Accounting for business combination: VALUING THE UNSEEN...

A study of purchase price allocation in India

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Foreword

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The adoption of Ind AS has significantly increased the focus on the principle of Fair Value Measurement (FVM), distinguishing it from the erstwhile Indian GAAP.

Ind AS 103 Business Combinations (Ind AS 103) transforms the way companies plan and execute their acquisition strategies. The new standard applies to most of the business combinations, including amalgamations and acquisitions. The change in accounting for business combinations calls for assets/liabilities (including intangible assets and contingent liabilities which did not exist on the balance sheet of target entities/businesses) acquired in a deal to be measured at fair value applying appropriate valuation methods and residual value allocated to goodwill/capital reserve.

Understanding the implications of Ind AS 103 is important since they not only affect future earnings and balance sheet of a company but may also have tax implications, questions from shareholders, etc. Further, in the era of intense auditor and regulatory scrutiny, this matter warrants careful attention.

Depending on the transaction structure, purchase price allocation (PPA) will also have relevance from income tax perspective, as tax treatment for different intangibles and goodwill could be different.

Ernst & Young Merchant Banking Services LLP’s Valuation, Modelling & Economics Services has undertaken a study of business combination accounting for transactions that were disclosed in annual reports of top 500+ listed companies in India by market capitalization since implementation of Ind AS till 31 March 2020. The results of type of assets (primarily various intangible assets) that a company typically recognizes and reports in an acquisition are presented in this study. However, the results of this study cannot be viewed in isolation.

Our Valuation, Modelling & Economics Services professionals are available to provide further insight on this, or on any other valuation topic, should you have any questions.
**Fair value accounting of business combination and its manifold implications**

- **Investor communications**
- **Amortization charges**
- **Tax implication**
- **Risk of impairment**
- **Finite vs. infinite life**
- **Return ratios**
- **Size of balance sheet**
- **Intangibles vs. goodwill**
- **Earnings per share**

**Goodwill: an important element**

**Factors justifying goodwill**

- **Synergies**
  - Operating
  - Marketing
  - Administrative
  - Tax
  - Purchasing power

- **Organization model**
  - Well-functioning organization
  - Business processes and routines
  - Overlapping assets from market participant perspective

- **Workforce**
  - Skilled workforce
  - Technical skills and efficiencies of the employees

**Key findings**

Based on the study, 31% of the enterprise value of the acquired companies was allocated to identified intangible assets and 34% was attributable to goodwill, with the allocation varying considerably from industry to industry.

In sectors like consumer products, life sciences, information technology (IT), information technology enabled services (ITeS) and retail, majority of the deal value is allocated to intangible assets, reflected by the underlying products, brands, intellectual property and customer relationships.

For sectors like real estate and hospitality, and energy, which are capital intensive, more than two-third of the enterprise value is allocated to tangible assets.

**Number of intangibles identified**

- In 20% of the transactions analyzed, no intangible asset was recognized. These transactions majorly originated from asset heavy sectors such as metal, real estate and hospitality, and energy.
- Transactions where more than two intangible assets were identified majorly belonged to sectors like life sciences, IT, ITeS and consumer products.
### Frequency of intangible assets recognized by sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of transactions</th>
<th>Brand/Trademark/IPR</th>
<th>Software/Technology/platform/design/know-how</th>
<th>Customer contract/relationship</th>
<th>Dealer network</th>
<th>Non-compete agreement</th>
<th>License and rights</th>
<th>Other intangibles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive and ancillaries</td>
<td>24</td>
<td>29%</td>
<td>38%</td>
<td>21%</td>
<td>4%</td>
<td>21%</td>
<td></td>
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</tr>
<tr>
<td>Chemicals</td>
<td>21</td>
<td>43%</td>
<td>33%</td>
<td>29%</td>
<td>5%</td>
<td>33%</td>
<td>5%</td>
<td>29%</td>
</tr>
<tr>
<td>Consumer products</td>
<td>37</td>
<td>68%</td>
<td>22%</td>
<td>19%</td>
<td>14%</td>
<td>8%</td>
<td>3%</td>
<td>8%</td>
</tr>
<tr>
<td>Energy</td>
<td>18</td>
<td>6%</td>
<td>28%</td>
<td>17%</td>
<td>22%</td>
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<tr>
<td>Financial services</td>
<td>12</td>
<td>25%</td>
<td>42%</td>
<td>33%</td>
<td>8%</td>
<td>17%</td>
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<tr>
<td>Healthcare</td>
<td>10</td>
<td>30%</td>
<td>30%</td>
<td>50%</td>
<td>10%</td>
<td>10%</td>
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<tr>
<td>Industrial products</td>
<td>35</td>
<td>14%</td>
<td>23%</td>
<td>31%</td>
<td>23%</td>
<td>9%</td>
<td>14%</td>
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</tr>
<tr>
<td>IT</td>
<td>59</td>
<td>39%</td>
<td>39%</td>
<td>78%</td>
<td>2%</td>
<td>20%</td>
<td>2%</td>
<td>14%</td>
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<tr>
<td>ITeS</td>
<td>41</td>
<td>49%</td>
<td>39%</td>
<td>83%</td>
<td>2%</td>
<td>22%</td>
<td>2%</td>
<td>17%</td>
</tr>
<tr>
<td>Life sciences</td>
<td>59</td>
<td>76%</td>
<td>24%</td>
<td>12%</td>
<td>3%</td>
<td>12%</td>
<td>10%</td>
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</tr>
<tr>
<td>Media and entertainment</td>
<td>12</td>
<td>33%</td>
<td>42%</td>
<td>25%</td>
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<tr>
<td>Retail</td>
<td>5</td>
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<td>40%</td>
<td>20%</td>
<td>20%</td>
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<tr>
<td>Real estate and hospitality</td>
<td>16</td>
<td>6%</td>
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<td>13%</td>
<td>6%</td>
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<td></td>
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<tr>
<td>Services</td>
<td>22</td>
<td>27%</td>
<td>23%</td>
<td>41%</td>
<td>23%</td>
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<td>50%*</td>
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<tr>
<td>Total</td>
<td>371</td>
<td>41%</td>
<td>30%</td>
<td>38%</td>
<td>3%</td>
<td>13%</td>
<td>7%</td>
<td>16%</td>
</tr>
</tbody>
</table>

- 0% < 15% | Between 15% to 30% | Between 30% to 45% | Above 45%

*Other intangibles in services sector appears higher as break-up of intangibles was not adequately disclosed.

Note: Sectors classified as “Others” are not considered in the analysis.

Marketing-related intangibles were the key acquisition driver in the consumer products and life sciences sector.

Customer-related intangibles seem to be the acquisition driver in IT/ITeS sector. Though the frequency of marketing-related intangibles is high, the proportion of value allocated to such intangible is lower for the ITeS sector.

### Allocation within intangible assets

The average allocation of an intangible asset’s value within different types of intangible assets (excluding goodwill), recognized amongst sectors is tabulated below:

<table>
<thead>
<tr>
<th>Allocation within intangible assets</th>
<th>Sector wise</th>
<th>Brand/Trademark/Product/ANDA*</th>
<th>Technology/platform/design/know-how</th>
<th>Customer contract/relationship</th>
<th>Dealer network</th>
<th>Non-compete agreement</th>
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<td>2%</td>
<td>17%</td>
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<tr>
<td></td>
<td>Consumer products</td>
<td>64%</td>
<td>5%</td>
<td>13%</td>
<td>5%</td>
<td>3%</td>
<td>9%</td>
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<td></td>
<td>Healthcare</td>
<td>34%</td>
<td>16%</td>
<td>44%</td>
<td>0%</td>
<td>4%</td>
<td>1%</td>
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<tr>
<td></td>
<td>Industrial products</td>
<td>15%</td>
<td>16%</td>
<td>36%</td>
<td>15%</td>
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<td>ITeS</td>
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<td>12%</td>
<td></td>
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</tbody>
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*ANDA: Abbreviated New Drug Application

Note: Sectors classified as “Others” are not considered in the analysis.

Allocation of the value to dealer network is amongst the lowest, implying that it is not a key driver for acquisitions, though considered a critical element for many industries.

Generally, non-compete agreement is a part of most acquisitions as a safeguard to the buyer. However, allocation of value to non-compete agreement is on the lower side – possibly indicating either a shorter life or probability/impact of competition is perceived to be minimal.

This study is based only on annual reports of top 500+ listed companies in India by market capitalization from FY17 to FY20. Transactions with enterprise value less than INR100 million and with goodwill more than 100% of the enterprise value were ignored. A total of 396 transactions were found where adequate information about PPA was disclosed. Appropriate assumptions were considered with regard to classification of intangibles where full information was not disclosed. For certain transactions, only the total value was disclosed for all intangible assets recognized. For such transactions, value of intangible assets was classified under other intangible assets.

Results are presented as percentages of enterprise value. If cash and cash equivalent is not disclosed, gross debt is assumed as net debt.

### Methodology

Marketing-related intangibles were the key acquisition driver in the consumer products and life sciences sector.

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