Demystifying IFRS

“Fair Value” Issues

How CFOs of unlisted entities in KSA should gear themselves up?

INTRODUCTION

In 2017, the Kingdom of Saudi Arabia (KSA) joined a set of 130+ countries by adopting IFRS for listed entities. This was a big step by the Saudi Organization for Certified Public Accountants (SOCPA) to strengthen the regulatory framework and send a clear signal to international investors. The SOCPA recognizes the significance of having a sound financial reporting framework aligned with global standards to attract foreign investment, which is critical to diversify the economy, a key goal of the country's Vision 2030.

By implementing IFRS for listed companies in 2017, KSA crossed the first critical milestone. On December 31, 2018, the first reporting period under IFRS for unlisted companies in KSA took effect. Fair value measurement is one of the most crucial elements within the IFRS framework. Unlisted companies across sectors are likely to face some challenges in migrating to fair value accounting for assets and liabilities. However, benefits in the medium to long term, including improved management reporting and better access to growth capital, would prompt companies to embrace the standards.

Unlisted companies have the option to adopt IFRS for SMEs, instead of adopting it in entirety. This will significantly lessen the compliance burden on entities and provide them more room to exercise their judgement in terms of complying with fair value provisions.

The objective of this publication is to assist CFOs in understanding and dealing with the challenges pertaining to valuation that fair value provisions under IFRS for SMEs will throw, specifically focusing on equity investments. The publication will also be of relevance to private equity and venture capital firms that need to restate their investment portfolios at fair value under IFRS.

I hope it will provide you clarity on complying with year-end reporting requirements. If you have any questions, please feel free to connect with us.

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TABLE OF CONTENT

IFRS for SME:
Genesis & Application

IFRS for SMEs developed to address international demand for simpler standards

IFRS for general purpose financial statements were primarily designed for large firms with public accountability that are generally listed in public markets. Like all financial reporting standards, the focus is on the users of financial statements, with the objective to facilitate informed decision-making.

IFRS for small and medium-sized entities (SMEs) were introduced to specifically address the main stakeholders of financial statements of SMEs that are very different from the users of listed entities.

- The users of financial statements of unlisted companies are believed to be closer to the entity and have better understanding of the business.
- Generally, they are better positioned to ask questions to the entity directly.

Moreover, the financial statements of SMEs are usually less complex; therefore, complying with full IFRS can be highly overwhelming for these entities, considering the much lesser resources at their disposal normally.

IFRS for SMEs simplified to achieve cost-benefit balance for entity

The IFRS for SME document is self-contained and independent of the full IFRS. The language is simpler and only issues pertinent to SMEs are detailed. Also, disclosure requirements have been reduced by up to 90%.

Conclusive definition of SME for adopting the said standards to be determined by local jurisdiction

The typical definition of an SME changes depending on the national or regional jurisdiction. Within one jurisdiction too, the version may vary to suit different purposes, based on several criteria: revenue, assets, employees and others.

While the ultimate decision regarding which entities are eligible to adopt IFRS for SMEs rests with local regulatory authorities, the definition of SME as per IFRS is structured around the absence or lack of public accountability. An entity has public accountability if:

- Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market; or
- It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

By the second criteria, most banks, insurance companies, mutual funds and investment bank will be presumed to have public accountability and hence will not be eligible to adopt IFRS for SME[1] .

1 However, it is not the intention of IASB to exclude entities who hold assets in fiduciary capacity for outsiders such as clients as incidental to their primary business (e.g. real estate agents, travel agents, others)

Key Fair Value Provisions

SMEs need to recognize most equity investments in other entities at fair value

Similar to full IFRS, under IFRS for SMEs, the classification criteria to determine the recognition and measurement model of an entity's investment in financial instruments[2] is based on its ability to control or exercise influence over the investee entity.

Investments in investee entities where an entity does not have the ability to exercise control or significantly influence the entity fall under Section 11: Basic Financial Instruments[3]. Section 11 requires measurement on subsequent recognition at fair value if such investments are in non-convertible preference shares or non-puttable[4] ordinary or preference shares.

Entity precluded from recognizing fair value if measurement involves undue cost or effort

If the equity investments eligible for measurement at fair value are not publicly traded, an entity may invest certain resources (for example, time and effort of employees) in researching relevant data and compiling necessary information to calculate the fair

2 A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

3 A compound financial instrument is a financial instrument that has the characteristics of both an equity and liability (debt).

4 A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

value. Alternatively, it could engage an outside valuation consultant for a fee to support fair value determination.

How far the cost or effort involved in obtaining the information necessary to arrive at fair value is warranted will be determined based on specific circumstances and the decision of the management. The standards require that the management, while making the judgement, factors in the probable impact on the economic decisions of users in a scenario where they do not have information related to fair value.

Please note that full IFRS do not encompass any concept of undue cost or effort exemption since it holds good for entities that generally have public accountability.

Even while the assessment of undue cost or effort presents a lesser hurdle to SMEs, the management would do well to make an objective assessment from the perspective of balancing cost and benefits.

Implications and Benefits of Fair Value for KSA Entities

The adoption of IFRS in Saudi Arabia indicates a major shift on the part of regulators to put the country's financial ecosystem on the right track and achieve the level of maturity desired for economic diversification. With the implementation of IFRS for listed companies in 2017, KSA crossed the first critical milestone in this regard.

That said, a significant part of the Saudi private sector comprises hundreds of family businesses, of which, majority are unlisted. Several larger companies initiated the overall IFRS convergence exercise right in early to mid-2018. However, it is only in the first quarter of 2019 that most CFOs would tackle the valuation issues under IFRS fair value measurement provisions.

Convergence to fair value likely to increase volatility in earnings and compliance burden in the first year

Going by our experience of working with them, several large and mid-size family businesses in KSA often have a sizeable portfolio of equity investments (ranging from minority to significant non-controlling) in private companies. A prominent part of the portfolio may be in the form of legacy investments that continue to be carried at cost.

These investments will now have to be measured at fair value with difference to be recognized in income statement. This may create significant volatility in the company's

earnings, particularly in the first year of implementation.

Complying with reporting requirements under the standards could prove to be a major burden on the CFO and finance departments with regard to the hours dedicated for conducting the valuation.

Benefits for early adopters in medium to long term to far outweigh the costs

Compliance is critical to enhance the quality of financial reporting, and improve comparability and transparency.

Amid globalization and cross-border investments, early investment in setting up the right processes for compliance with the provisions would provide companies in KSA a significant edge as government initiatives to diversify the economy and strengthen the private sector fructify. Moreover, the growing interest among local business entities in Saudi Arabia to collaborate and partner with international players is paving the way for a transparent financial reporting mechanism.

Companies, particularly family offices with a significant private investment portfolio, can benefit from periodic valuation in multiple ways. Some of these are discussed below.

Excellent opportunity to optimize balance sheet

CFOs can recalibrate their balance sheets to reflect the true fair value of their equity investment portfolios that may have grown significantly in value but continue to be carried at cost. This could arguably help them in better managing the various debt covenants associated with credit facilities.

Sound valuation exercise likely to reveal performance improvement opportunities

Aranca has been involved with multiple family office clients in KSA, supporting them in monitoring and improving the performance of their portfolios. Our experience shows that a credible valuation exercise often helps discover key value drivers that go frequently unnoticed in internally developed periodic management information reports. A thorough valuation, encompassing evaluation of all key risk-return elements related to the performance of each portfolio company, helps investors identify potential areas for EBITDA expansion and risk reduction.

Quality management information and quick decision making was rated one of the top three benefits by 74 preparers of financial statements (presented by finance managers of quoted firms in Saudi Arabia) and 65 users of annual reports (i.e., investors represented by financial analysts) in a survey[5] to rank the benefits of adopting IFRS.

Access capital markets

To boost growth in the private sector, the kingdom has initiated reforms for developing and opening up its capital markets and using them as gateway for higher international investment. The Capital Market Authority (CMA) launched NOMU, a platform for smaller companies to access capital from foreign investors that are exempted from meeting the qualification requirements applicable to the main market.

Adopting fair value measurement would ensure optimal compliance with IFRS for SMEs; this, in turn, could increase the confidence of investors.

A step toward institutionalizing investment management process

With family businesses and family offices undergoing a transition as the business environment in KSA matures, catching up with global best practices in private investment management has become a pressing need. Periodic valuation of investment portfolio helps CFOs identify key sources of risk and take better decisions pertaining to divestment of business. We partner with a number of family offices in KSA to optimize their investment portfolio strategy. Some of the professionally managed family offices often follow the business plan and conduct valuation exercise to proactively identify key issues from the buyer's perspective.

5 Publication titled "Expected benefits and challenges of adopting IFRS- A focus on Saudi Arabia" by Dr. Jamal Radi El Zoubi, Assistant Professor, Jubail Industrial College, Management and Information Technology, Jubail Industrial City, Kingdom of Saudi Arabia published in International Journal of Novel Research in Humanity and Social Sciences Vol. 4, Issue 4, pp: (19-25), Month: July – August 2017,

What are the valuation challenges CFOs could run into?

CFOs may face teething troubles as they implement the valuation exercise to determine the fair value of their entities' investment portfolio in the first year. Some of the potential challenges are:

Lack of talent with valuation skills and bandwidth

This is likely to present the biggest challenge. Business valuation is a highly specialized discipline, requiring multi-disciplinary skills and knowledge, and it is unlikely that the existing internal talent and bandwidth at entities is capable of managing a smooth fair value transition.

Although finance departments may have qualified professionals with experience in business valuation, the valuation exercise for financial reporting often differs from that for investment decision purposes. Valuation under IFRS would require intricate knowledge of relevant standards, including nuances on quality of valuation inputs, techniques and use of discounts/premiums, among others.

As valuation is most likely to be reviewed by the entity's audit firms at a later date during finalization of accounts, documentation of the valuation analysis in a report would be time-bound. This would ensure that CFOs do not spend unreasonable time in explaining the basis of their valuation analysis to auditors.

Data-related

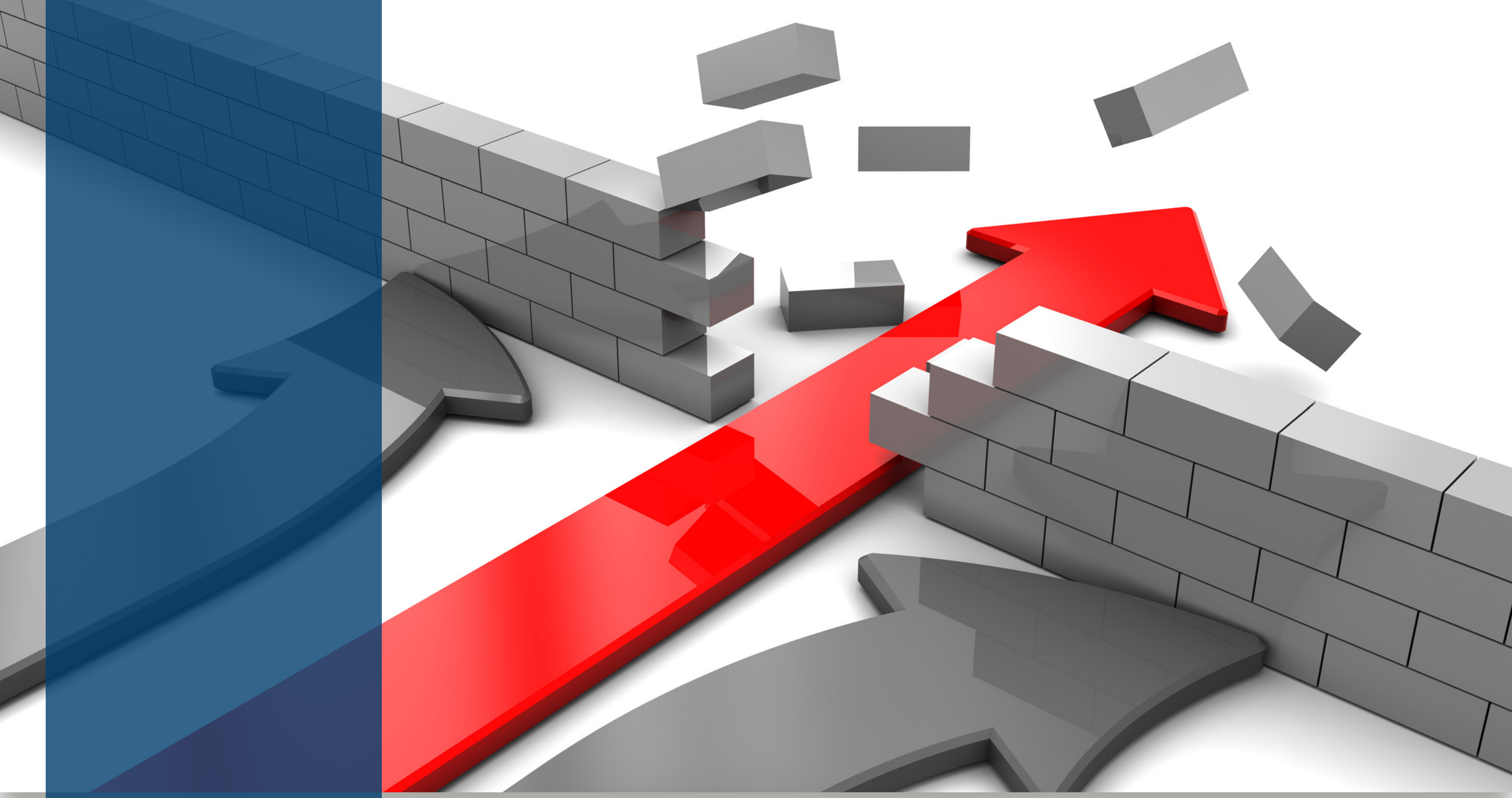
Given the depth and breadth of financial markets in middle-east, conducting valuation exercise for private companies can be very challenging as it is difficult to find the suitable comparable publicly listed companies for applying the market based trading multiples.

Applying income-based DCF valuation could be equally challenging, as reliability of financial projections prepared by management is a critical factor in developing an estimate of fair value.

Cooperation from portfolio company in providing appropriate information

Valuation, to put it simply, is quantifying the expected future cash flows that a business will likely generate by adjusting these against the expected return that largely represents various risks, such as related to the economy, industry and market in which the company operates, and the management's execution capabilities. Hence, a sound valuation exercise requires information about the company's operating metrics and the management's business plan that will drive financial performance in future.

Our experience of working in the Middle East, and especially KSA, tells us that at times CFOs struggle to get suitable information beyond the financial statements from portfolio companies where the investor entity holds an insignificant minority stake. This typically happens when the management of the portfolio company is ill-disposed toward sharing such information due to confidentiality reasons.



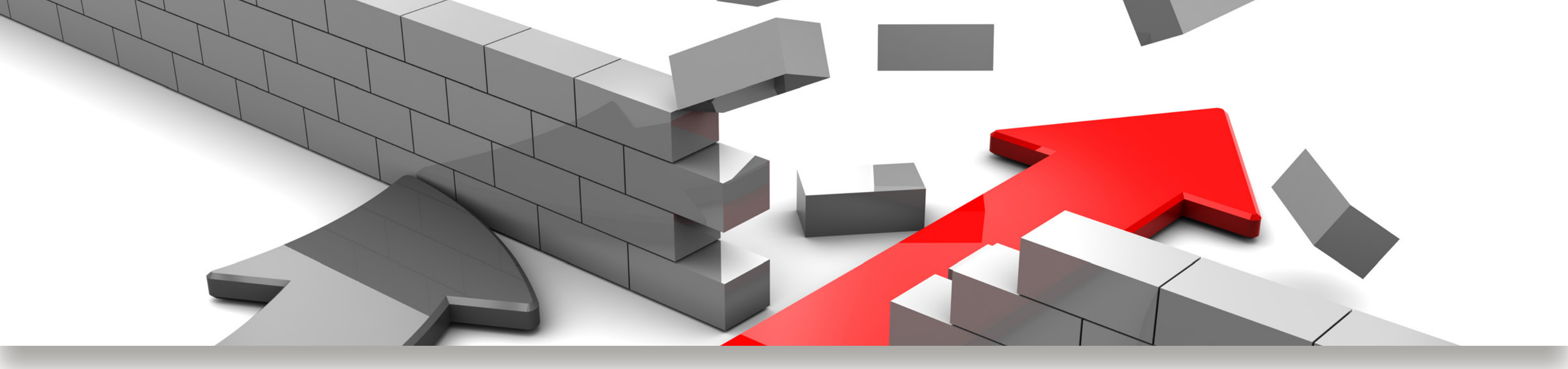
How to overcome these?

One of the best ways to address the challenges effectively is that CFOs hire the right consultants with relevant experience in conducting fair value appraisals for IFRS purposes. That said, the business valuation services professional ecosystem in KSA is at a nascent stage. Hence, CFOs would do well to engage with valuation firms having the right mix of global exposure and valuation experience in working with clients in the Middle East. We have compiled a list of issues/questions CFOs should consider while choosing a valuation firm to support the transition to IFRS for fair value reporting purposes.

What to look for while engaging an outside valuation firm?

CAPABILITIES, TRACK RECORD & EXPERIENCE

- Since how long has the firm been in business valuation services? What is the size of the firm's business valuation practice vis-à-vis its revenue streams?
- What is the firm's experience in valuation of businesses/ companies in the relevant industry /sector in the Middle East in general and KSA in particular?
- Who are the key clients globally and in the region? Are some of them available to provide references for the firm's work and delivery experience?



CREDENTIALS & RESOURCES

- What are the credentials and designations[6] of the senior professionals who are actually going to the sign the valuation report?
- Does the valuation firm have access to the relevant financial databases[7] in order to find credible market data inputs to support its valuation analysis?

RESEARCH CAPABILITIES

- Does the valuation firm have the capability to bridge the gap between required information and limited information made available by the investee companies?
- Does the valuation firm have enough experience in the relevant industry to interpret the limited information correctly and complete the valuation thesis?

AUDIT REVIEW EXPERIENCE

- What experience does the valuation firm have in managing audit review, including with the Big Four audit firms?
- Has any valuation report produced by the firm been challenged by regulatory authorities?

VALUATION APPROACH & REPORT

- What is the level of information the valuation firm will need to complete its valuation assignment and submit a report?
- What valuation approaches will be followed for portfolio companies across different levels of enterprise lifecycle?
- Will the valuation firm require more information, beyond what is available with the investor entity, from the portfolio company's management?
- If the information (mentioned in the previous point) cannot be made available owing to confidentiality or other reasons, can the firm develop a reasonably reliable estimate of fair value despite the data constraints?

COST AND ONGOING SUPPORT

- What is the valuation firm's fee or billing rate? How material is the fee, relative to the significant of such investment in the overall portfolio?
- How will the valuation firm support you in the audit closing/review process? Will the time/ effort be factored in the fees or will it be charged separately?

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6 In several geographies there are no licensing requirements for practicing business valuation profession. However, over the last three decades, there is a shift towards securing accreditation to differentiate the level of expertise and experience. Different national and international organizations have begun to certify and accredit business appraisers. Some of these internationally recognized designations include American Society of Appraisers (ASA) , CFA Institute (CFA), Institute of Business Appraisers (IBA), International Institute of Business Valuers (IIBV), National Association of Certified Valuation Analysts (NACVA)

7 Some of the well-known data sources for capital markets include Bloomberg, CapitalIQ, Reuters, others. There are also specialized data sources for private equity and venture capital ecosystem like PitchBook

About Aranca

Founded in 2003, Aranca is a global research & advisory services firm working with clients worldwide across financial markets, industry sectors and technology domains. Aranca brings to play the strong combination of best data and best talent to empower decision makers with intelligence and insights, enabling them to reach better business decisions. Our multi-disciplinary expertise is designed to cater to clients of all sizes across a wide spectrum, from Fortune 500 companies and financial institutions to private equity and high potential startups. In the MENA region, Aranca works with some of the top family groups, private equity and investment management firms with strong focus on strategic corporate and financial advisory services.

About the Author

Bharat Ramnani leads the Financial Advisory & Valuation Services Practice at Aranca. His client service delivery experience of over 15 years includes advising global clients across diverse strategic and transaction advisory engagements, corporate finance, financial reporting and business valuation situations. Bharat has been instrumental in building Aranca's financial advisory services group, which caters to a wide spectrum of clientele, including large corporate, private equity & venture capital firms, family offices as well as hundreds of high performing startups. Bharat is closely involved in business development and managing key client relationships in the Middle East and APAC region.

Bharat is a qualified Chartered Accountant from India and holds an expert designation in business valuation from the American Society of Appraisers.

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