Indé Global
Valuation Services

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VALUATION UPDATES

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INTRODUCTION TO VALUATION STANDARDS

This thought leadership paper provides insights on Valuation Standards.

The Indian corporate scenario is abuzz with activity surrounding valuation and registered valuers. It is experiencing a landmark shift from randomness to a well-defined framework for a practice which has become indispensable since the advent of the Indian Accounting Standards (Ind AS).

The Ministry of Corporate Affairs issued the Companies Registered Valuers and Valuation Rules 2017 ("the Rules") on 18th October 2017. The Rules elucidate the eligibility for a registered valuer and delve into the other technical aspects for registered valuers under various statutes. Per Rule 16 of the Rules, a registered valuer shall make valuations per internationally accepted valuation methodologies, valuation standards adopted by any valuation professional organization, or specified by Reserve Bank of India, SEBI, or other statutory regulatory body.

Pursuant to these requirements, The Institute of Chartered Accountants of India (ICAI), being a body set up under an act of Parliament as well as registered valuers organization (RVO), released a set of valuation standards known as the Indian Valuation Standards ("IVS") on 25th May 2018.Since these standards have been released by a valuation professional

organization, they may very well be the valuation standards that are applicable for valuations under the companies act.

The IVS set benchmarks for a field which has been hitherto unregulated and subject to assumptions made without a solid underlying rationale. They set out guidelines for every step in the valuation process. One of the direct beneficiaries of the standards are those availing the services of the registered valuers. The standards provide the minimum content of the valuation report which serves as a benchmark to assess the quality of service received.

The IVS have brought into the valuation scenario discussions about topics enjoying international recognition but which until now found little or no references in the Indian scenario. Until now, there has been little academic support for appraisers justifying the adjustment of control premium or discount for lack of marketability etc. The standards provide teeth to appraisers for making such adjustments in the Indian scenario.

This article provides a holistic view of the standards, the aspects they cover and their applicability.

The standards cover topics spanning from the basic definitions to specialised valuation processes such as valuation for intangibles and financial instruments. The list of standards issued is as follows:

STANDARD	OBJECTIVE	KEY CONCEPTS
IVS 101: Definitions	Prescribe specific definitions and principles applicable to Indian valuation standards	Definitions of all terms used in the valuation standards
IVS 102: Valuation bases	Defines valuation bases and valuation premises	The following valuation bases are discussed ▪ Fair value ▪ Participant specific value ▪ Liquidation value The following premises of value are discussed: ▪ Highest and best use ▪ Going concern value ▪ As is where is basis ▪ Orderly liquidation ▪ Forced transaction
IVS 103: Valuation Approaches and Methods	Defines and provides guidance on valuation approaches and method	Various methods under the following approaches are discussed: ▪ Income approach ▪ Market approach ▪ Cost approach
IVS 201: Scope of Work, Analyses and Evaluation	Determining scope/terms of valuation, extent of analyses and responsibilities of valuer	Contents of an engagement letter Extent of analyses Treatment of subsequent events Work of other experts
IVS 202: Reporting and Documentation	Provides minimum content of report, basis for preparation of report and maintaining sufficient and appropriate documentation	Contents of valuation report Obtaining management representation Documentation
IVS 301: Business valuation	Provides guidance for business valuation	Pre-requisites for performing a business valuation engagement Introduction of concept of Rule of thumb or benchmark method
IVS 302: Intangible Assets	Provides specific guidelines and principles applicable to valuation of intangible assets	Identification criteria of an intangible asset Categories of intangible assets Valuation methods for intangible assets
IVS 303: Financial Instruments	Provides specific guidelines and principles applicable to valuation of financial instruments	Discussion of the specific valuation techniques applicable to financial instruments Other major considerations such as present value computation, adjustments for credit risk and control environment

VALUATION STANDARDS IN THE GLOBAL LANDSCAPE

Globally, there are various institutions that provide best-practice guidance on valuations of companies as well as intangibles. Few prominent institutions are:

- The American Institute of Certified Public Accountants (AICPA)
- The Appraisal Foundation
- The American Society of Appraisers
- The International Valuation Standards Council ("IVSC")

The standards issued by these institutions are:

- Statement on Standards for Valuation Services No. 1 ("SSVS") issued by the AICPA
- Uniform Standards of Professional Appraisal Practice ("USPAP") by The Appraisal Foundation
- ASA Business Valuation standards issued by the American Society of Appraisers
- International valuation standards issued by the IVSC

The standards above are more of a recommendatory nature than a mandatory nature. However, professionals holding membership of the standard-issuing institutions are required to comply with them. The Indian Valuation Standards while being mandatory for a valuer performing valuation under the Companies Act, they are recommendatory while performing valuation under other statutes.

ONUS ON VALUER

Corporate history is marked with examples of how fallacious valuations have eroded shareholder value as well as their faith in the Company. One of the most striking examples of such valuation is the brand valuation exercise of one the largest airlines performed by a well-known accounting firm. At the behest of the significant value attached to the tradename, the airlines obtained loans from banks by collateralizing the tradenames. When the company defaulted on its loans, the tradename was valued at an insignificant fraction of the original value and when an auction was conducted, there were no takers for the tradename

The valuation analysis performed by the accounting firm, though questionable, the firm itself could not be held responsible but for the lack of a regulatory framework. This is where the standards come into play. The IVS clearly spell out the responsibilities and duties of the valuer. Moreover, the mandatory nature of the standards under the Companies Act makes compliance indispensable. It should be noted that the standards are recommendatory for valuations under other statutes such as FEMA, Income Tax Act etc.

OUR TAKE ON THE STANDARDS

The standards provide comprehensive guidance on most of the relevant topics, however we believe that there are certain concepts which can be elucidated further.Topics we believe that should be elaborated further/included in the standards are:

1) Levels of value:

The standard discusses valuation bases, specifying inherent assumptions and premise of value. It would have been helpful if the standards discussed the concept of "Levels of value". Levels of value are conceptual points at which the value of business interest can be calculated.

There are three basic levels of marketability and control:

- the controlling interest (a controlling share in a public company or private company)
- the marketable minority interest (minority share in a public company)
- the non-marketable minority interest (a minority share in a private company)

For example, in the case of a valuation, using the discounted cash flow approach, using control projected financial information received from the management, we can derive a "Control" value. Now, if one needs to derive the value of a minority stake in the same company, a discount for lack of control shall be applied to the control value, resulting in a "marketable minority interest". Further, if the subject company were a privately held company, a discount for lack of marketability shall need to be applied, to reach to a "non-marketable minority interest" valuation.

We believe that discussing the levels of value in the valuation would be helpful, since it will eliminate the ad-hoc use of discounts and premiums for control, lack of control and marketability.

2) Discount for lack of marketability and discount for lack of control:

Paragraphs 42 and 49 of IVS 103 suggest use of professional judgement by a valuer to apply a discount for lack of marketability and discount for lack of control or a control premium, as the case may be. Advocating use of professional judgement may be very subjective and may lead to ad-hoc applications of such discounts and premiums. We believe that it would be helpful if the standard laid down a requirement for such discounts and premiums to be computed using a reasonable method. Picking up cues from the Valuation Standards issued by the IVSC, the computations could be discussed as follows:

DLOMs may be quantified using any reasonable method, but are typically calculated using option pricing models, studies that compare the value of publicly-traded shares and restricted shares in the same company, or studies that compare the value of shares in a company before and after an initial public offering.

Control Premiums and DLOCs may be quantified using any reasonable method but are typically calculated based on either an analysis of the specific cash flow enhancements or reductions in risk associated with control or by comparing observed prices paid for controlling interests in publicly-traded securities to the publicly-traded price before such a transaction is announced.

The standard could also provide illustrations demonstrating the computation of discounts/premiums in line with the above discussions.

3) Prospective financial information (PFI):

IVS 302 is focussed on the valuation of intangible assets and should be referred to for the valuation analyses under Ind AS 103: Business Combinations. However, certain concepts pertaining to valuation of intangible assets find no mention in the standard, the most important one being discussions about "prospective financial information" (PFI). The PFIs form the base of any valuation analyses for financial reporting purposes. Following is the discussion on PFI in the IVSC valuation standards:

Cash flow for the explicit forecast period is constructed using prospective financial information (PFI)

A valuer must perform analysis to evaluate the PFI, the assumptions underlying the PFI and their appropriateness for the valuation purpose. The suitability of the PFI and the underlying assumptions will depend upon the purpose of the valuation and the required bases of value. For example, cash flow used to determine market value should reflect PFI that would be anticipated by participants; in contrast, investment value can be measured using cash flow that is based on the reasonable forecasts from the perspective of a particular investor.

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