APRIL 2022

# THE VALUATION PROFESSIONAL

YOUR INSIGHT JOURNAL

ICMAI REGISTERED VALUERS ORGANISATION

## About ICMAI Registered Valuers Organisation

The Companies Act, 2013 brought into the light the concept of 'Registered Valuers' to regulate the practice of Valuation in India and to standardize the valuation in line with International Valuation Standards. Consequentially, The Ministry of Corporate Affairs (MCA) notified the provisions governing valuation by registered Valuers [section 247 of the Companies Act, 2013] and the Companies (Registered Valuers and Valuation) Rules, 2017, both came into effect from 18 October, 2017.

In view of the above, the Institute of Cost Accountants of India (Statutory body under an Act of Parliament) has promoted ICMAI Registered Valuers Organisation (ICMAI RVO), a section 8 company under Companies Act, 2013 on 23rd February 2018, which is recognised under Insolvency and Bankruptcy Board of India (IBBI) to conduct educational courses on Valuation for three different asset classes - Land & Building, Plant & Machinery and Securities or Financial Assets and to act as frontline regulator as Registered Valuers Organisation. ICMAI Registered Valuers Organisation is an Academic Member of International Valuation Standards Council.

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Managing Director

# FROM THE CHAIRMAN's DESK

**CS (Dr.) Shyam Agarwal**
*Chairman*
*ICMAI Registered Valuers Organisation*

Successful businesses are the ones which deliver tangible profits, "trusty old concepts" like gross margins and cash flows will matter eventually even while valuations jump. Ultimately unit economics will have to matter. Fund raising by companies at high valuations had led many to point out the lack of profits while those supporting the valuations are of the view that that it is the future potential which these businesses possess that should make someone overlook the conventional way of looking at a business.

It is important to protect the interests of retail investors putting money into initial public offerings (IPOs). A disclosure-based system and greater transparency from merchant bankers and issuers will help improve the trust in the system. SEBI does not want to dictate IPO valuations. But pricing is critical. Better explanation on the basis of which pricing is arrived at in the offer document may be a good practice, especially for new-age companies that are typically loss-making

The government has used four key methods to arrive at indicative value of Rs 6 lakh crore worth of assets to be monetized under the National Monetization Pipeline. This is based on the suitability of the valuation approach to the nature of the assets and the accompanying revenue streams. For roads, power transmission and telecom tower assets, the government has used the market approach, where the value is determined based on comparable market transactions for the identified asset classes. Capex approach has been considered for asset classes that may be monetized through PPP (public-private partnership)-based models envisaging capital expenditure by private sector. The principle under the capex approach is that in the absence of the asset monetization transaction, the Public Asset Owner would have to incur the outlay towards augmentation and O&M (operations & maintenance) of the brownfield asset.

# FROM THE PRESIDENT's DESK

**CMA P. Raju Iyer**
*Nominee Director*
*ICMAI Registered Valuers Organisation*

*President*
*The Institute of Cost Accountant of India*

Along with various approaches used for the valuation of equity, there is a significant degree of uncertainty involved regardless of the valuation approach used. The future is inherently uncertain and valuing businesses requires making assumptions about the future. Taking into consideration this uncertainty, an effective analysis must consider scenarios in addition to the most likely "base case" result. Sensitivity analysis involves changing one assumption at a time to see the effect on the estimate of intrinsic value. To explain with an example, analysts might examine the impact of a different revenue growth rate on the company's valuation. On the other hand, scenario analysis works with the same goal but involves changing multiple assumptions at the same time

We are witnessing outflows from Indian markets, it appears to be a part of profit booking or rebalancing and hence does not appear to be a major cause of concern."With the economy returning to normalcy as per results of various companies and demand returning to pre Covid levels across sectors, it is expected that the broader outlook of the Indian markets will remain constructive and positive. As the world continues to recover from the COVID-19 crisis, it's important to remember that there is no handbook, We don't know how it will play out. But if we are at the start of a powerful cyclical recovery, which is exactly what it looks like to me, then cyclical stocks by definition appear to be attractive in this environment.

# FROM THE MD's DESK

**Dr. S. K. Gupta**
*Managing Director*
*ICMAI Registered Valuers Organisation*

There's really no way around it: judging value is a subjective process. Whether you're shopping for a new television set or helping a client seek investment for a start-up company, it all comes down to perceived value. When a company undergoes a formal business valuation, experts examine similar criteria, including the company's history of operations, the growth history and potential of its target market, and its business environment (including the benefits that an incubator provides). The valuation process results in a final appraisal that entrepreneurs can use when negotiating investments and loans, selling a company

Value has many meanings depending on the situation. It is highly dependent upon the individual goals of each participant. For investors, value is getting the greatest return relative to the risk of losing an investment. For an acquiring company, value is tied to the strategic benefits and/or increased profits that will result from acquiring a company – this makes value highly variable from one acquirer to the next. In both instances, the investor or buyer prefers a lower appraised value for a company, which will in turn provide a greater return on investment.

From the other perspective, an entrepreneur seeking investment or selling a business wants as high a valuation as possible. In the end, a third-party valuation seeks to take into account all of these viewpoints to form a single appraisal. It is essential that all parties involved in a valuation understand that it is not a final answer. Valuation is the basis of negotiation; understanding the underlying assumptions used in the process of the valuation is just as important as the final valuation number given to a company.

# PROFESSIONAL DEVELOPMENT

## ICMAI REGISTERED VALUERS' ORGANISATION

**Registered Office**
The Institute of Cost Accountants of India
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**www.rvoicmai.in**

# PROFESSIONAL DEVELOPMENT PROGRAMS

| February '2022 to April '2022 | |
|---|---|
| **Date** | **PD Programs** |
| 04th-05th-06th February 2022 | 3 Days Focused Learning Program Case Studies |
| 05th -06th February 2022 | Certificate Course Practical Aspects of Valuation |
| 10th -13th February 2022 | Executive Development Program Certificate Master Course on Enhancing effectiveness of Valuation Professionals |
| 15th February 2022 | Learning Session Emerging Business and Economic Environment |
| 17th -18th February 2022 | Power Learning Session - Using Automated Valuation Models for Effective Valuation |
| 26th -27th February 2022 | Professional Facilitation Program |
| 02nd March 2022 | Emerging Professional Opportunities Current Economic Scenario and its Effects on Valuation |
| 05nd -06rd March 2022 | Power Learning Session – AVM and Data Analysis Tools |
| 08th March 2022 | Seminar on the occasion of International Women's Day |
| 09th 10th 11th March 2022 | Certification Course on Valuation of Intangible Assets |
| 12th -13th March 2022 | Certificate Course on Valuation-Online Mode |
| 15th March 2022 | Current Economic Scenario and its Effects on Valuation |
| 16th -17th March 2022 | Certification Course on IVS (Revised) |
| 19th -20th March 2022 | Certificate Course on Advanced Valuation |
| 23rd -24th March 2022 | Master Class How to Execute a Valuation Assignment |
| 26th -27th March 2022 | Certificate Course on Valuation |
| 30th -31th March 2022 | Certificate Course on Proficiency in Valuation |
| 06th -07th April 2022 | Certificate Course on Valuation |
| 10th April 2022 | Certificate Course on Valuation Report |

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### 50 Hours Training Programs

| February ‘2022 to April ’2022 | |
|---|---|
| **Date** | **Programs** |
| 11th to 09th & 17th -20th February 2022 | 50 hours Valuation Course on Land & Building and Plant & Machinery |
| 11th to 09th & 17th -20th February 2022 | 50 hours Valuation Course on Securities or Financial Assets |
| 25th -27th March 2022 & 31st March 2022-03rd April 2022 | 50 hours Valuation Course on Land & Building and Plant & Machinery |
| 25th -27th March 2022 & 31st March 2022-03rd April 2022 | 50 hours Valuation Course on Securities or Financial Assets |

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| Date | PD Programs |
|---|---|
| 21st April 2022 | Profession and Practice of Valuation - Vision 2025 |
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# Articles

# PITFALLS IN BUSINESS VALUATION: AWARENESS AND AVOIDANCE

**Dr. S. K. Gupta**
*Managing Director*
*ICMAI Registered Valuers Organization*

## The Perspective

A business valuation is the process of enumerating the value of an owner's interest using predetermined formulas and a set of methodologies. A business value means different things to different people, that's why business valuations are nothing but opinions of value. Business valuation is essential for countless business owners that can influence their decision to sell, continue or even adjourn a project.

The reliability of a valuation conclusion heavily hinges upon the assumptions and inputs used in the exercise. Often, failure to consider critical factors such as the lack of understanding of valuation theory, mechanical application of valuation theory or over simplification of assumptions result in material misstatements in value. This article highlights some of the common pitfalls in business valuations.

### 1. Insufficient consideration of impacts from COVID-19 and seasonality

The COVID-19 outbreak has brought about many uncertainties, increasing the complexity of projecting future cash flows. Using historical results is a common starting reference in the projection of future financials. Nonetheless, the pandemic has caused major disruptions to many industries, bucking any trajectory a business may originally had been on if not for such extraordinary times. This inevitably results in distortions in financial performance, be it in revenue growth or profitability margins, necessitating careful consideration of the impact of COVID-19, both historically in 2020 and 2021 and going forward from hereon.

Issues that typically arise include:

- **Using 2020 or 2021 as a base to forecast future revenues:** It is common for businesses that are relatively stable to apply a sustainable growth rate, such as the expected inflation rate or GDP growth rate, to revenues from the latest financial year. However, given that 2020 and 2021 are anomalous years, doing so without careful scrutiny of revenue drivers going forward may yield results that end up being highly inaccurate. This is especially so for businesses that have benefited from the effects of COVID-19, for instance e-commerce businesses and food processing businesses. Careless application of a sustainable growth rate to possibly unsustainable 2020 or 2021 revenues can cause material overvaluation of the business due to a very likely possibility that revenues may actually fall in the short term as business returns to normal and positive effects from COVID-19 wear off.
- **Using 2019 as a base for business as usual :** Very often, when thinking about post-COVID-19 normalization, it is common for companies to project that businesses will return to 2019 levels in the short term, the rationale being 2019 is a year that precedes the onset of COVID-19. *Much less considered is the question: Will that be the case?* For instance, are the revenue drivers resulting from COVID-19 going to be a new normal or are they merely temporary or perhaps a combination of both? Critically, will the dynamics of the business environment be different? With work-from-home arrangements being a new normal during this COVID-19 period, some employers have looked to having hybrid work arrangements in the future where employees will work from office for only part of the week. F&B businesses in the Central Business District may therefore expect lower business volumes going forward compared to 2019, even after the lifting of COVID-19 working and dining restrictions. As such, due consideration is needed when projecting whether revenue and profitability will return to a level similar to pre-COVID-19 period.

Another issue that is commonly missed is seasonality in a business. The commencement of cash flow projections is based on the valuation date

of the exercise. As such, situations may arise where the valuation date is different from the financial year end of the business, resulting in the need to project cash flows for a partial period. For seasonal businesses which experience a spike in activities during certain months of the year, mechanical extrapolation of the partial period prior to the valuation date will result in a skewed projection. For instance, a retail business may expect high business volume in June and December due to mid-year and year-end sales. Assuming a valuation date of 31 May 20XY and a financial year end of 31 December 20XY, simply extrapolating the first five months of revenues to seven months for June to December will materially understate the revenues projected for the period. While it is often the case that historical financials are analyzed on an annual basis—in cases where seasonal businesses and partial periods are involved—it is important to analyze quarterly or even monthly financials in order to take into account fluctuations in business activities.

### 2. Using net income as a proxy for free cash flows in a discounted cash flow model

In general, the value of a business equals to the present value of all future cash flows expected to be generated by a company. It is common to use other metrics in place of cash flows to the firm. For instance, a common proxy used is the net income. However, this can be quite different from free cash flows to the firm and erroneous when valuing the company. Net income on a company's income statement is generally prepared in accordance with IFRS/GAAP which is based on accrual accounting. This aims to match revenues to expenses in the period where they are earned or incurred, as opposed to when cash flows are received or paid. As such, net income has to be adjusted in order to be converted to cash flows, which includes:

1. adding non-cash items, such as depreciation and amortization expenses;
2. adding finance expenses;
3. subtracting required capital expenditure for the maintenance of existing property, plant and equipment ("PP&E") or to purchase the new PP&E to expand the business; and
4. subtracting the required investment in working capital (i.e. trade receivables, inventory, trade payables, etc.).

### 3. Double-counting of risk in cash flow and discount rate

A valuation exercise, regardless of approach, is based on the combination of inputs and assumptions. However, many a time, inputs and assumptions (inconsistent with each other) are applied to a valuation. Care should be taken to avoid any double counting of risks, for example additional risk premiums are not required for factors that have already been addressed in cash flows. For instance, where expected cash flows in the short term have been reduced to account for uncertainty due to COVID-19 measures, an additional risk-premium for uncertainty arising from COVID-19 should not be included in the discount rate. Likewise, when it comes to valuing emerging market companies, care should be taken not to over-count country risk. For instance, if one was to use a higher discount rate to reflect country risk and at the same time haircut expected cash flows to reflect the same country risk, one would be double counting the risk of operating in an emerging market.

### 4. Omission of non-operating assets when estimating equity value

Under Accounting Standards, a cash-generating unit (e.g. a product line or a subsidiary) is impaired if its carrying amount exceeds its recoverable amount, the latter being the greater of its fair value less disposal costs or its value in use. In assessing the recoverable amount, one looks at the present value of future cash flows expected to be derived. When making a comparison between the carrying amount and recoverable amount, one has to ensure the comparison is on a like-for-like basis. In assessing the recoverable amount, free cash flows to the firm only captures the value of core operations of a company i.e. the enterprise value. To get to the equity value of a company, non-equity claims on the firm have to be subtracted. These claims include interest bearing liabilities, shareholder loans or hire purchase. Cash and other non-operating assets on the other hand will be added to the value. This should be compared with the carrying amount captured under the balance sheet under investment in subsidiary. It would have been erroneous to compare the enterprise value with the carrying amount as it would not be a like-for-like comparison.

### 5. Accounting based on Book value does not necessarily equal market value

Generally, the assets and liabilities shown on companies' balance sheets, which are prepared in accordance with generally accepted accounting principles (GAAP), are stated on a historical cost basis, not a market value basis. Thus, a valuation expert relying on the net book value of a company (i.e., the balance sheet value of assets less liabilities) will typically misstate its true market value. Another reason for the resulting misstatement

is due to the fact that the intrinsic intangible assets of a company (e.g., patents, customer lists, trade names, goodwill, etc.) are not on the balance sheet. Even if they are, they are typically recorded on a historical cost basis. Similarly, a company could have unrecorded liabilities (e.g., environmental claims), which would cause net book value to differ from market value.

### 6. Blind reliance on the past

The valuation of a company is typically based on its expected future results because that is what a buyer will be enjoying upon the purchase and that is what the seller will be giving up in a sale. Past results are only relevant to the extent that they are reflective of what would reasonably be expected for the future. For example, if the latest 12 months' results do not reflect the impact of a new 10-year contract that the company was awarded, then reliance on the historical results alone would tend to understate the company's value. Too often, a valuation expert will simply extrapolate past results (e.g., a five-year average of earnings) and mechanically base the valuation analysis on this number. By doing this, the expert is implicitly assuming that this financial result is reflective of what will reasonably occur in the future. Blind reliance on historical results is not a sound practice.

Sometimes the past performance of a company is reflective of the expectations of the future with the exception of some identifiable nonrecurring past events. One way to account for this is for the valuation expert to adjust the historical financial results of the company so as to present them on a normalized basis. When appropriate, the adjusted, normalized historical results can then be used to form the basis for future projections.

### 7. Reliance on unsupported projections

Often a valuation expert will rely on a set of projections that bear no resemblance to the company's actual historical performance. This, in and of itself, is not necessarily a problem, assuming that the valuation analyst conducts appropriate due diligence and bridges the past to the future (i.e., what is expected to be different about the future). However, a valuation expert will often rely on a forecast by management that is either: a) overly aggressive (i.e., it represents management's hopes and goals as opposed to what would be relevant to an actual market participant buyer), or b) overly conservative (i.e., it represents management's worst-case scenario and is not truly reflective of what opportunities the seller believes he or she will be giving up in the future by selling the company).

### 8. Reliance on Rule of Thumb

Relying solely on a rule of thumb is one of the most common shortcuts used by untrained valuation practitioners. In these cases, the valuation expert simply multiplies a rule of thumb multiple (e.g., 10x earnings) by the financial result (e.g., earnings of $1 million) to derive a valuation conclusion (e.g., $10 million in this example). In these situations, there is typically no substantive market support for the multiple applied. Even in those situations where the multiple applied is disclosed in some sort of broker's handbook, using a rule of thumb method is still problematic, for reasons illustrated below.

An earnings-based multiple reflects two general factors: risk and growth. The higher the risk associated with the subject company, the lower the applicable multiple. The higher the growth prospects associated with the subject company, the higher the applicable multiple. By using a rule of thumb multiple, the valuation analyst is essentially assuming that the risk and the growth prospects of the subject company are similar to the risk and growth prospects of the companies included in the rule of thumb formula. When viewed this way, it should be obvious that rules of thumb can create misleading results because the relative risk and growth prospects between companies can differ quite substantially.

### 9. Inadequate consideration of Non- operating assets

Forms of the Income Approach and the Market Approach only capture the value of the core operations of the subject company. Assets that are not related to the company's core operations need to be considered separately. For example, if a company owns excess vacant land that does not produce income and that is not needed by the business' core operations, the value of this land should typically be added in separately in the valuation of the company. Another common example of a non - operating asset is marketable securities.

### 10. Inadequate Reconciliation of indicated Value conclusions

Once indications of value are calculated through various valuation methods, the valuation analyst needs to reconcile the results to derive a final opinion of value. The shortcut taken by some is to simply take an average of the indications of value. It is more appropriate to consider the quantity and quality of data available that support each of the methodologies applied in order to evaluate the merits of each. For example, if three valuation methods produce diverse valuation conclusions simply basing a valuation opinion on the average, without any analysis as to the strengths and weaknesses of each method, can open the valuation expert up to serious criticism, especially in a cross-examination. In addition, if there is other strong evidence of market value with respect to the subject company related to market participants operating at arm's

length outside of the context of litigation contemporaneous with the valuation date, the valuation expert should be prepared to reconcile his or her conclusion of value with this indication.

### 11. Measuring business value against the accounting profits instead of cash flow

Business value depends largely on its profitability, financial health, and earning power. Two metrics to measure this are the Accounting profits and Cash flows. The difference between the revenue received and costs incurred gives us the Earnings or Profits of the company. Profit is the overall picture of a business and the basis on which tax is calculated. Cash flow is the net change in the company's cash position from one period to the next. If you fetch more cash than you send out, you have a positive cash flow. Cash flow is a key indicator of financial health. Cash received by the company causes the cash flow to go up but the net income remains the same. This tells us that cash flow and net income are not identical, it's just that they are recorded at different times. In conclusion, we learn that Free Cash Flow is a better metric to analyze profitability than earnings. The two main reasons for this are:

- Revenues and Expenditures are accounted for at the right time
- Cash flows can' t be manipulated as much as Earnings

### 12. Thinking that the business purchase price and project costs are the same.

In case of a business acquisition, the buyer will need to infuse adequate working capital into the company. This supplemental working capital is over and above the purchase price at the time of a business sale. Another situation that requires adjustment can be deferred equipment maintenance costs which need to be deducted from the purchase price. Valuators need to be sure to adjust for such costs and other incomes streams to get an unbiased purchase price for a business.

### 13. Assuming that every established business has positive business Goodwill.

A common perception about Business Value is: it is the aggregate of the business's tangible assets and goodwill. One should be mindful of the fact that the business goodwill is directly related to the remunerativeness of the business. A business appraiser's view should ideally be: Business goodwill exists if the business is able to bring in earnings on top of a fair return on its tangible assets. If the earnings fall below an acceptable return on its assets, this gives rise to negative business goodwill.

### 14. When to "normalize" financial statements.

There may be some discrepancies in some elements of the financial statements that may not be considered "normal". Certain adjustments should be made to the financial statements so that they are at the same level as the comparable companies. Some items that may command adjustment are:

- Higher management salaries and perquisites that may be above normal level.
- Depreciation policies
- Unusual or non-recurring income/expenses

The valuators not only need to be sure that appropriate adjustments have been made, but should also be able to support them.

### 15. Having unr ealistic expectations

It's common for business owners to have an overly optimistic view of their company's value. This can be because of unrealistic assumptions about future earnings or cash flow, a poor understanding of buyer appetite for their company or lack of knowledge about how companies are valued. As a result, entrepreneurs can end up questioning the results of an outside valuation. "Entrepreneurs may feel that the valuator doesn't believe in them if they have unrealistic expectations about the value of their company or its future growth," At the same time, buyers can also have unrealistic expectations about a target company's value. For example, they may be ready to pay a premium for the business because of expected synergies, but buyers often underestimate the costs of an ownership transition and overestimate savings from the merger.

### 16. Incorrectly Calculating the Partial Period for Present Value Factors

When using a discounted cash flow ("DCF") method of the income approach, it is generally accepted in the valuation community to use the mid-period convention when present valuing cash flows. Theoretically, this practice assumes cash flows are collected at the mid-point of the year, rather than year-end. A common mistake is to add 0.5 to the first year's present value factor, thus under-discounting cash flows, and overvaluing the enterprise.

### 17. Incorrectly Discounting the Terminal Year

Typically, in a multi-year DCF, the terminal year is valued utilizing the Gordon growth model – a widely accepted valuation practice. Often times the terminal year value is discounted using the wrong rate; the valuation analyst will extend the present value discounting factor an extra year, rather than correctly using the last discrete year's present value factor. This error deflates the value of the enterprise.

### 18. Using Models that are not Dynamic

A non-dynamic or hard coded model refers to the practice of embedding data or an assumption directly into a model or calculation. For some valuation firms, it is not uncommon to roll forward prior analyses and models when working with the same client for a new engagement, or to leverage a model from a different engagement entirely, as this saves time and can lower fees. The pitfall arises when hard coded numbers are not updated, and then stale or errant inputs or assumptions are incorporated into the analysis. This pitfall culminates in a flawed conclusion of value and will often time require rework.

### 19.Missing the Balance Sheet

Those preparing business valuations typically focus on the future cash flow that a company will generate. In many cases, the balance sheet is not given adequate consideration. The balance sheet sets out the net operating assets a company requires to generate the cash flow upon which the valuation is premised.

An appropriate business valuation exercise should include an analysis of the normalized level of non-cash working capital (e.g. accounts receivable, inventories, accounts payable, deferred revenues, etc.) required to support the company's operations. Where appropriate, an adjustment to the equity value conclusion should be made where the actual amount of working capital at the valuation date (or the closing date of a transaction) is greater than (or less than) the estimated normalized amount. Adjustments are particularly applicable (and often missed) where the business is seasonal in nature.

Another common error is to automatically add cash on hand to the equity value conclusion (or apply cash on hand against outstanding debt) without assessing whether that cash is required in order for the company to maintain an adequate level of working capital. Finally, the balance sheet may include redundant assets that can be withdrawn without disrupting the operations of the company. In some cases, redundant assets are not obvious. Missing these redundant assets can understate the value conclusion. Examples of where hidden redundant assets may exist include the following:

- **Accounts receivable:** which may include non-trade receivables, such as amounts owing from shareholders or employees.
- **Fixed assets:** which may include unused equipment that can be disposed of.
- **Real estate:** where a company owns the property in which it operates, it may be better to assess the value of the real estate separately from the business itself. Quality real estate assets often fetch higher valuation multiples than operating businesses, which can significantly impact value.

### 20. Insufficiently normalizing EBITDA

Earnings before interest, taxation, depreciation and amortization (EBITDA) is the main number upon which a market-based valuation will be predicated. In order for the historical and forecast EBITDA to be reliable from a valuation perspective, it must be 'normalized'.

'Normalization' is the exercise of removing all 'extraordinary' (i.e. unique or one-time) transactions which are not an ordinary and recurring revenue (or cost) of the business. From a revenue perspective this could involve income from the sale of a division, government rebates and grants, or the sale of other assets such as business property. Extraordinary costs may be expenditures such as Research & Development (R&D), Business Development, or other one off outgoings such as legal settlements.

### 21.underestimating the needs of working capital

Businesses need working capital, and the more they grow the more working capital is needed. Underestimating the need for future working capital can result in over-inflated free cash flows and can jeopardize the sustainability of the business. A clear business plan will outline future cash flow projections including fixed, stepped and variable costs and, of course, future tax liabilities. It will also set out fixed asset purchases and working capital requirements including cash, debtor and stock levels. Higher levels of working capital will impact valuations, driving cash inflows down, but more importantly they can stunt growth and impact the chance of success for a business.

### Keeping an eye out for pitfalls

The process for valuing a company is often riddled by complexities, and requires robust consideration of granular factors in order to achieve a sensible and supportable conclusion. Given that a valuation hangs upon the selection of inputs and assumptions, one can easily risk arriving at a garbage-in-garbage-out value where pitfalls fail to be recognized by the valuer. As the proverbial saying goes, the devil is in the details. With valuations having high stakes in play, it is all the more important to accord commensurate attention to them

# CLASSIFICATION OF PROPERTY BETWEEN IMMOVEABLE AND MOVEABLE OR REAL AND TANGIBLE PERSONAL PROPERTY FOR VALUATION

**Anil Kumar Sharma**
*Registered Valuer (Plant & Machinery)*


### Synopsis

Getting the classification of assets right before valuation is vital to conducting a successful valuation of assets, there are a variety of asset classes relevant to valuation, some of these being tangible personal properties, real properties, moveable and immoveable properties and intangible properties. This article attempts to assist Valuers with the guidance available in international standards and more importantly the Indian law and some case laws. (Author is an Insolvency professional and a registered Valuer of Plant and machinery and a member of ICMAI RVO)


Generally, classifying properties in valuation is a simple and straightforward exercise. However, there are instances where it is more difficult to determine the correct class of an asset. Classification of Assets can at these times be confusing and unsettling for a valuer. After, a Plant and Machinery asset class valuer gets a scope of work and a fixed asset register, he draws a list of those assets that fall within the boundaries of the scope of valuation relevant to the asset class, to do this, he needs to quickly figure out any exclusions from moveable property or tangible personal property and separately has to exclude intangibles and inventories as well.

### What the IVS standard recommends:

Clause 20.7 of IVS 300, the IVSC standard for valuation of plant and equipment, requires valuers to comply with the requirement to identify the assets to be valued, and as per IVS 101 Scope of Work, clause 20.3(d), valuers have been advised to consider the extent to which an asset is attached to, or integrated with, other assets, to an extent it impacts the assets value. IVS does not clarify any more than this but it also recommends that ventilation, air conditioning and heating or water or similar serves like gas supply systems should be treated as real property in particular if these services are to be treated as building services and not meant for production.

Further, a Valuer has to identify assets that may be permanently attached to the land which are not possible to remove without serious demolition of either the asset or any surrounding structure or building.

IVS 300 recommends that Plant and equipment being used for the supply or provision of services to a building are frequently integrated with the building and once these, equipment are installed and cannot be separated from the building these assets are to be treated as part of real property. These assets should normally form part of the immoveable or real property interest, and include once what was moveable property, since the primary function of these equipment's is to supply electricity, gas, heating, cooling or ventilation to a building.

This, exclusion should comprise all motors, compressors, pipes and ducts as part of the above service supply systems once installed, it is implied that all the imbedded electric wiring, escalators, elevators and sprinkler systems fall into this category.

IVSC recommends that if a valuer is asked to value such a plant and equipment separately as explained above, the scope of work must include a statement clarifying that the value of those items, would normally be included in the real property interest and may not be separately realizable and should be done by distinguishing these assets. Again, the valuer has been advised to ensure the assets are not omitted or counted twice when being valued separately.

IVS 300, the international IVSC standard on valuing plant and equipment also clarifies that, intangible assets, fall outside the class of plant and equipment assets. And suggests that an intangible asset may have an impact on the value of plant and equipment assets and if required are to be included and valued. For instance, Valuers may need to value dies and patterns, operating software, technical data, and patents, all examples of intangible assets that impact the value of plant and equipment assets, depending on whether or not they are included in the Scope of Valuation. IVSC further provides that when there is an intangible asset component, the valuer should follow IVS 210 standard on Intangible Assets.

### How the Indian Laws distinguish between immoveable and moveable property:

In order to appreciate some complexities around classification of

Real and tangible personal property, we need to look at the provisions of "The Transfer of Property Act" and also see relevant Indian and international case laws but apart from this the Valuer needs to follow guidance offered by IVSC as above or any other permitted international valuation standard.

Before we look at the Transfer of Property Act, we must look at the other laws in India that define moveable and immoveable properties. The General Clauses Act, 1897, defines Immoveable and moveable properties as under:

(26) "immovable property" shall include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth;

(36) "movable property" shall mean property of every description, except immovable property;

Normally, movable assets are referred to as tangible personal property, however the term tangible personal property refers to the right of ownership and not the actual asset itself. A *similar distinction exists between real property and land, real property means all rights over as recognized by law (with such advantages and exceptions as the law has seen fit to establish*) Jurisprudence and Legal theory by V D Mahajan , Fifth Edition)

The Supreme Court of India has laid down a test to distinguish between moveable and immoveable as found in the well-known case of Municipal Corporation of Greater Bombay vs Indian Oil Co Ltd 1991 Suppl (2) SCC 18 can be summarized as under:

"*The test was one of permanency; if the chattel was movable to another place of use in the same position or liable to be dismantled and re-erected at the later place, if the answer to the former is positive it must be movable property but if the answer to the latter part is in the positive, then it would be treated as permanently attached to the earth.*"

Yet another asset class nomenclature that needs clarity is that of a "fixture", in English Law, it is generally classified as that property which "was moveable at one time, but has since been installed or attached to the land or building in a somewhat permanent manner in a way that it is regarded as part of the real estate.

However, the Indian Law is at variance with the English law, it was held in *Mofix Sheik v. Rasik Lal Ghose (1910) I.L.R. 37 C. 815*, that the technical English Law of Fixtures is not applicable to India. The provisions as to fixtures are somewhat alluded to in the Transfer of Property Act, Section 8 of the Transfer of Property Act

The Transfer of Property Act 1882 (The TP Act) -Section 8 (regarding operation of transfer) states that unless the transfer deed states expressly to the contrary or implies otherwise, a transferor passes to the transferee along with land property all interest including all things attached to the earth and includes any machinery attached to the earth along with its moveable parts.

Section 3 of the TP Act defines expression "attached to earth" as including:

a. rooted in the earth such as trees and shrubs;

b. imbedded in the earth, as in the case of walls or buildings; or

c. attached to what is so imbedded for the permanent beneficial enjoyment of that to which it is attached;

The Apex Court in India has, very clearly, spelt out the difference between movable and immovable machinery as defined in the General Clauses Act in the Commissioner of Central Excise, Ahmedabad ...Appellant Versus Solid & Correct Engineering Works & Others.

The Apex Court distilled the Section 3 of the Transfer of Property Act further in the above judgement and held that an attachment of a plant to a foundation cannot be compared to imbedding a wall in land as the foundation is meant only to provide stability to the plant especially so if it can be easily detached from the foundation. For an attachment to fall in the third category it must be for permanent beneficial enjoyment of that to which the plant is attached.

In English law, the general rule is that what is annexed to the freehold becomes part of the realty under the maxim *quidcquid plantatur solo, solo cedit* (Mulla the Transfer of Property Act, the 13thEdition).However, this principle has not been applied, in Indian courts.

The Indian law on Fixtures has been held to be different as between a lessor and a lessee and also a mortgagor and mortgagee, thus it was held in Pormanicks' case *(Thakur Chander Pormanick v Ramdhone 1866*), "*that buildings and other improvements do not by the mere accident of their character of their attachment to the soil become the property of the owner of the soil*." (ibid)This was in line with the Section 108(h) of the TP Act which was enacted later in 1882 which provides for the lessees right to remove fixtures.

The Sec 108(B) under subclause (h) of the TP Act 1882 states regarding rights of Lessees as follows:

*(h) the lessee may even after determination of lease remove, at any time, whilst he is in possession of the property leased but not afterwards, all things which he has attached to the earth; provided he leaves the property in the state in which he received it*;

This section is relevant when classifying moveable property for Valuation held by a lessee in a factory on lease from a lessor, even though it may be attached to earth

In a landmark case, *Jnan Chand Chugh vs Jugal Kishore Agarwal And Ors*, on 21 September, 1959, the High Court of Calcutta observed in its judgement quoted Lord Lindleys' observation that English Common Law related to Fixtures has no application as between Lessor – Lessee and Mortgagor – Mortgagee after enactment of The TP Act and other statutes.

**Intention, degree and object of annexation principle:**

The question in Indian Law whether, a chattel that is embedded in earth has become immovable property, is decided by the same principles as those that determine what constitutes an annexation to the land, under English Law. (Mulla the Transfer of Property Act,13th Ed)

In Holland vs Hodgson Blackburn J devised an important principle:

That, to meet the requirement of what constitutes sufficient annexation for the purpose of meeting the definition of what is attached to earth according to him." *It is a question he felt depended on the intention, degree and object of annexation.*

Therefore in a known ruling by Madras High Court in the matter of **Perumal Vs Ramaswami,** 1969, the court was of the view and held that the test to be performed to decide whether a Chattel forms part of the land or building should be based on whether annexation is for the permanent object of enjoyment of the land/ building or the plant itself , therefore in this matter before the court, it was held that the Fetter engine and the pump-set were movable properties, and that there was nothing wrong in the procedure applied to the attachment and sale thereof.

For a chattel to become part of immovable property or to be regarded as such as real property, it must become attached to the immovable property as permanently as a building or a tree is attached to the earth. It, was also held in *A.D. Narayana Sa vs Balaguruswami Nadar And Ors.* on 18 April, 1923, by Kumaraswami Sastriar, J. "*It will be a dangerous doctrine to hold in this country that plant and machinery brought into a building for the purpose of trade being carried on whether by the owner or by the mortgagee were so annexed to the building as to make them pass for fixtures merely because the building is sold either by the owner or by the Court in execution.*"

These principles stated above are relevant to identifying assets, when there is doubt in classifying assets, between Immoveable or moveable assets, it is important to apply these principles during Insolvency or Liquidation for instance, in sales of assets when assets are being conceived to be sold under Regulation 32 (c) and 32 (d) of the IBBI (Liquidation Process) Regulations 2016, as sales of assets collectively or sales of assets in parcels (e.g. land parcels). Classification is also significant when cost allocation of assets is being made within a fixed asset register, under a class of either immoveable or moveable property.

It therefore applies from what has been said above, that generally in a factory the part of the electric supply system including wiring and electrical fixtures that render building services , meant to keep the building services running will be included in real property, thus a fire sprinkler system, elevators, water supply and plumbing system for basic building services in a factory will form part of the real property or immoveable property because these assets were intended for the beneficial enjoyment of the building and not the plant.

This principle therefore excludes from immoveable property, the electrical supply system meant to serve a charging plant, in a battery manufacturing unit or for that matter, also excludes a water supply system acting as circulating water system for heat exchange in production of electricity. These assets are not classified under immoveable property being mainly beneficial and annexed to land for the purpose of use of machinery. A boiler plant foundation is part of plant and equipment in tangible personal property and is not part of real property. A chimney stack servicing a production process will be part of the moveable property in a coal fired power plant except for the supporting RCC structure for reasons of permanent annexation. A central heating system for building services should be treated as real property and not moveable property annexed permanently to the building with an intent of enjoyment of the building but a dehumidifier and heating system for a certain production process should be treated as a moveable property. Railway siding as part of a thermal power utility or a steel plant is treated as immoveable property (*components of railroad track that are assembled and attached to the land are considered real property*), RCC ash storage silo, RCC water reservoirs are immoveable properties, a pump station or water treating plant structure is an immoveable structure. Any tunnel for movement of traffic or passengers is real property but a tunnel for conveying coal or waste heat is a tangible personal property.

Large tanks of metal are used for storage of petroleum products in oil refineries or installations. These tanks, even though not embedded in the earth, are erected at site, post completion these tanks cannot be physically moved. For sale/disposal these have to be dismantled and then sold as metal sheets/scrap, it is not feasible to assemble the tank all over again. These tanks are, therefore, considered immoveable forming part of Real property.

Thus, Cold storage – comprising built-in cold storage rooms including refrigeration and related equipment – are Real property. Cooling towers - primary use for manufacture are considered Tangible personal property. Boilers with the primary use meant for manufacture or production process are considered Tangible personal property. However, Boilers - for service of the building– are considered Real property. Sprinkler system – are Real property. Tanks - Bulk storage (large capacity water & fills) above or below ground are considered Real property. Tanks - welding steel pressure tanks, (for propane, butane, and natural gas storage) are considered Personal property. Towers - cellular, radio broadcasting and television – are again considered Personal property. Water treating and softening plant building and structure – is Real property but equipment for water treatment and softening plant is considered as a personal property, escalators and elevators are considered Real property.

## Conclusion:

The inclusion of personal tangible property as immoveable /real property has been a matter of disputes in courts for a long time, however, several, Judicial pronouncements providing lasting principles have made the distinction between the two easier to apply. I therefore conclude that, a Valuer needs to carefully scrutinize classifying properties between real property interest and tangible personal property or what is immoveable and moveable, thus whenever in doubt a Valuer should apply, the aforementioned principles.

# AUTOMATE VALUATION MODELS – A NEXT STEP IN EVOLUTION OF VALUATION

**Pawan Kothari**
*Registered Valuer of Insolvency and Bankruptcy Board of India*

I believe in the quote that "Valuation is not just a number, there is Story behind it." In fact, if we do not know the story, numbers may not make full sense. Let me tell you a story about evolution of transactions. The first transaction for exchange of goods happens with a barter system. You give me grains I will give you milk.

This worked for people in ancient times and when they started facing a challenge in barter system, they moved to gold as medium of exchange for anything one need, be it grains, cattle or milk. After gold, metal coin became first currency. At a time when it became too bulk to carry metal coins and there was a need for different medium of exchange, printed paper currency notes were invented. And when paper also became bulky, we shifted to electronic media as of plastic cards and online transactions and today we are evaluating whether crypto will be the new currency or not.

Similarly, what happened in transportation , it all started with the wheel this invention of a wheel changed how we used to travel before and how we use to travel after but we did not stop there we did not stop there and we have gone far and beyond that we have evolved to airplanes we have evolved railways, ships and all those things and electric vehicles we did not stop there, today we are talking about travel in space, travelling to Mars, traveling outside earth, so in every in every field automation is coming evolution is coming.

Just imagine few years back till post covid also people used to say they want to have a cup of tea with newspaper today the first thing that we want when we start our day is mobile is laptop is a tool, we are so much engraved in tech enabled gadgets because they enable us to do more in the same limited time and energy and effort. just imagine smart lights have come in you can control all your home equipment everything even temperature like everything sitting at a remote place COVID has proven that automation if used in a way that it becomes an enabler it gives us immense productivity immense perfection and it gives us a lot to do.

So, valuation is no different and in Valuation field also, there is a need of automated valuation models. In valuation you cannot replace a valuer are but definitely if we can have automated valuation models to improve the way we for a valuation assignment.

An automated valuation model is algorithm which simulates the work of a valuer, and it gives reliable values for a particular purpose. Now there are different kinds of valuation models which are valuation algorithms, the most used algorithm is a combined algorithm which uses the history of price, the history of tax paid for a particular property and the current market parameters more than that some of the parameters which should be taken care or which should be used in valuation are:

1. political, for example stability of government political changes in legislation and global changes, economic factors so if there is a better economic growth in a certain area the Property rates are tend to increase,
2. social and demographic parameters- for example if we are evaluating a property in an area which is having high income group people or which is having people who are influential the property prices will have an impact,
3. technological adoption like the adoption of smart light is smart things will also have impact on property or for that matter industry
4. legal aspects taxation policies, industrial regulations, health and safety related regulations
5. Also, environmental challenges so for example if the industry is having some green credits, they will have better prices they have better value.

Let me just explain you, in four steps what is an automated valuation model and what are the steps to be followed,

First of all, big data is to be collected from various sources and for various properties so that we are able to establish a big database.

Secondly, related information about the GPS location of the subject property or set of properties is feed into the AVM.

Third, based on this data, the valuation models are generated by artificial intelligence and machine learning algorithms. These models encapsulate the valuation logic, so learned from the data.

Forth, the information is presented in the form of a report and trends from AVM. It enables us to give better data-based decision making capabilities and intelligent inputs for future.

So, with these four steps we will be able to get better evaluation and advisory inputs. AVM are better, let me make an attempt to put numbers, as to how AVMs are better as compared to traditional valuation practices, for example it reduces human error by 16%. I mean that if we use valuation models (automated valuation models) in place of traditional valuation human error is reduced by 16% for the valuation till four crores and five crores of value.

Inbuilt biases it is natural human tendency that the thing, the person, the property, the industry, or the company which you know, you feel more comfortable working on their valuation, so it removes inbuilt biases, and it gives three times more accuracy. definitely it saves time because collection of data manually and taking care of all these parameters, parameters of property and parameters of political, social, environmental impact.

If we do this all manually it usually takes a lot of time vs if we automate some steps, it takes 35- 40 % less time. When we are valuing a property and we are able to give more information about the trends, about the past history about the future expectation,

we are able to give almost one and half times more information because it is machine driven and it is driven by algorithm. The subjectivity is removed to a large extent in automated valuation models.

Now one of the main factors where AVM are being utilized these days is for mortgage purposes like we are checking civil of a person today with automated valuation models we can actually check civil of a property, valuation of a property to the accuracy of ,to the very accurate acceptable limits with 5-10% deviations so when a person is coming to a bank he or she can just get the estimate that this will be the value this will be the kind of loan in the starting itself if we have automated valuation model, at a very lesser cost.

Then Automated valuation models can be utilized for audit of valuations, by audit I mean that whether the valuation given by the valuer or the valuation given by the IP , or the valuation given by the professional for that matter is accurate to what extent or the realizable value and the market value is it off or it is in line with the expected Trend another very important thing is it can be used for fraud identification for example

if all the houses in a township are valued let say 50 lacs there can be 5-10% variation for a nearby house of similar nature similar size of course but there cannot be double or triple the value that cannot be 30% variation this can be detected using AVM's when AVM's are very useful if we try to do mass appraisals by mass Appraisals I mean if let's say we want to evaluate an area for example dharavi area, for example a township or for example of posh new developing area that what could be the trend in this this development what could be the realization what could be the opportunity from a Financial institute prospective or from a developer's perspective we can also utilize it to actually calculate capital gains what could be the estimated capital gains and hence the tax assessment for a particular property, this can be done for individual as well as for institutes so when we try to do it for individual we can plan better taxation and in case of institutes or income tax authorities if we try to do it we can actually assess that this could be the kind of tax which is expected to be paid for this kind of a property.

In case of infrastructure and land acquisition project, projects where government needs to acquire land this could be very handy to optimize the cost of the project by actually understanding if for example if there is a highway going on, there is a new alignment of a highway so government is going to acquire land and when government is going to acquire land they'll have to give compensation for that so when you have to give compensation that also is a cost to the government. so, for land acquisition assessment and land acquisition decision making, automated valuation models can be of significant help. When we are doing large asset valuations for example if we are doing an old Heritage building assessment or when we are trying to do infrastructure evaluations these algorithms, these automated valuation models can be put to use there. In case of a full new smart City development or full new development of a big project, again there could be lot of inputs which we can get from automated valuation models. When a factory or if government is planning or big institute or big developer is planning to develop a large facility let us say a cluster of certain industry we can actually decide and analyze what would be the better area for these kinds of facilities, so AVMs are useful in this project.

We can actually do cost benefit analysis for public projects, so when public projects are to be taken care for example redevelopment of an old area, for example setting up a new business district so in these kind of public related works can be a very cost effective tool which can be used for better decision making and hence also for the cost benefit analysis of these kinds of projects, when the kind of expenditure is very high.

So, in my opinion these are some of the cases where AVM can be put to use. Let me also showcase what are the areas where already across the world banks and financial institutes are using automated valuation models as of today as we speak –

(1) in portfolio valuation

(2) in securitization and mortgage,

(3) in risk management and

(4) in reviews and monitoring.

By portfolio valuation I mean like I showed a mass valuation or valuation of all the properties in a certain area. In securitization and mortgage of infrastructure projects where government or financial institutes are backing up and giving loans to the developer based on the revenue which the asset will generate in future BOT projects PPP projects and hence also we are able to do with risk management what is my exposure for these kind of projects, banks and financial institutes and hedge funds also using AVM for reviews and monitoring of their strategy of their plans which they have developed for a particular time.

The leading countries are Netherlands, Norway, Germany and Italy who have already started utilizing AVM for these four purposes primarily. In Netherlands, it is almost more than 80-90 % that they are utilizing AVM so I would like to sum up my presentation in this slide that if we are able to use AVM is a technology as a tool to support us with our human intelligence with the inputs from the valuer or with the professional expertise of valuer be it land and building, be it plant and machinery, be it for company valuation it will enable us to make better decisions for a lot of use cases that I showcased and maybe more in time to come.

# THE VALUER - WHOM TO APPOINT??

**Anil Bhattar**
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It is common understanding that with the introduction of Section 247 of the Companies Act, 2013, the Registered Valuer (RV) can only undertake all the valuations. But a careful study of various laws, this is not the case in all situations and creates confusion about who is eligible to undertake valuation to meet the regulatory requirement.

Valuation is a critical activity in the corporate affairs and needed for the regulatory purposes and the non-regulatory purposes, sometimes. Valuation could be either of equity shares or immovable/movable assets or intangible assets depending upon the nature of transaction or requirement.

However valuation on most frequent basis needed is of, ***"Equity Shares"*** where it is advisable to undertake voluntarily on some matters but "mandatorily" under the Companies Act, 2013 in the following matters:

- Further issue of shares other than rights issue
- Merger, amalgamation or restructuring u/s 230-232 for determination of a swap ratio
- Acquisition of minority shareholding u/s 236 by existing shareholders who hold over 90% of the company's shares
- Issue of shares for consideration other than cash and issue of sweat equity
- Buyback of shares from some or all shareholders under Section 68
- Liquidation of a company under the Insolvency and Bankruptcy Code, 2016

Valuation is also required under the Income Tax Act for determining Fair Market Value (FMV) of capital assets for the purpose of section 56 read with Rule 11UA of Income Tax Rules whereby the valuation methods are prescribed along with who could undertake the Valuation.

Furthermore, transfer of capital instruments between resident of India or vice versa are governed under FEMA (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017. As per the regulations, such transfer should be done at Arm's Length Price to be valued in accordance with any internationally accepted valuation method.

Valuation under the regulatory purposes requires adherence with the various parameters set out for the purpose of valuation.

As per section 247 of the Companies Act, 2013, a Registered Valuer ("RV") is eligible for all valuation to be carried out under the Act following the regulations set out for them under the Companies (Registered Valuers and Valuation) Rules, 2017.

Rule 16 of Companies (Registered Valuers and Valuation) Rules, 2017 states as under:

1. A registered valuer shall make valuations as per the Valuation Standards notified from time to time by the Central Government.
2. Until such time as the Valuation Standards are notified by the Central Government, a valuer shall make valuations as per-
   a. an internationally accepted valuation methodology;
   b. valuation standards adopted by any valuation professional organisation; or
   c. valuation standards specified by Reserve Bank of India, Securities and Exchange Board of India or any other statutory regulatory body.

Importantly, the selection of Valuation Method based on the above underlying factors will also play a vital role in selection of the Valuer. There are various methods of valuation but typically, the most internationally accepted valuation method is using Discounted Cash Flow (DCF) method whereby taking into consideration the future business plan including cash flows and applying discount rate taking into market and non-market risks and applicable industry norms.

By reading of above i.e. Section

247 of the Companies Act, 2013 with Rule 16 of Companies (Registered Valuers and Valuation) Rules, 2017, it seems that all valuation to be undertaken by the Registered Valuer (RV) but it is not the case.

There are various overlapping provisions under different acts regarding who should be undertaking the valuation. This happens because the transaction may covered under the Foreign Exchange Management Act, 1999 or the Income Tax Act, 1961 or the Securities & Exchange Board of India guidelines and international tax requirements, besides the Companies Act, 2013 basis various factors applicable such as the nature of transaction, country of transaction and residential status of parties involved and purpose etc.

A Chartered Accountant or Registered Valuer is not allowed to perform valuation based on DCF under Income Tax Act. FEMA provisions still have to give acknowledgement of Registered Valuer or RV should be in addition to being either Chartered Accountant or Merchant Banker.

A comparative chart will be useful to understand the various provisions under different acts on who could be the Valuer:

| **Valuation Method** | **Companies Act** | **Income Tax Act** | **FEMA** |
|---|---|---|---|
| DCF method | Registered Valuer | Merchant Banker | Chartered Account or Merchant Banker |
| Non DCF Method | Registered Valuer | Registered Valuer | CA or Merchant Banker |

Based on the above table, it is pertinent that if the transaction is covered under the Income Tax Act or Foreign Exchange Management Act then there is need for additional valuation to be undertaken either by Merchant Banker or CA respectively in addition to RV under the Companies Act, 2013. In addition if the transaction is related to the Listed Corporate than SEBI regulations will also be required to factor.

Till such time, there is not uniformity under various laws and based on the above table, it is to be seen first:

- Nature of transaction
- Under which provisions valuation to be done
- Method of Valuation
- Finalisation of the Valuer

It may be possible that for one transaction, Corporate may have to opt for two valuations from different Valuer as specified in the respective acts to meet the compliance requirement of regulatory valuation. A caution to be used to have the same set of information for valuation by different Valuers to avoid different valuation of the same period.

# VALUATION OF CONTINGENT CONSIDERATION

**Abraham Mathews**
*Registered Valuer, M no 10159*

### Earn-outs and claw-backs:

In a business combination, part of the consideration could be structured as an **earn-out or as a claw-back**. Ind AS 103 defines contingent consideration as an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

An earn-out or a claw-back structured into the transaction means that the sellers' involvement with the acquiree's performance does not end at the date of closing of the transaction.

### Milestones:

Earn-outs or claw-backs are structured to kick-in on the achievement or non-achievement of certain milestones. These milestones could be financial or non-financial. A few examples of financial milestones are:

- Revenue
- Revenue growth %
- EBITDA
- EBITDA %
- Number of customers acquired
- Number of units sold

Inclusion of these milestones gives rise to both market risk (systematic risk) and milestone specific risk (unsystematic risk), to the valuation of the consideration by the seller and the buyer. This classification is important in determining the discount rates to be used in the valuation exercise.

A few examples of non-financial milestones are:

- Regulatory approvals (e.g., obtaining an NBFC license)
- Product launch
- Hiring of key personnel
- Perfecting title to Intellectual Property (patent registration, obtaining copyrights, etc)

Inclusion of these milestones gives rise to milestone specific risk (unsystematic risk).

### Reasons for structuring of contingent consideration:

In a combination, there could be a number of reasons why contingent consideration is included as a part of the purchase price. Some of these are:

- Uncertainty of achievement of key premises based on which the price has been fixed.
- Bridging the gap in expectation of price between the seller and the buyer
- Deferring cash payouts to future periods
- Deferring tax payouts to future periods
- Increasing the nominal consideration, to incentivize the seller to enter into the transaction

### Recognition and measurement under Ind AS:

Ind AS requires contingent consideration to be **measured at fair value** at the acquisition date. The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree. The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an equity instrument and a financial liability in paragraph 11 of Ind AS 32 *Financial Instruments: Presentation*, or other applicable Indian Accounting Standards. The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

On subsequent measurement dates, the consideration is re-measured at fair value till the contingency is resolved.

### Escrow accounts:

Payments of contingent consideration may be made from escrow accounts that are set up at the time of the acquisition. Payments would be dependent on the occurrence of specified future events.

It is however possible that the payment from the escrow account is not linked to a contingency, but to the verification of a condition that already existed on the acquisition date. This would not be contingent consideration.

Other payments that are not included in contingent consideration include payments made to employees or sellers which are linked to employee

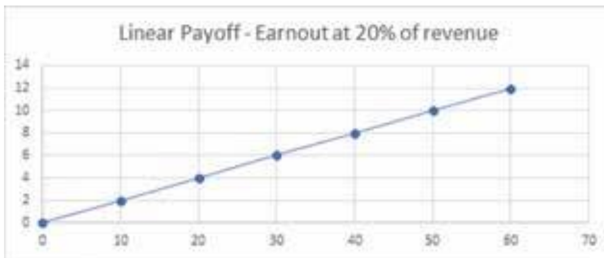
retention, since these are post combination expenses.

### Payoff structures:

Payoffs could be structured as linear payoffs, fixed payoffs, payoffs based on multiple metrics or path-dependent payoffs.

A few examples of **linear payoffs** are illustrated below:

| Linear Payoff - Earnout at 20% of revenue | |
|---|---|
| Revenues (cr) | Earnout Payoff (cr) |
| 0 | 0 |
| 10 | 2 |
| 20 | 4 |
| 30 | 6 |
| 40 | 8 |
| 50 | 10 |
| 60 | 12 |




| Linear Payoff - Earnout at 20% of revenues above INR 20 cr | |
|---|---|
| Revenues (cr) | Earnout Payoff (cr) |
| 0 | 0 |
| 10 | 0 |
| 20 | 0 |
| 30 | 2 |
| 40 | 4 |
| 50 | 6 |
| 60 | 8 |

| Linear Payoff - Earnout at 20% of revenues with a cap of INR 10 cr | |
|---|---|
| Revenues (cr) | Earnout Payoff (cr) |
| 0 | 0 |
| 10 | 2 |
| 20 | 4 |
| 30 | 6 |
| 40 | 8 |
| 50 | 10 |
| 60 | 10 |

| Linear Payoff - Earnout at 20% of revenues with a cap of INR 10 cr and a floor of INR 4 cr | |
|---|---|
| Revenues (cr) | Earnout Payoff (cr) |
| 0 | 4 |
| 10 | 4 |
| 20 | 4 |
| 30 | 6 |
| 40 | 8 |
| 50 | 10 |
| 60 | 10 |

**Fixed payoffs** could be structured as a fixed amount payable on achievement of the financial or non-financial metric., e.g., INR 2 cr to be paid on achievement of a revenue of INR 20 cr.

**Payoffs based on multiple metrics** – in such cases, each underlying metric needs to be modeled based on its forecasts and correlation to the other underlying metrics.

**Path dependent payoffs** – where the payoffs are over multiple periods and the payoff in a subsequent period is dependent on the payoff in an earlier period, the path has to be modeled over multiple periods.

### Earn-out settlement:

Earn-outs can be settled either with cash consideration or non-cash consideration. If the earnout is designated as an ascertainable amount, e.g., INR 20 cr, it would not matter

whether the settlement is made with cash consideration or by transfer of shares of the acquirer. However, if the earnout is designated as a certain number of shares of the acquirer, it would require fair valuation of the shares likely to be transferred.

### Currency of settlement:

The currency in which the earnout is structured can impact its fair value, and should ideally be the currency in which the valuation analysis is performed to avoid the need to model future exchange rates.

### Forecasting the expected cashflows:

Valuation of the earnout requires forecasting the future revenues and the expected value of the revenues, if likely scenarios for revenue are being forecast. It should be kept in mind that the expected value of future revenues need not necessarily result in the expected value of future payoffs. Discussions with management and reviewing and using their forecasts are important in this exercise, as management is most likely to be the best source of information for arriving at these forecasts.

### Use of scenarios:

The scenarios that are to be used in estimating revenues or other metrics, and probability of occurrence of such scenarios require validation with management, which again, is typically best placed to provide such information.

### Earnout contractual terms:

The earnout contractual terms need to be reviewed and interpreted correctly, while setting up the valuation model.

### Use of discount rates:

Since earnouts are typically based on metrics, e.g., Revenue or EBITDA, the metric specific risk profile could result in a discount rate different from the WACC or Cost of Equity.

The discount rate could be decomposed into:

- The risk free rate
- The counter party credit risk
- Metric specific risk premium

The risk free rate needs to be consistent with the expected time horizon of the earnout, and could change with every subsequent remeasurement, since the time horizon would be from the date of measurement to the expected payout date.

The counter party credit risk of the buyer is used in the valuation of the contingent consideration by the seller, and the counter party credit risk of the seller is used in the valuation of the claw back by the buyer.

While the risk free rate and the counter party credit risk apply to all types of earnouts, the metric specific risk premium applies only to the earnouts that have a systematic risk component, e.g., where earnouts are computed as a percentage of revenue, it is sensitive to returns in the overall market.

### Valuation approaches:

Since the income approach incorporates future expectations, it is typically used to value contingent consideration. Two income approach methods typically used are (a) the Scenario Based Method (SBM) or (b) the Option Pricing Method (OPM).

Monte Carlo simulation and binomial lattice models are techniques that can be used with either of these two methods.

The market approach is rarely used to value contingent consideration, and the cost approach is normally not appropriate to use in valuing contingent consideration.

The key elements of valuation using an income approach include:

- The expected (mean) cash flow
- The probability distribution around the mean cash flow (for nonlinear payoffs)
- The discount rate (risk free rate and counter party credit risk) and the metric specific risk premium
- The estimated volatility in growth of the metric
- Mid period discounting convention

Estimates of variance are based on the historical volatility of the acquired business or comparable companies.

### The Scenario Based Method:

Under this method, the valuer identifies the outcomes, weights the payoffs under each outcome, and discounts the result at an appropriate discount rate to arrive at the expected present value of the contingent consideration. This method is appropriate where the risk of the underlying metric is largely diversifiable and there is binary or a linear payoff.

### SBM - Binary Payoff:

For example, if the seller needs to obtain a critical client relationship, to obtain the earnout, the payoff could be modelled as follows:

Assumptions – earnout of INR 2 cr, payout at the end of one year, 80% probability of a positive outcome, risk free rate of 6%, counter party credit risk of 4%.

| Scenario | Probability | Earnout | Expected Future Value |
|---|---:|---|---:|
| Yes | 80% | INR 2 cr | INR 1.6 cr |
| No | 20% | | 0 |
| | | | |
| discount Rate | | | |

| Risk free rate | 6% | | |
|---|---|---|---|
| counter party credit risk | 4% | | |
| total | 10% | | |
| Present value (1 year) | | | INR 1.44 cr |

### SBM - Linear Payoff:

Assumptions – earnout of 20% of year 1 revenue, payable at the end of year 1, linear payoff with no cap or floor. Expected revenue is based on the weighted average of 3 scenarios:

| Scenario | Probability | Revenue (cr) | INR cr |
|---|---|---|---|
| High | 30% | 30 | 9 |
| Base | 40% | 25 | 10 |
| Low | 30% | 20 | 6 |
| Adjusted revenue | | | 25 |
| Earnout % | 20% | | |
| Expected Earnout | | | 5 |
| | | | |
| discount rate | | | |
| risk free rate | 6% | | |
| counter party credit risk | 4% | | |
| MSRP | 10% | | |
| total | 20% | | |
| Present value (1 year) | | | 4 |

### The Option Pricing Method:

This method can be used where the payoff structure is nonlinear and involves a metric with non-diversifiable risk.

As an example, where there is linear payoff with a floor, with the assumptions that earnout is 20% of the amount exceeding INR 20 cr, payable at the end of one year, the variables incorporated into the BSM model would be:

- Present value of underlying = revenue
- Strike price = earnout revenue threshold
- Term of the option = 1year
- Risk free rate = risk free rate for 1 year
- Volatility of the underlying = Volatility of the revenue

Firstly, the present value of the underlying is to be obtained; next, this value is input into the BSM model to obtain the earnout payoff at the end of the term; lastly, the present value of the earnout payoff is computed.

### Monte Carlo Simulation:

Monte Carlo Simulations are used to value payoffs where there is a path dependency. Many iterations would be required to get reliable results. The valuer has to assess the correlation between the revenue of each year or the independent metric of each year, where there is path dependency. Once a risk neutral framework has been created to project the simulated metric, the earnout cashflow is calculated based on the estimated path.

For example, if there is a payoff of INR 50 cr., in the year in which the revenue crosses INR 150 cr., for a company which presently has a revenue of INR 20 cr., then using the simulation, the year in which the revenue crosses INR 150 cr., will be computed. The present value of the payoff is then computed as the next step.

### Claw backs:

In some acquisitions, the buyer may be entitled to a claw back or refund of a part of the initial purchase consideration, from the seller, if the acquired business does not perform as well as expected, or if some specified milestones are not achieved, e.g., regulatory approvals. Claw backs are valued in a manner similar to earnouts, except that, the value of the claw back is inversely correlated to the performance of the specific metric based on which it is estimated, and the counter party credit risk is that of the seller, unless the amount is placed in escrow. Claw backs are similar to put options and are valued as such.

### Documentation:

The valuer needs to document the following in a valuation:

- Who has prepared the prospective financial information that is relied upon
- The process used to develop the prospective financial information from the view point of a market participant
- The key assumptions made in deriving the forecasts
- The process followed to test the reasonableness of the of the forecasts, consistency of the forecasts with historical financial information, comparison of previous forecasts against actual performance, consistency of the forecasts with industry forecasts
- Computation of the discount rate and its components
- Reasons for changes in the valuation approaches used or in estimation of any of the components or inputs, in subsequent valuations on subsequent measurement dates as compared to the initial measurement date.

### References:

Valuation advisory #4 from The Appraisal Foundation

# FREQUENTLY ASKED QUESTIONS ON VALUATION

## ICMAI REGISTERED VALUERS' ORGANISATION

**Registered Office**
The Institute of Cost Accountants of India
4th Floor, CMA Bhawan 3, Institutional Area
Lodhi Road, New Delhi – 110003

**www.rvoicmai.in**

# Frequently Asked Questions: Registered Valuers (For Valuer Entity Applicants)

### 1. Who is a valuer entity?

**Ans.** A Valuer Entity is a registered Partnership firm, Limited Liability Partnership or Company, who does the work of valuation.

### 2. Who is a registered valuer entity?

**Ans.** A registered valuer entity (RV-E) means a registered partnership firm or a companywhich is registered with the Authority as valuer in accordance with the Companies (Registered Valuers and Valuation) Rules, 2017 (the Rules).

### 3. Who is the Authority?

**Ans.** Insolvency and Bankruptcy Board of India (IBBI) has been specified as the Authority by the Central Government under section 458 of the Companies Act, 2013.

### 4. Who is eligible to be registered as a valuer entity under the CompaniesAct,2013?

**Ans.** A registered partnership entity or a company is eligible for registration, subject to meeting the eligibility requirements provided for in the Rules.

### 5. Who is a Registered Valuer Organisation (RVO)?

**Ans.** Registered Valuers Organisation (RVO) is an organisation recognised under sub- rule (5) of rule 13 of the Rules and are the first line of regulators. An applicant has tobe first a member with an RVO before seeking registration as a registered valuer entity.

### 6. What work can a registered valuer entity undertake?

**Ans.** A registered valuer entity can undertake valuation of only such assets for which the RV-E is registered for.

### 7. Registered valuer entities are registered for how many asset classes?

**Ans.** Three, namely,

i. Land and Building

ii. Plant and Machinery

iii. Securities and Financial Assets.

### 8. Can a Registered Valuer Entity for one asset class register for anotherassetclass?

**Ans.** Yes, subject to meeting the eligibility criteria specified for the said asset class for which registration is being sought. The entity must have at least one individual registered valuer for each asset class, for which it seeks registration.

### 9. Can an applicant be registered as valuer entity for all asset classes?

**Ans.** Yes, subject to satisfaction of eligibility conditions prescribed under the Rules. Theentity must have at least one individual registered valuer for each asset class, for which it seeks registration.

### 10. Can an applicant be registered directly with the Authority?

**Ans.** No, an applicant cannot seek direct registration with the Authority. The application(Form B along with Addendum to Form B) of a partnership entity or company must be routed through the RVO along with the recommendation of the RVOrecognised for the asset class for which registration is being sought.

### 11. Where can an applicant be enrolled as a valuer entity member?

**Ans.** Applicant needs to be enrolled as a member with a Registered Valuers Organisation.

### 12. How can an applicant valuer entity select RVO for enrolment?

**Ans.** The applicant entity can seek membership with any of the RVO, the details of whichis displayed on IBBI website. However, the applicant may seek membership of only that RVO which is recognised for the asset class, for which it intends to take registration withthe Authority.

### 13. Can an applicant valuer entity be enrolled with two RVOs?

**Ans.** No. A registered valuer entity should be a member of only one RVO.

### 14. What are the conditions of Registration?

**Ans.** The registration granted under the Rules shall be subject to the valuer entitycomplying at all times the conditions stipulated under rule 7 of the Rules.

### 15. What is the process for a partnership firm or company to become aregisteredvaluer entity?

**Ans.** Following are the (mandatory) stages to be followed by an Individual tobecome a Registered Valuer (RV):

| Stage | Particulars |
|---|---|
| I | Seek membership (Valuer entity Member) with a Registered Valuers Organisation (RVO).<br><br>*NB: On receipt of application, RVO will scrutinise the application to ensure that the same conforms to the eligibility requirements for registration as prescribed under rule 3 of the Rules. After establishing eligibility with the Rules, RVO shall enroll an Applicant as Valuer Entity Member.* |

## Frequently Asked Questions: Registered Valuers (For Valuer Entity Applicants)

| | |
|---|---|
| II | Submission of Application for Registration (Form-B) in hard copy by applicantto RVO. Applicant to ensure submission of following physical documents to RVO:<br>i. duly signed Form-B;<br>ii. copies of documentary proofs and;<br>iii. proof of payment of fees.<br>*NB: Application for registration (Form-B) will be submitted by the Applicant to the RVO with whom the applicant is enrolled, for its verification.* |
| III | RVO, upon receipt of Application for Registration from the Applicant, shallverify the application and enclosed documentary proofs. RVO while processing the application, may seek additional documents or clarifications with respect tothe application from the applicant. |
| IV | RVO may recommend and send physical application to IBBI.<br>The application must include the following:<br>a. Physical Form B (signed by authorized representative) and Addendumto Form B (signed by all the partners/ directors)<br>b. Recommendation for registration by RVO (duly signed by authorizedofficer with seal of RVO affixed);<br>c. copies of documentary proofs; and,<br>d. Proof of Payment of Fees. |
| V | The IBBI while processing the application, may seek additional documents or clarifications with respect to the application from applicant, through the applicant's RVO. |
| VI | After the applicant has been granted registration by the Authority, theAuthority would update details of the RV-E on its website and issue aCertificate of Registration to RV-E. |

### 16. Can a valuer entity member shift its membership from one RVO to another?

**Ans.** Yes, prior to registration as a registered valuer entity, a valuer entity member can shift his membership from one RVO to another. The process prescribed in circular No. IBBI/RVO/029/2020 dated 28th January 2020 (copy on the website of IBBI), as faras applicable to entity, should be followed.

### 17. Can a registered valuer entity shift its membership from one RVO to another?

**Ans.** Yes, with the prior permission of IBBI, a registered valuer entity can shift his membership from one RVO to another. The process prescribed in circular No. IBBI/RVO/029/2020 dated 28th January, 2020 (copy on the website of IBBI), as far as applicable to entity, should be followed.

### 18. Can an applicant surrender its membership with RVO?

**Ans.** Yes, an entity member may surrender its membership of RVO. The registration status of the entity, if registered, shall become inactive.

### 19. Whether any membership card, identity card, registration certificate etc. isissued upon registration as a registered valuer?

**Ans.** An eligible applicant RV-E, upon registration would receive a Certificate of Registration. Soft copy of the certificate is sent to the applicant on its registered email address, while physical copy is handed over to the respective RVO of which RV-E is a member. However, no membership card / identity card etc. is issued other than the certificate of registration.

### 20. What are the eligibility norms for a Partnership entity or company to beregistered as a valuer?

**Ans.** The eligibility norms for a partnership entity or company to be registered as a valueris stated under Rule 3(2) of the Rules.

### 21. Can a partnership entity or a company rendering any kind of services beregistered as a valuer?

**Ans.** A partnership entity or a company can be registered as valuer only if it has been setup with the object of rendering professional or financial services including valuation services. In case of Company, it should not be a subsidiary, joint venture or associate ofanother company or body corporate.

### 22. Are all partners or directors required to have passed the valuation examination for a partnership firm or a company to be eligible for registrationas a valuer?

**Ans.** Yes, all partners or directors should have passed the valuation

## Frequently Asked Questions: Registered Valuers (For Valuer Entity Applicants)

examination under rule 5 within three years preceding the date of making an application for registration under rule 6.

**23. How many partners or directors need to be registered valuers for a partnershipfirm or a company to be eligible for registration as a valuer?**

**Ans.** Three or all the partners or directors, whichever is lower, of the partnership firmor company, as the case may be, need to be registered valuers with at least one of the partner or director being a registered valuer for the same asset class for which registration is being sought by the partnership firm or company. The registered valuers must possess certificate of practice for the relevant asset class.

**24. Can a registered valuer be director or partner in more than oneregisteredvaluer entity?**

**Ans.** No.

**25. If a partnership firm or a company has partners or directors who are registeredvaluers in the asset class of 'Plant and machinery', can the firm or company be registered as a registered valuer entity in the asset class of 'Land and Building'?**

**Ans.** No, a partnership firm or a company needs to have at-least one partner or directorin the asset class of 'Land and Building', to be granted registration as a registered valuerin the asset class of 'Land and Building'.

**26. Can an unregistered firm be registered as a valuer?**

**Ans.** No. Only a partnership entity registered under the Indian Partnership Act, 1932 or a limited liability partnership registered under the Limited Liability PartnershipAct, 2008can be registered as a Valuer.

**27. Can the application for registration of a partnership entity or company besentdirectly to the Authority for registration?**

**Ans.** No, application (Form B along with Addendum to Form B) of a partnership entity or company must be routed through the RVO along with the recommendation of the RVO recognised for the asset class for which registration is being sought.

**28. Can the composition of partnership firm or company be changed after beingregistered as valuer?**

**Ans.** Yes. However, the same must be communicated to the Authority at the earliest and not later than 7 days of such change. In case of removal of partner or director, the detailed reasons for such removal should also be intimated.

**29. Can the terms of Partnership Deed, or Articles of Association/ MemorandumofAssociation in case of Company, be changed after being registered as valuer?**

**Ans.** Yes. However, the same must be communicated to the Authority at the earliest and not later than 7 days of such change coming into effect.

**30. Is there a standard format for an application for registration as RegisteredValuer Entity?**

**Ans.** Yes. A Partnership Entity or Company needs to submit the application as per Form- B of Annexure II of the Rules.

**31. Within how many days of submission of application, registration is granted?**

**Ans.** Subject to fulfilment of terms and conditions, registration is granted to an applicantwithin 60 days of receipt of application excluding the time given to the applicant for presenting additional documents, information or clarification, or appearingin person, as the case may be.

**32. In case there is an observation / query with regard to an application, inhowmany days should the query be addressed by the applicant?**

**Ans.** Within 21 days from the date of query.

**33. What happens if the query is not addressed within 21 days?**

**Ans.** The application is liable to be rejected.

**34. If rejected in the absence of submission of clarification / information within 21days, can fresh application be made?**

**Ans.** Yes.

**35. Is there a fee required to be paid along with application form?**

**Ans.** Yes, a non-refundable application fees of Rs.10,000/- (plus applicable tax) shall be paid by the applicant Partnership Entity or Company.

# Frequently Asked Questions: Registered Valuers (For Valuer Entity Applicants)

### 36. What is the Process flow for submitting an application?

**Ans.** The process flow for submitting an application is as under:

| STEP | Activity | Activity to be Performed By | Details |
|---|---|---|---|
| 1 | **Submission of Form-B** | **Applicant** | Applicant submits Form-B and supportingdocumentary proofs to its RVO.<br>Applicant to send the following documents toRVO in physical form:<br>i. physical Form-B;<br>ii. proof of supporting documents and;<br>iii. Payment proof to RVO. |
| 2 | **Verification of Form B** | **RVO** | RVO to verify Physical Form B and supporting documents received from the applicant entity. |
| 3 | **Recommendation / Approval of RVO** | **RVO** | RVO may recommend application for registrationandsend physical application to IBBI.<br>The application must include the following:<br>a. Checklist for Form-B (shared with RVOs);<br>b. Physical Form B signed byauthorized representative of the entity);<br>c. Addendum to Form B signed by allthepartners/directors;<br>d. Recommendation by RVO for registration(dulysigned with seal affixed of RVO)<br>e. Supporting documents, and<br>f. Proof of Payment of Fees. |
| 4 | **Final Approval** | **IBBI** | IBBI may grant registration to the applicant entityafterestablishing the eligibility of the applicant entity with the Rules. The details of RVE is reflected on the website of IBBI. A Certificate of Registration will also be issued by the Authority after final approval. |

### 37. After filing of application, whom should the applicant contact in case an updateon status of application is required?

**Ans.** Respective RVO may be contacted with due consideration of the timelinesstipulated under the rules.

### 38. In case a query / clarification request has been received by the applicant, whom should be contacted in case further clarification is required on the matter?

**Ans.** Respective RVO may be contacted. RVOs will guide applicants withclarifications on the observation/s received.

### 39. Where can we find contact details of RVO?

**Ans.** IBBI website link capturing contact details of RVO is as under:

https://ibbi.gov.in/service-provider/valuer-organisations

### 40. Where to contact in case of clarification regarding registration as aRegistered Valuer?

**Ans.** Respective RVO may be contacted.

*In case any of the query referred to RVO is not resolved within 7 days, the emailshould be forwarded to valuer@ibbi.gov.in with a copy to respective RVO.*

# OTHER READINGS

## ICMAI REGISTERED VALUERS' ORGANISATION

**Registered Office**
The Institute of Cost Accountants of India
4th Floor, CMA Bhawan 3, Institutional Area
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# Can your valuation be improved? New research on diversification discounts can help conglomerates manage their portfolio strategy - KPMG

## Introduction

In 1995, two academic researchers (Philip Berger and Eli Ofek)[1] introduced the concept of the "diversification discount" and demonstrated that conglomerates with differing businesses were frequently undervalued. They estimated what each of the company segments would have been worth had they operated as stand- alone businesses, then compared the sum of these imputed segment values to each company's actual market capitalization. Companies whose market caps were lower than their imputed market values were said to be operating with a diversification discount. They found that, on average, these companies operated at a 13–15 percent discount relative to the sum of their parts. These findings had two significant implications: (1) companies might be making strategic choices that were leading them to be undervalued by investors and (2) companies might be able to take strategic steps to tackle this undervaluation.

Since then, there has been much debate on this topic in both the academic and the business communities. Economists have argued about the magnitude of the diversification discount and its variance over time, across geographies, and across industries. The business community has also debated the factors that might cause the diversification discount, such as the decision to diversify in and of itself, the choices that managers make concerning which businesses to invest in, and the extent to which reported data on segments accurately reflects their operational and financial performance.

More recently, activist investors have been pushing the idea that simply divesting or spinning off divergent businesses can significantly lessen a conglomerate's discount. Most management teams recognize that they have to consider the potential valuation discount when strategizing about maintaining or increasing the diversity of their corporate portfolio. But, they have received relatively little guidance on specifically what factors to consider and how to analyze this problem relative to other strategic portfolio considerations.

Working in conjunction with Professor Emilie R. Feldman at the Wharton School,[2] KPMG has produced new research that sheds insight on the portfolio strategy topic. Based on observations working with many client companies, we hypothesized that a disparity of financial characteristics among the business units within a corporate portfolio would be correlated with the size of the diversification discount. We conducted a rigorous set of statistical data analyses to test this thesis.

**Our research demonstrates the hypothesis that financial disparity among business units is significantly correlated with the diversification discount.**

These findings have practical implications for managers contemplating the valuation consequences of portfolio changes through both acquisitions and divestitures.

**The financial characteristics analyzed in this study were:**

**Growth rates:** Business units with very different growth rates (fast or slow)

**Profitability profiles:** Business units with very different profitability profiles (high or low)

**Asset intensity:** Business units with very different capital / asset intensities (heavy or light)

### Financial disparity as an explanation for the discount

Most corporations have a working model regarding how their strategies link to their valuations. That model is generally reflected in their definition of acceptable operating performance ranges and how they allocate capital. Similarly, external securities analysts (both buy-side and sell-side) use a simplified financial model to value corporations. These models inform shorthand metrics for expected financial ratios and valuation multiples.

Business units whose financial characteristics deviate from their prevailing corporate model have the potential to be undervalued by investors and analysts. This can occur because the investors' application of the prevailing financial model does not accurately value the disparate units or because investors anticipate that financially dis-similar units will lead to sub-optimal capital allocation.

To test our thesis, we conducted a rigorous statistical analysis, which included the following steps:

1. Gathered quarterly Capital IQ data from 1999 to 2016 on almost 750 companies with greater than $200 million in market capitalization and reporting at the segment

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[1] *Berger, P., Ofek, E., 1995. Diversification's effect on firm value. Journal of Financial Economics.*

[2] *Emilie R. Feldman is an associate professor of Management at the Wharton School of the University of Pennsylvania. Her research focuses on corporate strategy and governance, with particular interest in the internal functioning of multibusiness firms and the role that divestitures, spin-offs, and mergers and acquisitions play in corporate reconfiguration.*

level (excluding companies operating in the financial services industry)

2. Calculated the diversification discount for each company

3. Defined metrics for three types of financial disparity amongst segments within a firm (growth rate, profitability, and asset intensity)

4. Calculated the disparity metrics for each segment / year in the population

5. Tested whether financial disparity was significantly correlated with the size of the diversification discount.[3]

Our results showed a large correlation between the diversification discount and the existence of financial disparity among business units. Within our sample, consistent with prior research, the average diversification discount for multisegment firms was 15 percent. Within that population, multisegment firms that did not meet our criteria for any dimension of financial disparity had a much smaller diversification discount, an average of 4 to 5 percent. Conversely, firms that registered one or more measures of financial disparity between segments had a much larger diversification discount.

**In fact, our research found that the greater the points of financial disparity, the greater the discount:**

**— 12 to 20 percent for firms having one measure of disparity across segments**

**— 20 to 28 percent for firms having two measures of disparity across segments**

**— 33 percent for firms having all three measures of disparity across segments**

Professor Feldman explains, “For various reasons, companies often end up operating in sets of businesses that are not fully valued by investors. The concept of the diversification discount is a particularly interesting one because it provides a concrete and concise way of quantifying the magnitude of a problem faced by many management teams. Conventional wisdom holds that companies that operate in diverse businesses face a significant diversification discount. KPMG’s research is a very exciting development and an important contribution to the field because it introducesa novel factor—financial disparity across business segments—that appears to be strongly correlated with the diversification discount. We now have a better understanding for why the discount exists.”

In addition to contributing to the academic research, these findings have important implications for business leaders. KPMG Principal Alex Miller notes, “This research provides management teams with a new way of thinking about portfolio decisions by raising the possibility that financial disparity, rather than divergent business sectors, may cause the market to undervalue their companies. It also provides corporate strategists with an actionable set of tools, from changing investor communications to divesting financially disparate businesses, as a way to unlock value.”

**The greater the number of financial disparities, the deeper the discount**

**The data represents the mean observed discounts by financial disparity characteristic(s).**

[3] *The statistical methods are described in detail at the end of the article*

### Implications for corporate portfolio strategy

While not all companies whose business units exhibit financial disparity may be undervalued by the market, management should be aware that financial disparity may be as important or even more important a factor than sector diversification when examining their companies stock performance.

According to KPMG Principal Todd Dubner, "Companies should use these new insights to identify elements of their firm's portfolio that are financially disparate, especially those relating to growth rates, profitability, and capital intensity for a better understanding of both their valuations and strategic options."

In summary, if both a discount and financial disparity is found, management teams should consider strategies to tackle their diversification discount.

1. **Business management:** Develop strategies to shift and better align performance of operating units and/or to re-align capital alignment across the portfolio.[4]
2. **Investor communication:** Refine Investor Relations strategies to ensure segment reporting, investor presentations, and other communications provide adequate information to enable investors and analysts to understand how to fully value disparate units.[5]
3. **Changes to the portfolio:** Develop new portfolio management strategies and define associated divestiture or acquisition plans to craft a better-aligned and higher-valued portfolio.[6]

### Notes on statistical research methods

#### Valuation and calculation of the conglomerate discount

The discount for each multi-segment company was calculated based on the difference between its market value and a sum of the parts buildup of the estimated market value of its individual segments. To do this, each segment was valued using an enterprise value to asset value multiple based on the median multiple for single business companies operating in the segment in the year being evaluated.

#### Defining disparity

The three disparity metrics were defined by the percentage difference between a segment and the company-level values in terms of growth rates, profitability, and capital intensity in a year. For each of the three financial characteristics, we quantify a "normal" range of the percentage difference based on its distribution across all companies in the sample. The normal range was defined by starting with the first and third quartile points, and extending each of them outward by 1.5 times the interquartile range. A company was classified as disparate for each metric if it has at least one segment outside of the range in the year being evaluated.

#### Estimating the impact of disparity

The effect of disparity on diversification discount was quantified by running a linear regression with year, industry, and company asset as control variables. All disparity metrics were statistically significant with P value less than 0.05, which lead to the conclusion that disparity between

a company's business units is predictive of how much the company is undervalued. We also tested different control variables and thresholds for disparity, which produced similar results. Increasing the threshold for disparity resulted in larger coefficients for the disparity variables, indicating the greater disparity is correlated with a larger valuation discount.

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*[4] For example, Feldman (2016) and Gertner, Powers, and Scharfstein (2002) showed that capital resources may not be allocated as efficiently as they should be in multibusiness firms. These findings support the recommendation that internal changes could help reduce the diversification discount in companies with financially disparate business units.*

*[5] For example, Villalonga (2004) showed that a lack of clarity in how companies report financial data on their business segments is correlated with a larger diversification discount, and Feldman, Gilson, and Villalonga (2014) showed that companies may be undervalued by investors when analysts have less information available to them about the multibusiness firms that they cover. These findings support the recommendation that communication changes could help reduce the diversification discount in companies with financially disparate business units.*

*[6] For example, Feldman (2014, 2016) showed that investors respond favorably to divestiture and spin-off announcements that are made by large, diversified companies, and McConnell, Sibley, and Wu (2015) found that companies that undertake spinoffs, as well as the businesses they spin off, outperform comparable benchmark portfolios. These findings support the recommendation that structural changes could help reduce the diversification discount in companies with financially disparate business units.*

OTHER READINGS

# Modern Methods of Business Valuation—Case Study and New Concepts

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**Abstract:** *In the modern world, the terms enterprise value and valuation are of great importance. Knowledge about how much an enterprise is worth is of fundamental importance for both the owner of that company and investors when negotiating the price of an enterprise at the time of conducting a commercial transaction. The article presents the goals of the company's valuation and characteristicstages of the company's life at which such valuation is necessary. The article classifies the methods of enterprise valuation used today. On this basis, the valuation methodology is presented according to the MDI-R concept (Assets, Income, Intellectual Capital-Market), which in a broad spectrum measures the effectiveness of the company's operations and, in accordance with the current featuresof good valuation, aims to determine the fair value of the company. The purpose of the article is to demonstrate the need to improve the code of conduct and valuation standards. As part of the implementation of the objective, multi-faceted and complex valuation issues are presented, as well as factors that may distort the determination of fair value. The methodology of the study is based on inferences about the methodology of business valuation, and verification is based on practical examples, by which a hypothesis on the existence of critical elements of valuation is verified that allows the use of broad subjectivity in estimating the value of assets. At the same time, the factors that determine the possibility of the existence of too wide a subjectivity in estimating assets, which isin contradiction with the features of good valuation, are presented. The attempt is made to draw attention to the threats arising from modern business valuation methodologies and their challengesin the future. Additionally, this article offers the authors' proposed hybrid method MDI-R, which draws from existing solutions to improve their functionality and applicability.*

**Keywords:** *corporate finance; creating value; valuation of the company; management; financial market*

## 1. Introduction

The term "enterprise" or "company" can be understood as a separate economic entity, an economic entity producing and selling on its own account goods and services with the goal to maximize profits.Modern enterprise financial management is about maximizing its value. An enterprise is a special form of investment. The owners, by investing in their own capital resources, expect to obtain certain benefits resulting from the multiplication of capital invested in this way, which leads directly to the increase in the value of the enterprise they own. Recognizing at the same time that the economic essence of ownership issues is closely related to issues of utility and the problem of the monetary value of the object of ownership, the issues relating to enterprise value, its specifics, various conditions, as well as methods and training procedures, are invariably important.

Business valuation is a complex process that requires the application of the vast knowledge of many fields of science, and there are many scientific and practical problems associated with this [1]. Despite the fact that a group of specialists has already done much in terms of efforts to standardize the valuation process, there are still many unsolved problems or controversial solutions adopted. Methods of the valuation of enterprises and their organized parts have not been regulated legally as strictly binding [2]. Also, there is no closed and complementary set of rules applicable to this process.The lack of uniform regulations is primarily due to the fact that it is not possible to fully codify a process that may relate to entities with different specificities, legal forms, assets or ownership structures. However, there are standards that allow for its partial structuring. Therefore, in many countries of the world, for many years, there have been standards for business valuation [3]. They relate to the methodology of valuation and the range of expertise that the valuator must have. They were developed by professional organizations that contain specialists in dealing with valuations. Experts are bound by codified procedures and standards of conduct, which guarantee the comparability of valuations and ease of their verification. Such a situation contributes to the security of business transactions.

The need for business valuation results from economic development. Along with the globalization of the economy, which is accompanied by an intense flow of capital to a growing number of countries, valuation becomes necessary to the sale, privatization, mergers and acquisitions or creation of joint ventures and many other processes relating to enterprises [4]. Determination of the final value of theentity is difficult due to the subjectivity of the concept of "value" itself. The problem is also the fact that business valuation is the combination of both theory and practice. It also depends on the capabilitiesof the business model used by the specific economic entity. It should be remembered, though, that theactual market value of the enterprise is very rarely exclusively determined by the assets taken into account in the balance sheet. The actual valuation is determined by a number of variable factors, such as the economic situation of the country, attractiveness of the market, the company's development strategy, human resources, the nature and manner of the use of assets owned [5]. Therefore, it can be stated that business valuation is the process of estimation of the price for assets and benefits achieved by the company as a result of their effective management. It is carried out in the moment, since the market is like a living organism and new information affecting the condition and operations of enterprises occurs over and over again.

Therefore, because of the complicated, constantly changing processes of business valuation, it isimportant to establish certain

norms and legal standards. The International Valuation Standards Council developed a document including international norms in this field [6]. It contains the guidelines recommended in the process of assessment of the company's value, as well as appraisal reports and recommendations concerning their application. Obviously, these rules are not strictly binding, however, they constitute a set of good practices and guidelines specifying certain generally accepted principles, both ethical and methodological. This aims at the elimination of significant disparities in relation to the results of the valuation made, e.g., with respect to the assets of the same type. These rules may bealso applicable in the case of court disputes concerning the outcome of the valuation, as well as doubtsabout the valuation for tax purposes. In the countries where a certain framework and standards for estimating the value of assets have been determined, there is separate certification of experts in the field of valuation.

The objective of the article is to demonstrate the need to improve the code of conduct and valuation standards. Within the framework of the accomplishment of the objective,the multidimensionality as well as the complex issues of valuation are presented along with the factors that could distort the establishment of fair value.

## 2. Methodology

The research methodology was based on a review of scientific literature and conclusions drawn from business valuation methodology. As part of this methodology a detailed analysis was performed of the subsequent stages of business valuation methods used in business practice. Also in the article practical examples were verified. On their basis, the hypothesis about the existence of key valuation elements was verified, which allows the use of broad subjectivity when estimating the value of assets. The research methodology used demonstrated the need to improve the code of conductand valuation standards. Additionally, as part of the critical analysis, factors that may distort the determination of fair value were presented. Therefore, the original concept of MDI-R was presentedto improve practical valuation methods. At the same time, the necessity of further development of valuation methods and the search for objective methods of fair value measurement for the conductedbusiness was shown, which require further detailed research based on the analysis of numerical dataon practical examples.

## 3. Literature Review

Business valuation is a set of procedures, analyses and assessments leading to the estimation of the company's value in monetary units for the specific moment [7]. Contemporary realities of the market economy and the globalization process have determined that business valuation is of fundamental importance for economic processes. Contemporary management of corporate finance consists in maximizing its value. Business valuation is the process of estimating the price of assets (fixed and current assets, as well as different intangible assets and characteristics) and benefits achieved due to their effective management [8]. Generally, the objective of business valuation is always to facilitate strategic decision-making in terms of organization, shares or investments. Valuation enables the selection of both ownership and financial options in assets and liabilities. It is actually the opinion of the value prepared by specialized experts, analysts and valuators on the basis of the collected and properly utilized information about the company considered and the environment of its operations [9]. At thesame time, it can be acknowledged that the company's value is the market measure of the effectiveness and efficiency of actions taken by the enterprise. Despite such a crucial function performed by business valuation in the economy, its specificity and essence pose many problems. These are related to a variety of conditions and numerous procedures and methods serving business valuation. Another component resulting in problems in the valuation of fair value is the growing importance of intellectual capital. This is due to global technological and organizational transformations, which have led to theknowledge-based economy. Intellectual capital, among others, consists of legal assets, technology and relationships with customers. At the same time, among the issues of intellectual capital, there are many ambiguous and various solutions for both theory and practice. Due to difficulties in the valuation of intangible and legal assets, which primarily determine the contemporary value of enterprises,in particular highly developed ones, in terms of technology, one deals with difficulties in achieving the so-called fair business valuation [10]. The methodology of the valuation of intangible and legal assetsis subject to constant changes in search of a universal method. Therefore, at present, in the subject literature, the conclusion is that, in order to make the best possible valuation, it is necessary to valuateindividual components affecting the value of the company with separate methods that best reflect thenature of their value.

The existence of many subjective factors affecting the valuation may lead to abuse, pressure and the desire to influence the experts' decisions, which result in the distortion of fair value. Therefore, in order to streamline business valuation, there is the need to develop a synthetic and universal, yet consistent, methodology for the valuation of basic parameters. This also requires the implementation of appropriate regulations or standards concerning the generally accepted methods of business valuation since, depending on the subjective choice of the method by the appraiser, significant differences in the final valuation may be observed, resulting in low values of the company [11]. Therefore, the objective should be to develop standards that will determine acceptable methods (patterns) for specific industries or cases. All practitioners carrying out business valuations must accept certain fundamental principles. The appropriate model for the estimation of the value of the economic entity should not only informabout the total value but also indicate the structure of the sources of its creation. Therefore, business valuation methods should take into account as many components of the company affecting its value as possible. Nowadays, the valuation process is already moving in this direction, the example of which is a simultaneous use of, most frequently, asset-based, income-based and comparable company methodsto determine the final value of the company. The use of several valuation methods in the course of the applied procedure provides an opportunity to make rational decisions as to the final value of theenterprise [12]. In this paper, the problem areas are analyzed and indicated, which can be useful when building Polish business valuation standards. Undoubtedly, standardization will lead to a reduction ina certain degree of subjectivity, present in valuations. Moreover, valuations made on the basis of thesame requirements will become comparable and more easily verifiable in terms of their correctness.

Contemporary realities of the market economy along with the globalization process have caused business valuation to become of fundamental importance for economic processes

[13]. Additionally, growing information needs have led to the development of numerous methods of valuation. The enterprise (company) is an economic entity producing and selling goods or services for its own account and at its own risk, an objective of which is to maximize profits. Contemporary management of corporate finance consists in maximizing its value. This is due to the fact that the enterprise, as a separate economic and legal entity, is a particular form of investment. Owners, investing their own capital resources in its economic activities, expect to obtain certain benefits, mainly to multiply the capital invested in this way, which directly leads to an increase in the value of the enterprise they own. At the same time, when recognizing that the economic essence of the issue of ownership is closely linked to the issues of usability and the problem of the monetary value of an object of property, the issue relating to the category of the company's value appears to be invariably important. Business valuation is the process of estimating the price of assets (fixed and current assets,as well as different intangible assets and characteristics) and benefits achieved due to their effective management [14].

The need for business valuation results from economic development. Along with the globalization of the economy, which is accompanied by an intense flow of capital to a growing number of countries, valuation becomes necessary to the sale, privatization, mergers and acquisitions or creation of joint ventures and many other processes relating to enterprises. It is also important for value management of subsidiaries located in the developing countries. Generally, the objective of business valuation is always to facilitate strategic decision-making in terms of organization, shares or investments. Valuation enables the selection of both ownership and financial options in assets and liabilities. It is actually theopinion concerning the value, prepared by specialized experts, analysts and valuators on the basis of the collected and properly utilized information about the company and the environment of its operations [15]. At the same time, it can be acknowledged that the company's value is the market measure of the effectiveness and efficiency of actions taken by the enterprise.

The process that aims to determine the value of the company is valuation. The term "enterprisevaluation" means that the subject of the valuation is the economically and legally isolated organizational unit, with specific potential in the form of fixed and current assets, as well as different intangible assets and characteristics. Valuation can be treated as the opinion, judgment, estimation of the preciousness of something. According to Miles, valuation is an opinion concerning the value, usually made in writing and, at the same time, it is the process of estimating the value of the cost of the asset, a group of assets or all the assets belonging to the business or the specific investment [7]. However, despite such a crucial function performed by business valuation in the economy, its specificity and essence pose many problems as measures of effective operations, among others. This is related to a variety of conditionsand numerous procedures and methods serving business valuation. At the same time, the reasons forthe contemporary crisis of confidence in the methodology of business valuation are presented and thedirections of future development are indicated, which is of fundamental importance for the operations and opportunities of the conducted business. The essence of the valuation of the company is to give its value as expressed in the specific monetary units using set prices, rules and analyses.

The research methodology is based on reasoning on the basis of the methodology of asset-basedmethods of business valuation and the analysis of practical examples in order to verify the hypothesis about the existence of critical components of valuation that enable wide subjectivity in estimating thevalue of assets.

*The Process of Business Valuation–The Essence and Classification of Methods*

In the contemporary world, the value of the company and its valuation are of crucial importance.

The value of the enterprise

- is an invariably important issue of the economic essence of ownership, which is closely linked toissues of usability and the problem of the monetary value of an object of property,
- is the market measure of the effectiveness and efficiency of actions taken by the enterprise.

The process of the valuation of the company, its specificity and essence pose many problems andcontroversies. This is connected with the essence of monetary valuation, which is a subjective measure. Then, there are various conditions and numerous procedures and methods for business valuation. The knowledge of the company's value is of great importance for making strategic decisions concerning characteristic stages of the company's operation [16]. The essence of the business valuation of the company is to give its value expressed in the specific monetary units using set prices, rules and analyses. Table 1 contains the objectives of business valuation under different conditions, which indicate fundamental importance for the conducted business.

**Table 1.** The objectives of business valuation.

| Internal | External | Internal–External |
|---|---|---|
| - Ability to control the capital invested by the owner to multiply value<br>- Measurement of the value of shares for the purposes of their presentation<br>- Acceptance of new shareholders or exclusion of some of the existing ones<br>- Change in the legal form of the business<br>- Management contracts, remuneration systems based on value creation<br>- Identification of value determinants<br>- Strategic planning<br>- Division of the company | - Dimension of taxes<br>- Determination of the amount of stamp duty, notarial fees, etc.<br>- Determination of the amount of insurance premiums<br>- Public offers<br>- Determination of the amount of compensation arising from insurance | - Purchase or sale of the company<br>- Ownership transformations<br>- Privatization and re-privatization<br>- Transfer of the company under the rent, franchise or lease<br>- Merger of enterprises<br>- Valuation of listed companies for the comparison with the stock market valuation<br>- Sale of newly issued shares<br>- Loan and credit collateral |

Source: Own study based on: [7,17].

Accurate preparation of the business valuation helps in achieving better trading terms since, in the course of negotiations, it allows for relying on facts and not intuition, feelings and emotions [18].At the same time, it enables avoiding the situation where the owner's idea significantly exceeds the actual value of the company or, on the contrary, where this idea definitely does not estimate the company's value. Therefore, the situation in which the transaction under objective conditions might fail is avoided. There are five functions of valuation resulting from the reasons for carrying it out [19]:

- Advisory (decision-making) function

  The essence of the advisory function (also known as decision-making) is to provide the necessaryinformation on the value of the company in relation to the intended execution of certain transactions.

- Argumentative (justifying) function

  The implementation of this function consists in the skillful use of information obtained in the course of valuation. This is about the selection of information that will strengthen the bargaining power of the party to the transaction.

- Mediation function

  The mediation function, also known as negotiating, refers to situations where the opinions of parties to the transaction as to the value are significantly divergent.

- Security function

  Its essence is to provide information on the value of the company for the purposes of protectionagainst the adverse effects of disputes arising in connection with the value.

- Information function

  Its essence is to provide information obtained in the process of valuation for the purposes of enterprise management. The recipients of this information are investors, banks, trading partners, customers, financial analysts, authorities at different levels, etc.

After conducting the preliminary analysis of the subject and purpose of the business valuation, it is necessary to choose the method that is the most adequate to the situation of the enterprise and the specificity of its industry. Contemporary realities of the market economy and the globalization process have determined that business valuation is of fundamental importance for economic processes [5]. Additionally, growing information needs have led to the development of numerous methods of valuation. The determinants of the selection of the business valuation method include [20]:

- Valuation objective;
- Who orders (recipient);
- Type of the company due to usability;
- Economic condition of the company and the condition of the environment (economy, industry,region);
- Type, scale and diversity of business;
- Type and number of assets;
- Operation and development prospects of the company;
- Type and quality of information about the company and the market that it is possible to obtain;
- Approaches and types of value in business valuation.

A wide range of practitioners carry out business valuation on a daily basis. Therefore, valuationshould be perceived as a practical activity and defined as a way of value (monetary) measurement ofthe enterprise, i.e., its resources and economic effects of decisions taken.

Fair value is the amount for which an asset can be exchanged if the transaction takes place under market conditions between interested parties who are not related to each other and possess the information that allows for full assessment of the value of the subject of the transaction. At the same time, business valuation is a complex process that is able to illustrate the actual and fair value ofthe company only if it is carried out in accordance with the so-called characteristics of good (reliable) valuation, which include [21]:

- Compliance of the valuation with the facts;
- Timeliness of data, transparency and relative simplicity;
- Clearly defined purpose of its preparation;
- Being based on the financial data of the company;
- Not being made exclusively on the basis of the value of the company's assets unless it concernsthe so-called liquidation method;
- Taking into account income and intangible factors;
- Taking into account the company's development forecasts and risk factors;
- Taking into account all relevant information which affects the valuation and is available in theprocess of its preparation;
- Being objective and reliable.

On the other hand, the selection of the valuation method itself constitutes the most important partof the process of estimating the actual fair value of the company and must be adjusted to the subject ofthe valuation. Despite the fact that a wide range of practitioners carry out business valuation on a daily basis, this process still requires improvement. Table 2 presents the methods of business valuation the most frequently applied in practice.

**Table 2.** The classification of business valuation methods.

| Business Valuation Methods | | | | |
|---|---|---|---|---|
| **Asset-Based** | **Income-Based** | **Mixed** | **Comparable Company** | **Unconven-tional** |
| - Book value method | - Discounted dividend method | - Average cost method | - Multiples method | - Option theory-based methods |
| - Adjusted net assets method | - Discounted cash flow method | - Swiss method | - Method of comparable transactions | - Time lag methods |
| - Replacement method | - Discounted future earnings method | - Berlin method | | - Others |

| - Liquidation method | | - Excess earnings method | | |
|---|---|---|---|---|
| | | - Stuttgart method | | |
| | | - UEC[1] method | | |

[1]The name of the method comes from the commission called by Union Europeene des Experts ComptablesEconomiques et Financiers. Source: Own study based on: [22].

Another component resulting in problems in the valuation of fair value is the growing importance of intellectual capital. This is due to global technological and organizational transformations thatled to the knowledge-based economy [23]. Intellectual capital, among others, consists of legal assets,technology and relationships with customers, etc. At the same time, among the issues of intellectual capital, there are many ambiguous and various solutions for both theory and practice. Figure 1 illustrates the changes in the significance of assets of enterprises for their valuation.

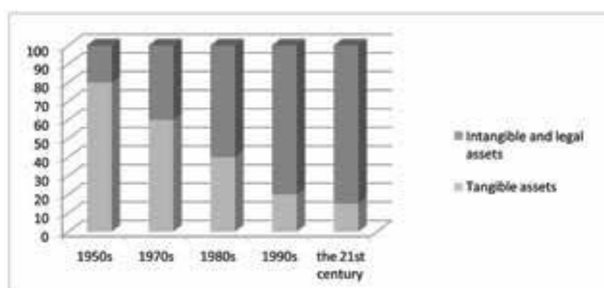


**Figure 1.** The significance of the values of tangible and intangible assets over the years. Source: Ownstudy based on the data: [24].

Therefore, due to difficulties in the valuation of intangible and legal assets, which primarily determine the contemporary value of enterprises, in particular, highly developed ones, in terms of technology, one deals with difficulties in achieving the so-called fair business valuation. The methodology of the valuation of intangible and legal assets is subject to constant changes in search of a universal method. Therefore, along with the aforementioned components, these are the main reasons for the contemporary crisis of confidence in the methodology of business valuation.Therefore, at present, in the subject literature, the conclusion is that in order to make the best possiblevaluation it is necessary to valuate individual components affecting the value of the company with separate methods, which best reflect the nature of their value.

## 4. Results

An extremely important factor in the business valuation process is the appropriate selectionof methods. This choice is determined not only by the objective of valuation and the situation ofthe valuated entity but also by the nature of the business and the specificity of areas of its business activity. The economic situation of enterprises, i.e., their market position, status of assets, ability to generate income, are some of the determinants having an impact on the selection of the valuation method. Additionally, in the course of analyses of information concerning the valuated entity and also within the framework of the application of the same method, one deals with the so-called criticalpoints of valuation, i.e., components subjected to the subjective selection. The proper determination of the financial condition of the company can also be a source of differences, depending on the person carrying out the valuation and availability of information [25]. Additionally, it should be noted that each industry is characterized by a certain specificity, which has a large impact on many componentsthat determine the valuation process. The existence of many subjective factors affecting the valuationmay lead to abuse, pressure and the desire to influence the experts' decisions, which results in the distortion of fair value. Therefore, the following should be mentioned as risks and problems to solvein the future:

- Freedom of selection of input data,
- Use of wide subjectivity in the common valuation procedure,
- Subjectivity of selection of valuation methods and internal parameters,
- Lack of coherence in estimation of parameters,
- Lack of legal regulations and standards of valuation.

Therefore, in order to streamline business valuation, there is a need to develop a synthetic and universal yet consistent methodology for the valuation of basic parameters. This also requires the implementation of appropriate regulations or standards concerning the generally accepted methods of business valuation since, depending on the subjective choice of the method by the appraiser, significant differences in the final valuation may be observed with low values of the company [26]. The related works appeared due to the association of a group of specialists and practitioners. One of the tangibleresults of efforts to eliminate a number of risks is the announced *New Interpretative Note No 5—General Principles of Business Valuation* [27]. Despite a large number of ways of carrying out valuations and with the high quality of analytical work at the valuation, it should be remembered that a business is worth as much as someone is willing to pay for it. On the other hand, good and factual valuation is essential for preparing oneself for substantive discussions with the buyer. Within the framework of this paper, the essence, objectives and functions of business valuation were determined and the overall classification of valuation methods applied in the practice of economic life was made.

### *4.1 The Examples of Business Valuation Using the Adjusted Net Assets Method–Case Study*

#### 4.1.1 The Practice Example No. 1—Valuations Using the Adjusted Net Assets Method

Under ideal conditions, business valuation would consist in estimating the value of each asset individually and then subtracting all liabilities. The net asset value is then received, i.e., the value less liabilities, adjusted for the book value. For example, such a procedure occurs when valuating enterprises under court cases for

division of assets or repayment of some of shares, which is illustrated by the example in the table below (Table 3).

**Table 3.** The listing of the values of fixed assets adjusted for the market values in relation to thebook values.

| No. | The Name of the Fixed Asset | Book Value [PLN] | Market Value on the Valuation Date [PLN] |
|---|---|---|---|
| 1. | A fiscal printer—Viking | 1.499 | 800 |
| 2. | A printer—Canon 250 | 0 | 210 |
| 3. | A computer set | 3.200 | 1.200 |
| 4. | A car—Toyota Avensis | 14.500 | 9.500 |
| 5. | Cell phones—Motorola M3588—2 pieces | 1.350 | 250 |
| 6. | A fax machine | 0 | 200 |
| 7. | Software—WF-MAG | 658.25 | 658.25 |
| 8. | A computer upgrade—HDD 4GB | 340 | 0 |
| 9. | A truck—Citroen Berlingo OP15937 | 15.100 | 12.000 |
| 10. | Etc. till the inclusion of all the assets | ... | ... |

Source: Own study based on the opinion of the court expert on behalf of the District Court of Katowice—Wschódin Katowice.

However, for practical reasons, only the most important balance sheet items are often subjectedto adjustment, which are also different depending on the valuation objective. Due to the fact that the starting point of the valuation of the company is its net assets, there are many drawbacks tothis method, which, to an extent dependent on the resources designed for valuation (mainly cash and time), are adjusted in the course of the valuation. The largest discrepancies between actual and balance sheet values are mostly caused by referring the balance sheet valuation to historical costs and the difficulty in clear classification of some items as equity or foreign capital (reserves, special funds, accruals). Therefore, in order to obtain the real value of the company, it is necessary to make adjustments to balance sheet items. When making adjustments, one should take into account the valuation objective. Other adjustments will be made when the company is purchased for resale, merger or significant reorganization. Adjustments of individual items are also dependent on the type of the conducted activity. The significance of balance sheet items is also assessed in order to reduce the costsof adjustments of less important items. Valuation should start with the determination if all the itemsare properly reflected in the balance sheet and if the items included in the balance sheet are not just empty records. Obviously, the balance sheet that is the basis for the valuation should be up to date.

The first item is intangible and legal assets. They are usually valuated under the market value; however, when they are unsellable they are valuated at zero. However, there are exceptions, e.g., non-transferable software licenses. In the case of business continuation, they will present measurable value. It should be taken into account that most development costs cannot be activated. Therefore, e.g., in research companies, the relevant adjustment may be essential. Another group is tangible fixed assets. If there is a secondary market for tangible fixed assets, the market price should be taken into account, since depreciation write-offs illustrate formal and not actual consumption of these assets. It is also possible to consider the price of a new fixed asset, taking into account a range of adjustments (due to technological underdevelopment, wear, expert opinion, market conditions, liquidity of the secondary market, etc.). It is also important to include, in the valuation, the fact that market prices may significantly vary depending on the stage of the business cycle [28]. The possessed land is usually underestimated, and making its value realistic results in an increased valueof the company valuated. In the case of the right to perpetual usufruct over land, under the item of tangible fixed assets the difference can be found between the first (higher) and subsequent (lower) charges. This difference will be subjected to depreciation write-offs in accordance with the general rules. Therefore, the possession of the right for perpetual usufruct over land will increase the value ofthe company valuated.

When valuating receivables, despite the existing reserves, lowering adjustments are additionallymade, which result from insufficient reserves. It is also necessary to indicate receivables that are not due to specific, already conducted transactions but agreements that cannot be included in the balancesheet on the day of its production [29]. It should be verified if the stocks included in the balance sheetactually exist and if the way of their valuation corresponds to the market value. It is also essential todetermine whether the stocks owned by the company are not obsolete, broken or damaged. In the case of receivables, first of all, it should be checked if they are not underestimated and if there are not off-balance sheet obligations and what is the probability of their maturity. Such liabilities will additionally decrease the value of the company valuated. Also, tax liabilities may require adjustments.

While valuating financial assets, the market price of shares and/or stocks should be taken into account. Valuation ought to include the valuation of units in which the specific company has shares/stocks, as long as their value justifies such a way of conduct. When valuating cash, one should pay attention to whether it is cash or whether, under this item, there are also promissory notes and cheques that are associated with risk, which should be

considered in appropriate adjustments. Prepayments and accrued income may also require adjustments. Most of all, it is necessary to determine if their allocation over time is correct. In the case of inappropriate estimation, accruals and deferred income may also require adjustments. A typical example would be not taking into account delayed invoices for external services that increase the costs of the specific period. Additionally, when business valuation is made with the intention to merge two entities, there are adjustments to harmonize the accounting approach used in each of the merged enterprises. Also, the need to pay dividends in the future or to recapitalize one of the merging enterprises by the third party will require adjustments increasing or decreasing the entity valuation.

Despite the fact that valuation is carried out on the basis of data resulting from the balance sheet, legal regulations or concluded agreements, this method is also not without a certain dose of subjectivity, since the valuator makes the decision on what adjustments and in relation to what assets they will be applied. Each business valuation should be approached individually, since it may turn out that each item in the balance sheet may require adjustments adapting it to the market value. The adjustednet assets method, due to less complicated assumptions necessary for its conduct and adjustmentof prices to current net prices, is the most frequently applied asset-based method when making business valuations.

4.1.2 The Practice Example No. 2

The objective of the valuation in the Example 2 (Table 4) is to inform about the value of equity forthe previous owner, who is interested in selling his or her block of shares and is planning to use the valuation as a starting point in negotiations.

Downward adjustments adopted in the valuation related to the following assets:

- Intangible and legal assets—this is an integral part of computer hardware. In this case,the equipment along with the software was included under the item of technical equipment and machinery;
- Means of transport—the market value of the means of transport was lower than their balance sheet value by 11.7%. One of the three vehicles had had an accident; therefore, its value was reduced, which resulted in a lower value of the whole item;
- Fixed assets under construction—these were repair expenditures in the company's main office; the liquidation value of 0 PLN was accepted for the balance sheet after adjustment;
- Long-term receivables—20% was assumed, considering the failure in getting back all the deposits;
- Long-term investments—revaluation of the B2X Ltd. company, in which the Service company has 51% of shares, lowered the value by 24.5% from the balance sheet value;
- Goods and receivables on account of supplies and services—the adjustment indicator of 20% was adopted.

Upward adjustments on the asset side are the following components:

- Real estate (buildings, premises)—revaluation prepared by valuators increased the value by23.7%, to PLN 5125 thousand and this amount was accepted for the adjusted balance sheet;
- Technical equipment and machinery—were subjected to adjustment on the basis of current marketprices and the total value increased;
- Other fixed assets—the appraisal reports produced by valuators indicated a higher value thanthe balance sheet value.

**Table 4.** The assets of the Service S.A. company prior to and after adjustments.

| | (PLN Thousand) | Prior to Adjustment | Adjustment % | Adjustment | After Adjustment |
|---|---|---|---|---|---|
| **A.** | **Fixed Assets** | 9453.39 | | | 10,303.05 |
| **I.** | **Intangible and Legal Assets** | 81.54 | | | 0 |
| 1. | Other intangible and legal assets (software) | 81.54 | | −81.54 | 0 |
| **II.** | **Tangible Fixed Assets** | 6550.52 | | | 7825.00 |
| 1. | Fixed assets | 6539.09 | | | 7825.00 |
| a) | Buildings, premises and civil engineering facilities | 4144.62 | 23.7% | 980.38 | 5125.00 |
| b) | Technical equipment and machinery | 1076.26 | 23.7% | 255.29 | 1331.54 |
| c) | Means of transport | 169.79 | −11.7% | −19.79 | 150.00 |
| d) | Other fixed assets | 1148.42 | 13.2% | 151.58 | 1300.00 |
| 2. | Fixed assets under construction | 11.43 | −100.0% | −11.43 | 0.00 |
| **III.** | **Long-term Receivables** | 583.01 | −20.0% | −116.60 | 466.41 |
| **IV.** | **Long-terms Investments** | 1258.22 | | | 950.00 |
| 1. | Long-term financial assets | 1258.22 | | | 950.00 |
| a) | in affiliated entities | | | | |
| | Shares in B2X Ltd. | 1258.22 | −24.5% | −308.22 | 950.00 |
| **V.** | **Long-term Accruals** | 980.10 | | | 980.10 |
| 1. | Deferred tax assets | 964.47 | | | 964.47 |

| | | | | | |
|---|---|---|---|---|---|
| 2. | Other accruals | 15.63 | | | 15.63 |
| **B.** | **Current Assets** | 3939.26 | | | 3692.45 |
| **I.** | **Stocks** | 1234.05 | | | 987.24 |
| 1. | Goods | 1234.05 | −20.0% | −246.81 | 987.24 |
| **II.** | **Short-term Receivables** | 461.54 | | | 390.26 |
| 2. | Receivables for the other entities | 461.54 | | | 390.26 |
| a) | On account of supplies and services, in the repayment periodof up to 12 months | 356.39 | −20.0% | −71.28 | 285.11 |
| b) | Due to taxes, subsidies, customduties, social and health insurances and other benefits | 79.60 | | | 79.60 |
| c) | Others | 25.55 | | | 25.55 |
| **III.** | **Short-term Investments** | 2000.00 | | | 2000.00 |
| 1. | Short-term financial assets | 2000.00 | | | 2000.00 |
| a) | Cash and other monetary assets | 2000.00 | | | 2000.00 |
| | - cash in hand and at bank | 1000.00 | | | 1000.00 |
| | - other cash | 900.00 | | | 900,00 |
| | - other monetary assets | 100.00 | | | 100.00 |
| **IV.** | **Short-term Accruals** | 243.68 | | | 243.68 |
| | **Total assets** | 13,392.65 | | | 13,924.22 |

Source: [30].

No adjustments were made to foreign liabilities; therefore, their balance sheet value was assumed in the amount of PLN 7980.28 thousand. The adjusted assets in the amount of PLN 13,924.22 thousand—the adjusted liabilities in the amount of PLN 7980.28 thousand equals the value of PLN 5943.95 thousand. A lot of professionals in the field of business valuation usually end the valuation with the adjusted net assets method at this stage. However, within the framework of the development of the method, it is worth taking into account other components, which may have an impact on the value of the company (value sources), e.g., trademark (brand), know-how, own patents or licenses. In the businesspractice, the adjusted net assets method usually indicates a lower value of the operating enterprise since it does not include, for example, the value of the company's contacts or knowledge of employees. Therefore, in the process of business valuation, the value determined by the asset-based valuation method was considered as the minimum value for the seller, which constitutes the company's assets.

4.1.3 The Practice Example No. 3

The ABC company, among its assets, has:

- The office building worth (according to the appraisal report of 2009) PLN 3 million,
- The production building worth (according to the appraisal report of 2009) PLN 5 million,
- The assembly line of 2003 worth (in the valuator's opinion) PLN 0.5 million,
- Stocks of materials and products worth PLN 4 million,
- Receivables worth PLN 3 million, PLN 0.5 million of which is uncollectible.

The total value of assets amounts to PLN 15 million (the market value of assets, which may significantly vary from the book value). At the same time, the value of liabilities of the company is two investment loans for a total value of PLN 8 million and liabilities to suppliers worth PLN 3 million. The value of liabilities amounts to a total of PLN 11 million. On the basis of the above, the adjusted netassets value amounts to PLN 15 − 11 = 4 million.

The advantages of the valuation using the adjusted net assets method include:

- Objectivity and ease in carrying out by oneself,
- Access only to basic data,
- Taking into account the condition and usability of assets for operation,
- Possibility to compare with the value determined using other methods,
- Possibility to determine the lower range of values in negotiations.
- On the other hand, the primary disadvantages include:
- Not taking into account important components of the company's value not recorded in the balance sheet, e.g., contracts of the company, knowledge of employees, possessed brands and value of trademarks;
- Possibility to determine only the value of assets in the categories of the so-called material substance, which usually underestimates the value of the operating enterprise.

Undoubtedly, the adjusted net assets method offers the greatest usability in the case of enterprises with a high share of fixed assets in the value of the whole company, i.e., traditional production companies. This is confirmed by the evolutionary history of business valuation methods. At the same time, despite the increasing importance of income-based and comparable company methods, nowadays asset-based methods are still the basis for the estimation of business value.

4.1.4 The Practice Example No. 4

Practical Example number 4 (Table 5) shows the valuation of the enterprise using the income method. This is one of the most popular methods of this type used in practice, namely, Discounted Cash Flows (DCF). For the calculation, the available econometric software used in business valuation practice in the market was applied.

**Table 5.** Example of valuation with the method of income (Discounted Cash Flows).

| XYZ S.A. | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2026+ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Model DCF (Discounted Cash Flows)** | | | Forecast | Forecast | Forecast | Forecast | Forecast | Forecast | Forecast | Forecast | Forecast |
| 1. Operating result (EBIT) | 1531 | 1607 | 1688.1 | 1772.5 | 1861.1 | 1861 | 1861 | 1861 | 1861 | 1861 | 1861 |
| 2. Tax rate % | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% |
| 3. Tax on EBIT | 290.9 | 305.5 | 320.7 | 336.8 | 353.6 | 353.6 | 353.6 | 353.6 | 353.6 | 353.6 | 353.6 |
| 4. Tax-adjusted operating result (NOPLAT) | 1240 | 1302 | 1367.4 | 1435.7 | 1507.5 | 1507 | 1507 | 1507 | 1507 | 1507 | 1507 |
| 5. Depreciation | 1317 | 1445 | 1597.6 | 1764.9 | 1949 | 2154 | 2384 | 2643 | 2936 | 3268 | 3644 |
| 6. Investment outlays (CAPEX) | 1310 | 1517 | 1646,5 | 1788.6 | 1945.5 | 2154 | 2384 | 2643 | 2936 | 3268 | 3644 |
| 7. Change in working capital | 180.0 | 171.8 | 180.3 | 189.4 | 198.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **8. FCF–free cash flow** | **1067** | **1058** | **1138.1** | **1222.7** | **1312.8** | **1507** | **1507** | **1507** | **1507** | **1507** | **1507** |
| 9. Risk-free rate% | 5% | 5% | 5% | 5% | 5% | 5% | 5% | 5% | 5% | 5% | |
| 10. Beta indicator | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | |
| 11. Market premium % | 2% | 2% | 2% | 2% | 2% | 2% | 2% | 2% | 2% | 2% | |
| 12. Cost of equity % | 7.4% | 7.4% | 7.4% | 7.4% | 7.4% | 7.4% | 7.4% | 7.4% | 7.4% | 7.4% | |
| 13. Cost of debt % | 8% | 8% | 8% | 8% | 8% | 8% | 8% | 8% | 8% | 8% | |
| 14. Tax rate % | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% | 19% |
| 15. Cost of debt after tax % | 6.5% | 6.5% | 6.5% | 6.5% | 6.5% | 6.5% | 6.5% | 6.5% | 6.5% | 6.5% | |
| 16. Value of equity (resulting from the valuation) | 14092.6 | 14092.6 | 14092.6 | 14092.6 | 14092.6 | 14092.6 | 14092.6 | 14092.6 | 14092.6 | 14092.6 | |
| 17. Value of debt | 7075 | 7075 | 7075 | 7075 | 7075 | 7075 | 7075 | 7075 | 7075 | 7075 | |
| 18. Share of equity | 66.6% | 66.6% | 66.6% | 66.6% | 66.6% | 66.6% | 66.6% | 66.6% | 66.6% | 66.6% | |
| 19. Share of debt | 33.4% | 33.4% | 33.4% | 33.4% | 33.4% | 33.4% | 33.4% | 33.4% | 33.4% | 33.4% | |
| ***20. Weighted Cost of Capital (WACC)*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** | ***7.09%*** |
| 21. Discount indicator | 0.933 | 0.871 | 0.8142 | 0.7603 | 0.709 | 0.662 | 0.619 | 0.578 | 0.539 | 0.504 | 0.504 |
| 22. FCF growth rate after 2026 | | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| 23. Residual value after 2026 | | - | - | - | - | - | - | - | - | - | 21,255 |
| **24. Discounted FCF–Free Cash Flow** | **996.9** | **923.2** | **926.6** | **929.6** | **932.0** | **999.3** | **933.1** | **871.3** | **813.6** | **759.8** | **10,712** |
| **25. Discounted Free Cash Flow Ascending** | **996.9** | **1920.1** | **2846.7** | **3776.3** | **4708** | **5707** | **6640** | **7512** | **8325** | **9085** | **19,797** |

| | |
|---|---|
| **1. Value of the Company from the Valuation** | 19,797.6 |
| 2. Net debt at the end of 2018 | 5705.0 |
| **3. Value of Equity from the Valuation** | **14,092.6** |
| 4. Number of shares in the company | 1000 |
| **5. Value of 1 share** | **14.09** |

Source: [31].

The most common methods currently used in valuation practice are the adjusted net asset method and the discounted cash flow method [32]. They form the basis for determining the explanatory variables regarding assets and income options. To combine the advantages of both methods, mixed methods were created that look for optimal structural parameters.

*4.2 The Analysis of Methods and the Valuation Process to Establish the Determinants of Value Subjectivity*

Asset-based methods are historically the oldest concept of business valuation, adopting assets as the bases for determining the value. Therefore, the value of enterprises, being the effect of this valuation, is known as the asset value. This means that the company is worth as much as its valuated assets. However, due to the fact that many companies are in debt, one may talk about the gross and net assets value, i.e., the value reduced by the value of debt. In these methods, the market value of the company, understood as the sum of the value of business asset liquidation, is subjected to valuation.The first and simultaneously the simplest valuation of assets is carried out using the net book value method (recordkeeping). The information included in the balance sheet is directly used. The formulafor business valuation using the recordkeeping net assets value method:

$$WP = A - Po = KW,$$

WP—business value (net book value), A—
total balance sheet value of assets, $P_o$—
balance sheet value of foreign liabilities,
KW—balance sheet value of equity.

However, the book value of assets and liabilities does not usually equal their market value, which, in the current rapidly changing market conditions—in particular, in the segment of high technologies—may result in significant differences in value, which become unacceptable in order to determine the current fair value. The valuation based on the market value of the possessed assets andliabilities is known as the adjusted net assets method. The formula for business valuation using the adjusted net assets value [33]:

$$WP = AW - POW = KWW$$

AW—total adjusted assets value, POW—
value of adjusted foreign liabilities,
KWW—value of adjusted equity.

It is the most common method of valuation of business assets applied nowadays.

The objective of the replacement method is to estimate the total financial outlay that would be needed to restore individual assets of the valuated company. This method is often used by entrepreneursmaking a decision on whether it is more profitable to buy a company or build it on one's own from the ground up [34]. The formula for business valuation using the replacement method (valuation of infrastructural enterprises—the main asset is infrastructure, e.g., power distribution companies) [8]:

$$W_{ON} = W_{OB}\ (1 - Z_f)(1 - Z_m),$$

$W_{ON}$—net replacement value (the value of the fixed asset, taking into account its physical and moralwear),

$W_{OB}$—gross replacement value (the value of the new fixed asset),

$Z_f$—physical (technical) wear indicator, $0 \le Z_f$,

$Z_m$—moral wear indicator (technological change, aging), $Z_m \le 1$.

A specific case is business valuation using the liquidation method (for the purposes of insolvency proceedings), but then fair value is being dealt with.

Income-based methods consist in estimating the market value of the company understood as the sum of net income obtainable from the company in the future. The general formula of business valuation using the income-based method [10]:

$$WP = \sum_{i=1}^{n} a_t D_t,$$

t—year of the analysis, $a_t$—
discount rate for the year t,
$D_t$—income in the year t.

In practice, the most frequently applied method is referring valuation to discounted cash flows. The formula for business valuation using the discounted cash flow method [9]:

$$W_d = \sum a_t \cdot NCF_t + RV,$$

$W_d$—income value,

$a_t$—discount rate for the year t, NCFt—net cash flows for the year t,RV—residual value.

There are many types of valuations using the DCF (Discounted Cash Flow) method, varying both in the level of detail and the structure of cash flows, as well as the determination of the discount rate.According to the DCF method, the value of the company equals the sum of cash flows discounted at an appropriate rate, which, after cumulation and summing, creates the total cash flow at the disposal ofthe owners [1].

Asset-based methods, as the oldest concept of the valuation of assets, contemporarily also usingthe practice of comparable company methods, seem to be to the greatest extent objective and compliant with the intention to determine fair value. On the other hand, income-based methods still require improvement in creating good practices and standards, at least in terms of defining discount rates andthe number of years accepted for valuation since, among others, these factors allow for the excessive subjectivity of valuation. Comparable company methods consist in estimating the market value, which is established on the basis of the known sale and purchase transactions. The principle of this methodis applied when valuating assets, the prices of which are adjusted to market values. However, the method of comparable company valuation is also the method based on market multiples, which is based on the assumption that the financial market provides the best information for business valuation. The selection of multiples and their use is complicated and causes a lot of controversies, particularly in pursuit of fair value. Therefore, the choice of multiples undoubtedly belongs to the subjective determinants of business valuation.

Mixed valuation methods combine the methods of the valuation of assets with income-based methods. This is due to the assumption that the value of the company is affected not only by its assets but

also by the ability to generate income. However, these methods may be unreliable, and thisis associated with the possibility of overestimation or underestimation in valuation due to different proportions in the value of assets and profitability in the formulas proposed. Table 6 contains examples of valuation for various mixed methods using the example of actual data presented in the court reports in Katowice and Cracow. The examples were selected because of the same assumptions concerning the valuation using the income-based method. The valuators chose the methods in the following order: the Swiss, German and Stuttgart methods.

**Table 6.** The examples of valuation for various mixed methods.

| Method | Assets and Income | Stuttgart Formula: W = M + (5r/1 + 5r) (D − M) | Anglo-Saxon Formula: W = M + [1 − 1/(1 + r)^n] (D − M) | German Formula: W = (M + D)/2 | Swiss Formula: W = (2D + M)/3 |
|---|---|---|---|---|---|
| Valuation (in PLN Thousand) | M = 120<br>D = 410 | 216 | 230 | 265 | 313 |
| | M = 98<br>D = 546 | 247 | 268 | 322 | 397 |
| | M = 290<br>D = 110 | 230 | 221.5 | 200 | 170 |

Source: Own study based on the valuations by appraisers at the District Court in Katowice and Cracow.

Depending on the subjective choice of the method by the valuator, significant differences in the final valuation may be observed, with low values of the company. Therefore, the objective should be to develop standards that will determine acceptable methods (patterns) for specific industries or cases.

In the above example, it can be seen that the Swiss method prefers (valuates higher) companies that bring higher income with fewer assets, and therefore prefers companies in which assets are less important, e.g., modern IT companies. While the Stuttgart method will price companies higher having a high value of assets with less importance assigned to income possibilities. In this case, it is possible to choose a method that is more favorable to one of the valuation stakeholders of the company. Most often it is a contradictory interest, because one party wants a higher and the other wants a lower valuation. However, as part of the standard and certain norms, objective valuation of the business should be sought: the so-called fair value price. That is why it is so important to define norms and standards even for specific industries. There are also possibilities to create econometric models that, dependingon the changing values of determinants, will create a valuation tailored to specific conditions and types of companies. This is an interesting research direction in this field, which requires numerous numerical calculations to develop appropriate patterns. This clearly shows the need for development and the need to come up with new proposals for business valuation methods, which can be seen today.

*4.3 The Methodology of Business Valuation According to the MDI-R Concept*

The contemporary methodology of business valuation according to the authors' concept takes place in accordance with MDI–R (assets, income, intellectual capital and all these components embedded in the market) [35]. Changes in the economic realities of the world (globalization and rapid technological development) have resulted in alterations in valuation methods according to the change in the significance of the components affecting the company's value. Nowadays, the so-called intangible and legal assets are the most important for the total valuation, which has resultedin the natural development and changes in the concepts of business valuation. Additionally, due to the complexity of issues and the share of all historically known components in the total valuation, undoubtedly, one should look for synthetic and universal calculation models. Mixed methods combine asset-based and income-based calculations. The methodology of MDI–R additionally takes into account comparable company methods, as well as the intangible assets and legal valuation. This results from the assumption that the value of the company is affected not only by its assets, including intangible and legal assets, but also by the ability to generate income and the current market (economic) situation of the environment. The company's assets are valued using the following general formula [36]:

$$M = A - P_o,$$

where:

M—the company's assets,A—assets, Po—

foreign liabilities,

where the value of fixed assets can be calculated according to the following formula:

$$Wst = Wn(1 - Zf),$$

where:

$W_{st}$—value of the fixed asset,

$W_n$—value of a new fixed asset,

$Z_f$—wear rate of the fixed physical asset, in the range of 0 <= $Z_f$ <= 1,

or using the market comparable company method, i.e., the current price of the worn fixed asset inthe market.

Income is calculated according to the general concept adopted in income-based methods,in particular, using widely known and utilized indicators, for example:

$$D = \frac{NOPAT}{\text{WACC}},$$

where:

*NOPAT*—projected annual net operating profit after tax,

*WACC*—discount rate, reflecting weighted average cost of capital of the valuated company.

The DCF method is the most popular income-based method. According to the DCF method, business value equals the sum of

discounted cash flows generated by the enterprise, which, after cumulation and summing, create the total cash flow at the disposal of the owners [31].

The MDI–R calculation model takes into account the so-called intangible and legal assets, i.e., human potential, know-how, reputation, the company's market position, etc. These assets are not subjected to the objective valuation since the assets of this type depend on the subjective behavior of market entities, which decide how much they are able to offer for intangible and legal assets. Therefore, these values are considered (valuated) using the comparable company method, consistingin comparisons with transactions of similar companies in the same industry [34]. Depending on the quantity of available transactions, the formula is the following:

$$WNiP = \frac{(W_1 + W_2 + \ldots + W_n)}{n},$$

where:

$W_{NiP}$—market value of single, specific intangible and legal assets, $w_1$, $w_2$—known market prices of similar intangible and legal assets,$n$—number of transactions of the specific value.

The importance of intellectual capital has increased substantially in recent years since business value is less and less dependent on tangible factors. This is caused by global technological, organizational changes, etc., which have led to the knowledge-based economy [35]. Intellectual capital, among others, consists of:

- Specific knowledge, experience, technology,
- Legal assets (brand, know-how, reputation, etc.),
- Relationships with customers and professional skills.

At the same time, the issues associated with intellectual capital are still not well-known and there are many ambiguous and various solutions for both theory and practice in this field [37].

Undoubtedly, due to difficulties in the valuation of the so-called intangible and legal assets, which primarily determine the value of enterprises, in particular highly developed ones, in terms of technology, one deals with difficulties in achieving the so-called fair business valuation. Nowadays, the conclusion is that, in order to make the best possible valuation, it is necessary to valuate individual components affecting the value of the company with separate methods that best reflect the nature of their value. This rule is obeyed by the MDI–R model, which allows the estimation of the total businessvalue, i.e., takes into account all the components affecting business value while assuming that human capital (knowledge, skills) remains unchanged. Business valuation, in accordance with the MDI–R concept, will present the overall image of changes in the company's value, as well as the ones resulting from changes in the business environment. Such valuation will be a good measure of the effectivenessof operations conducted in the enterprise. The characteristics of the MDI–R methodology include:

- Taking into account both tangible and intangible assets (WNiP),
- Taking into account the abilities to generate income,
- Taking into account the current situation in the market in which the company operates,
- Taking into account the company's financing method,
- Taking into account future investment needs,
- Universality—variability of the applied methods in the valuation of specific components,taking into account the conditions for the specific industry.

Therefore, it can be concluded that the MDI–R methodology presents the overall image of changes in the value of the company, as well as the ones that result from changes in the business environment and have an impact on its value. The vast amount of frequently contradictory information concerning economic processes is a characteristic feature of the contemporary knowledge-based economy. Therefore, it is very important to include intangible assets in the valuation, which is an extremely complicated challenge.

The econometric model using an equation (system of equations) helps to explain the mechanism of changes occurring in the studied area. It describes the relationships between given economic quantities. This is a formal mathematical record of existing economic regular$^n$ities.

$$Y_i = \alpha_0 + \alpha_1 X_{i1} + \alpha_2 X_{i2} + \varepsilon_{i.}$$

A basic example of a linear model is also used in the valuation model, although the actual relationship can be more complicated, which evolves through a number of practical studies. Building an econometric model requires not only good knowledge of economic theory and mathematical andeconomic knowledge, but also knowledge of economic practice. The econometric model should not only have a cognitive value from the point of view of economic theory, but also a practical value, which means that it can serve as a tool of inference in the future.

In the valuation model, the explained value is the business value. The main explanatory variables are the value of company assets and the value of income brought. The random component contains, among others, all variables omitted or errors in measurements and calculations. This property is closer to real variables, to what is happening in the real world. After all, we can never determine perfectly straightforward functional dependencies. The function of such a component is performed by the comparative method, which is used to calculate the explanatory variables $M_R$ and $D_R$. That is why the comparative method often appears as a peculiar random component in the econometric model regarding the valuation of enterprises. It allows comparison with transactions (of individual components and also of the most similar companies) that have already taken place on the market. Such a synthetic and universal calculation model is a way to eliminate many risks and problems in business valuation that need to be faced in the future.

As part of the available valuations made by appraisers in the District Court in Katowice and Krakow, a linear regression was performed to estimate structural parameters in the valuation model based on the MDI-R methodology. The companies valued belong to the IT industry. The first row in Table 7 contains estimates of structural parameters, the second row contains standard errors of theseestimates. The coefficient of determination (determination) informs about how much of the variability(variance) of the variable explained in the sample coincides with the correlations with the variables contained in the model. It is therefore a measure of the extent to which the model matches the sample. The bigger the regression line, the better suited the data. If the value is between 80% and 90%, then the match is considered good, as in the following example.

**Table 7.** Linear regression model in MDI-R methodology for known valuations at the District Court in Katowice and Krakow for the IT industry.

| $\alpha_0$ | $\alpha_1$ | $\alpha_2$ |
|---|---|---|
| −0.864 | 0.379 | 0.621 |
| S ($\alpha_0$) | S ($\alpha_1$) | S ($\alpha_2$) |
| 4.791 | 0.119 | 0.252 |
| | $R^2 = 0.8065 = 80.65\%$ | |

Source: own study.

$$M_R = (W_{NAP} + A) - P_o,$$

$$D_R = \sum_{i=1}^{n} a_i * NCF_i + RV,$$

$$WP = 0.379 * M_R + 0.621 * D_R - 0.864.$$

Undoubtedly, structural variables require further practical research. For example, the search formore complex relationships than the linear relationship and the values of the structural variables themselves should be assumed. Nowadays, due to the knowledge-based economy (the greater significance of intangible assets and the smaller value of tangible assets), income value is more important in valuation. This allows for practical calculations in the proposed model, as shown in Table 8. However, there are still and will continue to be industries where the high value of material assets will be necessary for business operation. Therefore, estimating structural variables for these differences will require different equations. This will allow a search for the optimal method of business valuation. Currently, it can be concluded that due to differences in industries (resulting from differences in the value of owned assets), a system of equations will most likely be required that will allow tailoring of the selected equation to a particular industry or type of company.

**Table 8.** The examples of valuation for MDI-R methods.

| Method | Assets and Income | MDI-R |
|---|---|---|
| Valuation (in PLN thousand) | M = 120<br>D = 410 | 299 |
| | M = 98<br>D = 546 | 375 |
| | M = 290<br>D = 110 | 177 |

Source: own study.

Summing up the business valuation methods, it can be concluded that the appropriate model forthe valuation of the economic entity should not only inform about the total value but also indicate thestructure of the sources of its creation. Therefore, business valuation methods should take into accountas many components as possible of the company affecting its value, which was proposed in the MDI-Rconcept. Additionally, the proper valuation should be adjusted to the nature of the company and thespecific areas of its business activity.

## 5. Discussion and Conclusions

Within the framework of this article, the essence and manner of business valuation using asset-based methods, which constitute the basic and historically first approach to the monetary business valuation, were determined. Within the framework of the conducted analysis, in terms of the new approach, the reasons for the contemporary crisis of confidence in the business valuation process were presented, including problems and risks occurring in asset-based methods, which, according to the subject literature, are the oldest and most objective foundations for the valuation of a company's assets. While aimed at solving the existing problems and risks, the possibilities of implementing new rules that will restore the quality and confidence in standards for determining the monetary value of a company were determined. Within the framework of determining the direction towards the accomplishment of the objective, which is the most objective valuation of enterprises, the authors' proposals of changes were depicted, which at least related to the need to specify certain valuation methods that can be used in relation to specific industries of the economy and categories of components creating the valuated assets. Nowadays, intangible assets and the ways of their use are more important than the category of so-called material substances, which determine the abilities of the company to multiply the invested capital (including, among others, human potential, brand, know-how, etc.). In the study, through the prism of the analysis and classification of asset-based business valuation methods used in practice, it was shown that the adjusted net assets valuation method is currently the best (objective and the closest to the model fair value) solution, which is confirmed by the fact that it is the basis for all valuations in economic practice. On the other hand, within the framework of the accomplishment of the authors' objective, through the analysis of the literature and practical examples, the need for improvement in the code of conduct and valuation standards was indicated, both in the overall process and within the framework of individual principles applied under asset-based methods, since there is a serious problem in the application of these methods to intangible and legal assets. At the same time, in the study, the factors that can distort the establishment of fair value werepresented, while attention was paid to the multidimensionality and complexity of issues of valuation,due to which the pursuit of optimal solutions requires a number of studies of both scientists and practitioners of the discussed subject matter. The research methodology in this study was based on reasoning regarding the methodology of asset-based methods of business valuation and the analysis of practical examples in order to verify the hypothesis of the existence of critical components of valuation, which enable the use of wide subjectivity in estimating the value of assets. The process of valuation of the company, its specificity and essence pose many problems and controversies. This is connected with the essence of monetary valuation, which is a subjective measure. Then, there are various conditionsand numerous procedures and methods for business valuation, presented in the study. At the same time, the reasons for the contemporary crisis of confidence in the methodology of business valuationwere presented and the directions of future development were indicated, which are of fundamental importance for the operations and opportunities of the conducted business. The study is a part of the discussion concerning the future and development of subsequent solutions aimed at determining,as far as possible, the most objective patterns and standards of business valuation implemented in the practice of economic life.

Summing up, it can be concluded that the appropriate model for the valuation of the economic entity should not only inform about the total value, but also indicate the structure of the sources of its creation. Therefore, business valuation methods should take into account as many components of thecompany affecting its value as possible. Nowadays, the valuation process is already moving in this direction, the example of which is a simultaneous use of, most frequently, asset-based, income-basedand comparable company methods to determine the final value of the company. The use of several methods of valuation in the course of the applied procedure provides an opportunity to make rationaldecisions as to the final value of the enterprise. Such a tool will lead to the desired harmonization of the methodology for estimation of the basic parameters serving valuation with such a degree of quality, which will provide the recipients of this information with a selection of

accurate decision-making options in the future.

In accordance with the literature on the subject, it was found necessary to search for more perfect methods for optimal valuations of fair value for enterprises. An undoubted contribution is the authors' proposed hybrid method MDI-R, which draws from existing solutions to improve their functionalityand applicability. In addition, the article indicates the possible directions of development of valuationmethods and the use of existing valuation models to identify companies threatened with bankruptcy.However, in the case of valuation, it is much more complicated and probably should determine the system of equations that will take into account various industries and economic situations.

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# Technical Factsheet
# Valuing goodwill

## 1. INTRODUCTION

1.1 This Factsheet aims to provide the user with a summary of the issues that need to be considered when valuing goodwill in most types of companies.

1.2 The Factsheet will deal with valuing goodwill via means of whole company approaches, simple multiple approaches and turnover approaches. In addition, it will look at personal and corporate goodwill and, finally, will provide a summary of the new guidelines provided by HMRC when looking at goodwill with regard to trade-related property and the like.

1.3 Goodwill has been addressed by the courts over a very considerable period of time. As early as 1810 the courts defined goodwill as "nothing but the probability that the old customers will resort to the old place".

1.4. In the case of Whiteman Smith Motor Company v Chaplin (1934) KP35 we find the "zoological" definition of goodwill classifying customers into cats, dogs, rats and rabbits. The cat represents a customer who will go to anoriginal shop no matter who owns that shop, and therefore represents local goodwill. The dog represents goodwillattaching to a person rather than a place, and therefore represents personal goodwill. The rat has no attachment and is a free agent, and the rabbit merely visits a business premises because of its closeness and the difficulty in visiting businesses further away.

1.5 One of the standard definitions of goodwill that has been in use for many years is that provided in re Commissioners of Inland Revenue v Muller & Co Margarine (1901) AC215. Lord MacNaghten speaks of goodwillas follows "what is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of the business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start … Goodwill is composed as a variety of elements. It differs in its composition in different trades and in differentbusinesses in the same trade. One element may preponderate here: and other there".

1.6 A good definition of goodwill taken from a book on that subject written in the 1930s defines commercial goodwillas "the right which grows out of all kinds of past effort in seeking profit, increase of value, or other advantage … the exchangeable value of the right depends upon the probability of earning future super profit – the term "super profit" meaning the amount which revenue, increase of value or other advantage received exceeds any and all economic expenditure incidental to its reduction".

1.7 The legal cases that have addressed goodwill give little or no particular help in valuing goodwill in practical terms. This factsheet, therefore, restricts itself to a purely practical consideration of the computation of goodwill via various methodologies.

## 2. WHOLE COMPANY APPROACHES

2.1 Perhaps the most common approach in valuing goodwill is to be found by valuing the entirety of a company or business and then deducting the tangible and other intangible assets. The residual can then be termed goodwill.Examples of intangible assets other than goodwill are licences, brands, trade names, quotas, patents, copyright, franchises and trade marks.

2.2 In this Factsheet we do not address this further complication, restricting ourselves to the calculation of theentirety of the goodwill including any other intangible value.

2.3 The valuation of the whole company will proceed along the lines outlined in Factsheet 167 and this GoodwillFactsheet does not, therefore, address the technicalities of a whole company valuation approach in any detail.

2.4 Normally, however, the whole company valuation approach will be based on a multiple applied to maintainableprofits. Where this computation gives a value less than the adjusted net asset value then the implication is that there is little or no goodwill within the business and any surplus is deemed to be goodwill.

2.5 Valuers should be aware however, that the goodwill in certain types of business is not valued by reference to profitability as is discussed in paragraph 4 below.

2.6 When applying a whole company methodology the valuer needs to be aware that assets within the balance sheet need to be brought to market value where appropriate (as opposed to the lower of cost or market that will be appropriate in the compilation of the balance sheet itself).

2.7 A short example is given below.

***Example***

- Small machine tool Company with a wide variety of customers, established for many years and withmuch repeat business.
- Turnover stable and growing steadily at £10million as is profits after tax of £500,000.
- No one off or exceptional items in the accounts and directors fees at a commercial rate for the services provided.

- Net assets £500,000, but original commercial premises in the accounts for many years at £100,000have a current market value of £1.1million.
- Research shows an appropriately adjusted P/E ratio is 5.

| Company Valuation | £500,000 x 5 = | £2,500,000 |
|---|---|---|
| Net Assets | £500,000 | |
| Property Uplift | £1,000,000 | £1,500,000 |
| **Goodwill** | | **£1,000,000** |

2.8 In the above example a single asset needs to be adjusted making a material difference to the calculation of the goodwill. It should however be borne in mind that other factors may need adjustment, the more common of which include:

- Assets not contributing to the business profitability may need to be removed, for example premises letout.
- Any income from non trading activities (such as rent from let premises) will need to be removed.
- The Company may have surplus cash that needs to be accounted for, as will the interest on the cash.

2.9 The valuer needs to look at the business in the round to isolate only those income streams and assets that directly contribute to the goodwill of the business, and exclude those that are not contributing.

## 3. SIMPLE MULTIPLE APPROACHES

3.1 It is possible to ascertain a rough and ready valuation for goodwill in simple straightforward businesses via the application of a multiple applied to maintainable profits before any form of managerial/owners' remuneration or the like. Over the years this approach has found some favour with the courts, particularly in dealing with cases ofcompensation claims in cases where for example a new road is to be built that will result in the destruction of abusiness.

3.2 A summary of the various cases is contained within Dymond's Capital Taxes which give brief details of at leastsome of the individual cases. Dymond's Capital Taxes is published by Sweet & Maxwell and can be obtained from the following address:

http://www.sweetandmaxwell.co.uk/Catalogue/ProductDetails.aspx?recordid=443&productid=7019

3.3 Within these cases the courts have used a simple multiple approach in valuing goodwill not only in small "oneman band" types of business, but also in dealing with goodwill in small limited companies.

3.4 The range of multiples used by the courts in calculating the goodwill is between 1 and 5, and a brief summary ofthese multiples and the types of business to which they relate is outlined below:

- A multiple of 3 in the valuation of a joinery business.
- A multiple of 3 in the valuation of a used car business.
- A multiple of 3 in the valuation of an opticians business.
- A multiple of 2.5 in the valuation of a butcher's shop.
- A multiple of 2.5 in the valuation of a chip shop.
- A multiple of 4 in the valuation of a plumber's business.

3.5 In the author's view, the level of multiple will depend on factors such as the rate of growth of the business, and the margins that can be generated. Businesses that are growing quickly and are making strong margins will command multiples at the upper end of a range, with businesses showing poor or declining turnover and weakmargins being at the bottom end of this scale.

3.6 Often the valuation of the goodwill using a simple multiple can be looked at by way of a basic whole companyapproach to act as a cross check. A simple example follows.

*Example*

- Small husband and wife owned limited company selling products via the internet, established and stablewith a web site, trading name and broad customer base and repeat business. Business is growing at 5% per annum.
- Turnover £2,000,000 and pre tax profits (after directors' fees of £50,000) of c£50,000.
- Net assets are small – business operated from home and computer equipment is the principal asset innet assets of £20,000.
- Valuation: £50,000 + £50,000 remuneration gives £100,000 profits. A small multiple of say 1indicates **goodwill of** £100,000 and a business valuation of £120,000.
- As a cross check, a value for the business of £120,000 indicates a P/E ratio of 3 based on after taxprofits of c£40,000 (£50,000 less tax of c21%).

## 4. TURNOVER AND OTHER APPROACHES

4.1 Under this heading we address not only those businesses valued by reference to turnover but also otherbusinesses that are frequently valued by reference to factors other than profitability.

4.2 The principal application of a turnover multiple to value goodwill is found in the valuation of goodwill in professional practice. Often, but by no means always, the turnover used as the basis for the computation isdefined as gross recurring fees, and not overall turnover.

4.3 A multiple is then applied to these fees. Usually, this multiple is between 0.5 and 1.5, however occasionally thisrange can be as low as 0.25 and as high as 2.5.

4.4 As with the multiples appropriate in simple multiple cases the level of turnover multiple is subjective. It will depend upon the quality and nature of the clients, the growth shown historically and the margins that the business has made in the past. Again, the better the growth and margins then the higher the multiple is likely tobe.

4.5 It is possible to research for deals that indicate turnover multiples, and also to look at the ratings of companies inthe quoted sector to ascertain the turnover multiple implied in the market capitalisation. Statistics from either of these sources will need to be adjusted for points of difference between those companies and the subject business. A simple example is outlined below.

*Example*

- Non-quoted corporate recovery business, well established with a strong client base and growing strongly.3 principals and with rented premises.
- Turnover £1,500,000. Making industry standard margins.
- Research shows quoted comparators trading at about 1.3 x turnover.
- Valuation: £1,500,000 x 1.0 (reduced from 1.3 to take account of the small scale of the business, reliance on key individuals and lack of asset backing) to give £1.5million **goodwill**.

4.6 There are various other businesses where turnover can be a crucial factor including the following:

- Chemist shops.
- General corner shops.
- Betting shops (where the multiple is frequently expressed as a number of weeks purchased per shop,with the multiple rising steeply the higher the turnover of the shop is).
- Garages (but not any gallonage aspect).

4.7 In addition to turnover based approaches there are many different industry specific valuation criteria, some of the more common being as follows:

- Pawnbrokers – sometimes the business is valued as the book value of the debts plus an agreed premiumfor goodwill expressed as a percentage of total pledges.
- Funeral Directors – the goodwill can be expressed as a notional price per adult funeral, although articlesin the trade press also support a normal capitalised earnings approach.
- Hotels – often "ball park" valuations can be arrived at by reference to a price per bedroom, although capitalisation of earnings and/or discounted cash flow (DCF) approaches are also principal methodologies.

Further information relating to the use of discounted cash flow calculations can be found at the followingaddress:

http://www.accaglobal.com/pubs/students/publications/student_accountant/archive/sa_apr08_coulthurstIRR.pdf

4.8 It should be borne in mind that industry specific methodologies and turnover based methodologies need greatcare in their application and (with the exception of the valuation of professional partnerships) in the view of theauthor these methodologies tend only to have use as a secondary methodology, perhaps in cross checking a valuation arrived at via the adjusted net earnings of the business.

## 5. PERSONAL AND CORPORATE GOODWILL

5.1 In certain types of business the nature of the goodwill is such that it does not attach to the business itself, but to the person of the owner/director. In these circumstances it is difficult for the goodwill to be transferred or sold if the business is disposed of.

5.2 This is likely to be the case to at least some degree in many transfers, but the purchaser will seek to maximise the value that they obtain by tying in the key individual in such a way that all of their personal goodwill is subsumed into the business over time. In this way the seller achieves the best price as well.

5.3 However, in certain trades the personality of the owner is crucial – for example a chef in a small restaurant. Unless the chef is famous (in which case the name and concept can perhaps be franchised or otherwise leveraged), it is likely that the goodwill in the small restaurant will die with the change of ownership.

5.4 It is in the interests of both the purchaser and the seller to maximise the value of any "personal" goodwill and to try to get as much of this as possible into the business itself. Therefore the circumstances where there is absolutely no business goodwill and all of the value resides in the person of the owner are likely to be rare, andto exist only in very small business with few staff were the personality and skill of the owner might be crucial and cannot be subsumed into the new ownership.

## 6. TRADE RELATED PROPERTY - NEW REVENUE GUIDELINES

6.1 The valuation of goodwill in trade related properties (for example public houses, hotels, petrol filling stations, restaurants, care homes and the like) has long been debated within organisations such as the Royal Institution of Chartered Surveyors ("RICS") and HMRC. The HMRC website provides the following quotation – "In the past, HM Revenue & Customs have taken the view that it was unlikely that there would be "free goodwill" of any significant value in businesses carried on from trade related properties because the occupation and use of the particular, specially adapted

premises was usually essential and integral to the generation of the business income. However it is now acknowledged that when a business is sold as a going concern the sale price will reflect the combined value of the tangible assets together with the benefit of other business assets such as any contracts with customers, staff and suppliers, records of previous customers etc. Substantial value can be realised by combining the tangible and other business assets together for sale as a going concern but this enhanced value may be reduced if the assets are split and sold separately."

6.2 The valuation of goodwill in trade related properties within HMRC is, in practical terms, split between Shares &Assets Valuation based in Nottingham and the Valuation Office Agency ("VOA").

6.3 At the time of issuing this factsheet it is understood that the VOA and RICS are still discussing the valuation of goodwill in this area, and that material difficulties still exist. One issue is that goodwill is not subject to Stamp Duty Land Tax (SDLT) whereas the business premises are. The Valuation Office contends that Goodwill should bevalued by reference to the profit-making potential of the Premises. Whereas RICS contend that a just and reasonable apportionment should be made according to market practice and must be just and reasonable to both HM Revenue & Customs and the Taxpayer, rather than automatically in accordance with the Revenue's practice note.

6.4 However, a practice note has been issued entitled "Apportioning the price paid for a business transferred as a going concern". This practice note provides a background to the problem, outlines the statutory provisions and legal definitions of goodwill, discusses goodwill in trade related properties and goes on to discuss the valuation of goodwill and other intangible assets, outlining how their preferred approach will apply in cases of CGT and SDLT, as well as cases under Schedule 29 FA 2002. The practice note referred to above can be found at the following address:

http://www.hmrc.gov.uk/svd/practice-note.pdf

6.5 In addition, as an appendix the practice note gives the RICS guidance to members dated July 2006.

6.6 This Factsheet is restricted to a resume of the practical aspects of the practice note only.

6.7 In cases where it is necessary to value the business as a going concern (perhaps because the sale price was not at arm's length) then this valuation is the responsibility of HMRC Shares and Assets Valuation ("SAV"). Similarly, if it is necessary to apportion the excess value between goodwill and any other intangible assets this is also the responsibility of HMRC SAV.

6.8 HMRC takes the view that, in cases where the going concern value of the business is known (for example following an arm's length sale) then "the difficulties in arriving at the value of the goodwill is usually related to the assumptions and approaches to be adopted when arriving at a valuation of the tangible assets".

6.9 HMRC then goes on to describe two potential approaches that might be used in valuing trade related properties on a profits basis – capitalised IBITDA/Fair Maintainable Trade ("FMT") approach and a rental value/investment based approach.

6.10 HMRC sees considerable problems in the application of the latter of these two approaches and is of the view that a capitalised EBITDA/FMT approach "will nevertheless give a reliable valuation in most cases".

6.11 As HMRC point out "the difficulty with this approach is that in cases where the contracts with customers, staffand suppliers are of some value it is necessary to reflect this in the valuation". It appears that this approach is likely to materially undervalue these aspects of goodwill.

6.12 For information, we outline below an example of the valuation of the goodwill using HMRC's approach (with theexample being based on the HMRC Practice Note).

*Example*

- Nursing home sold as a going concern for £3million based on a fair maintainable trade (FMT) of £500,000 and a 6 year purchase.
- Assume that it will take 12 months to get the business properly staffed, fully occupied and trading atFMT level again.
- Valuation of goodwill would be price paid less value of the tangible assets. Value of the tangible assets using the fair maintainable trade approach would be £500,000 for 6 years (£3,000,000) deferred for one year at 10% (3,000,000 x (1/1.1) to give £2,727,273. Goodwill is then £3,000,000 less £2,727,273 which is £272,737 say £273,000.

6.13 In practice, the best approach is to set out a reasonable basis for the valuation of the goodwill and then negotiate with HMRC in order to try and reach a settlement. Cases have not yet gone before the Courts to provide additional guidance in this difficult are.

6.14 HMRC has, using the methodology outlined above and in the practice note, managed to clear the majority of thebacklog of cases and it can, therefore, be surmised that frequently the application of this methodology will give an answer that, after negotiation, is acceptable to all sides.

6.15 However, there will inevitably be cases where this methodology does not satisfy all of the parties and in theauthor's view it is only a matter of time before there is further litigation in this area.

# The Board's Perspective on M&A: From due diligence to Day 1 and beyond

*As deal activity gains momentum from 2008 lows— fueled by high stock prices, low interest rates, and cash-heavy balance sheets—many boards will be faced with the challenge of helping to ensure a deal delivers the value that it should. That's no easy task given the challenges posed by an increasingly complex M&A and business environment.*

Deal activity has increased steadily from its 2008 low, but prospects for 2014 are uncertain. In 2013, announced value for U.S. M&A topped $1.1 trillion, a 28 percent increase from the year before; deal volume remained essentially flat, according to Thomson Reuters. However, confidence remains the key to whether M&A will make a stronger comeback. Several factors point to a possible rebound of M&A activity: Stock prices have reached record territory; despite recent fluctuations, interest rates remain near historic lows; and corporate cash balances and cash flow are at record levels. And for many companies, M&A is the key to growth, given the limited opportunity for organic growth in existing markets. It is also likely that companies will continue to engage in M&A "bolt-on" activity to fill gaps in products or channels, and acquire talent and technology.

At the same time, companies and their boards are sensitive to shareholder concerns regarding M&A success rates. A significant number of deals fall short of achieving their projected shareholder returns for a variety of reasons, ranging from valuation overreach, to overly optimistic projections and assumptions, to lack of a rigorous due diligence process, to failure to develop a robust postmerger integration plan and monitor the execution of that plan. We believe that companies can create more successful deals by engaging their boards to improve both the M&A process and its results. "Directors have a unique opportunity to help their companies meet strategic goals through M&A," says Tracy Benard, Accounting Advisory Services, Americas and U.S. Partner in Charge. "Frequently, a board will have experienced directors who have worked on many more acquisitions than the management team, and will be in a unique position to add value to the M&A process."

According to a recent KPMG survey of directors, there may be an opportunity for boards to do more to improve the M&A process and deal performance. About one in three of the directors surveyed say their board could be more involved in shaping M&A strategy and in evaluating deals proposed by management.

Based on our experience in the M&A process, and interviews with directors who have served on numerous boards and worked through scores of M&A transactions, we offer the following suggestions as to the role the board and the audit committee can play in the M&A process, and how they can help their companies capture more value—and help minimize the risk of failure—in M&A:

- Test alignment of the deal with the company's strategy, and challenge the value creation potential of the deal.
- Be sensitive to possible management bias and maintain the board's objectivity—don't fall in love with the deal.
- Closely monitor key aspects of the due diligence process before approving the deal.
- Examine the postmerger integration plan in detail, and track performance against the plan.
- Ensure the company has a rigorous M&A process and the right M&A leadership.
- Build a diverse board with different roles and perspectives.

**Test alignment of the deal with the company's trategy, and challenge the value creation potential of the deal**

As part of its oversight role, the board should nderstand the company's strategy, including its organic and strategic growth opportunities as well as key "gaps" (e.g., talent, technology, new products and markets, etc.) in achieving the company's objectives, and monitor whether the company's deal pipeline has the potential to fill those gaps. Generally, deals aligned with long-term strategic goals have higher success rates than more "opportunistic" transactions.

> *Cal Darden, a director at The Coca Cola Company and Target, Inc., believes directors should participate in their companies' strategy sessions "to gain a better understanding of what's in the deal pipeline and whether there is a strategic fit."*

Cal Darden, a director at The Coca Cola Company and Target, Inc., believes directors should participate in their companies' strategy sessions "to gain a better understanding

of what's in the deal pipeline and whether there is a strategic fit." According to Bob Finocchio, a director of Broadcom Corporation, when management proposes an M&A opportunity large enough for board consideration, "the board should challenge the alignment of the deal with the company's strategy. What is the reason behind the deal?

*Simply "increasing revenue" is not enough of a reason to do a deal, according to Bob Finocchio, who currently serves as a board member of Broadcom Corporation, Echelon Corporation, is chairman of the board of Santa Clara University, and is also a board member of two private companies.*

Is it to acquire technology? To enter a new market?" Simply "increasing revenue" is not enough, says Finocchio

Another important role for the board is to test the value creation potential of the deal. "The audit committee can play a key role here," according to Rob Coble, a KPMG Transactions & Restructuring partner, "by scrutinizing the financial assumptions behind the deal, and understanding the economic impact of the deal, including the financing."

Finocchio also emphasizes the audit committee's role in testing the economics of the deal. "How will the deal affect our own cost of capital? Will we be able to do another deal anytime soon? How will the deal affect our balance sheet and Wall Street's assessment of our financial strength?"

**Be sensitive to possible management bias and maintain the board's objectivity—don't fall in love with the deal**

Challenging management's assumptions and limiting some of the enthusiasm for a deal is one of the most important roles the board can play in M&A. "Management is not going to propose any deal unless it believes in the deal and its value- creating potential for the company," says Rita Foley, a director of PetSmart, Inc. and Dresser-Rand Group, Inc. "That's to be expected, and the board needs to be particularly sensitive to management bias and maintain

*Rita Foley, a member of the audit committee of PetSmart Inc. and Dresser-Rand Group, Inc., says "the board needs to be particularly sensitive to management bias and maintain its own objectivity."*

its own objectivity."

To help ensure a more balanced decision-making process, Foley says it's important for the board to probe deeply into the potential value created by the deal and its strategic fit, and make sure that the discussion is data-driven to the extent possible.

"Having access to better data and deeper analysis helps directors ask the right questions," says KPMG's Phil Isom, U.S. head of KPMG Corporate Finance & Restructuring. "It's more important than ever to understand if valuations are consistent with industry norms, and value creation is realistic for the market."

**Closely monitor key aspects of the due diligence process before approving the deal**

"A rigorous due diligence process is an essential element of

any successful M&A transaction," says Coble. The directors we interviewed identified a number of critical areas of focus during the due diligence phase, including:

- Test the valuation and synergy assumptions.
- Vet the financial and strategic health of the target.
- Understand the key transaction risks including financial, tax, operational, and commercial matters.
- Understand the cultural issues and roadblocks.
- Determine management's ability to execute.

For example, Finocchio says he wants to know what assumptions are being made about the market and competitors, what do the projections assume about customer behavior and loyalty, and where are the target's products in their life cycle?

What are the key assumptions on sales and channel strategies? Further, how dependent is the deal's success on the people, customers, key vendors, and suppliers of the target company?

Foley, an audit committee member at PetSmart and Dresser-Rand, emphasizes the key role the audit committee plays in ensuring that management understands the target's accounting. "Do they lean aggressive or conservative? What is their policy on reserves? Due diligence should also assess the target's general culture around compliance and internal controls. Are there FCPA or antibribery concerns in the countries they may do business? What is the assessment of risk in the supply chain?" She also emphasizes the need to focus on the relevant Sarbanes-Oxley requirements, and ensure that the target has the required processes in place.

*Diane Baker, most recently the chairman of the board at Sleep Innovations, Inc., emphasizes the importance of an M&A postmortem as part of the company's overall M&A process.*

**Examine the postmerger integration plan in detail, and track performance against the plan**

The board also plays an important role in monitoring

execution of the company's postmerger integration plan in order to help ensure that the strategic objectives of the deal—including synergies and cost savings—are achieved. Yet, according to a recent KPMG survey of directors, most directors see opportunity for improving board oversight in this area. According to Benard, "an inadequate postmerger integration plan is a huge risk to any deal. A very detailed and robust plan needs to be developed early on, and it needs to be adjusted during the due diligence process as risks are identified."

For audit committees, the postmerger integration plan is a particularly important area of focus "early on" because the committee's oversight responsibility for the acquired company's financials—e.g., financial reporting and controls, establishing reserves, internal audit's focus, controllership, etc.—*starts on Day 1* and the quarter close will be fast approaching.

After the deal closes, integration risk and execution risk— including cultural integration—remain critical areas of focus for the board. "Even with a robust and detailed postmerger integration plan, execution risk can be high, and directors

need to focus on execution risk, and track performance closely against the merger integration plan," says Benard.

For international deals, execution risk is often tied to resource allocation and distance from the acquirer's primary operations or headquarters. According to Foley, "if the deal involves a remote target, with the management time and attention that is required—boards need to ensure that management has the bandwidth, time, and resources required for a successful integration."

Darden says that it is important for the audit committee or board to assess the status of the overall deal—and particularly execution of the postmerger integration plan—perhaps quarterly, and certainly after 6, 12 and 18 months to make sure that the acquisition is meeting the company's overall objectives. "If the deal is not on target, we have to figure out how to fix it," he says.

**Ensure the company has a rigorous M&A process and the right M&A leadership.**

Boards should make sure that the management team has a

disciplined M&A process and employs that process uniformly for every deal. Management's M&A process needs to be rigorous and incorporate a well thought out methodology for each phase of the transaction—strategy, valuation, financing, due diligence, synergy identification and capture, closing the deal, and integration. Boards should understand the company's M&A playbook and carefully challenge deals that are not consistent with it.

Finocchio adds that it's also crucial for the deal to have "an owner," who is accountable for both the transaction as well as the postmerger integration. "No deal can succeed unless there is an operating person who owns the deal, not just the business development person presenting the deal," he says.

Diane Baker, most recently the chairman of the board at Sleep Innovations, Inc., emphasizes the importance of an M&A postmortem as part of the company's overall M&A process. She stresses that "postmortems must be done painstakingly. You need to be meticulous in reviewing the entire process, strategy, due diligence, the adequacy of the postmerger integration plan, and how management executed the plan."

One important area of focus during the postmortem is whether key sources of information within the company—e.g., HR, tax, legal, IT—are comfortable that the concerns they expressed during the due diligence process were appropriately considered.

**Build a diverse board with different roles and perspectives** Having a board with the right composition—a diversity of director backgrounds, perspectives, skills and experiences— can greatly enhance the board's effectiveness and value-add in the company's M&A process, according to Isom.

Foley explains that a diverse group of directors can contribute to M&A process in at least two different ways, both of which are crucial. For example:

- Directors who have experience in a similar industry often have industry connections and may know the target and its reputation. They will also be in a better position to understand the strategic value of the deal and assess the valuation multiples in light of what they have seen in similar deals.
- Directors from outside the industry may have a range of other experiences and perspectives that enable them to see the transaction through a different lens—and avoid some of the industry biases. They may also offer different expertise and perspectives important to the success of the deal in critical areas such as emerging technologies, globalization, and compliance.

Darden agrees that diverse perspectives add significant value. "By actively sharing our opinions, informed by diverse experiences, we can greatly enhance the M&A process," he says.

## Final Thoughts

Boards and audit committees can play an important role in helping their companies capture more value during the M&A process and reduce the risk of failure. The question for every board and audit committee is "how"—how can the board best add value to the M&A process? The answer will certainly vary from board to board and from transaction to transaction based on a number of factors, including the size and complexity of the deal, the sophistication of management's M&A team and processes and the volume and scale of deals they typically handle. We encourage every board to consider how it can best add value to its company's M&A process.

# MULTIPLE CHOICE QUESTIONS

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# MULTIPLE CHOICE QUESTIONS

## MCQ FOR SFA

**1. The national income estimation is the responsibility of**

a) NSSO

b) CSO

c) Finance Ministry

d) National Income Committee

**Ans)** CSO

**2. The most appropriate measure of a country's economic growth is**

a) GDP

b) NDP

c) Per capita real income

d) GNP

**Ans)** Per capita real income

**3. To avoid double counting when GDP is estimated, economists**

a) Use GDP deflator

b) Calculate value added at each stage of production

c) Use retail prices

d) Use price of only intermediategoods

**Ans)** Calculate value added at each stage of production

**4. Capital Budgeting Decisions are based on:**

a) Incremental Profit

b) Incremental Cash Flows

c) Incremental Assets,

d) Incremental Capital

**Ans)** Incremental Cash Flows

**5. Operating leverage helps in analysis of:**

a) Business Risk,

b) Financing Risk

c) Production Risk

d) Credit Risk

**Ans)** Business Risk,

**6. Which of the following cost of capital require tax adjustment?**

a) Cost of Equity Shares

b) Cost of Preference Shares

c) Cost of Debentures

d) Cost of Retained Earnings.

**Ans)** Cost of Debentures

**7. Financial Leverage arises because of:**

a) Fixed cost of production

b) Variable Cost,

c) Interest Cost

d) manufacturing cost

**Ans)** Interest Cost

**8. Dividend Payout Ratio is**

a) PAT÷ Capital

b) DPS ÷ EPS

c) Pref. Dividend ÷ PAT

d) Pref. Dividend÷ Equity Dividend

**Ans)** DPS ÷ EPS

**9. Dividend Distribution Tax is payable by**

a) Shareholders to Government

b) Shareholders to Company

c) Company to Government,

d) Holding to Subsidiary Company

**Ans)** Company to  Government,

**10. Stock split is a form of:**

a) Financial Restructing

b) Bonus Issue

c) Dividend Payment

d) Dividend in kind

**Ans)** Financial Restructing

**11. Retained earnings are:**

a) Not important when determining dividends

b) The same as cash in the bank

c) An indication of a company's liquidity

d) The cumulative earnings of the company after dividends

**Ans)** The cumulative earnings of the company after dividends

**12. Financial Analysis includes:**

a) External

b) Internal

c) Horizontal

d) All of the above

**Ans)** All of the above

**13. In Inventory Turnover calculation, what is taken in the numerator?**

a) Sales

b) Cost of Goods Sold

c) Opening Stock

d) Closing Stock

**Ans)** Cost of Goods Sold

**14. Who has the authority to certify that any instrument is not chargeable with duty?**

a) Magistrate

b) Collector

c) Bank Official

d) None of the above

**Ans)** Collector

**15. What is the maximum amount of penalty prescribed under section 62 of the Indian Stamp Act 1899 for executing instrument not duly stamped?**

a) One hundred rupees

b) Two hundred rupees

c) Five hundred rupees

d) One thousand rupees

**Ans)** Five hundred rupees

## MULTIPLE CHOICE QUESTIONS

**16. What is the maximum amount of penalty prescribed under section 63 of the Indian Stamp Act, 1899, for failure to cancel adhesive stamp?**

a) One hundred rupees

b) Two hundred rupees

c) Five hundred rupees

d) One thousand rupees

**Ans)** One hundred rupees

**17. What is the maximum amount of penalty prescribed under section 65 of the Indian Stamp Act, 1899, for refusal to give receipt, and for devices to evade duty on receipts?**

a) One hundred rupees

b) Five hundred rupees

c) One thousand rupees

d) Five thousand rupees

**Ans)** One hundred rupees

**18. What is the maximum amount of penalty prescribed under section 66 of the Indian Stamp Act 1899 for not making out policy within one month after receiving, or taking credit for, premium or consideration for any contract of insurance or making one not duly**

a) One hundred rupees

b) Two hundred rupees

c) Five hundred rupees

d) One thousand rupees

**Ans)** Two hundred rupees

**19. Who has the power to make the rules relating to sale of stamps?**

a) Central Government

b) State Government

c) Collector

d) Chief Controlling Revenue Authority

**Ans)** State Government

**20. Where an instrument is chargeable with ..........in respect of any money expressed in any currency other than that of India, such duty shall be calculated on the value of such money in the currency of India according to the current rate of exchange on the**

a) Fixed amount duty

b) Ad valorem duty

c) Duty of Rs 1000

d) None of the above

**Ans)** Ad valorem duty

**21. A owes B Rs 1000. A sells a property to B, the consideration being Rs 500 and the release of the previous debt of Rs 1000. Stamp-duty is payable on .......... :**

a) Rs 500

b) Rs 1000

c) Rs 1500

d) None of the above

**Ans)** Rs 1500

**22. A sells a property to B for Rs 500 which is subject to a mortgage to C for Rs 1000 and unpaid interest Rs 200. Stamp-duty is payable on ......... :**

a) Rs 500

b) Rs 1000

c) Rs 1500

d) Rs 1700

**Ans)** Rs 1700

**23. A mortgages a house of the value of Rs 10,000 to B for Rs 5000. B afterwards buys the house from A. Stamp-duty is payable on ........ :**

a) Rs 5000

b) Rs 10,000

c) Rs 10,000 less the amount of stamp-duty already paid for the mortgage

d) None of the above

**Ans)** Rs 10,000 less the amount of stamp-duty already paid for the mortgage

**24. How is stamp duty paid in transactions where more than one instrument is required?**

a) Stamp duty is paid on all the instruments equally

b) Stamp duty is paid on any one of the instruments

c) Stamp duty is paid only on one of the principal instruments and on the balance documents only minimum duty is payable

d) Stamp duty is paid on ad valorem basis

**Ans)** Stamp duty is paid only on one of the principal instruments and on the balance documents only minimum duty is payable

**25. Rates of Stamp Duty payable for different types of documents are as per:**

a) Schedule I

b) Schedule II

c) Schedule III

d) Schedule IV

**Ans)** Schedule I

**26. Income by way of rent of agricultural land is:**

a) Business Income

b) Income from other sources

c) Agricultural Income

d) Casual Income

**Ans)** Agricultural Income

**27. As per section 2(31), the following is not included in the definition of 'person' :**

a) An individual

b) A Hindu undivided family

c) A company

d) A minor

**Ans)** A minor

**28. In which of the following cases, income of previous year is assessable in the previous year itself?**

a) Assessment of persons leaving India

b) A person who is into illegal business

c) A person in employment in India

d) A person who is running a charitable institution

# MULTIPLE CHOICE QUESTIONS

**Ans)** Assessment of persons leaving India

29. **According to section 2(24), definition of 'income' is:**

a) Inclusive

b) Exclusive

c) Exhaustive

d) Descriptive

**Ans)** Inclusive

30. **CBDT in controlled by:**

a) Central Government

b) State Government

c) Both (a) and (b)

d) None of the above

**Ans)** Central Government

31. **Who is an Ordinarily Resident?**

a) Followed both basic and additional

b) Only basic

c) Only additional

d) Not basic and additional conditions

**Ans)** Followed both basic and additional

32. **Fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability. What is the definition of the principal market used in Ind AS 113?**

a) The one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity

b) The one with the highest and best price for the asset or liability that can be accessed by the entity

c) The one with the highest value activity for the asset or liability that can be accessed by the entity

d) The most advantageous market for the asset or liability

**Ans)** The one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity

33. **Fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used. What inputs are required for a fair value measurement to be classified as level 1 inputs?**

a) Unadjusted quoted prices in active markets for items identical to the asset or liability being measured

b) Inputs based on the highest and best use of the asset as determined by a market participant

c) Inputs other than quoted prices that are directly or indirectly observable for that asset or liability

d) Inputs which must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability

**Ans)** Unadjusted quoted prices in active markets for items identical to the asset or liability being measured

34. **Which of the following is NOT a valuation technique prescribed by Ind AS113?**

a) the fair value approach

b) the income approach

c) the cost approach

d) the market approach

**Ans)** the fair value approach

35. **Which of the following is NOT an example of a level 2 input?**

a) a financial forecast of cash flow or earnings

b) quoted prices for identical or similar assets or liabilities in markets that are not active

c) inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves, volatilities, prepayment speeds, and credit risks

d) inputs that are derived from or corroborated by observable market data by correlation or other means.

**Ans)** a financial forecast of cash flow or earnings

36. **Fixed assets which are subsequently measured in accordance with the revaluation model in Ind AS 16 Property, Plant and Equipment are not within the scope of Ind AS 113 in terms of both measurement and disclosure.**

a) TRUE

b) FALSE

c) Sometimes true

d) Need more information

**Ans)** FALSE

37. **Which of the following is considered standards of value?**

a) Liquidation of Value

b) Actual value

c) Going concern value

d) Investment value

**Ans)** Investment value

38. **While valuing 'synergy' which of the following is to be looked at!**

a) Operating synergy

b) Financial synergy

c) marketing synergy

d) Operating synergy orFinancial synergy

**Ans)** Operating synergy & Financial synergy

39. **When valuation process is under multiple scenarios, you take into consideration,**

a) Scenarios

b) Ranges of value

c) Ranges of value or Scenarios

d) none of the above

**Ans)** Ranges of value & Scenarios

40. **Which of the following is the "as of" date for valuation?**

a) Anytime within one year

b) Date that the report is signed

c) "As of" a single point in time or six months later

d) "As of" a single point in time

# MULTIPLE CHOICE QUESTIONS

**Ans)** "As of" a single point in time

**41. As the amount of __________ increases the present value of __________.**

a) debt; net tax-shield benefits of debt increases

b) common equity; bankruptcy and agency costs increase

c) debt; net tax-shield benefits of debt decrease

d) common equity; net tax-shield benefits of debt decrease.

**Ans)** debt; net tax-shield benefits of debt increases

**42. Assume that the market imperfection of taxes exists. If thecorporate tax rate were increased under new legislation, the use of debt would __________.**

a) rise

b) fall

c) not be impacted

d) There is not sufficient information provided to determine the impact.

**Ans)** rise

**43. What are the specific inputs that you would consider while preparing a Valuation Report?**

a) Key Financials,Valuation methodologies considered,Valuation Workings,Fair Value Recommendation

b) Key Financials,Valuation methodologies considered,Valuation Workings,negative assurance

c) Valuation methodologies considered,Key Financials,postive assurance,disclaimer opinion

d) Key Financials,postive assurance,disclaimer opinion Industry overview

**Ans)** Key Financials,Valuation methodologies considered,Valuation Workings,Fair Value Recommendation

**44. If a bond sells above its par value, it is called ........... bond:**

a) Premium

b) Callable

c) Convertible

d) Discount

**Ans)** Premium

**45. Leverage is:**

a) The ability to easily raise needed fund

b) A notion from probability

c) The compounding of risk

d) A measure of investment performance

**Ans)** The compounding of risk

**46. American option is an option which:**

a) Cannot be exercised prior to its expiration date

b) Can be exercised only on the expiration date

c) Can be exercised prior to its expiration date

d) None of the above

**Ans)** Can be exercised prior to its expiration date

**47. is a notion relating to fixed income instrument:**

a) Rate of return

b) Par

c) Face value

d) Beta

**Ans)** Par

**48. is a value of security shown on certificate:**

a) Market value

b) Face value

c) Maturity value

d) All of the above

**Ans)** Face value

**49. Collar is:**

a) An option to purchase an asset

b) A type of derivative position

c) A notion from probability

d) A condition where spot prices exceed forward prices

**Ans)** A type of derivative position

**50 ............ bond has its interest payment contingent on sufficient earnings of the firm:**

a) Subordinated debenture

b) Debenture

c) Junk bond

d) Income bond

**Ans)** Income bond

**51. The spread between Treasury securities and non-Treasury securities that are identical in all respects except for quality rating are called:**

a) Credit spread

b) Interest spread

c) Rate spread

d) None of the above

**Ans)** Credit spread

**52. First rating agency of India:**

a) SME Rating Agencies of India Limited (SMERA)

b) Investment Information and Credit Rating Agency of India Limited (ICRA)

c) Credit Rating Information Services of India Limited (CRISIL)

d) Credit and Research Limited (CARE)

**Ans)** Credit Rating Information Services of India Limited (CRISIL)

**53. Credit rating AAA denotes for:**

a) Extremely unlikely to default

b) Unlikely to default

c) Likely to default

d) Currently in default

**Ans)** Extremely unlikely to default

**54. A credit rating of bonds affects:**

a) Interest rate

b) Investment appetite

## MULTIPLE CHOICE QUESTIONS

c) Bond pricing

d) All of the above

**Ans)** All of the above

**55. A credit rating once given to an corporate or government bond is:**

a) Cannot be upgraded in future

b) Cannot be downgraded in future

c) Can be upgraded or downgraded in future

d) Stable over the maturity period of the bond

**Ans)** Can be upgraded or downgraded in future

**56. An embedded option is:**

a) An option that is embedded into the stock, bond, etc

b) There may be more than one embedded option in a security

c) Generally, cannot be separated from the securities to which they are attached

d) All of the above

**Ans)** All of the above

**57. Which of the following is true about the callable bond?**

a) Callable bonds always trade at a discount to non-callable bonds

b) Callable bonds expose issuers to the risk of reduced re-investment return

c) Callable bonds are actually variable tenor bonds

d) Callable bonds are not as liquid as non-callable bonds

**Ans)** Callable bonds are actually variable tenor bonds

**58. Bonds with embedded put options are called:**

a) Putable bonds

b) Bondholders puts

c) Callable bonds

d) None of the above

**Ans)** Putable bonds

**59. A callable bond is worth .......... to an investor than non-callable bond because the company issuing the bond has the power to redeem it and deprive the bondholder of the additional interest payments he would be entitled to if the bond was held to matur**

a) Less

b) More

c) Equal

d) None of the above

**Ans)** Less

**60. As per the valuation of investment circular issued by the FIMMDA, security receipts will be valued at:**

a) Carrying cost

b) Maturity cost

c) Net present value given by the issuing reconstruction company

d) None of the above

**Ans)** Net present value given by the issuing reconstruction company

**61. Which of the following is the correct one?**

a) Clean price = dirty price - accrued interest

b) Clean price = dirty price + accrued interest

c) Clean price = dirty price/accrued interest

d) Clean price = dirty price * accrued interest

**Ans)** Clean price = dirty price - accrued interest

**62. Securities issued by companies are traded in ............ :**

a) Derivatives market

b) Tertiary market

c) Primary market

d) Secondary market

**Ans)** Secondary market

**63. Does either the NPV or free cash flow model add the value of nonoperating net assets in its calculations_**

a) Only the NPV model does

b) Only the free cash flow model does.

c) Neither the NPV nor the free cash flow models do

d) Both the NPV and free cash flow models do

**Ans)** Both the NPV and free cash flow models do

**64. Does either the NPV or free cash flow model discount the firm's free cash flow at the unlevered cost of equity in its calculations?**

a) Both the NPV and free cash flow models do

b) Only the NPV model does

c) Neither the NPV nor free cash flow models do

d) Only the free cash flow model does

**Ans)** Only the NPV model does

**65. Does either the NPV or free cash flow model subtract the value of debt in its calculations?**

a) Only the free cash flow model does

b) Both the NPV and free cash flow models do

c) Only the NPV model does

d) Neither the NPV nor free cash flow models do

**Ans)** Both the NPV and free cash flow models do

**66. The adjusted present value (NPV) and free cash flow models give equivalent results. An analyst may prefer to use the NPV model because the :**

a) NPV uses the historical cost flow statement, which the free cash flow model does not

b) NPV highlights the extent to which the value of the firm is enhanced by the use of leverage in its capital structure

c) NPV focuses on the value of core operations whereas the free cash flow model does

not

d) free cash flow model focuses of the

## MULTIPLE CHOICE QUESTIONS

effect of leverage,which NPV does not

**Ans)** NPV highlights the extent to which the value of the firm is enhanced by the use of
leverage in its capital structure

**67. In internal rate of returns, discount rate which forces net present values to become zero is classified as_**

a) positive rate of return
b) negative rate of return
c) external rate of return
d) internal rate of return

**Ans)** internal rate of return

**68. In calculation of internal rate of return, an assumption states that received cash flow from project must_**

a) be reinvested
b) not be reinvested
c) be earned
d) not be earned

**Ans)** be reinvested

**69. In which of the following basic categories can business environment be divided?**

a) Local and Regional
b) Regional and National.
c) Internal and External.
d) Financial and Nonfinancial.

**Ans)** Internal and External.

**70. Economic environment refers to all forces which have a _____.**

a) political.
b) natural
c) economic.
d) social.

**Ans)** economic.

**71.______environment is with in the control of the business.**

a) Internal.
b) External.
c) Micro.
d) Macro.

**Ans)** Internal.

**72._____ environment is beyond the control of the business.**

a) Internal.
b) External.
c) Micro.
d) Macro.

**Ans)** External.

**73. Micro environment is also called as ________.**

a) general environment.
b) operating environment.
c) economics environment.
d) political environment.

**Ans)** operating environment.

**74. Internal factors affecting a business environment also are referred to ___factors.**

a) controllable.
b) uncontrollable factors.
c) relevant.
d) global.

**Ans)** controllable.

**75. A systematic application of scientific knowledge to practical task is known as________.**

a) technology.
b) culture.
c) demograpic.
d) legal.

**Ans)** technology.

**76. Buying in a cheaper market and selling higher in another market is known as**

a) Hedging
b) Speculation
c) Arbitrage
d) Gambling

**Ans)** Arbitrage

**77. In arbitrage pricing theory, required returns are functioned of two factors which have_**

a) dividend policy & market risk
b) market risk & historical policy
c) historical policy & dividend policy
d) dividend policy & earning policy

**Ans)** dividend policy & market risk

**78. Complex statistical and mathematical theory is an approach, which is classified as_**

a) arbitrage pricing theory
b) arbitrage risk theory
c) arbitrage dividend theory
d) arbitrage market theory

**Ans)** arbitrage pricing theory

**79. Which of the following method of fair exchange ratio is acceptable to court in view of Supreme Court decision in Miheer H. Mafatlal vs. Mafatlal Industries Ltd (1997) 1 SCC 579:**

a) Manageable Profit Method
b) Net worth Method
c) Market Value Method
d) All of the above

**Ans)** All of the above

**80. In the matter of Dinesh Vrajlal Lakhani vs Parke Davis (India) Ltd, the Division Bench of the Bombay High Court also held that:**

a) The Court is neither a valuer nor an appellate forum to re-appreciate the merits of the valuation. What the court has to ensure is that the determination should be contrary to law or unfair to the shareholders of the company which has been merged
b) The Court is neither a valuer nor an appellate forum to re-appreciate the merits of the valuation. What the court has to ensure is that the determination should not be contrary to law or unfair to the shareholders of the company which has been merged.

## MULTIPLE CHOICE QUESTIONS

c) The Court is neither a valuer nor an appellate forum to appreciate the merits of the valuation. What the court has to ensure is that the determination should not be contrary to law or unfair to the shareholders of the company which has been merged.

d) None of the above

**Ans)** The Court is neither a valuer nor an appellate forum to re-appreciate the merits of the valuation. What the court has to ensure is that the determination should not be contrary to law or unfair to the shareholders of the company which has been merged.

**Use the following information to answer Questions 81-84**

**Lois Fischer, Valuer, believes that the retail industry will perform well over the next several quarters and is interested in selecting a retail stock on the basis of its price-to-book multiple. Fischer's research has resulted in a list of**

**five stocks from which she will make her final selection: Wally's, Home Decor, Redrug, Lester's, and Harmon's. The following table contains the information upon which Fischer will base her decision.**

**P/B Comparables for Retail Firms**

| | 2013 | 2014 | 2015 | 3-Year Average | Current | 2-year ROE Forecast | Beta |
|---|---|---|---|---|---|---|---|
| Wally's* | 9.85 | 8.01 | 6.93 | 8.26 | 6.53 | 20.00% | 0.98 |
| Harmon's* | 6.35 | 4.60 | 4.16 | 5.04 | 3.29 | 19.95% | 1.02 |
| Redrug** | 14.93 | 11.08 | 13.32 | 13.11 | 5.78 | 18.20% | 0.58 |
| Home Decor*** | 9.75 | 7.24 | 8.88 | 8.62 | 3.31 | 19.29% | 1.36 |
| Lester's*** | 7.65 | 6.25 | 6.66 | 6.85 | 4.32 | 18.90% | 1.22 |

| | Current | 2-year ROE Forecast |
|---|---|---|
| *Retail industry (department & discount) | 5.75 | 19.98% |
| **Retail industry (drugs) | 4.69 | 15.27% |
| ***Retail industry (home improvement) | 3.62 | 19.29% |

Annabelle Clementi, is Fischer's supervisor and has more than 15 years of experience analyzing firms in the retail industry. Clementi typically uses the P/B ratio when comparing retail stocks with the industry and among peers. However, Clementi has concluded that firms in the home improvement segment of the retail industry utilize their assets so efficiently that P/B valuation is not appropriate. Since these firms are typically characterized as having relatively strong cash flows, Clementi has decided to assess them using valuation measures that are based on cash flows and cash flow-related concepts. With this in mind, Clementi has obtained the following financial statements for Lester's, Inc., a major player in the home improvement segment of the retail industry. Other relevant information that will assist her with the valuation of Lester's includes the following:

- Lester's financial statements are prepared using U.S. GAAP.
- Actual interest paid for the year was $240 million. The reported cash flow from operating activities includes this effect, net of tax savings.
- The marginal tax rate is 37%.
- Lester's is currently trading at $42.10 per share.

**Lester's, Inc. Income Statement**

| *Period Ending December 31, 2015* | |
|---|---|
| Total Revenue | 22,111,108,000 |
| Cost of Revenue | (15,743,267,000 |
| Gross Profit | 6,367,841,000 |
| Operating Expenses Depreciation | **534,102,000** |
| Selling General and Administrative Expenses | **3,379,253,000** |
| Nonrecurring | **139,870,000** |
| Other Operating Expenses | **516,828,000** |
| Total Operating Expenses | **4,570,053,000** |
| Operating Income | **1,797,788,000** |
| Total Other Income and Expenses, Net | **58,431,000** |
| Earnings Before Interest and Taxes | **1,856,219,000** |
| Interest Expense | **(231,968,000)** |

# MULTIPLE CHOICE QUESTIONS

| | |
|---|---|
| Income Before Tax | **1,624,251,000** |
| Income Tax Expense | **600,989,000** |
| Equity Earnings or Loss Unconsolidated Subsidiary | **N/A** |
| Minority Interest | **N/A** |
| Net Income from Continuing Operations | **1,023,262,000** |
| Nonrecurring Events | **N/A** |
| Discontinued Operations | |
| Extraordinary Items | **N/A** |
| Effect of Accounting Changes | **N/A** |
| Other Items | **N/A** |
| Net Income | **1,023,262,000** |
| Preferred Stock and Other Adjustments | **N/A** |
| Net Income Applicable to Common Shares | **1,023,262,000** |
| Earnings per Common Share Basic | **$1.62** |
| Weighted Average Shares Outstanding Basic | **631,643,000** |

**Lester's, Inc. Statement of Cash Flows**

| *Period Ending December 31, 2015* | $ |
|---|---|
| Net Income | 1,023,262,000 |
| Cash Flow Operating Activities | |
| Depreciation | 534,102,000 |
| Changes in Operating Activities | |
| Changes in Accounts Receivables | (4,593,000) |
| Changes in Liabilities | 306,869,000 |
| Changes in Inventories | (325,406,000) |
| Changes in Other Operating Activities | (36,792,000) |
| Cash Flow from Operating Activities | 1,497,442,000 |
| Cash Flow Investing Activities | |
| Capital Expenditures | **(2,199,334,000)** |
| Cash Flows From Investing Activities | **(2,199,334,000)** |
| Cash Flow Financing Activities | |
| Dividends Paid | **(59,884,000)** |
| Sale (Purchase) of Stock | **115,870,000** |
| Net Borrowings | **873,480,000** |
| Other Cash Flows From Financing Activities | **N/A** |
| Cash Flows From Financing Activities | **929,466,000** |
| Effect of Exchange Rate | **N/A** |
| Change in Cash and Cash Equivalents | **227,574,000** |
| Cash and Cash Equivalents at Beginning of Period | **455,658,000** |
| Cash and Cash Equivalents at End of Period | **683,232,000** |

81. **Based on the information in the first figure, which of the following statements least likely supports Fischer's recommendation of Home Decor over Lester's?**

a) Home Decor's P/B ratio relative to the industry.

b) Home Decor's P/B ratio relative to Lester's P/B ratio.

# MULTIPLE CHOICE QUESTIONS

c) Home Decor’s historical P/B ratios.

d) None of the above

**Ans)** Home Decor’s historical P/B ratios.

82. **Which of the following statements is least likely a justification of Fischer’s selection of Harmon’s over Wally’s on the basis of the information in the first figure?**

a) Harmon’s level of systematic risk relative to Wally’s.

b) Harmon’s P/B ratio relative to the industry.

c) Wally’s P/B ratio relative to the industry.

d) None of the above

**Ans)** Harmon’s level of systematic risk relative to Wally’s.

83. **Clementi requests that Fischer calculate several ratios using the previous information. The P/CF for Lester’s using earnings-plus-noncash-charges for cash flow is closest to:**

a)15.89.

b)17.08.

c)25.99.

d)None of the above

**Ans)** 17.08.

84. **Clementi requests that Fischer calculate the P/CFO for Lester’s, using adjusted cash flow from operations for cash flow for comparison with other companies. The adjusted P/CFO for Lester’s is closest to:**

a)15.

b)17.

c)19.

d)None of the above

**Ans)** 17.

**Use the following information to answer Questions 85-87**

**A bond named Galaxy has 4 years remaining till its maturity and is currently trading at US $102. Interest on the bond is paid on a semiannual basis based on a coupon rate of 5%. The bond is first callable in 2 years and on coupon dates after that date in accordance to the given table below:**

| End of Year | Call Price |
|---|---|
| 2 | 101.5 |
| 3 | 101 |
| 4 | 100 |

85. **Which of the following is most likely to be the bond’s annual yield to maturity?**

a)2.22%.

b)4.44%.

c)6.66%.

d)None of the above

**Ans)** 4.44%.

86. **Which of the following is most likely to be the bond’s annual yield to first call?**

a)4.42%.

b)4.66%.

c)4.78%.

d)None of the above

**Ans)** 4.66%.

87. **Which of the following is most likely to be the bond’s annual yield to second call?**

a)4.26%.

b)4.38%.

c)4.59%.

d)None of the above

**Ans)** 4.59%.

Use the following information to answer Questions 88-90

A 6% corporate bond is priced for settlement on 15 September 2015. The bond matures on 30 June 2018 and makes semiannual coupon payments on 30th June and 31st December. The bond is currently trading at 7.0% yield to maturity.

88. **Based on the above information, the full price of the bond on the settlement date is closest to:**

a)973.36.

b)987.47.

c)975.52.

d)None of the above

**Ans)** 987.47.

89. **Based on above information, the accrued interest on the settlement date is closest to:**

a)12.55.

b)22.55.

c)15.55.

d)None of the above

**Ans)** 12.55.

90. **Based on the above information, the flat price of the bond on settlement date is closest to:**

a)973.36.

b)974.92.

c)972.52.

d) None of the above

**Ans)** 974.92

Source : Judicial Pronouncements in Valuation, Published by Valuation Standards Board and ICAI Registered Valuers Organization, The Institute of Chartered Accountants of India

**Case No. 1**
**G.L. Sultania and Ors. Vs The Securities and Exchange Board of India and Ors. (2007)**

**IN THE SUPREME COURT OF INDIA**
Appellants: G.L. Sultania and Ors.
**Vs.**
**Respondent: The Securities and Exchange Board of India and Ors.**

Civil Appeal No. 1672 of 2006
Decided On: 16.05.2007

**1. Brief Facts of the** Case

The issue in the instant case was on valuation of shares by SEBI under the 'Takeover Code' viz Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (which has now been substituted by Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011) in context of offer for takeover of Hindustan National Glass and Industries Ltd. (target company) by ACE Glass Containers Ltd and C.K. Somany.

The Somany family comprising of four brothers managed several companies including the target company. All the brothers held equal shares in the target company and the public share-holding in the target company was negligible (less than 0.30%). The shares of the target company were infrequently traded.

In the year 1994, about 40% of the equity capital of the target company was transferred to Shri C.K. Somany pursuant to a family settlement arrived at between the brothers. According to the appellants on August 5, 1994; there was an agreement between Shri C.K. Somany, and his brothers for the sale of the entire balance shareholding in the target company held by his brothers to Shri C.K. Somany at Rs. 267/- per share. This, however, is disputed by Shri

C.K. Somany and in this background, disputes arose between the parties and the brothers and Civil Suit was filed in Calcutta High Court.

<u>G.L. Sultania and Ors. Vs The Securities and Exchange Board of India and …</u>

During the pendency of the suit, Shri S.K. Somany, one of the brothers offered to sell 7.30% share held by him in the target company to Shri C.K. Somany on the basis of price mutually acceptable to the parties. In view of the agreement arrived at between the two brothers, Shri C.K. Somany moved to Calcutta High Court for modification of the interim order thereby permitting him to acquire 7.30% shares of Shri S.K. Somany in the target company. This triggered the provisions of the Takeover Code which obliged Shri C.K. Somany to make a public announcement to acquire shares in accordance with the Takeover Code.

**2. Scheme of Events** and **Valuations Done**

i. The Takeover Code having been triggered, acquirers were directed to make an open offer under the provisions of the Takeover Code by order dated 2.9.2003. The merchant banker, appointed by the acquirer, determined the price of shares to be offered to the shareholders in accordance with the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 viz Takeover Code at Rs. 40 per share.

ii. Some of the appellants not being satisfied with the price of the share which was offered to the shareholder under aforesaid SEBI Regulations objected to the price being low and complained that the same had not been determined in accordance with the parameters laid down in Regulation 20(5) of the Takeover Code.

iii. Respondents in consultation with the Merchant Banker appointed a renowned firm of Valuers (First Valuer) to value the shares of the target company. The aforesaid firm of Valuers determined the price of each share of the target company as Rs. 43.02 per share.

iv. The appellants still persisted in their objection that the value of each share determined by the aforesaid firm of Valuers was also not correct.

v. SEBI took serious note of the objections and appointed an Independent Valuer (Second Valuer), to once again value the shares of the target company under Regulation 20(5) of the Takeover Code. The said Independent Valuer, carried out valuation of the target company and submitted a report on 20.5.2004 to SEBI. The valuation was done on the basis of the market price of the shares of the target company and other methods as required under valuation principles and revised the valuation to Rs.64.17 per share.

vi. The acquirers felt aggrieved by the hike in the valuation and felt that the valuation by the first Valuer at Rs. 43.02 was reasonable. The merchant bankers pursuant to this objection by the acquirers wrote a letter dated 9.3.2005 to SEBI on this aspect of the matter. SEBI permitted the merchant bankers to obtain valuation from a third Chartered Accountant.

vii. Accordingly, the merchant bankers in consultation with SEBI appointed third Valuer to carry out the valuation of the shares of the target company. The said Valuer submitted a report on 13.4.2005 stating that the fair market value of the share was Rs. 60.04 per share of the target company.

viii. SEBI after considering all the three reports felt that in public interest justice must be done to the shareholders and held that the highest price per share amongst the three valuations be the fair price.

ix. The merchant bankers and acquirers accepted the suggestion of SEBI.

x. Appeal was filed before the Appellate Tribunal and it may be further noted that the appellant G.L. Sultania

had complained against the valuation of shares by the Merchant Banker and while doing so he had enclosed copies of two Valuation Reports valuing the shares of the target company at much higher rates namely, Rs.408/- and Rs.590/- per share.

xi. The Appellate Tribunal did not accept the Valuation Reports of produced by the appellants which valued the shares at abnormally high rates of Rs. 408/- and Rs. 590/- per share. Apart from other reasons, the very fact that there was such a wide disparity in valuation in the aforesaid two reports, was itself a sufficient ground to reject them.

xii. The Appellate Tribunal held that the Board (SEBI) had acted strictly in terms of the Takeover Code and approved the public offer. The valuation of shares as accepted by the SEBI was arrived at after following the norms laid down in Regulation 20(5) of the Takeover Code and, therefore, it could not be characterized as either erroneous, arbitrary or unreasonable.

xiii. Aggrieved by the order of the Appellate Tribunal the appellants had filed the instant appeal under Section 15(Z) of the Securities and Exchange Board of India Act, 1992.

**3. Issues Raised**

i. First objection was that the SEBI, as well as the Merchant Banker had not properly valued the shares of the target company in accordance with SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (which has now been substituted by Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011).

ii. Learned counsel argued that the price approved by the Board was not a fair price.

**4. Relevant clause** of SEBI **Regulations**

Regulation 20(5) of the Takeover Code provides as follows

"Offer price –

(1) The offer to acquire shares under Regulation 10, 11 or 12 shall be made at a price not lower than the price determined as per Sub-regulation (4) and (5).

…………………..

(5) Where the shares of the target company are infrequently traded, the offer price shall be determined by the acquirer and the merchant banker taking into account the following factors:

a. the negotiated price under the agreement referred to in sub-regulation (1) of Regulation 14;

b. the highest price paid by the acquirer or persons acting in concert with him for acquisitions, if any including by way of allotment in a public or rights or preferential issue during the twenty-six-week period prior to the date of public announcement.

c. other parameters including return on networth, book value of the shares of the target company, earning per share, price earning multiple vis-à-vis the industry average;

*Provided that where considered necessary, the Board may require valuation of such infrequently traded shares by an independent merchant banker (other than the manager to the offer) or an independent chartered accountant of minimum ten years' standing or a public financial institution.*

*Explanation;*

*i. For the purpose of sub-regulation (5), shares shall be deemed to be infrequently traded if on the stock exchange, the annualized trading turnover in that share during the preceding six calendar months prior to the month in which the public announcement is made is less than five per cent (by number of shares) of the listed shares. For this purpose, the weighted average number of shares listed during the said six months period may be taken.*

*ii. In case of disinvestments of a Public Sector Undertaking, the shares of such an undertaking shall be deemed to be infrequently traded, if on the stock exchange, the annualized trading turnover in the shares during the preceding six calendar months prior to the month, in which the Central Government of the State Government as the case may be opens the financial bid, is less than five per cent (by the number of shares) of the listed shares. For this purpose, the weighted average number of shares listed during the six months period may be taken.*

*iii. In case of shares which have listed within six months preceding the public announcement, the trading turnover may be annualized with reference to the actualnumberofdaysforwhichtheshareshavebeenlisted."*

So far as Clauses (a) and (b) are concerned, there can be no dispute that the highest price offered by the acquirers for the shares of the target company under the Memorandum of Undertaking dated 7th October, 2002 was Rs. 40/- per share and the price to be paid by C.K. Somany group for purchase of shares permitted by the High Court of Calcutta was also Rs. 40/- per share. Thus, the offer price based on factors under Clauses (a) and (b) of Regulation 20(5) works out to be not less than Rs. 40/- per share. **The thrust of the challenge to the valuation is with respect to Clause (c) of Regulation 20(5) of the Takeover Code.**

**5. Salient features of Valuation Report accepted by the SEBI** (i.e. **Report of** the **Second Valuer)**

- The Report takes note of the three commonly adopted methods of valuation of shares, namely, the Net Asset Method, the Profit Earning Capacity Method, and the Market Price Method.
- While the Net Value Method represents the value of the shares with reference to the value of the assets owned and the liability as on the valuation date, the Profit Earning Capacity Method (for short the "PECV") involves determination of the future maintainable earnings of the Company from its normal operations.

Under the Market Approach, the common method employed to derive the value of the business is to multiply estimated maintainable earnings with the price earning ratio of comparable companies in the industry.

- **Profit Earning Capacity Method** – The Valuer calculated the "yield value" by taking the average of 9 years, from 1993-1994 to 2001-2002. The year 2002-2003 was excluded for the reasons recorded in the Report which show that on account of abnormal situations the profits of the Company had decreased. Taking the capitalization rate as 15% as suggested for manufacturing companies in erstwhile Controller of Capital Issues guidelines, the value of shares was worked out to Rs. 55.06 per share.
- **Net Asset Value Method** - The Valuer ascertained a value of Rs. 77 per share by dividing the Share Capital of the Company plus Reserves and Surplus (excluding Revaluation Reserve and Contingent Liabilities) by the number of equity shares of the Company.
- **Market Value Method** - having regard to the infrequently traded shares of the Company, the average market price of six months prior to October 7th, 2002, the reference date as stated in the letter of offer was considered, and same resulted in a value of Rs. 66.87 per share.
- Weightage for market value was reduced from 2 to 1 because. in the case of infrequently traded shares, the market price has less relevance. Thereafter, applying the same weightage as in Hindustan Lever, (except for the market price), the fair value per share was found to be Rs. 63.50 paise.
- The Valuer expressly noticed the provisions of Regulation 20(5) of the Takeover Code in their Valuation Report and after taking the values by the three methods i.e. PECV, NAV and EPS and giving them weightage, the value per share was ascertained to be Rs. 57.55 per share.

**6. The Hon'ble Apex Court's View and Decision**

**i. With respect** to **the Regulation 20(5)** of **the Takeover Code the** Court **observed the following:**

- This Regulation applies to infrequently traded shares of a company and lays down the parameters that must be considered in arriving at the valuation. But it must be understood that the parameters laid down are by no means exhaustive. There are many other considerations which may be factored into any valuation process.
- The Regulation mandates that the parameters expressly laid down therein must in all cases be considered by the Valuer since they are basic and essential to the valuation of infrequently traded shares of a company.
- If the Valuation Report discloses non-consideration of any of the enumerated parameters, the report shall stand vitiated for that reason. This, however, does not prevent the valuer from considering other relevant factors according to accepted principles of valuation of shares.
- The Regulation seeks to protect the interest of an investor by ensuring that he gets a fair price for his shares in the target company.
- The Board has to act prudently and within the limits of its jurisdiction. It cannot object to the price offered by the acquirer unless it has reasons to suspect that the price offered has not been determined fairly taking into account the enumerated factors. In case of doubt, it may require valuation of the shares by an Independent Merchant Banker or Chartered Accountant. If the valuation determined by the acquirer or his merchant banker agrees with the valuation of the Board's Valuer, more or less, then the Board has no option but to accept the offer price of the acquirer.

**ii. With respect** to **the allegations** on **the Valuation Report**

- **Allegation No. 1**

Valuer took P/E ratio at 9.6 instead of 20.9. According to the appellants, the figure pertaining to March 1 to 14, 2004 which had been taken into account by the Valuer was not relevant and he should have taken the figures relevant to the public announcement dated 13th November 2003 and the letter of offer dated 25th August, 2005.

**Observation: -** The Capital Market which is a fortnightly magazine gives the necessary data with regard to each industry. The data pertaining to every industry category reflect the "full year", the "latest quarter" and the "trailing twelve months" figures. The "trailing twelve months" reflects the most current computation of the price earnings multiple and that period includes more companies with an EPS of more than 1 and was, therefore, more representative of the market.

The Valuer in his Report had observed that the Industry P/E of 20.9 is not the correct indicator of the industry. As the industry (glass and glass products) covers 12 companies out of which 6 companies are loss making; hence having a negative P/E ratio and the other 3 companies having minimal profit, the Industry Composite P/E ratio of 20.9 is calculated based on P/E ratio of 3 profit making companies only, thereby ignoring the performance of other 9 companies.

- **Allegation** No. 2

The Net Asset Value comes to Rs. 133.27, if reserves and surplus as per consolidated accounts of the target company and subsidiaries at book value were taken. According to the appellants, the Net Asset Value would have come to Rs. 233.04 if 50% of the net worth of the controlled associate company, ACE Glass Containers Ltd. was considered. The value of the shareholding of the target company in the subsidiaries and ACE Glass as reflected in the Balance Sheet of the target company merely reflected the historical cost of such investments and not the true value thereof.

**Observation:-** ACE Glass was a potentially sick company registered with the BIFR having carry forward losses of Rs. 266 crores as on March 31, 2003 and there is no reasonable

prospect of earning any dividend from ACE Glass in the immediately foreseeable future. There was no question of consolidating the net worth of ACE glass into the net worth of the target company or the profit earning capacity of ACE Glass with the profit earning capacity of the target company.

Further, it is not mandatory to derive the valuation of shares on the basis of consolidated financial statement. As per normal accounting practices, for determining the value of shares as a going concern only individual financial statements are considered because parent company is entitled to dividend only and has no right whatsoever in the assets of subsidiary and associate companies.

- **Allegation** No. 3

The capitalization ratio of 15% was taken; whereas the capitalization ratio should have been 8% and the guidelines issued by the CCI had been repealed.

**Observation:-** CCI guidelines had been followed which laid down the principles which are applicable in working out the profit earning capacity which involve two important factors, namely - average profit before tax and capitalization ratio.

- **Allegation** No. 4

If revaluation reserve was considered, the Net Asset Value would have come to Rs. 124.82.

**Observation:-** Revaluation reserves are never considered as part of the net-worth computation. Section 2(29A) of the Companies Act, 1956 (now substituted by the Companies Act, 2013) which defines "net worth", expressly excludes revaluation reserves. Moreover the CCI guidelines for "Valuation of equity shares for companies and the business and net assets of branches" clearly provided that the revaluation reserves arising out of revaluation of fixed assets should ordinarily be ignored. Only after an efflux of 15 years would it be reasonable to consider non-exclusion of revaluation reserves. Even SEBI guidelines for initial public offerings of shares expressly exclude capitalization arising out of revaluation reserves for purposes of determining "promoter's contribution" to be eligible to make an initial public offering.

- **Allegation** No. 5

Profit Earning Capacity Value should not be calculated on the basis of past earnings alone as done by the Valuer but on future maintainable profit basis.

**Observation:-** The Valuer has correctly applied the HLL/ TOMCO principles for computation of the "Yield Value". Adopting those principles audited financial statements of 9 years between 1993-1994 and 2001- 2002 were considered. The financial statement for the year 2002 -2003 was excluded since the profits for that year had fallen by nearly 50%. Adopting these principles and taking into account the discounting rate of 15% applicable in terms of the CCI guidelines a value of Rs. 55.06 per share was computed by the valuer. The Valuer also independently applied the yield value and without applying HLL principles computed the value of the shares as Rs. 34.39. After having arrived at two distinct values as aforesaid, the Valuer adopted the higher of the two values.

iii. The Court held that unless it is shown to the Court that some well- accepted principles of valuation have been departed, without any reason; or that the approach adopted is patently erroneous; or that relevant factors have not been considered by the Valuer; or that the valuation was made on a fundamentally erroneous basis; or that the Valuer adopted a demonstrably wrong approach or a fundamental error in going to the root of the matter; the Court cannot interfere with the valuation of an expert.

iv. The Court held that the Valuer, had not committed any such error which may justify their interference. They have considered all the factors relevant under Regulation 20(5) of the Takeover Code and have adopted a reasonable approach which does not call for interference by the Court.

The Court held that "Board committed no error in accepting the Report, as Valuer has acted in a reasonable manner. Unless it is shown to the Court that some well-accepted principle of valuation has been departed from without any reason or that the approach adopted is erroneous, the Court cannot interfere with the valuation of an expert."

Hence, Board had exercised its discretion wisely.

**7. Key Learnings for Valuers from the above Case**

**i. Important Valuation Principles upheld**

- It is an established principle that for working out the average profit under the Profit Earning Capacity Method, profit of only those years which were normal and not affected by abnormal situations should be considered.
- It is not mandatory to derive the valuation of shares on the basis of consolidated financial statement. As per normal accounting practices, for determining the value of shares as a going concern only individual financial statements are considered because parent company is entitled to dividend only and has no right whatsoever in the assets of subsidiary and associate companies.
- Revaluation reserves are never considered as part of the net-worth computation. Section 2(29A) of the Companies Act, 1956 (now substituted by the Companies Act, 2013) which defines "net worth", expressly excludes revaluation reserves. Moreover, the CCI guidelines on "Valuation of equity shares for companies and the business and net assets ofbranches" clearly provided that the revaluation reserves arising out of revaluation of fixed assets should ordinarily be ignored. Only after an efflux of 15 years would it be reasonable to consider non-exclusion of revaluation reserves. Even SEBI guidelines for initial public offerings of shares expressly exclude capitalization arising out of revaluation reserves for purposes of determining "promoter's contribution" to be eligible to make an initial public offering.
- CCI guidelines on "Valuation of equity shares for companies and the businessandnetassetsofbranches" have always been and continued to be a material and significant indicator for purpose of valuation in India.

The mere fact that the CCI as a Statutory Authority has since been abolished does not make the CCI guidelines redundant.

ii. Mathematical precision and exactitude are not the attributes of share valuation, for at best the valuation arrived at by an expert is only his opinion as to what the value of the share should be. No doubt the variation may not be very wide between two valuations prepared honestly by two Valuers applying the correct approach and the correct principles, but some variation is unavoidable.

iii. Views may differ and even experts may differ in their conclusions or even reasoning. The Court must take notice of this fact and must not interfere unless there are compelling reasons to upset the finding of the expert Valuer. While the appellant expects Courts to step in to the role of an expert; the Court is forbidden to act in the said role and examine the imponderables in exercise of valuation of shares. As per the rationale laid in the case of Miheer H. Mafatlal, the Apex Court has held that the valuation of shares is a technical and complex problem and shall be appropriately left to the considerations of an expert.

iv. For the acquirer, the decision to acquire shares is a commercial decision. The same block of shares may have different value for different acquirers. An acquirer who intends to control the management of the target company by acquisition of the shares in question, without acquiring majority shares, may value the shares differently from an acquirer who is already in management of the Company but wishes to acquire the majority of shares to strengthen his voting rights.

v. A majority shareholder may also wish to acquire shares so as to hold 75% of the equity capital which will ensure passage of special resolutions. Such an acquirer may value the shares differently from his point of view. Similarly, a shareholder already holding 75% shares may acquire more shares only to consolidate his holding in the target company. It may not suit his objectives to pay a higher price than the other three categories noticed above.

**Case No. 2**

**Renuka Datla Vs Solvay Pharmaceutical B.V. and Ors. (2003)**

**IN THE SUPREME COURT OF INDIA**

Appellant: Renuka Datla Vs.

**Respondent: Solvay Pharmaceutical B.V. and Ors.**

Special Leave Petition (C) No. 18035 of 2000 with Interlocutory Application No. 2 of 2002 with S.L.P. (C) Nos. 18041-18042/2000 with I.A. Nos. 3 and 4/2002

Decided On: 30.10.2003

**1. Brief Facts of the** Case

The case arose from the dispute between the petitioners, Mrs. Renuka Datla and her husband Dr. Vijay Kumar Datla, and the company Solvay Pharmaceutical and Shri D. Vasant Kumar. The petitioners were shareholders of two Pharmaceutical Companies namely Duphar Pharma India Ltd. (DPIL renamed as Solvay Pharma India Ltd.) and Duphar Interfran Ltd. (DIL). The dispute was with respect to the transfer of shares of these two Pharmaceutical Companies to the respondents.

The petitioners filed three appeals in the High Court under Order 43 Rule 1

C.P.C. The appeal filed by the petitioner in the first S.L.P. against the refusal of injunction was dismissed by the High Court and the other two appeals filed by the aggrieved defendants were allowed and the ad interim injunction in both the cases was vacated.

Against this common order of the High Court, the present S.L.Ps. were filed by the petitioners namely, Mrs. Renuka Datla and Dr. Vijay Kumar Datla. During the course of the hearing itself, the parties settled the disputes and the terms of mutual settlement were signed by all the parties. The Court passed the following order on 15th July, 2002 to give effect to the settlement.

Counsel for the parties stated that the dispute between them has been settled. A copy of the terms of mutual settlement signed by the parties has been filed in Court and initiated by the Court Master. Terms of settlement are recorded. The terms contemplate valuation to be done of the intrinsic worth of the two companies and the value of 4.91% shares in the said two companies held by the petitioners. Valuation has to be completed within a period of four weeks. The terms of mutual settlement shall form part of this order. Copy of the order be sent to the Valuers.

According to the terms of settlement, M/s. Solvay Pharmaceuticals and Mr. Vasant Kumar agreed to purchase 4.91% shares held by the petitioners (Dr. Renuka Datla/Dr. Vijay Kumar) in the two companies namely Duphar Pharma India Ltd. (DPIL renamed as Solvay Pharma India Ltd.) and Duphar Interfran Ltd. (DIL). A Chartered Accountant, had to evaluate the intrinsic worth of both the Companies— DPIL and DIL as going concerns and the value of the said 4.91% shares held by the petitioners in those two Companies "by applying the standard and generally accepted method of valuation". The Valuer was also asked to give an opportunity to the respective parties to make their submissions.

**2. Basic Principle** and **Valuation Methodology adopted by the Valuer**

The Valuer considered three methods of valuation.

i. Asset based

ii. Earning based

iii. Market based.

DCF was not applied in absence of any independent projections and also because the projections provided by both the parties differed substantially.

**a. Intrinsic Value**

As per the Valuer, intrinsic value of the share should be based on the asset and earnings-based value with appropriate weightage given to the two methods.

Since the value of a company/business is more influenced by its earnings value, a higher weightage was given to the earnings value as compared to its asset value. The asset value is considered as an integral part of the intrinsic value as it has a persuasive impact. The Valuer hence allocated following weightage for determining the intrinsic value: -

i. Asset based value -1/3rd weightage
ii. Earnings based value- 2/3rd weightage

**b. Market Value**

The market (for listed company--its market price) based value indicates the value ascribed by the buyer/seller of the share at a given point in time. This is influenced by:

i. the floating stock and the supply and demand, which gets reflected in the volume and price of market transactions; and
ii. market perceptions related to
   - the overall market
   - the industry
   - the company

**c. Recommended Value**

The recommended value considered by the Valuer was higher of the intrinsic value or the market-based value. Though ideally, the recommended value should be the intrinsic value but, in some cases, it may be possible that the market-based value at a given point of time is higher than the intrinsic value, which is indicative of a bullish phase/ perception of the market and/or industry and/or the company. Therefore, to take into account this practical reality, the Valuer suggested higher of the two as the final value.

**Based on the above methodology, the intrinsic worth of the two Companies and the value of 4.91% shares in the two Companies was worked out at Rs 8.24 crores.**

**3. Issues Raised by the Petitioners**

The petitioners objected to the valuation on the following grounds:-

a. Control premium had not been added;
b. The value of the brands Vertin and Colopsa, which according to the petitioners continued to be the property of DIL, was not included;
c. Discounted Cash Flow method had not been adopted though it is a generally accepted method, even according to the Valuer.

**4. The Apex Court's View and Decision**

**a. Contention 1 - Control premium had not been added;**

It was the contention of the petitioners that 4.91 percent shareholding which the respondents Mr. Vasant Kumar and another have agreed to purchase was part of the promoters' shareholding of 25% and certain special rights and privileges were attached to these promoters' shareholding.

As per the Valuer, this holding of 4.91% did not give any special advantage to the holder or in this case even to the purchaser since the respondents collectively held in the two companies 60.5% of the share capital of each company. On that consideration, the value of the shares could only be 4.91% of the intrinsic worth of the two companies.

The Court held that in answering this question, the terms of settlement must be kept uppermost in the mind. The Court has to go by the terms of settlement which is the last word on the subject. The terms did not, either in express terms or by necessary implication, contemplated the valuation by determining the intrinsic worth of 4.91% shares, having due regard to their special or distinctive characteristics.

If the parties wanted a special treatment to be given to these shares and a control premium or the like had to be added, it should have been specifically expressed and mentioned in the terms of settlement. Such an important aspect should not have been omitted while framing the terms of settlement if the parties had agreed to the valuation on that basis. What has not been said in the terms of settlement in specific and clear terms, cannot be superimposed by the Court while interpreting the terms of settlement.

**b. Contention** No 2 - **The value** of **the brands Vertin and Colopsa was not included**

The petitioners contended that DIL was legally entitled to carry on its business in 'Vertin' and 'Colospa' along with other brands. The rights over these two brands were transferred to Dupen Laboratories Private Ltd. and such transfer, according to the petitioner, was in breach of contractual obligations under the Trademark License Agreement dated 15.7.1975 etc.

In this respect, the respondents submitted that the brands VERTIN and COLOSPA have been purchased by Solvay Pharmaceuticals BV from Dupen Laboratories Private Limited. As such, these were not the assets of DIL. DIL also has no investment in Dupen Laboratories Private Limited. This is not a matter which should affect the valuation of the shares of DIL.

The Court held that the petitioners cannot be permitted to thwart the terms of the settlement by inviting the Valuer or this Court to go into the extraneous issue as regards the validity of the transfer or incidental matters. The assets as per the relevant records had to be taken into account by the Valuer and that had been done. The Hon'ble Court, therefore, found no apparent error in excluding those brands.

**c. Discounted** Cash Flow **Method had not been adopted though** it is a **generally accepted method,** even **according** to **the Valuer.**

The Court held that the DCF method is adopted while resorting to valuation based on future earnings but the future earning based valuation is not the only reliable method of 'earnings-based valuation'.

Moreover, the petitioners have not placed any facts and figures to show that such method of valuation would result in a definite increase in the share value going by independent projections.

There were vast discrepancies between the projection

given by the parties and independent projections had not been provided; the Valuer had chosen the best possible method of evaluation by capitalizing the past earnings. In doing so, the future maintainable profits based on past performance were also an element that had gone into the calculation. No prejudice whatsoever was shown to have been caused to the petitioners by the earnings-based valuation.

*The court decided that the Valuer approached the question of valuation having due regard to the terms of settlement and applying the standard methods of valuation. The valuation has been considered from all appropriate angles. No case has been made out that any irrelevant material has been taken into account or relevant material has been eschewed from consideration by the Valuer. The plea that the valuation is vitiated by fundamental errors cannot but be rejected.*

**5. Key Learnings for Valuers from the above Case**

i. In the given Case, the appellant faced substantial loss on account of poor drafting of the terms of settlement. Hence, while drafting an agreement/settlement one shall ensure to incorporate all the points that are there in his/her mind, and nothing shall be left to the interpretation of the readers. To avoid damages one shall apply a thorough mind and try and engage professional help in such situations.

ii. An explanation on Valuation Methodology applied to arrive at a specific valuation and 'selection' of any particular method or for 'disregarding' any approach shall always be included in a valuation report. In the given case the Valuer, clearly shared the logic and understanding behind the selection of Valuation Methodology and assignment of weightage in his Valuation Report. This surely helped him when his Valuation Report was being tested by the Court.

iii. Valuation is an opinion of value; it needs to be properly supported for credibility. It must be supported by relevant evidence and logic as necessary for the intended use.

iv. The valuation approaches and methods shall be selected in a manner which would maximise the use of relevant observable inputs and minimise the use of unobservable inputs. In the given case the Valuer didn't select the DCF method as adequate inputs i.e. the projected cash flows were not available from an independent party and also there were vast discrepancies between the projections given by the parties.

v. It was held that "If the valuer had applied the standard method of valuation, considering the matters from all the appropriate angles, his valuation could not be challenged on the ground of being vitiated by fundamental error."

vi. Further DCF method was not considered by Valuer due to unavailability of independent projections. In respect of projections, the Valuer had chosen the best possible method by capitalizing past earning and considering maintainable profits.

vii. In case the minority holding does not give any special advantage to the holder or the purchaser then the control premium is not to be added while ascertaining the value of the shares. In the above case, the holding of 4.91% did not give any special advantage to the holder or in this case even to the purchaser since the respondents collectively held in the two companies 60.5% of the share capital of each company. On that consideration, the value of the shares can only be 4.91% of the intrinsic worth of the two companies.

viii. It was further held that "If a valuer has not added control premium in intrinsic value and the same has not been specifically mentioned in the terms of settlement, the treatment done by Valuer will be considered as correct."

ix. The Court also ruled that the Valuer had arrived at market-based valuation in addition to the other modes of valuation and observed that the recommended value is the higher of the intrinsic value or the market- based value. Thus, the petitioners had the benefit of higher valuation. The first principle laid down in the above decision has been kept in view. Moreover, the profit earning method which has been referred to in the above decisions in the context of valuation of shares of a private limited company has also been applied, though future earnings-based valuation has not been done in the absence of reliable figures. As observed by us earlier, the profit earning capacity of the company has not been excluded from consideration, Thus, the Valuer's mode of valuation does not in any way infringe the principles laid down in the case of ***Commissioner of Gift Tax, Bombay v. Smt. Kusumben D. Mahadevia*** to the extent they are applicable.

# Prize-winning entries of the Essay Competition organized by ICMAI Registered Valuers Organization

## IMPORTANCE OF VALUATION - BUILDING AATM NIRBHAR BHARAT

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### INTRODUCTION;

It seems apt to re-title this as "Aatm Nirbhar Bharat and Importance of Valuation" ?, The reason – " ***Aatm Nirbhar Bharat" is our goal***, a national goal, and *Valuation is an important tool.* The Government Of India considers- Economy, Infrastructure, System, Demography, and Demand as the five pillars to become Atma Nirbhar Bharat or Self- reliant India (GOI, 2020). A special economic package amounting to Rs 20 lakh crore, an equivalent of 10% of India's GDP, and several other policy measures were announced as part of this programme. The sizeof the package is enormous. It is 3.65 times the current fiscal deficit, of Rs 5, 47, 026 croresas at the end of October 2021,(PTI, 2021). Much of this is likely to flow into the goods market, comprising of the market for consumption goods and market for investment goods( the asset market), and will be used to build infrastructure, sustain demand during the pandemic, and stimulate the economy, achieve the growth targets and make India self-reliant. A portion of this package will find its way into the asset market, create the necessary infrastructure and other capital goods. Valuation will have an important role in this market and a tool in the creation of Atma Nirbhar India

### ATMA NIRBHAR BHARAT : TARGETS

The "Atma Nirbhar Bharat" aims to be an economy of $5 trillion US Dollars by fiscal 2024-25 at an average annual growth of +9%. This is an ambitious target, As private consumption demand and investment demand together account for 85% of GDP (RBI, May 2021),. the target's fruition requires huge sustained investment and consumption demand during the period. Further investment demand-led GDP growth enables job creation and is more sustainable. Even the RBI, Report of May 27, 2021 avers this. The RBI's autoregressive model for figuring out GDP growth shows that investment led recovery post-pandemic could boost both output and consumption. However, investment has not at all been encouraging and private investment remains low and is a weak spot in the economy. (Sharma, October 16, 2021) The Gross Fixed Capital Formation( GFCF) decreased by 12.4% in 2020-21 over the previous year.The ratio of real gross fixed capital formation (GFCF) to GDP decreased from 32.5 percent in 2019-20 to 30.9 percent in 2020-21. This is reflective of weak investment sentiments.

### ATMA NIRBHAR BHARAT: INVESTMENT REQUIREMENTS

As said before to enable "Atma Nirbhar Bharat "requires huge investments in infrastructureand human capital. Much of this has to be funded through government investments as private sector participation in these projects is usually low. The government capital expenditure budget for the financial year 2021-2022 is Rs.554 thousand crores. The Government expects to finance a part of these through disinvestment: the disinvestment target being Rs 175 thousand crores. As stated before private sector investment is very low in India, and more so in infrastructure and social capital. Another source of capital is Foreign Direct Investments (FDI). A report estimates that India will need $8 trillion USD in GCFC by FY 2026-27 and 667 million USD annually to become a $5 trillion USD economy by 2026-27. (Deloitte, September 2021). The bulk of these investments, whether Government investments, FDI, or private investments will flow into the Asset market . These assets can be both private assets and public assets, like infrastructure projects and capacity building of social infrastructure

### VALUATION: THE TOOL

Valuation can be seen as a process of establishing the value of an asset or liability (Pratt SP, 2011). The output of the process is the estimate or opinion of the value of the asset or liability. (AICPA). Thus this opinion of value can be the basis of any transactions,- sale-purchase, mergers, acquisitions, re-organizations, liquidations between the two negotiating sides of the transaction. Opinion of value is also important in the case of financing transactions where the value of the collateral needs to be ascertained. The tool of valuation not only finds use in transactions where the change in ownership or possession of assets or rights of use of asset changes, but also in other cases like the resolution of disputes between two parties, as in say,tax dispute over the fair market value of a capital asset ( Sec 55, Income Tax Act). However such valuation purposes are less important in building an Atma Nirbhar Bharat. It finds use in a non-commercial setting as well. Valuation techniques can be used to value a social infrastructure project. A RICS report spells out the role of valuers in such infrastructure projects. (RICS, 2020). Hence valuation is an important tool that links the providers of Capital, whether it be the Individual or the Government with the creators of assets.

### VALUATION: ITS ROLE IN THE ASSET MARKET AND THE FINANCIALMARKETS

As valuation links the suppliers of capital and creators of assets, it aids in the flow of capital from one to the other. Since it interfaces with the two, valuation has a role to play in the financial markets as well as the asset market, the two important markets in the economy.

In financial markets, valuation is used to value financial assets. A large capital project may be financed by the financial institutions through financial instruments like bonds , equity or other instruments which are traded in the capital markets. On the financing side, valuation will value the financial instruments at various stages of the assets' life. Thus in financial markets, the valuers help create a market for these financial instruments and help sustain the financial markets by continuously valuing these instruments throughout their life-cycle.

In the asset market, the valuation will estimate the value of the asset and help in the price discovery of the asset between two negotiating parties. This price can be for the possession of assets as in a sale-purchase transaction or as a rental which denotes the price of use: or it can be the price for the alternate use of the asset, as in a mortgage transaction. In the asset market too, the valuation can be done at the different stages of the assets' life.

## VALUATION AND REFORMS ;

Economic policies have to be supplemented by structural reforms to achieve the targeted economic status. Valuation too can be a tool of reform of the markets and the corporate environment as discussed in the following paragraphs.

### 1. Valuation: Reduction of Information Asymmetry.

An important contribution of valuation in the asset market is the reduction of information asymmetry. Many asset markets exhibit high information asymmetry. The Indian real estate industry is a good example. Homebuyers in apartment complexes have to buy apartments valued with rates fixed by builders denominated at Rupees per unit area but have no knowledge of building structure and materials used. The valuation professional is expected to reduce this information asymmetry. Valuers are expected to conduct investigations appropriate for the purpose of valuation and the basis of value(20.1, IVS 102 Investigations and Compliance) and assemble sufficient evidence by means such as inspection, inquiry, computation, and analysisto ensure that the valuation is properly supported and also ensure through professional judgment that the information so obtained is adequate for the purpose of the valuation (20.2, IVS 102 Investigations and Compliance). Such an exercise is expected to reduce information asymmetry and help improve investor sentiment and increase investor confidence.

### 2. Valuation and Corporate Governance

A strong valuation ecosystem - a strong community of professional valuers, regulation of valuation professionals, ethical valuation practices, established and recognized valuation standards, and continuous improvement of valuation methods based on continuous education and research is sure to push best practices in corporate governance. It is often stated that " corporate governance helps in building an environment of trust, transparency, and accountability necessary fostering long-term investment, financial stability, and business integrity, thereby supporting stronger growth and more inclusive societies (Organisation Of Economic Co-operation and Development, 2021). Definition of Corporate definition is not unique. The Cadbury Report defines it as the system by which companies are directed and controlled (Cadbury, 1992). Another definition is "the institutional framework that regulatesthe division and exercise of power in the corporation" (Licht, 2013). Various organizations, research groups have created Governance index (GI) to measure corporate governance of a firm, that has information on board meetings, director level education, director compensation. Some components of this GI, like the election of Board members, number and quality independent directors on Board, option grants to directors, poison pills in use, were found to be related to firm value. (Bebchuk L, 2005) (Brown LD, 2006). Both Internal and external governance influenced firm valuation (Cremers, 2005). So good corporate valuation leads to better valuation and as a corollary, strong valuation ecosystem will spur good corporate governance practices.

### 3. Valuation and Value Management

Valuation can provide encouragement for value-based management (VBM). "Value-Based Management" focuses on (1) measuring company value; (2) design and implementation of strategies with the largest potential for the creation of shareholder value; (3) development and implementation information systems that are directed at value creation and the "value, drivers throughout a corporation's business departments, product, and customer segments; (4) integration of business plan and resource allocation with that of value creation; (5) and use of performance measurement systems that track value creation. (Ittner CD, 2001). So, the exercise of valuation will not only give an estimate of the value of the business but can also identify the elements of businesses that stimulate the business itself. (Martin JD, 2009).In other words, 'valuation" can identify value drivers and reduce wastes and valuation can be used as a strategicmanagement tool for enterprise value enhancement.

### 4. Valuation and Accounting Environment

Valuation and improvement in valuation practices are likely to have a positive impact on the accounting environment. Since valuation estimates are strongly based on accounting and financial reports, the quality of accounting and audit would go up if valuation quality is good and vice versa. Research has shown that a firm's accounting environment affects its valuation. When the accounting standards environment change for the better, the number of analysts and forecast accuracy increase and there is a positive correlation between firm value and improvements in the information environment. (Lang MH, 2001).

### 5. Valuation and Disclosure

Valuation is expected to encourage the disclosure of

both financial and non-financial information. As valuers' estimates of value are based on methods based on income, markets, and costs, the higher the disclosure and dissemination of information, the better would be the value judgment. Consequently, investors too would value information disclosures and prefer businesses that voluntarily disclose key information. This would have a positive impact on the business environment, as more and more businesses voluntarily disclose information in a bid to compete for investors' funds. A positive association between voluntary disclosure of non- mandatory information on environmental, social, corporate governance, and financial matters has been empirically found. (Charumathi B, June 2020). The result is especially significant since the sample companies chosen were from the BSE-100 index.

### 6. Valuation and Transparency

Pressure to disclose crucial information from valuers and investors would also force businesses to be more transparent. As greater the disclosure of information and data, the greater can the information be subjected to analysis and validation for authenticity. This in turn is likely tobring out transparency in the processes and systems of financial and non – financial reporting. Greater transparency will be welcomed by investors and analysts and regulators as well. With greater transparency, costs of control and regulations are likely to come down. Research on the issue of transparency of accounting statements in emerging markets has shown a positive correlation between transparency of accounting statements and price to book value ratios, which led the researchers to conclude that the market reacts positively to transparency. (Patel SA, 2002).

### 7. Valuation and Regulatory Environment:

A strong valuation eco-system can exert a positive influence on a country's regulatory eco- system, ensure the protection of minority interests in a corporate setting against misappropriation by controlling interests. This is expected as firm valuation is usually higher when investor protection is high. Research using a model with a sample of 539 firms in 27 developed economies has found evidence of higher valuation of firms in countries with better protection of minority shareholders (La Porta R, 2002). It was also found that firms in more corrupt countries trade at lower market multiples. (Lee C, 2002) As per this article, a firm in Singapore would likely have 18.1 higher P/E and 1.2 times higher book value than a firm of similar characteristics in Mexico. Investor protection is inversely related to private costs of control. Hence private costs of control are low in countries that render higher investor protection. Such economies have also more developed capital markets. (Dyck A, 2004)

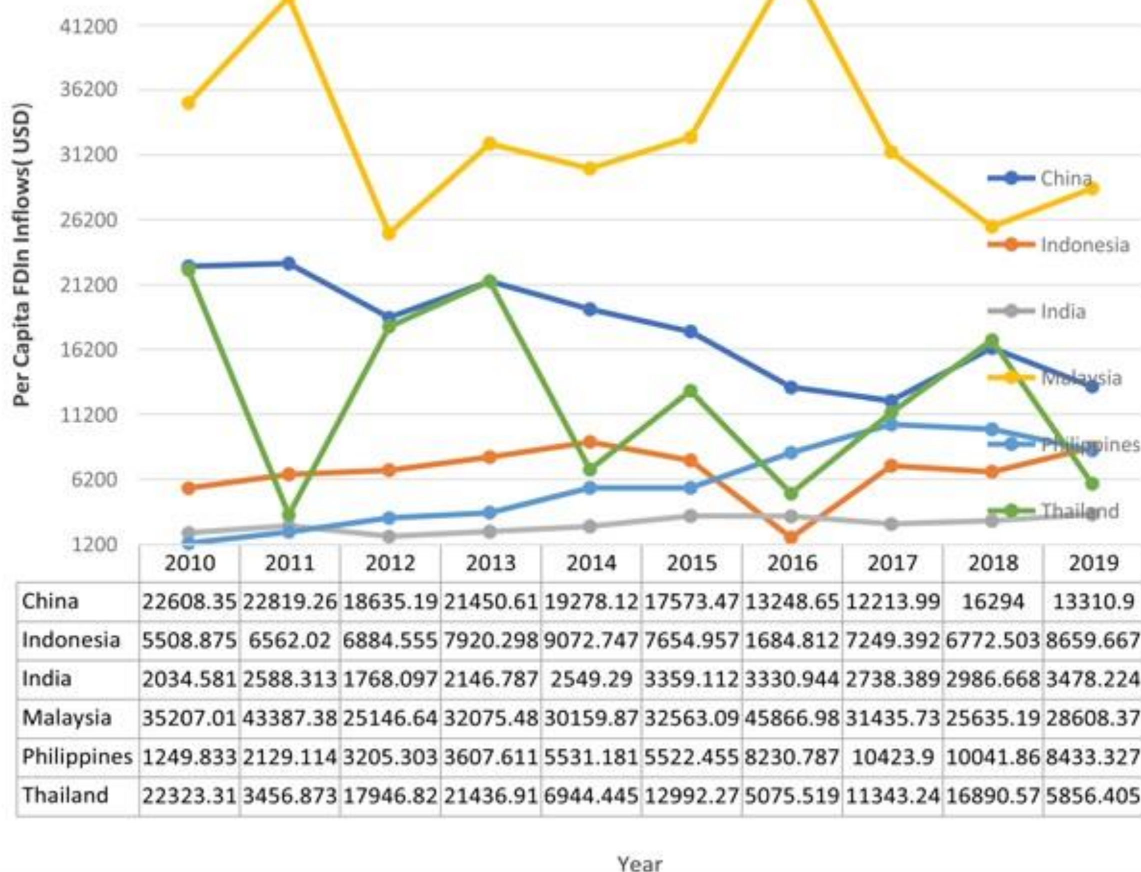
## STATE OF VALUATION ECO-SYSTEM IN SOME DEVELOPED COUNTRIES AND EMERGING ECONOMIES

In North America- (Canada and the USA) and in the UK, the valuation professional organizations (VPOS), conduct courses for their members, certify their members for practice and regulate their members. Many of these have been in existence for quite a long time. Manyof them, like AICPA, ASA, CFA, are members of The International Valuation Standards Council (IVSC), a trust consisting of representatives from financial regulators and securities regulators from various countries, heads of VPOs and other standard-setting bodies which sets valuation standards internationally and encourages their adoption. Some others have adopted Uniform Standards of Professional Appraisal Practice (USPAP) standards, These VPOs are in turn regulated by some provisions of both Federal and state laws. The US Internal Revenue Service has also created standards to guide the valuation of businesses, intangible and tangible assets, and personal property/ real estate. In Europe some 70 professional valuation organisations have teamed to form The European group of valuers Association (TEGOVA) and released the European standards and European Business Valuation standards. These associations are regulated as per their home country laws.

Emerging economies in Asia, like China, Indonesia, Malaysia, Philippines, and Thailand, with whom "Bharat" has to compete for FDI have developed an active valuation ecosystem.

Most of these nations had started developing the valuation ecosystem by the end of the 2000- 2010 decade. In China, the valuation profession is regulated by the state, through three valuation agencies. One of these CAS is under the Ministry of Finance and its members deal with business valuation, general assets and plant and machinery. IVSC standards are one of the two recognized standards followed in PRC. Valuers in Indonesia are also regulated by the state. They are issued a public valuer license by the Ministry of Finance. The recognized standard is the Indonesian Valuation Standard. Among these emerging economies mentioned, Malaysia led in developing its valuation ecosystem. There, valuation is regulated and governed by a Board, which was established under The Valuers, Appraisers, and Estate Agents Act 1981.The Board is under the control of the Ministry of Finance. Malaysian standards are adapted fromthat of IVSC. In the Philippines, valuation is regulated by the Ministry of Finance. The valuation profession is governed by the Professional Regulatory Council. The Philippines has adopted the IVSC standards to suit its settings. In Thailand appraiser companies, working in the capital market have to be registered with The Institute of Appraisal Profession approved by the SEC. There are two valuation associations, TVA and VAT, comprising of member valuation companies. Both of these are self-regulatory associations.

Per capita FDI inflows (World Bank, 2021) to these emerging economies vis-à-vis FDI inflows to India are shown in Fig1. below: This chart provides an inducement to test the hypothesis that a strong valuation ecosystem is one of the leading factors affecting investment.




| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| China | 22608.35 | 22819.26 | 18635.19 | 21450.61 | 19278.12 | 17573.47 | 13248.65 | 12213.99 | 16294 | 13310.9 |
| Indonesia | 5508.875 | 6562.02 | 6884.555 | 7920.298 | 9072.747 | 7654.957 | 1684.812 | 7249.392 | 6772.503 | 8659.667 |
| India | 2034.581 | 2588.313 | 1768.097 | 2146.787 | 2549.29 | 3359.112 | 3330.944 | 2738.389 | 2986.668 | 3478.224 |
| Malaysia | 35207.01 | 43387.38 | 25146.64 | 32075.48 | 30159.87 | 32563.09 | 45866.98 | 31435.73 | 25635.19 | 28608.37 |
| Philippines | 1249.833 | 2129.114 | 3205.303 | 3607.611 | 5531.181 | 5522.455 | 8230.787 | 10423.9 | 10041.86 | 8433.327 |
| Thailand | 22323.31 | 3456.873 | 17946.82 | 21436.91 | 6944.445 | 12992.27 | 5075.519 | 11343.24 | 16890.57 | 5856.405 |

## STATE OF VALUATION ECOSYSTEM IN BHARAT:

The first step to create the valuation ecosystem in the corporate setup was probably with the adoption of The Companies (Registered Valuers and Valuation) Rules, 2017. These rules laid down the provisions for education, certification, licensing the valuers, adoption of valuation standards, and regulating the profession through valuation organizations. These rules are however limited to the valuation of assets and liabilities as per provisions of The Companies Act 2013. Valuation of assets and liabilities in other situations are covered by other provisions and laws. However, none of these laws called for education and regulation of valuers. An offshoot of The Companies (Registered Valuers and Valuation) Rules, 2017, was the establishment of the "Committee of Experts on Institutional Framework for Regulation and Development of Valuation Professionals" which submitted its report on the same and preparedthe "The Draft Valuers Bill, 2020"

## CONCLUSION:

"Atman Nirbhar Bharat" is an ambitious goal, requiring heavy investment in all sectors, extraordinarily huge job growth, at the same time, maintaining a moderate rate of inflation. Economic policy measures aiming for this goal must be accompanied by reforms in various other sectors. Developing a strong valuation ecosystem may be used as a tool to reform the asset market and the corporate environment. Since valuation, mostly finds uses in a corporate setting, a strong valuation ecosystem can incidentally result in a stronger regulatory environment, better corporate governance, greater investor protection, more disclosure, greater transparency, value management of companies, and consequently greater investor confidence. A professional valuation institute is the need of the hour. The valuation institute will conduct valuation courses and will also be responsible for the growth and development of valuation knowledge and valuation practices. It will set and recommend standards of valuation, certify and license valuers. It will have its code of ethics. enforce the same and regulate and exercise disciplinary authority over valuers. The Draft Valuers Bill 2020 envisages all these – a valuers institute, regulation of valuers and market for valuation services and protect the interests ofusers of valuation services. (Committee of Experts on Institutional Framework for Regulation and Development of Valuation Professionals, 2020) Passage of the bill in Parliament will be another reform measure in the financial and corporate

space of Bharat on its way to becoming "Atma Nirbhar".

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26. *World Bank, 2021. World Bank data. [Online] Available at: https://data.worldbank.org/ [Accessed 19 12 2021].space of Bharat on its way to becoming "Atma Nirbhar".*

# ICMAI REGISTERED VALUERS ORGANISATION

## Essay Competition on Importance of Valuation in New India - Building Aatm Nirbhar Bharat

**Conducted in 2021-22**

### First Prize

| Name | Prize Money (Rs) |
|---|---|
| INDRANIL CHAUDHURI | 20,000/- |

### Second Prize

| Name | Prize Money (Rs) |
|---|---|
| MISHRA SURYA NARAYAN | 10,000/- |

### Third Prize

| Name | Prize Money (Rs) |
|---|---|
| SHAMBHU NATH ROY | 5,000/- |

### Consolation Prize

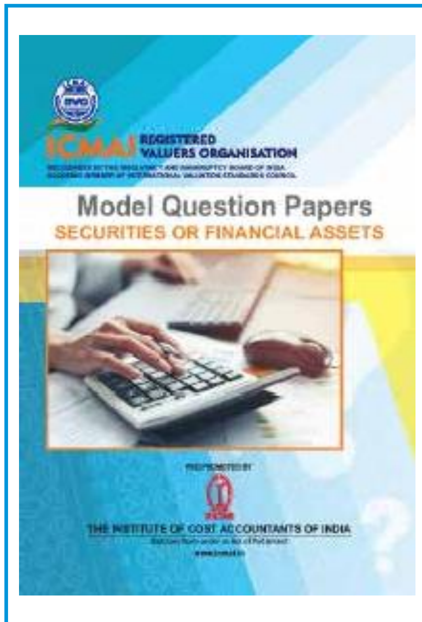
| Name | Prize Money (Rs) |
|---|---|
| SUSMITA MAITRA | 2,500/- |
| SUNIL DASARI | 2,500/- |

### 3 Women Participants apart from the Prize

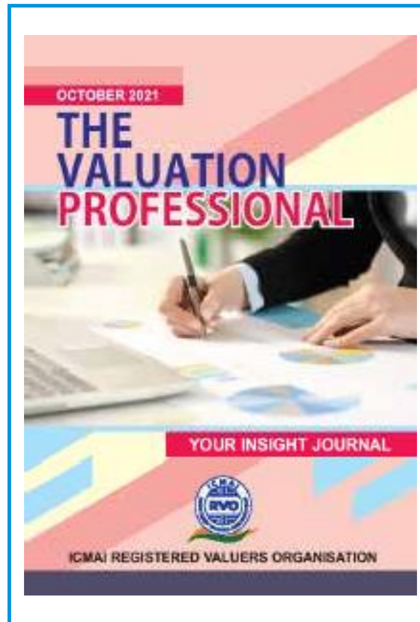
| Name | Prize |
|---|---|
| PARUL SINGH | Recognition Certificate |
| SONI KUMARI | Recognition Certificate |
| JAVALI PRAMILA BASAVARAJ | Recognition Certificate |

# Emerging Professional Opportunities Current Economic Scenario and its Effects on Valuation organised on 15th March 2022

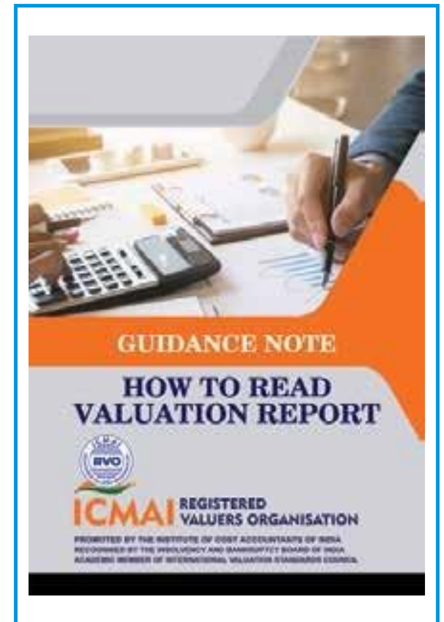
# PUBLICATIONS



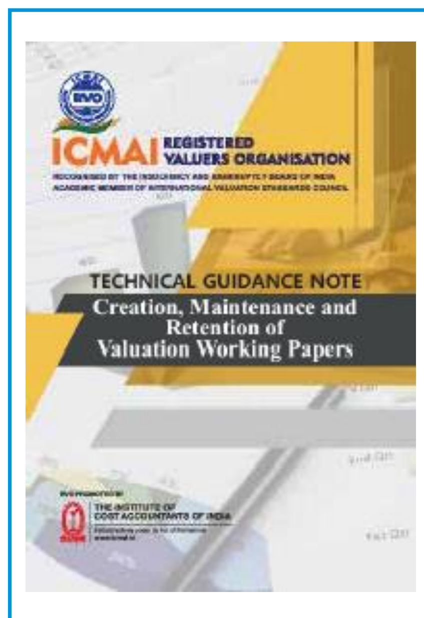

Model Question Papers
Securities or Financial Assets



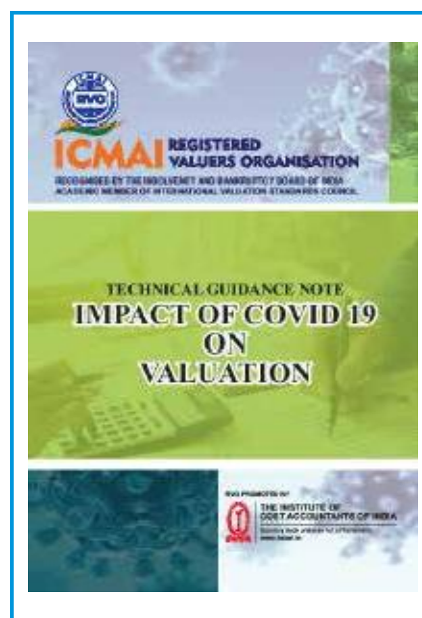

The Valuation Professional




Guidance Note
How to Read Valuation Report




Technical Guidance Note
Creation Maintenance and
Retention of Valuation




Technical Guidence Note
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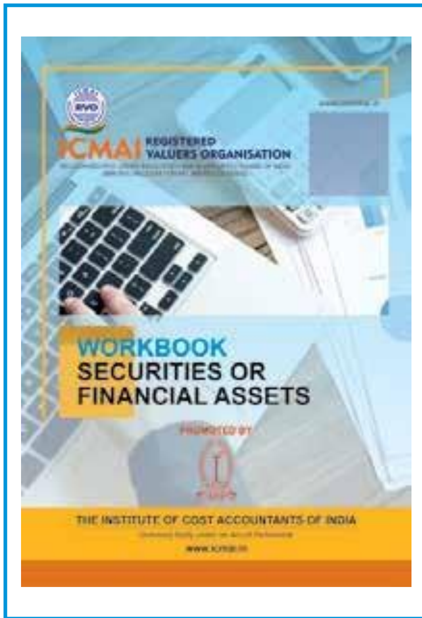
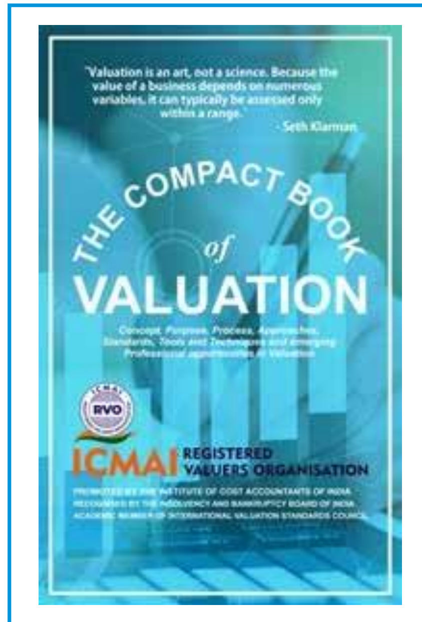
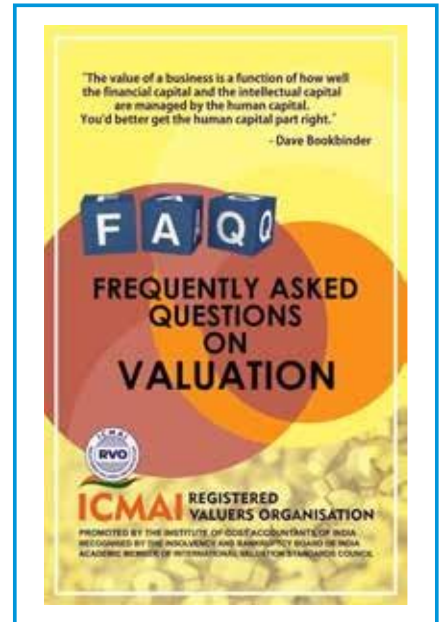



Work Book
Securities or Financial Assets

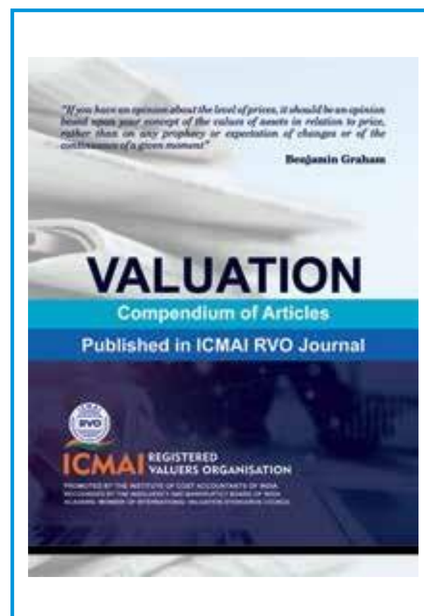



The Compact Book of
Valuation




FAQ
Frequently Asked Questions on
Valuation

Compendium of
Perspective Papers

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# OPPORTUNITIES FOR REGISTERED VALUERS

## Companies Act, 2013

- *Private placement of shares*
- *Issue of Share on Preferential basis*
- *Issue of Shares for consideration other than cash*
- *Issue of Sweat Equity Shares*
- *Non- cash transaction involving directors*
- *Merger and Amalgamations*
- *Demergers*
- *Scheme of compromise or arrangement with creditors/members*
- *Submission of report by company liquidator*
- *Purchase of minority shareholding*

## SEBI Regulations

- *SEBI (Issue and listing of Securitised debt Instruments and Security receipts) Regulation,2008*
- *SEBI (Infrastructure Investment Trusts) Regulations, 2014*
- *SEBI (Real Estate Investment Trusts) Regulations,2014*
- *SEBI (Listing Obligations and Disclosure Requirements) Regulations,2015*
- *SEBI (Issue of capital and Disclosure requirements) regulations,2018*
- *SEBI(Appointment of Administrator and procedure for refunding to the investors) Regulations,2018*

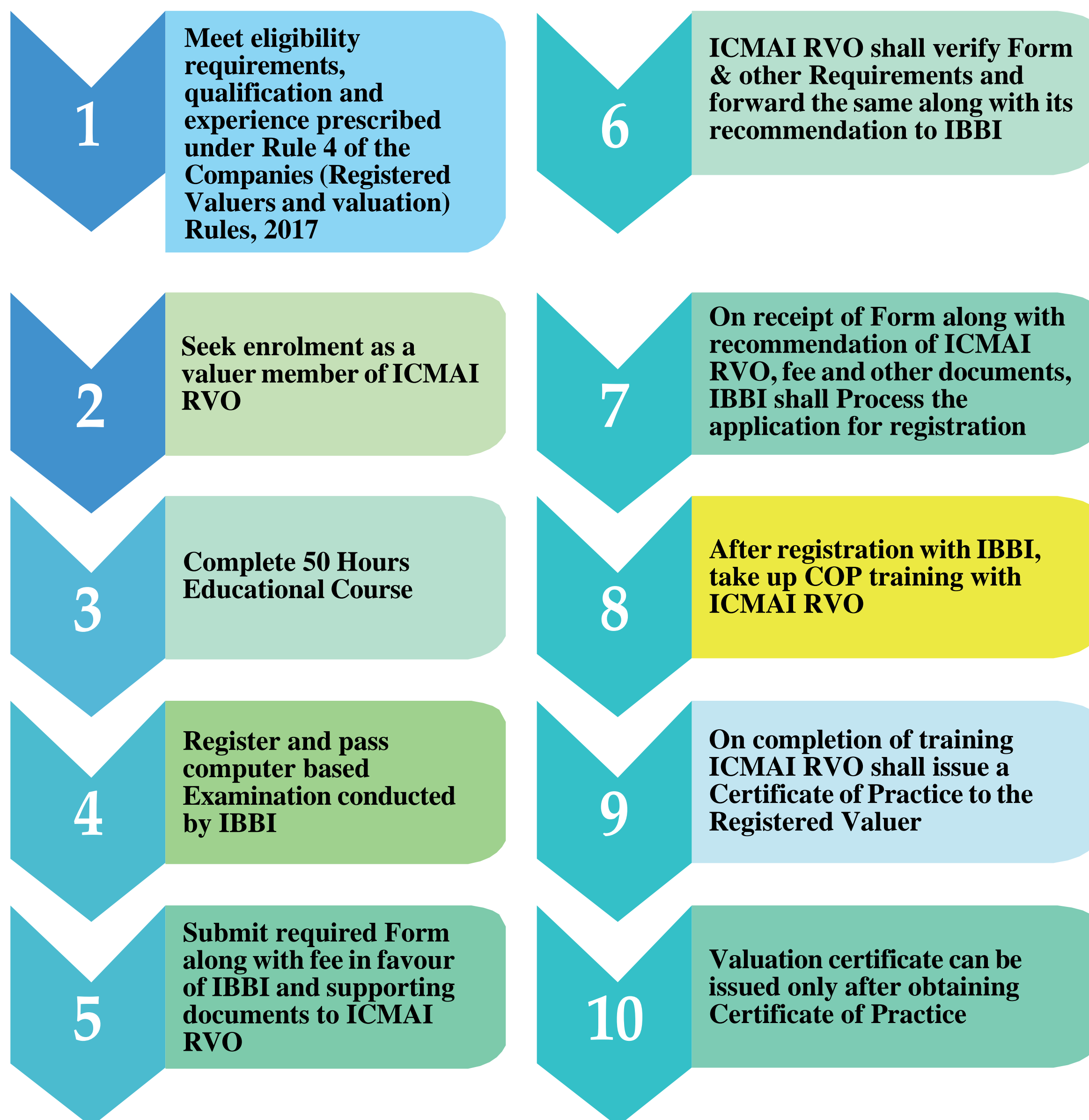
## Insolvency and Bankruptcy Code 2016

- *Determination of value of assets, realizable value, Fair value and liquidation value as the case may be*

## Income Tax Act, 1961

- *Valuation Methodology for Issue of Unquoted Equity Shares – Rule 11UA(2)2 56(2)*
- *Issue of Unquoted Shares (Other Than Equity Shares) – Rule 11UA(1)(c)(c)*
- *Transfer of Shares and other Securities*
- *Valuation for Capital Gains*
- *Transfer Pricing – International Transactions between Associated Entities*
- *Indirect Transfer Pricing – Capital Gain arising to Non-Resident on transfer of shares of foreign company*
- *Valuation of Equity Shares held by the Minority share Holders.*

# PROCESS FOR BECOMING REGISTERED VALUER



## EDUCATIONAL QUALIFICATION & EXPERIENCE

## FOR 50 HOURS EDUCATIONAL COURSE

| Asset Class | Eligibility/ Qualification | Experience in specified discipline. |
|---|---|---|
| **Plant and Machinery** | (I} Graduate in Mechanical, Electrical, Electronic and Communication, Electronic and Instrumentation, Production, Chemical, Textiles, Leather, Metallurgy, or Aeronautical Engineering, or Graduate in Valuation of Plant and Machinery or equivalent;<br><br>(ii) Post Graduate on above courses. | (i) Five years<br><br>(ii) Three years |
| **Land and Building** | (i) Graduate in Civil Engineering, Architecture, or Town Planning or equivalent;<br><br>(ii) Post Graduate on above courses and also in valuation of land and building or Real Estate Valuation (a two-year full time post-graduation course). | (i) Five years<br><br>(ii) Three years |
| **Securities or Financial Assets** | (i) Member of Institute of Chartered Accountants of India, Member of Institute of Company Secretaries of India, Member of the Institute of Cost Accountants of India, Master of Business Administration or Post Graduate Diploma in Business Management (specialisation in finance).<br><br>(ii) Post Graduate in Finance | Three years |
| Any other asset class along with corresponding qualifications and experience in accordance with rule 4 as may be specified by the Central Government.<br><br>*Note: The eligibility qualification means qualification obtained from a recognized Indian University or equivalent Institute whether in I ndia or abroad.".* | | |

## PROCESS FOR IBBI EXAMINITION

a. The candidate may enroll for the examination on payment of the fee as prescribed by IBBI
b. Online examination with objective multiple-choice questions
c. The duration of the examination is 2 hours
d. Wrong answer attracts a negative mark of 25% of the assigned for the question
e. A candidate needs to secure 60% of marks for passing.

## FORMAT AND FREQUENCY OF EXAMINATION

a. The examination is conducted online (computer-based in a proctored environment) with objective multiple-choice questions;
b. The examination centers are available at various locations across the country;
c. The examination is available on every working day;
d. A candidate may choose the time, the date and the Examination Centre of his choice for taking the Examination. For this purpose, he needs to enroll and register at https://certifications.nism.ac.in/nismaol/
e. A fee of Rs.1500 (One thousand five hundred rupees) is applicable on every enrolment;
f. The duration of the examination is 2 hours;
g. A candidate is required to answer all questions;
h. A wrong answer attracts a negative mark of 25% of the marks assigned for the question;
i. A candidate needs to secure 60 % of marks for passing;
j. A successful candidate is awarded a certificate by the Authority;
k. A candidate is issued a temporary mark sheet on submission of answer paper;
l. No workbook or study material is allowed or provided;
m. No electronic devices including mobile phones and smart watches are allowed; and
n. Use of only a non-memory-based calculator is permitted. Scientific Calculators (memory based or otherwise) are not allowed.

## GUIDELINES FOR ARTICLES

The articles sent for publication in the journal "The Valuation Professional" should conform to the following parameters, which are crucial in selection of the article for publication:

- The article should be original, i.e. Not Published/ broadcasted/hosted elsewhere including any website.
- A declaration in this regard should be submitted to ICMAI-RVO in writing at the time of submission of article.
- The article should be topical and should discuss a matter of current interest to the professionals/readers.
- It should preferably expose the readers to new knowledge area and discuss a new or innovative idea that the professionals/readers should be aware of.
- The length of the article should not exceed 2500-3000 words.
- The article should also have an executive summary of around 100 words.
- The article should contain headings, which should be clear, short, catchy and interesting.
- The authors must provide the list of references, if any at the end of article.
- A brief profile of the author, e-mail ID, postal address and contact numbers and declaration regarding the originality of the article as mentioned above should be enclosed along with the article.
- In case the article is found not suitable for publication, the same shall be communicated to the members, by e-mail.

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RECOGNISED RVO UNDER INSOLVENCY AND BANKRUPTCY BOARD OF INDIA

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