UNIT – XII

VALUATION FOR THE PURPOSE OF FINANCIAL STATEMENT (REVALUATION IN BOOKS OF ACCOUNT)

Introduction:

The accounting process provides information that management, creditors, investors, and other interested parties use to evaluate the success and efficiency of company. A Company has many types of assets and each type is reported in separate account. Every account has its own name. Assets of a company include cash, inventory, property, plant, machinery and equipment.

In an economy where price increase (inflation) is phenomenal, certain inherent limitations of historical cost-based accounting become apparent. The first and foremost thing, the monetary unit (rupee in India) which is used as a standard of measurement itself shrinks in value as the prices increase. The historical cost-based accounting ignores this shrinkage in the rupee as a measuring rod and keeps adding transactions which are represented by rupees of differing value over a period of time.

Due to inflation, historical cost based accounting depicts a considerable understatement in the operating capital and exaggerated and illusory profits. In an inflationary trend, depreciation based on historical cost is evidently not sufficient to maintain the operating capability of the enterprise. This results in an overstatement of profit inasmuch as the inventories consumed are also valued at their historical cost and not at current prices. On the other hand in the event of decline in the prices there is an understatement of profit. In order to avoid this and to give true and fair view of balance sheet periodical valuation of assets is desirable.

Where the fair value model is applied for the recognition of property assets in the balance sheet, International Accounting Standards require current revaluation of the assets.

12.0 OBJECTIVES

By the end of this chapter, the students will learn about –

- Financial statements
- Purpose of revaluation
- Process of revaluation
- Issues involved in valuation
- IVS on Valuation for financial reporting
- IAS 16 requirement for valuation
- Approach to valuation
- Treatment of revaluation reserve
- ICAI guidance note on revaluation

12.1 Meaning Objective of Financial Statements

Financial statements are the basic and formal means through which the corporate management communicates financial information to various external users. A complete set of financial statements normally includes balance sheet, profit and loss account, cash flow statement and explanatory notes and schedules thereof. Earlier cash flow statement was not considered as part of the financial statements in India. In June 1995, the Securities and Exchange Board of India (SEBI) required inclusion of cash flow statement in the set of corporate financial statements of the listed companies. Subsequently, the Institute of Chartered Accountants of India has also scrapped the Accounting Standard-3 "Changes in Financial Position" and issued a revised Accounting Standard-3 "Cash Flow Statements" in March 1997. In some countries, financial statements also include earning per share statement.

Preparation and presentation of corporate financial statements are governed by the company law and accounting standards. In case an accounting issue is neither covered by the company law nor by the accounting standard, it is possible to consider Statements and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI). International Accounting Standards can also provide useful guideline on certain issues wherein national accounting standards are either silent or there is no national accounting standard.

The objective of financial statement is to provide information about the financial position, performance and change in cash flow position of the reporting entity, which are useful to a wide range of users in making economic decisions and in discharge of accountability of the management towards the shareholders and other interest groups.

12.2 Users of Financial Information

At the international level the users of the financial statements include –

(i) present and potential shareholders,
(ii) employees,
(iii) lenders,
(iv) suppliers and other creditors,
(v) customers,
(vi) government and its agencies,
(vii) the public.

Users' information needs

Three important financial characteristics in which almost all the user – groups have general interest, of course, for different reasons, are **solvency, liquidity and profitability**. Solvency indicates ability of the reporting entity to meet its obligations in the long run and to continue operations at least in the same scale in the foreseeable future. Liquidity indicates ability of the reporting entity to meet all its current obligations as and when fall due. In other words, liquidity implies short term solvency. Profitability indicates earning capability of the reporting entity either in relation to revenue or assets or capital employed.

12.3 Qualitative Characteristics of Financial Statements

Sub-sections (1) and (2) of section 211 of the Companies Act, 1956 state the fundamental characteristics of the financial statements. As per this section every Balance Sheet should give a true and fair view of the statement of affairs of the company at the end of the financial year, and every Profit and Loss Account should give true and fair view of the profit and loss of the company for the financial year. Here the term financial year implies an accounting year of the company. Thus as per the company law 'truth and fairness' is a fundamental qualitative characteristic of financial statements. The proposed Directors' Responsibility Statement is a step to ensure "truth and fairness" in the financial statements.

The International Accounting Standards Committee in their document Framework for the Preparation and Presentation of Financial Statements have identified Four principal qualitative characteristics. These are –

- Understandability,
- Relevance,
- Reliability,
- Comparability.

Understandability

Information provided through financial statements should be understandable to the users of accounts, especially to shareholders and the public in general, who are common men.

Relevance

Information which are required to be disclosed statutorily are considered relevant to the users. This is because the legal requirements of disclosure are set after having a thorough public debate.

Reliability

A piece of information possesses quality of reliability if it is free from material error and bias. Even if particular information is relevant, it cannot be of use unless it is reliable. Reliability depends on –

- Faithful representation,
- Neutrality,
- Prudence, and
- Completeness

Comparability

Comparability is judged from the angles of inter-firm comparison. Users should be able to compare the financial statements information of the same entity over the periods (intra-firm comparison) and also they should be able to compare financial statements information of the reporting entity with that of the other entities (inter-firm comparison). Accordingly, it is necessary to follow standardized accounting policies consistently to the extent possible.

12.4 Purpose of Revaluation of Fixed Assets

Accounting data are mostly generated using historical cost valuation base. In an inflationary environment it is highly likely that the net book value of fixed assets mentioned in books of account do not reflect their current costs. It is possible that value of some fixed assets has impaired and their current values fall below the written down historical costs. It is also possible that current values of some fixed assets are much more than the written down historical costs. In both the occasions net asset value of equity is not correctly reflected. Periodic revaluation of fixed assets is, therefore, considered necessary to reflect the current value of fixed assets.

Presenting fixed assets at historical cost in an inflationary environment is improper to reflect their real value.

Historical cost balance sheet fails to reflect true and fair view of the state of affairs of the reporting entity. Periodic revaluation of fixed assets to reflect their current value is not prohibited in the company law.

Following are the purposes for revaluation of fixed assets:

a) To show the true rate of return on capital employed.
b) To conserve adequate funds in the business for replacement of fixed assets at the end of their useful lives. Provision for depreciation based on historic cost will show low depreciation and therefore inflated profits and lead to payment of excessive dividends.
c) To show the fair market value of assets which have considerably appreciated since their purchase such as land and buildings.
d) To negotiate fair price for the assets of the company before merger with or acquisition by another company.
e) To enable proper internal reconstruction, and external reconstruction.
f) To issue shares to existing shareholders (rights issue) or for an external issue of shares (public issue of shares).
g) To get fair market value of assets, in case of sale and leaseback transaction.
h) When the company intends to take a loan from banks/financial institutions by mortgaging its fixed assets, proper revaluation of assets would enable the company to get a fair amount of loan.
i) Sale of an individual asset or group of assets, at fair market value.

12.5 Process of Revaluation

Revaluation is commonly done through appraisal by competent valuers. Sometimes revaluation may be done using price index appropriate to the concerned fixed assets. Para 13.3 of Accounting Standard 10 (AS-10) states that revalued amount of fixed assets are presented in the financial statements by restating the gross book value and accumulated depreciation. It is also recorded by restating net book value adding therein net increase on account of revaluation.

However, Schedule VI to the Companies Act, 1956 requires that where sums have been added by writing up the assets, every balance sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of writing up shall also show the amount of increase made. For every fixed assets it is required to show (i) original cost, (ii) additions thereto and deductions there from during the year, and (iii) total depreciation written off or provided for upto the end of the year. Accordingly, as per Company law additions to original cost by revaluation should be disclosed.

Selective revaluation

It is not judicious to revalue the fixed assets selectively. This process may result in misleading valuation.

Para 27 of AS-10 requires that when a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis.

12.6 Valuation for Financial Statements

The main purpose of the financial statements of an undertaking is to disclose information showing the sources of raising funds, the manner in which they have been utilized and the extent to which such utilization has resulted in profits or losses during a period. A balance sheet shows in monetary terms the following financial components of a company:

- Capital
- Reserves
- Loans
- Other Liabilities

On a specific date it is prepared, it discloses how the total funds so raised have been distributed over several categories of assets. The profit and loss account on the other hand is a statement which indicates how the profits have been earned or losses have been incurred during a certain time interval, normally one accounting year of twelve months. All transactions in balance sheet as well as the profit and loss account are computed on a historical cost basis.

In an economy where price increase (inflation) is phenomenal, certain inherent limitations of historical cost-based accounting become apparent. The first and foremost thing, the monetary unit (rupee in India) which is used as a standard of measurement itself shrinks in value as the prices increase. The historical cost-based accounting ignores this shrinkage in the rupee as a measuring rod and keeps adding transactions which are represented by rupees of differing value over a period of time.

Due to inflation, historical cost based accounting depicts a considerable understatement in the operating capital and exaggerated and illusory profits. In an inflationary trend, depreciation based on historical costs is evidently not sufficient to maintain the operating capability of the enterprise. This results in an overstatement of profit in as much as the inventories consumed are also valued at their historical cost and not at current prices.

Another drawback of the historical cost based accounting is that by showing assets at their historical costs, the balance sheet does not reflect the current worth of the enterprise.

Numbers of proposals have been offered to reduce the limitations of the conventional system of accounting and to recognize the effects of changing prices on the financial statements. Though there is no consensus on solution yet reached on this matter, the professional accounting bodies in India, U.K., U.S.A. and International Accounting Standards Committee have issued a number of guidelines suggesting use of different methods of accounting for changing prices.

The practicing valuers must familiarize themselves with the following three methods used for accounting for changing prices:

- Periodical revaluation of fixed assets
- Current purchasing power accounting method
- Current cost accounting method

Periodical revaluation of fixed assets

Many undertakings have resorted to periodic revaluation of fixed assets in order to keep their operating capability more or less intact. This is achieved by ascertaining net current replacement cost at regular intervals of say, 3 to 5 years by experts. There is a constant tendency of the economy to travel along an inflationary track although waves of inflation and deflation may intermittently punctuate the traveling path. The adoption of periodical revaluation of fixed assets is a reasonable approach. It is true that in a high inflation trend, regular revaluation at the intervals of say, five years, may not serve the purpose of maintaining the operating capability of an enterprise.

In a situation of rising price level and erosion of the value of currency, it is important to trace the real value of assets including inventories so that the actual operating cost may be ascertained with precision. Periodic revaluation of fixed assets including inventories in old stock is an attempt to update the worth of operating capability by a rational analysis of input as well as output. Otherwise, fixed assets and inventories at historical cost tend to present an undervalued input and illusory profit in terms of output calculated at a current price. Accordingly, in a high inflationary trend, regular revaluation, say, every three to five years, may serve the purpose of reflecting a reliable operating capability of an enterprise.

Current Purchasing Power Accounting (CPPA)

The current purchasing power accounting system is an exercise to tune the inflationary effect with an accounting cure that is systematic and continuous. The method seeks to convert the historical rupees into uniform rupees as at the date of balance sheet. In other words, the financial statements of the undertaking is sought to be restated in terms of units of equal purchasing power. The index used for the purpose is that of consumer goods prices or price level in general. The value of currency is the reverse of the price index. The historical cost figures are converted to the present level by applying a multiplier or conversion factor arrived at by a ratio as between the index at the date of conversion and that at the date of transaction.

In this way, the shortcomings of money as a measuring rod during the periods of price changes may be substantially removed and the problem of gradual depletion of operating capital of an enterprise during the period of inflation may be counteracted by preparing the balance sheet on a CPPA basis.

Current Cost Accounting (CCA)

This method seeks to –

- State the assets and liabilities in the balance sheet at their current value, i.e. value as at the date of balance sheet;

- Measure the profit or loss after matching current costs with current revenues; and incidentally;
- Remove the distortions of summing up rupees of different values.

12.7 Revaluation in Books of Account

- The value of real estate is intended to reflect its worth to an undertaking, which is expected to continue in operation for the foreseeable future. The basis of valuation will be based upon its value on the assumption that the real estate will continue in its present existing use in the business of the company.

- All financial statements are prepared on the basis of the concept of a 'Going Concern' which means that the business entity will continue its operation in the foreseeable future, and will also continue to generate profits.

- It is important to be assured that the enterprise has neither the intention nor the necessity of liquidation nor of curtailing materially the scale of operation.

- The term 'Going Concern' is an accounting concept and accounting assumption. It is derived from capitalization of profits of the business reflecting turnover and assets and liabilities, including contingent liabilities. The capacity of the assets being important in business, the earning potential of the asset is considered as the basis on which valuation of the business is arrived at. A business may be treated as a 'Going Concern' so long as the earning capacity of the business is at least equal to a fair return on an investment equal to, at a minimum, the liquidation value of the net assets of the business.

- The earnings considered may be the past earnings, projected earnings, realized earnings and cash flows. Earnings / cash flows are capitalised (discounted) to arrive at a business value.

- The surplus assets of the company should be identified and valued on Market Value for highest and best use.

12.8 International Valuation Standard Committee (IVSC) – About Valuation for Financial Reporting

International Valuation Standard Committee has published **International Valuation Application 1 – Valuation for Financial Reporting (Revised and Adopted in 2005).**

The important points discussed in International Valuation Application 1 – Valuation for Financial Reporting are as under:

- Material for this Application is drawn from International Financial Reporting Standards (IFRSs) published by the International Accounting Standards Board (IASB).

- The objective of this Application is to explain the principles that apply to valuations prepared for use in financial statements and related accounts of business entities. Valuers undertaking work of this nature should have an understanding of the accounting concepts and principles underlying the relevant International Accounting Standards.

- The Valuer's adherence to market-based definitions, objectivity, and full disclosure of relevant matters within a pertinent and user-friendly format are fundamental to the requirements of valuation for financial reporting.

- This Application applies to all valuations of asset classes included in any financial statement, which fall within the skills and expertise of Valuers.

- **Important definitions as per IVS**

  - <u>Market Value</u>
    The estimated amount for which a property should exchange on the date of valuation between a willing buyer and willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion (IVS 1, para. 3.1)

  - <u>Depreciated Replacement Cost</u>
    The current cost of reproduction or replacement of an asset less deductions for physical deterioration and all relevant forms of obsolescence and optimization.

- <u>Improvements</u>
  Buildings, structures or modifications to land, of a permanent nature, involving expenditures of labour and capital, and intended to enhance the value or utility of the property. Improvements have differing patterns of use and economic lives.

- <u>Specialised Property</u>
  A property that is rarely, if ever, sold in the market, except by way of sale of the business or entity of which it is part, due to uniqueness arising from its specialized nature and design, its configuration, size, location, or otherwise.

- <u>Carrying Amount</u>
  The amount at which an asset is recognized after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon (IAS 36, para. 6).

- <u>Depreciation</u>
  The systematic allocation of the depreciable amount of an asset over its useful life. (IAS 16, para. 6; IAS 36, para. 5)

- <u>Revalued Amount</u>
  The fair value of an asset at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. (IAS 16, para. 31)

- <u>Property, Plant and Equipment</u>
  Tangible items that –

  (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes;

  and

  (b) are expected to be used during more than one period. (IAS 16, para. 6)

- <u>Value in Use</u>
  The present value of the future cash flows expected to be derived from an asset or cash-generating unit (IAS 36, para. 6)

- <u>Useful Life</u>
  Either

(a) the period over which an asset is expected to be available for use by an entity;

or

(b) the number of production or similar units expected to be obtained from the asset by an entity. (IAS 16, para.6; IAS 36, para. 6; IAS 38, para. 8)

In regard to leases, useful life is defined as :

The estimated remaining period, from the commencement of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity. (IAS 17, para. 4)

- Economic Life

  Either

  (a) the period over which an asset is expected to be economically usable by one or more users;

  or

  (b) the number of production or similar units expected to be obtained from the asset by one or more users. (IAS 17, para. 4)

- Impairment Loss

  The amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount (IAS, para. 6).

- This application applies the principles developed in IVS 1, IVS 2, and IVS 3 to the requirements of IASs/IFRSs.

- This application focuses on valuation requirements under IAS 16, Property Plant and Equipment; IAS 17, Leases; and IAS 40, Investment Property. Reference is also made to valuation requirements under IAS 36, Impairment of Assets; IAS 2, Inventories; and IFRS 5, Non-current Assets held for Sale and Discontinued Operations.

- Classification of Assets

  Valuers shall obtain from the directors of the owning entity a list of assets to be valued, designating them as operational assets, i.e., assets requisite to the operations of the entity, or non-operational assets, being properties held for future development, investment, or assets surplus to the operations of the entity.

- Applicable Standards

  The classification of assets determines which IAS or IFRS applies. IAS 16 requires non current property and plant assets held for the production or supply of goods or services to be recognized initially in the balance sheet at cost and thereafter carried in accordance with either the cost model or fair value model. Other accounting standards that require or permit the valuation of tangible assets include:

  - Investment Property – IAS 40
  - Lease – IAS 17
  - Impairment to Assets – IAS 36
  - Inventories – IAS 2
  - Business Combinations – IFRS 3
  - Non current Assets held for Sale and Discontinued Operations – IFRS 5

- **IAS 16, Cost and Fair Value**

  - IAS 16 deals with the Cost Model in paragraph 30 as follows:
    "After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses."

  - The Fair Value Model, which requires regular revaluations, is explained in paragraph 31 as follows:

    "After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date."

  - Financial statements are produced on the assumption that the entity is a **going concern** unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so (IAS 1, para 23). This assumption therefore underlies the application of fair value to property plant and equipment, except in cases where it is clear that there is either an intention to dispose of a particular asset or that option of disposal has to be considered, e.g. when undertaking an impairment review.

- **Valuations under IAS 16**

Where an entity adopts the fair value revaluation option under IAS 16, the assets are included in the balance sheet at their fair value as follows:

(a) "**The fair value of land and buildings is usually determined from market-based evidence** by appraisal that is normally undertaken by professionally qualified valuers. **The fair value of items of plant and equipment is usually their market value** determined by appraisal". (IAS 16, para. 32)

(b) **"If there is no market-based evidence of fair value because of the specialized nature of the item of property, plant and equipment and the item is rarely sold, except as a part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach". (IAS 16, para. 33)**

- IVSC considers that a professional Valuer undertaking an appraisal for this purpose should report the market Value of the asset. Any assumptions or qualifications made in applying Market Value should be discussed with the entity and disclosed in the report.

- The valuation conclusion shall be reported in accordance with IVS 3, Valuation Reporting. Valuers shall ensure that reports include sufficient information for the entity to meet the requirements of IAS 16, para. 77, when preparing financial statements:

  (a) the effective date of the revaluation;
  (b) whether an Independent Valuer was involved (Note, IVSC interprets this as an External Valuer);
  (c) the methods and significant assumption applied;
  (d) the extent to which the values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms, or were estimated using other valuation techniques

- **Surplus Assets – IFRS 5**

  Under IFRS 5, Non current Assets held for Sale and Discontinued Operations, surplus assets are to be separately identified. Such assets may be accounted for individually or as a "disposal group", i.e., a group of assets to be disposed of together, by sale or otherwise, and the liabilities directly associated with those assets that will also be transferred in the transaction.

12.9 Approach to Valuation for the purpose of Financial Statements

Market Approach

Market approach is particularly applied with regard to the assets having established markets for buying and selling. Value of the asset in question is derived by the comparison of sales of similar assets sold recently in the related locality and relative merits and demerits of sales instances are compared with the asset in question. Market data is an essential pre-requisite for application of market approach to valuation.

Cost Approach

The cost approach rests mainly on the principles of substitution. In this approach, the replacement cost is at first ascertained, wherefrom total depreciation during the age of the asset is deducted by giving due regard to physical deterioration, functional, technological and economic obsolescence.

The cost approach is applied primarily to assets which are not frequently exchanged in the market or do not generate revenue by themselves. The logic behind this approach is that a prudent investor would pay no more than the cost of producing a substitute asset with the same utility.

Building and Structures of the majority of Industrial Units are of specialized natures and have the utility restricted to particular user or users, and are rarely, if ever sold in the open market except by way of sale of the business or entity of which it is part, due to uniqueness arising from its specialized nature and design, its configuration, size, location otherwise. Therefore, in majority of cases cost approach to valuation is to be adopted.

12.10 Treatment of Revaluation Reserve

- Para 30 of AS-10 requires that an increase/decrease in book value arising on revaluation of fixed assets should be credited/debited directly to owners' interests under the head revaluation reserve.
- Direct Transfer to Profit and Loss Account

In case the concerned fixed asset was earlier revalued downward and the loss was charged to profit and loss account, revaluation profit arising out of current revaluation may be transferred to profit and loss account. However, maximum amount of revaluation profit that can be transferred to profit and loss account is restricted to the amount of loss earlier written off.

Para 26 of AS-6 (Revised) requires that where depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. A separate disclosure is necessary if revaluation has material effect on depreciation.

12.11 Important Aspects of ICAI Guidance Notes on Treatment of Reserve created on Revaluation of Fixed Assets

- As per ones view revenue is deemed to have arisen when it is actually collected or when justifiable claim to collect it arises or when there is knowledge and evidence that it is capable of being collected if a sale were to be made. This is true for current assets and fixed assets. Accordingly, revaluation reserve cannot be considered as unrealized reserve.

- The other view is that revaluation reserve is created by book adjustment only.

- As per section 205 of the Companies Act, 1956, a company can declare and pay dividend after providing depreciation, arrear depreciation for any of the earlier years and setting off loss. If accumulated losses and arrear depreciation are adjusted against revaluation reserve, this is not proper adjustment. The distributable profit is overstated in that process. Accordingly accumulated losses or arrears of depreciation should not be set-off against Revaluation Reserve.

- Depreciation is required to be provided with reference to the total value of the fixed assets as appearing in the accounting after revaluation. However, for certain statutory purposes e.g., dividends, managerial remuneration etc., depreciation is relatable to historical cost.

- Taking transfer from Revaluation Reserve to cover extra depreciation arising out of revaluation of fixed assets is allowed. However, it is prudent not to take such transfer.

- Revaluation reserve is not available for payment of dividend.

12.12 Conclusion

The estimation of Market Value for the purpose of Financial Statement is based on the principle of Value to the Business and Value to the Owner. The owner of the business should know the real worth of his assets and can analyse whether the investment made in the fixed assets generate any return in real terms or not and can take bold decision as far as the management of the assets is concerned and this will help him to design the future business policy in much better way.

12.13 Exercise:

1. What is Financial Statement of the company and what is its objective?
2. Who are the users of Financial Statement and what are the qualitative characteristics of Financial Statement?
3. What are issues involved in valuation of plant and machinery for revaluation in books of account?
4. Write short note on Revaluation Reserve.