuation, the purpose of valuation is also important to assess when TAB should be applied. TAB being a hypothetical benefit, it is important that TAB is not arbitrarily applied as it would erroneously inflate the value of the asset. TAB is hence applied only if the intangible asset is being valued separately which generally it is when a purchase price allocation is been carried out (either to account for a business combination for the purpose of financial reporting or at the time of a slump / group sale for tax reporting) or when the intangible is been sold / acquired separately. For financial reporting, the inherent assumption under which the valuation is carried out assumes a hypothetical sale of the intangible asset; in case of a purchase price allocation for a slump / group sale, the very reason the purchase price allocation is carried out is to claim tax amortisation.

4. **The applicability of TAB depends on the valuation approach followed to value the asset**

When the cost or market approach is used to value an asset, it is understood that the estimated cost to create / replace the subject asset and the market price used to realise the value of the subject asset respectively takes into account the value of all benefits and therefore there is no reason to additionally add the value of TAB when valuing an asset under these approaches. However when an income

approach is used to value an asset, because the cash flows / earnings / cost savings pertain only to the use of the subject asset, the amortisation benefit does not get captured in the calculation and hence the need to add TAB separately when valuing an asset under the income approach.

As amortisable tangible assets are valued using either the cost approach or the market approach or both, it is by implication clear that TAB is applicable only when valuing intangible assets and that too only if they are valued using the income approach.

5. **TAB applicability depends on the tax amortisation laws of the country in which the asset is used**

Although the amortisation is claimed in the books of the acquirer entity, it is the location where the asset is used that determines the applicability and the amount of TAB. For eg. if an acquirer in India buys an intangible asset used in Europe, if the European tax laws do not allow for amortisation of the acquired intangible asset, TAB should not be applied even if the acquired intangible asset is allowed to be amortised as per Indian tax laws.

6. **The value of TAB is calculated as per the amortisation method allowed by the laws of the country in which the asset is used**

As mentioned earlier, once it is established that TAB is applicable, the method of amortisation to calculate TAB would also depend on the location where the asset is used. For eg. if an intangible asset used in India, is acquired, as per the tax laws of India, such an intangible asset would be amortised at the rate of 25% per annum based on the written down value method. However if the asset was being used in the US, the amortisation method would be the straight line method and the number of years over which the asset could be amortised would have been different. The value of TAB could hence be different in different countries for the same intangible asset.

7. Calculation of TAB

The four primary inputs that go in the calculation of TAB are the amortisation rate, the discounting rate, the tax rate and the duration.

Amortisation Rate

As mentioned earlier, the amortisation rate is dependent on the situs where the intangible asset is used. Depending on the amortisation laws, the amortisation policy and the amortisation method, the amortisation rate should be decided.

Discounting Rate

Intangible assets are perceived to be riskier than the company as a whole and hence the discounting rate used to value an intangible asset is higher than that used to value a company. There is hence some debate over which discounting rate should be used to present value the tax savings for calculating TAB.

While some valuers use the company's discount rate commonly referred to as the weighted average cost of capital ('WACC') to discount the tax savings to calculate the present value of TAB, some others discount the tax savings using the discounting rate of the intangible asset. The school of thought which uses WACC to calculate TAB is of the view that as the amortisation benefit can be used to reduce the tax burden of the entire company, it is appropriate to use the WACC of the company. Proponents of the other school of thought believe that as the amortisation benefit is calculated on an intangible asset which is valued based on its own attributable cash flows /earnings / cost savings which are separate from the business, the intangible asset specific discounting rate should be used.

Both approaches are followed and are in vogue. The Valuation Standards issued by the Institute of Chartered Accountants of India as well the International Valuation Standards issued by the International Standards Valuation Council allow the use of both approaches. However one needs to be careful that the same is applied consistently in the entire valuation process. For example, where an intangible asset specific discounting rate is being used to calculate TAB, the tax rate used to calculate TAB also should be the one pertaining to the intangible asset and not the business as a whole and vice versa.

Tax Rate

As mentioned earlier, depending on what discounting rate is being used for calculation of TAB, the tax rate should be considered so as to be consistent with the logic.

Duration

The duration for which TAB is calculated is directly related to the amortisation rate. Where the amortisation method followed is the straight line method, the duration would be inversely proportionate to the amortisation rate. For eg. if the amortisation rate prescribed is 10%, then the duration over which the benefit would accrue would be 10 years. In some countries, the life itself is prescribed such as the US where the amortizable life prescribed is 15 years. In countries like India, the amortisation rate prescribed is 25% per annum and the method prescribed is the written down value method. As the method prescribed is a reducing balance method, TAB is generally calculated for a duration by which the present value of the tax savings becomes negligible.

Although transactions involving intangible assets have increased, valuation of intangible assets is not as widely accepted or understood as say a business or an equity valuation and because the information available in public domain about intangible assets exchanging hands is limited In India, it is easy to err. In India, the value of TAB can constitute almost 25% to 30% of the value of the intangible asset and hence it is a double edged sword that should be understood and applied with caution depending on the purpose of the valuation, the valuation approach and the tax laws of the relevant jurisdiction.

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IND AS 113 – Fair Value Measurement

Background

Before we deep dive into the Indian Accounting Standard 113 (the 'Standard') on Fair Value Measurement, it is important to note that this Standard does not by itself require any specific fair value measurement. Instead, it only provides the necessary framework for fair value measurement in those cases where any other accounting standard requires or permits fair value measurement. The primary role of the Standard is to define fair value, lay down a framework for fair value measurement and also to provide guidance about required disclosures related to fair value measurement.

While the unit of account for a fair value measurement requirement is always for a particular asset or liability, in practice it could be either a standalone asset or liability or a group of assets or liabilities. For instance, a fair value measurement of a financial instrument would be that of a standalone asset, while the fair value measurement of a cash generating unit would usually be that of a group of assets forming a business. In all cases, the requirement, whether a standalone asset is to be valued or a group of assets is to be valued, would be guided by the originating accounting standard that requires such fair value measurement in the first place.

The Standard defines fair value as *'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'*. This definition revolves around an exit price mechanism as at the measurement date.

One of the key principles essential to fair value measurement under the Standard is the concept of market participant. The Standard requires that the assumptions used in the fair value measurement must reflect the assumptions that market participants would use in such fair value measurement. This concept inherently assumes that market participants would always act in

their best economic interest. Such fair value measurement based on market participant assumptions would ensure that fair values are not vitiated by entity specific intentions and instead reflect a broader market perspective.

The 'highest and best use' concept is another important principle introduced by the Standard. This mandates that a fair value measurement must assume the highest and best use of the assets by market participants, irrespective of its present actual use while also considering its physical, legal and financial feasibility. However, this principle is to be applied primarily for valuation of non-financial assets.

Apart from all the above key aspects, the main focus of the Standard lies in guidance on valuation techniques and use of relevant inputs for valuations.

Valuation Techniques

The valuation techniques can be primarily classified into market approach, cost approach and income approach.

- **Market Approach**
  The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business. Although the Standard by itself does not lay down the specific methods available for use within each valuation approach, based on generally accepted valuation practices in India, the market approach includes valuation methods such as market prices method, comparable companies' multiples method and comparable transactions' multiples method. Under the market prices method, the instrument's own quoted prices form a basis for fair value measurement. The comparable companies' multiples method uses the implied multiples (of earnings / revenues / assets) of quoted comparable companies as the basis for valuation. The comparable transactions' multiples method uses similar implied multiples from recent transactions / deals / acquisitions in the subject company or similar sector.

- **Cost Approach**
  The cost approach reflects the amount that would be required to be spent currently to replace the service capacity of an asset (akin to a

current replacement cost). This can be based on either adjusted historical cost or even current replacement cost estimates.

- **Income Approach**
  The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts. The discounted cash flow method is the most widely known method of valuation under the income approach.

As far as selection of valuation technique to be used in any fair value measurement, there is no one-size-fits-all guidance. Like in any valuation, the choice of valuation techniques and methods would depend on the facts and circumstances of each case including availability of information. In some cases, a single valuation technique will be appropriate, while in some other cases use of multiple valuation techniques may be warranted. While using multiple valuation techniques, it would be also important to consider the deviation in fair values under different techniques and also their range of fair values. Even while using multiple valuation techniques, the valuer might have to arrive at a single conclusion based on use of appropriates weightages and other factors if any.

Since fair value measurements under the Standard are most likely to be a recurring annual / quarterly exercise, it is important to maintain consistency with respect to selection of valuation techniques for the same fair value measurement for each subsequent period, unless a change in circumstances warrants for a change in selection of valuation techniques. In such cases, this may also be construed as a change in accounting estimate.

In certain cases where initial transaction price itself is the fair value at initial recognition, the Standard provides for a calibration approach using applicable valuation techniques and inputs at the initial measurement date to calibrate the transaction price, which shall then thereafter be used for valuation techniques and inputs to be considered for the related future recurring fair value measurements.

Valuation Inputs

Under each of the above valuation techniques, every fair value measurement would require the use of various inputs and assumptions.

Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability are referred to as '*observable inputs*'.

Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability are referred to as '*unobservable inputs*'.

As per the Standard, an entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs. For this purpose, the Standard lays down a fair value hierarchy that categorizes such inputs into three levels viz. Level 1, Level 2 and Level 3. It is important to note that these levels are for valuation inputs or assumptions, and not directly for selection of valuation techniques or methods. As per such fair value hierarchy, the highest priority of usage is to be given to Level 1 inputs wherever available, thereafter followed by Level 2 inputs and Level 3 inputs respectively.

It is also pertinent to note that most times a single fair value measurement may require multiple inputs which form part of different levels of such hierarchy. In such case, the fair value measurement is categorized to be in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire fair value measurement.

The following are broad principles for each level of fair value hierarchy as laid down under the Standard:

- **Level 1 Inputs**
  Level 1 inputs are quoted prices in active markets for identical assets at the measurement date. A quoted price in an active market provides the most reliable evidence of fair value and must be usually used without adjustment to measure fair value whenever available. The

Standard also specifies that adjustments, if necessary, are permitted only in certain specified circumstances.

- **Level 2 Inputs**
  Level 2 inputs are inputs other than the above quoted prices that are observable for the asset either directly or indirectly. This generally includes quoted prices for similar assets in active markets, quoted prices for identical or similar assets in markets that are not active, market-corroborated inputs or other inputs that are observable such as interest rates, credit spreads, etc. While using Level 2 inputs, it is more common to make adjustments for various factors to account for dissimilarities between such comparable or similar assets and the subject asset being valued.

- **Level 3 Inputs**
  Level 3 inputs are unobservable inputs for the asset or liability. However, the Standard clearly states that such unobservable inputs are to be used only to the extent that the relevant observable inputs in the earlier levels of hierarchy are not available. A familiar example of Level 3 unobservable input could be the projected cash flows that were developed using the entity's own data which could not be corroborated using market benchmarks.

As is evident from all of the above, the crux of the Standard lies in the guidance given to prioritize the use of more market corroborated inputs and assumptions to lend more reliability to the fair value measurements.

A resultant outcome of the above is also that the Standard lays down detailed disclosure requirements for fair value measurements, including valuation techniques used, applicable level of fair value hierarchy, sensitivity analysis for use of significant unobservable inputs and such other similar requirements.

'A mind needs books like a sword needs a whetstone, if it is to keep its edge'

George R.R. Martin