Indian Valuation Standards issued by the ICAI

1 August 2018

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

Background

On 18 October 2017, the Ministry of Corporate Affairs (MCA) notified Section 247 of the Companies Act, 2013 (2013 Act). The section lays down provisions relating to valuation by registered valuers. On the same day, the Companies (Registered Valuers and Valuation) Rules, 2017 (Rules), were also issued by MCA. These Rules *inter alia* provide that the valuation standards would be notified by the Central Government (CG) on the recommendation of the committee set up for this purpose.

New development

On 10 June 2018, the Institute of Chartered Accountants of India (ICAI) issued the preface to the Indian Valuation Standards (Ind VS), the Framework for the preparation of valuation report in accordance with the Ind VS and also the following eight Ind VS applicable for all valuation engagements under the 2013 Act:

- Ind VS 101, *Definitions*
- Ind VS 102, *Valuation Bases*
- Ind VS 103, *Valuation Approaches and Methods*
- Ind VS 201, *Scope of Work, Analyses and Evaluation*
- Ind VS 202, *Reporting and Documentation*
- Ind VS 301, *Business Valuation*
- Ind VS 302, *Intangible Assets*
- Ind VS 303, *Financial Instruments*

Effective date of Ind VS

Ind VS are effective from 1 July 2018 till the time valuation standards are notified by the CG.

Ind VS would be applied for the valuation engagements carried out in accordance with the provisions of the 2013 Act.

In respect of valuation engagements under other statutes like the Income-tax Act, 1961 (IT Act), Securities and Exchange Board of India (SEBI), Foreign Exchange and Management (FEMA), Reserve Bank of India (RBI) etc., these Ind VS are recommendatory in nature.

Ind AS 113, *Fair Value Measurement*

Ind AS 113 sets out a single framework for measuring fair value as well as the disclosures about fair value measurements to be made in the financial statements prepared and presented under the Ind AS framework.

Ind AS 113 is a notified accounting standard under the 2013 Act and hence to be applied by entities covered under Ind AS road map. The standard provides that the term ‘fair value’ is a market-based measurement and not an entity-specific measurement.

This edition of First Notes focusses to provide an overview on significant aspects of Ind VS and also highlights key differences between Ind VS and Ind AS.

Overview of Ind VS

Ind VS 102, *Valuation Bases*

This Ind VS defines the valuation bases available to a valuer.

There are three valuation bases available in this Ind VS and it clarifies that valuation base selected by a valuer should be appropriate in relation to the purpose of an engagement and the terms of the engagement. The following are the three valuation bases:

- **Fair value**: Fair value is 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 valuation date.
- **Participant specific value**: Participant specific value is the estimated value of an asset or liability considering specific advantages or disadvantages of either of the owner, identified acquirer or identified participants.
- **Liquidation value**: Liquidation value is the amount that will be realised on sale of an asset or a group of assets when an actual/hypothetical termination of the business is contemplated/assumed.

It also defines the 'premise of value' which refers to the conditions and circumstances how an asset is deployed. In a given set of circumstances, a single premise of value may be adopted while in some situations multiple premises of value may be adopted. The Ind VS provides a list of common premises of value. These are as follows:

- Highest and best use
- Going concern value
- As is where is value
- Orderly liquidation
- Forced transaction.

Comparison with Ind AS 113

Ind AS 113 provides a framework for measuring fair value of certain assets and liabilities under Ind AS for preparation of financial statements.

On the other hand, Ind VS 102 defines three valuation bases (including fair value) to measure a value which could be fair value, participant specific value or liquidation value. Therefore, Ind VS are expected to apply to many more situations than just for preparation of financial statements.

Ind VS 103, *Valuation Approaches and Methods*

Ind VS 103 provides guidance to select an appropriate valuation approach and methodology for determining the value of an asset, liability or a business. The main three valuation approaches are as follows:

- Market approach
- Income approach
- Cost approach.

According to the Ind VS, a valuer would be responsible to select the appropriate valuation approach(es) and methods as there may not be a single approach/method that would be best suited for valuation in every situation. Additionally, the valuation approaches and methods should be selected in a manner which would maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The price information gathered from an active market is generally considered to be a strong indicator of value.

Ind VS explains the valuation approaches in the following manner:

- **Market approach**: Under this approach, a valuer is required to use 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.

  Commonly used valuation methods under the market approach are as follows:

  - Market price method
  - Comparable Companies Multiple (CCM) method/ guideline public company method
  - Comparable Transaction Multiple (CTM) method/ guideline transaction method.
- **Income approach**: Under this approach, maintainable or future amounts (e.g. cash flows or income and expenses) would be converted to a single current (i.e. discounted or capitalised) amount. Further, the fair value would be determined on the basis of the value indicated by current market expectations about the future amounts.

  Commonly used valuation methods under the income approach are as follows:

  - Discounted Cash Flow (DCF) method
  - Relief from royalty method
  - Multi-Period Excess Earnings Method (MPEEM)
  - With and without method
  - Option pricing models such as Black-Scholes-Merton model and binomial model.

- **Cost approach**: Under this approach, an amount that would be required currently to replace the service capacity of an asset (i.e. current replacement cost) would be estimated.

  Commonly used valuation methods under the cost approach are as follows:

  – Replacement cost method/depreciated replacement cost method

  – Reproduction cost method.

  The Ind VS explains each of the above approaches and valuation methods along with the likely situations in which the various methods could be applied.

Comparison with Ind AS 113

Like Ind VS, Ind AS 113 also elaborates on the three approaches of valuation i.e. market approach, income approach and cost approach. However, Ind AS 113 does not provide a list of commonly used valuation methods as explained in Ind VS 103.

Ind VS 301, *Business Valuation*

Ind VS 301 is a specific standard that provides guidance for business valuation or valuation for business ownership interests. Valuations of businesses and business ownership interests may be performed for a wide variety of purposes such as:

- Valuation of financial transactions such as acquisitions, mergers, leveraged buyouts, initial public offerings, employee stock ownership plans and other share-based plans, partner and shareholder buy-ins or buy-outs, and stock redemptions
- Valuation for dispute resolution and/or litigation/pending litigation relating to matters such as marital dissolution, bankruptcy, contractual disputes, owner disputes, dissenting shareholder and minority ownership oppression cases, employment disputes, etc.
- Valuation for compliance oriented engagements, such as financial reporting, tax matters such as corporate re-organisations, purchase price allocations, etc.
- Valuation for other purposes like the valuation for planning, internal use by the owners, etc.
- Valuation under the Insolvency and Bankruptcy Code, 2016.

To value business or business ownership, commonly used valuation approaches are as follows:

- Market approach
- Income approach
- Cost approach.

The Ind VS also explains the treatment of non-operating assets and inter-company investments.

Comparison with Ind AS 103, *Business Combinations and Ind AS 113*

Under Ind AS, Ind AS 103 provides guidance on the valuation and accounting of business combinations (acquisition accounting) and requires fair value measurement of the following:

- Consideration transferred, including deferred consideration and contingent consideration
- The gain or loss on the effective settlement of a non-contractual pre-existing relationship
- Assets acquired and liabilities assumed,
- 'Ordinary' non-controlling interest that the acquirer chooses to measure at fair value and
- The non-controlling equity interest in the acquiree before obtaining control in a business combination achieved in stages.

The principles in Ind AS 113 provide general guidance in measuring fair values in the context of acquisition accounting.

Ind VS on business valuation covers many more situations than just business combinations and therefore, has a wider scope.

Ind VS 302, *Intangible Assets*

Ind VS 302 prescribes specific guidelines and principles which are applicable to the valuation of intangible assets. The standard provides a list of situations in which intangible assets would be required to be valued. Following are some of those situations:

- Purchase price allocation for accounting and financial reporting under Ind AS 103
- Impairment testing under Ind AS 36, *Impairment of Assets*
- Transfer pricing when an intangible asset is being transferred/licensed in/out between geographies/companies
- Taxation by way of a purchase price allocation for claiming tax deductions when a business is transferred by a slump sale
- Bankruptcy/restructuring, etc.

It lays down significant considerations for the valuation of intangible assets e.g. to determine the purpose and objective of the overall valuation assignment, consideration of the legal rights of the intangible asset to be valued, evaluation of the highest and best use considerations, etc.

The Ind VS discusses the three approaches of valuation i.e. market approach, income approach and cost approach.

Under the market approach it highlights two methodologies and they are price/valuation multiples/capitalisation rates, and guideline pricing method.

Under the income approach, commonly used valuation methods are as follows:

- Relief-from-royalty-method
- Multi-period excess earning method
- With-and without method or premium profit method
- Greenfield method
- Distributor method.

For cost approach, commonly used valuation methods are reproduction cost method and replacement cost method. Additionally, it provides that the cost approach is generally adopted when market and income approach cannot be applied. It is required to be used with discretion and generally for intangible assets that are not the primary business drivers and for which a market participant may not be willing to pay a significant premium.

Comparison with Ind AS 38, *Intangible Assets*

Ind AS 38 provides guidance regarding recognition and measurement of intangible assets. Ind AS 103 provides guidance on intangible assets acquired in a business combination i.e. at fair value. A separately acquired intangible asset is recognised at either cash paid or at the fair value of any other consideration given.

Additionally, under Ind AS 38, an entity cannot adopt revaluation model for an intangible asset that does not have an active market.

Ind VS 302 is wider in scope and considers various situations for valuation of intangible assets and accordingly, has elaborated on various valuation methodologies.

Ind VS 303, *Financial Instruments*

Valuation of financial instruments is carried out for various purposes such as transactional pricing (i.e. buy and sell), financial reporting, etc. Since financial instruments have multiple categorisation and different usages, a detailed consideration of purpose of valuation and the features of the instrument being valued is essential to identify the relevant information available to be perused for valuing the instrument.

In selection of the approach and method, a valuer is required to give due consideration to the control environment under which the entity and the instrument operates. The usage of market linked methods with observable inputs is usually the preferred approach to arrive at a value since financial instruments are generally aligned to market linked factors.

Control environment consists of the entity's governance and control procedures that are set in place with the objective of enhancing the reliance on the valuation process and outcome thereof. A valuer placing reliance upon internally performed valuation should consider the reliance on the control environment, its adequacy and independence.

The methods used for the valuation of financial instruments are based on the market, income and cost approaches as described in Ind VS 103. It has also been provided that the usage of cost method is of more predominance in valuation of non-financial assets. Factors to be considered while determining the valuation method include:

- The valuation base and terms and conditions of the instrument being valued
- The purpose of valuation
- The control framework (environment)
- Input data sets, and
- Other considerations.

In case, financial instrument being valued is characterised by certain different terms than the identical quoted instrument, the valuer is required to adjust the comparable price to reflect the different terms and characteristics.

Generally, valuers should use market observable data, however, in the absence of such data, they may use unobservable inputs. While doing so, high emphasis should be laid on an entity's control framework and integrity of data used in deriving the inputs. Valuers should also factor an inherent risk element in the value derived using unobservable inputs.

Valuers need to evaluate the risks associated with the instrument and the issuer (including credit risk) when valuing financial instruments. Ind VS 303 provides the factors that should be considered when measuring credit risk, which include counterparty risk, capital leveraging, security hierarchy, collateral and default protection, history of default and offsetting.

Comparison with Ind AS 109, *Financial Instruments* read with Ind AS 113

Ind AS requires financial instruments to be fair valued. While, Ind VS does not mention that fair value to be the only method of valuation. Additionally, Ind AS 113 provides specific guidance on valuation of liabilities and entity's own equity instruments, valuation of financial liabilities with demand feature, valuation of financial assets and financial liabilities with offsetting positions in market risk or counterparty risk. This guidance is not specifically available in Ind VS 303.

Our comments

- **Applicability of Ind VS**: The preface to Ind VS mentions that these valuation standards are mandatory and it is the responsibility of the valuer to comply with these valuation standards. It is not clear from the preface to Ind VS that whether these standards are mandatory for only those valuers that are registered with ICAI's Registered Valuers Organisation. The ICAI may clarify the applicability status.

- **Scope of Ind VS:** The scope of application of Ind VS is much wider than Ind AS. Ind AS requires valuation from the financial reporting perspective only. Ind VS 101 provides definitions of various terms, while some of the definitions are aligned to Ind AS, there are many terms that are not used in Ind AS.

- **Valuation bases, approaches and methods (Ind VS 102 and Ind VS 103):** Like Ind AS, Ind VS 103 mentions three valuation approaches which are market approach, income approach and cost approach and does not mention an exhaustive list of valuation methods. Similar to Ind AS 113, Ind VS 102 provides that the fair value would reflect the highest and best use of a non-financial asset by market participants.

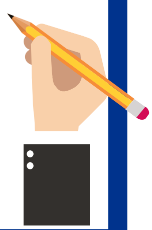
- **Business valuation (Ind VS 301)**: The scope of Ind VS 301 is much wider as compared to Ind AS 103 . The market approach methods for measurement of fair value (for business) mentioned in Ind AS 113 appear to be similar to those referred in Ind VS 301. Additionally, the term 'asset' has been defined to include business or business ownership interest in the Ind VS Framework. This term has not been defined in Ind AS 103.

- **Intangible assets (Ind VS 302)**: Given the specialised nature of most intangible assets, measuring fair value using the market approach may not always be possible. In our experience, intangible assets are usually measured using a technique that falls under the income approach - present value technique, the multi-period excess earnings method, the with-versus-without method, and/or the relief-from-royalty method.

- **Financial instruments (Ind VS 303)**: Ind VS 303 defines financial instruments in accordance with Ind AS 32, *Financial Instruments: Presentation*. However, for the purpose of accounting, the financial instruments will be classified and subsequently measured at amortised cost or fair value, as per the principles of Ind AS 109. Therefore, while measuring the fair value of the instruments, reference should be made to Ind AS 109 and Ind AS 113.

The bottom line

The valuation standards are expected to be used for valuation engagements under the 2013 Act even for entities which are not following Ind AS. Currently, the notified Accounting Standards (AS) under the Companies (Accounting Standards) Rules, 2006, do not have extensive application of the fair value concept. However, AS equivalent of Ind AS 109 is currently under formulation and hence, these Ind VS may be applied by entities not following Ind AS but which are expected to use the fair value concept.



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The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

Financier Worldwide: A panel discussion on IFRS 16, *Leases*

4 June 2018

Recently, Financier Worldwide moderated a discussion on IFRS 16 between four experts of the Accounting Advisory Services (AAS) of the KPMG global network (Markus Kreher, Global Head of AAS, KPMG International; Sai Venkateshwaran, KPMG in India; Michelle Gibbs, KPMG in Australia; and Ruben Rog, KPMG in the Netherlands).

The insights of the discussion have been published in the form of an article in the June 2018 edition of Financier Worldwide. This issue provides the link to the article.

Missed an issue of Accounting and Auditing Update or First Notes

Issue no. 24 – July 2018

The topics covered in this issue are:

- The changing future of financial instruments accounting
- Change in ownership interests in investees
- Construction contracts - income from surplus funds
- Regulatory updates.

MCA notified certain provisions of the Companies (Amendment) Act, 2017

28 May 2018

The MCA through its notification dated 7 May 2018 notified certain sections of the Companies (Amendment) Act, 2017. Additionally, MCA issued amendments to certain rules under the Companies Act, 2013 (2013 Act). The notified provisions are effective from 7 May 2018.

This issue of First Notes aims to provide an overview of the recently notified sections of the Companies (Amendment) Act, 2017 and the amendments issued to the rules to the 2013 Act.

Voices on Reporting – Quarterly update publication

Voices on Reporting – quarterly update publication (for the quarter ended 30 June 2018) provides summary of key updates from the Ministry of Corporate Affairs, the Securities and Exchange Board of India, the Reserve Bank of India and the Institute of Chartered Accountants of India.

Feedback/queries can be sent to aaupdate@kpmg.com

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