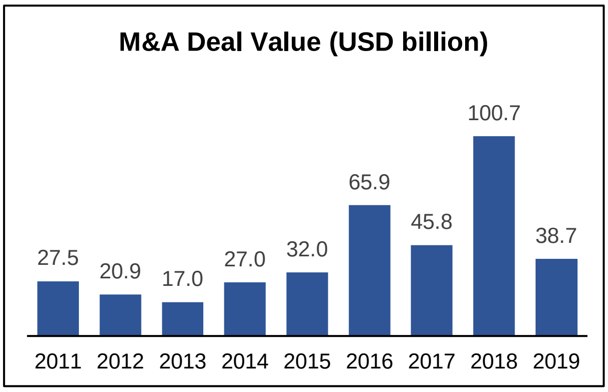
This article was first published in November 2019 news bulletin of Karnataka State Chartered Accountants Association (KSCCA)

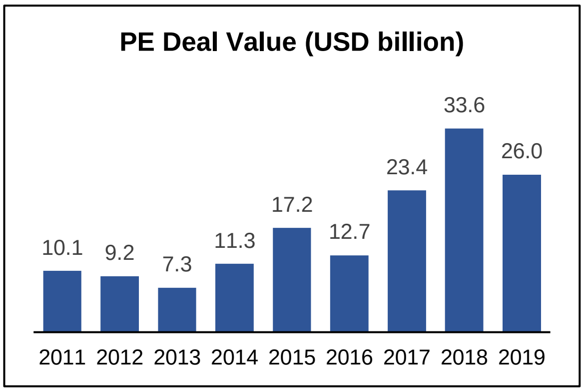
VALUATION OF INTANGIBLES FOR PURCHASE PRICE ALLOCATION REQUIREMENT UNDER IND AS 103 (BUSINESS COMBINATION) READ WITH IND AS 113 (FAIR VALUE MEASUREMENT)

- **CA VIKAS SURESH**

Increasing role of M&A in the Indian business scenario and hence the accounting framework gearing up to provide relevant insights

India has been witnessing a significant increase in M&A transactions and Private Equity transactions with value of total deals crossing over USD 100 billion in 2018. The total value of deals increased to USD 100.7 billion in 2018 from USD 27.5 billion in 2011 at a CAGR of 20.3 per cent and Private Equity deals have increased from USD 10.1 billion in 2011 to USD 33.6





billion in 2018 recording a CAGR of 18.7 per cent.

Sources: Secondary Research, Annual Reports, Venture Intelligence & Unithos Analysis

Note: *2019 numbers are till September 2019*

Such transactions normally require deeper understanding of business value drivers and the value creation opportunities in the businesses for both the acquirers and the sellers to assess the feasibility of the deal and analyze rationale for possible synergies. Financial investors like Private Equities, Venture Capital identify the core strengths/value drivers of the businesses and prioritize investments in assets which can result in maximizing returns.

With an objective to facilitate availability of objective information for analysis, the financial reporting framework in India is evolving based on references drawn from global practices in the matured markets.

Purchase Price Allocation under Ind AS 103, IFRS 3, ASC 805 – Business Combination

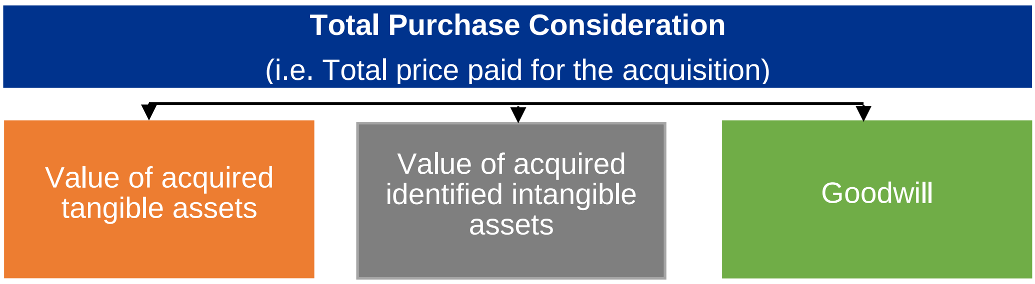
- As per current financial reporting framework, Purchase Price Allocation ("PPA") is required for every business combination where the investor acquires control over the business/es:
  (As per Ind AS 110, the existence of control by an investor over an investment is identified where the investor have (a) power over the investee; (b) exposure, or rights, to variable returns from its involvement with the investee; and (c) the ability to use its power over the investee to affect the amount of the investor's returns)
  - Ind AS 103, IFRS 3, ASC 805 – Business Combination requires all business combination to be accounted and reported using acquisition method. Under acquisition method, the acquirer recognizes the assets acquired and liabilities assumed at their respective fair values as on the acquisition date

  - Ind AS 113, IFRS 13, ASC 820 – Fair Value Measurement provides guidance valuation of assets
- Ind AS 103 defines business combination as a transaction or other event in which an acquirer obtains control of one or more businesses. The assets acquired and liabilities assumed should constitute a business with input-process-output relationship, i.e. an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants
- As part of applying the acquisition method, the acquirer shall recognize the consideration transferred for the acquiree; recognize and measure the identifiable assets acquired, liabilities assumed, and noncontrolling interest in the acquiree; and recognize and measure goodwill (or gain in a bargain purchase transaction)

Approach for Purchase Price Allocation

- Purchase Price Allocation refers to the allocation of the purchase consideration paid by the acquirer for the assets acquired and liabilities assumed as a part of transaction
  - Purchase Consideration represents the total purchase price or consideration paid as part of the transaction and includes upfront payments, earnouts and other contingent payments and deferred payments not linked to any employment conditions of the promoters (if the promoters continue post transaction)
  - Purchase Consideration is first allocated to acquired tangible assets and identified intangible assets
  - Balance consideration (i.e. purchase consideration paid over and above the value of assets of tangible assets and identified intangible assets) is assumed to be paid towards Goodwill
  - In cases where the sale is under desperate or stressed situation by the seller, the value of assets acquired may exceed the purchase consideration paid resulting in a bargain purchase

Purchase Consideration (Total Price paid for the acquisition) consist of 3 major components as listed below:



Value of Tangible Assets acquired as a part of the transaction are considered at Fair Value. It Includes Fixed Assets, Net Working Capital, Cash and Bank Balances and Other assets not forming part of working capital.

An Intangible Asset is an identifiable non-monetary asset without physical substance. It includes the following broad categories:

- Customer related intangible assets
- Distributor related intangible assets
- Technology related intangible assets

- Marketing related intangible assets (like brand, tradename, distribution network, etc)
- Contract related intangible assets
- Other intangible assets

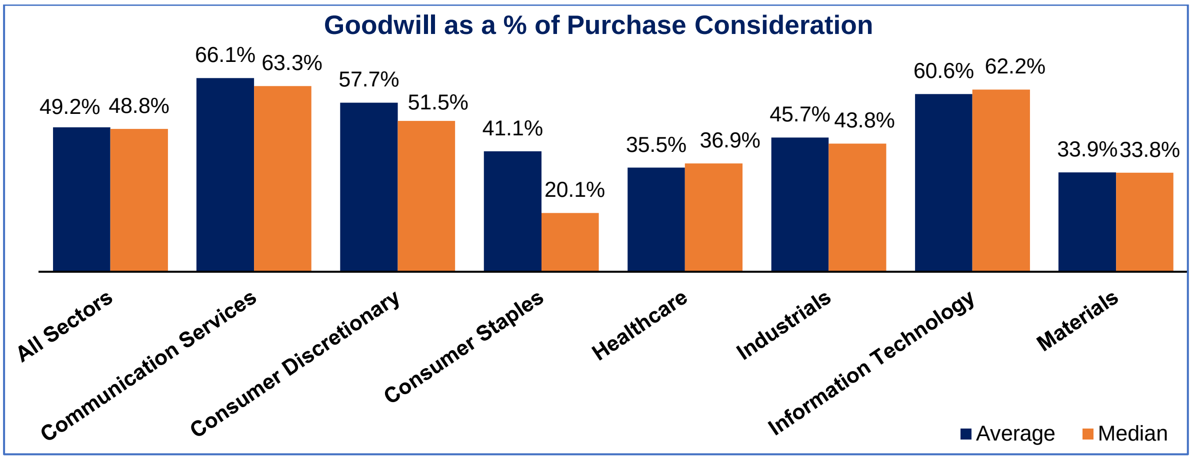
Goodwill relates to an asset representing the future economic benefits arising from a business, business interest or a group of assets, which has not been separately recognized in other assets.

Purchase Consideration	xxx
Less: Value of acquired tangible assets	(xxx)
Less: Value of acquired identified Intangible Assets	(xxx)
Goodwill	**xxx**

Insights from study of PPA from past transactions

Analysis of PPA recorded in past transactions could provide a good guidance on the key value drivers in different businesses. In the absence of any readily available studies on past Indian transactions in public domain in our understanding, we have presented inputs from internal analysis carried out by Unithos Business Advisors Private Limited (referred to herein as "Unithos") relating to domestic, inbound and outbound M&A transactions between FY2017 and FY2019. As part of this study, Unithos has analysed and shortlisted over 200 transactions wherein PPA is applicable and information is disclosed in the annual reports of the acquirers.

Overall Goodwill constitutes around 48.8 per cent (mean) to 49.2 per cent (median) of the purchase consideration across all industries during the period FY17 to FY19. This relates to the price paid by the acquirer for the future economic benefits arising from a business, business interest or a group of assets, which has not been separately recognized in other assets. This varies across sectors and normally the asset heavy businesses like manufacturing, healthcare where the underlying value creation is based on the physical assets, capacity and identified technology would record lower goodwill compared with service organizations who derive significant value from assembled workforce and higher valuations for future possible growth opportunities.



Sources: Secondary Research, Annual Reports, Venture Intelligence & Unithos Analysis

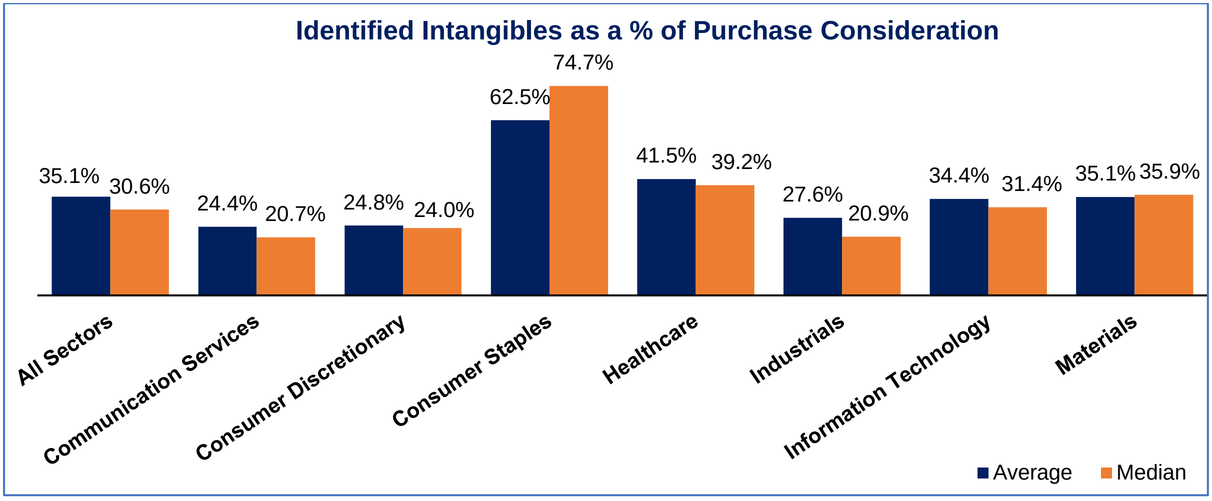
Note:

1. *Sector Classification is based on General Industry Classification Standards (GICS)*
2. *Bargain purchase transactions are not considered in the charts presented in this note*

In our sample analysis, around 12 per cent of the transactions recorded bargain purchase transactions where the fair value of assets acquired as part of the transaction is higher than the purchase consideration paid for such acquisition. We noted that Consumer Discretionary sector recorded the maximum number of bargain purchase transactions across sectors and Information Technology and Utilities sector the least. Such transactions are not considered in the charts presented in this note.

Overall identified intangible assets constitutes around 30.6 to 35.1 per cent of the total purchase consideration in M&A transactions across all industries during the period FY17 - FY19. This proportion varies across industries based on factors like nature of industry, business operational model, regulatory framework, level of competition, etc. within different sectors.

Transactions in select industries within the Consumer Staples sector like Household and Personal Products comprises significantly higher proportion of intangibles (mean and median of 62.5 per cent to 74.7 per cent) as compared to Communication Services and Industrials sector with relatively lower proportion of intangibles (mean and median in the range of 20.7 per cent to 27.6 per cent).



Sources: Secondary Research, Annual Reports, Venture Intelligence & Unithos Analysis
Note: *Sector Classification is based on General Industry Classification Standards (GICS)*

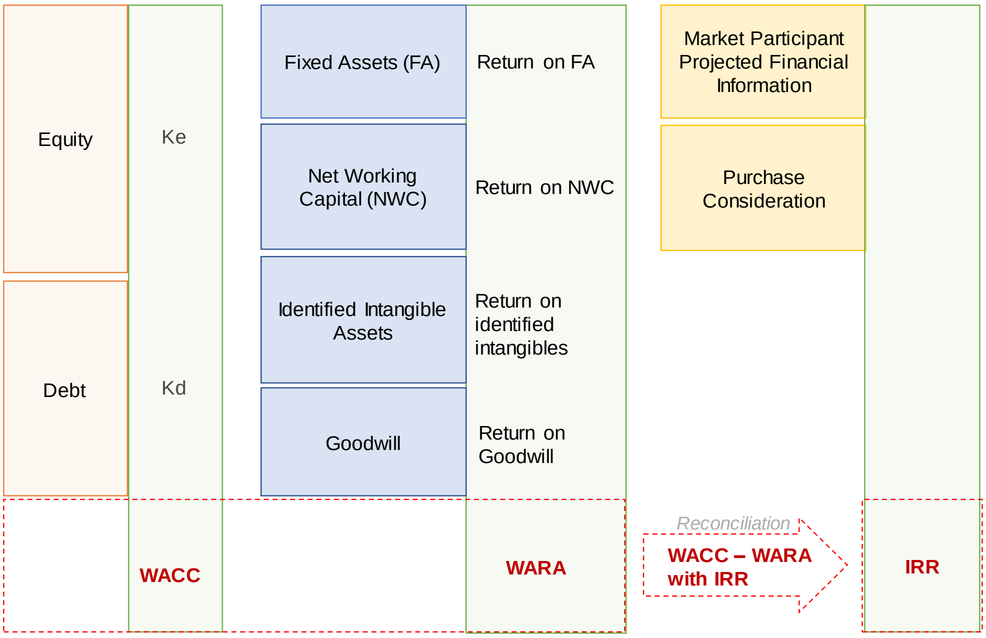
Useful life of Identified Intangible Assets

- Life of intangibles are normally analysed considering technical, economic and contractual factors
  - Management may take a call to record intangibles at a shorter life based on internal accounting policies, internal strategies for continued use for economic benefits.
  - Intangibles like non-compete are governed by the contractual terms in the transaction document.
- Normally the main value drivers of the business would have long lives establishing the very rationale for acquisition
- The acquired Intangible assets are amortised over the useful life of the asset
- In certain cases, Market related Intangibles have indefinite useful life. In these cases, the Intangible assets are tested for impairment on annual basis or as and when it is required

WACC – WARA reconciliation with IRR:

One of the key technical nuances of a purchase price allocation is to reconcile WACC-WARA with IRR:

- Weighted Average Cost of Capital (WACC) represents the rate of return required by the debt and equity stakeholders
- Weighted Average Return on Assets (WARA) represents the rate of return earned by the acquired assets
- Internal Rate of Return represents the rate of return in the transaction from the acquirer's perspective



- The interrelated nature of WACC and WARA, and its reconciliation with IRR is critical to the purchase price allocation and the failure to understand the relationship can lead to inaccurate discount rates
  - Contractual restrictions influencing life and valuation of intangibles
  - Assumptions relating to attrition rates of customers, vendors and employees
  - Use of the intangible (like brand, distribution network, IP, technology, etc.) from a market participant perspective
  - Valuation of non-compete involve subjective assessment of the ability and desirability of the sellers to compete post the transaction in the absence of non-compete clause in the agreement

Other technical nuances:

- Structure of the purchase consideration
  - Purchase consideration could be paid in lumpsum, can be deferred or contingent upon achievement of agreed criteria and/ or milestones with the seller(s)
  - Deferred consideration refers to amount agreed to be paid at a fixed date at a later point in time
  - Contingent consideration refers to amount to be determined and payable at a future date subject to achievement of agreed criteria/ milestones (such as achievement of future revenue, EBITDA, product release etc.)
- Assembled Workforce
  - Assembled workforce doesn't meet the definition of an identifiable intangible asset as it doesn't meet the contractual or separability criteria but acts as a contributing factor

in generating cash flows of other identifiable intangible assets

- Impairment of intangibles
  - Intangible assets with finite lives are amortized and assets with indefinite useful lives and intangible assets not yet available for use need to be tested for impairment at least annually or between annual tests whenever there is an indication of impairment
- Taxation aspects (TAB)
  - The tax benefits due to the amortization of intangible assets enhances the value of the intangible assets by the amount of the present value of tax savings
- Book Goodwill – link to Deferred Tax Asset and Liability
  - For tax purposes the write-ups/downs of the tangible and intangible assets are treated differently than the accounting treatment and this leads to the creation of Deferred Tax Asset/Liability

There is an increasing need for PPA analysis by various stakeholders of businesses:

- For Corporate Governance - To justify the price paid for the business combination
- For Accounting requirement - To support fair value reporting in the books of the Acquirer
- For pre-deal Valuation - For understanding constituents for the proposed deal
- For Taxation purposes – For ascertaining the depreciation of Intangible Assets

As an essence of the above analysis, PPA should normally reflect the acquirer's rationale for the transaction and involves subjective assumptions within the technical framework

PPA exercise involves subjective analysis of a given business/transaction and requires a deeper understanding of requirements from accounting, tax and valuation perspectives hence reference to past transactions is relevant besides consulting relevant subject matter specialists.

Disclaimers:

- *The contents of this note are for information purposes only. Any recipient of this document may choose to reproduce or redistribute this report for non-commercial purposes in part or in full to any other person with due acknowledgement of Unithos Business Advisors Private Limited ("Unithos").*
- *The observations, findings, analysis and conclusions presented in this document are entirely those of the author(s) and reference to the analysis of past transaction in India is based on study by Unithos (referred as the "Study"). Unithos has made every effort to use reliable and comprehensive information, but Unithos does not represent or assure or guarantee that the contents of this document are accurate and complete. This document has been prepared without regard to the objectives or opinions of those who may receive it.*
- *In preparing this study, our primary source has been publicly available information on the M&A/Private Equity transactions from databases, annual reports, corporate filing with stock exchanges in India or outside India and other general secondary research. We have considered the information from secondary sources to be reliable and have not independently verified the same.*
- *This document is prepared based on information available in the public domain until 30 September 2019. Kindly note this study is not updated for any information available post this date and any such updates or additional information could change the information herein and have an impact on the findings/ conclusions.*
- *This Study is targeted at providing a general understanding of the transactions and purchase price allocation from available information. This Study involves analysis, classifications, groupings which are subjective and different valuers/analysts/users may arrive at different conclusions based on the selection of transaction, approach for analysis, experience and personal judgement. NO copyright infringement is intended. This note forms an integral part of the document and Study.*
- *Reference to any notes or comments may not necessarily be verbatim of the accounting standard / any other regulations.*
- *Unithos or any of its partners, directors, associates, affiliates, retainers, employees or any member of its team does NOT accept any responsibility to anyone for the information contained in this document and in this Study.*

Acknowledgements:

- *Author would like to thank the team members at Unithos for assisting in the above analysis of transactions.*