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# 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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RECOGNISED RVO UNDER INSOLVENCY AND BANKRUPTCY BOARD OF INDIA

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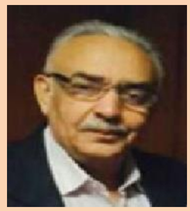

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# FROM THE CHAIRMAN's DESK

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

Organizations need to adapt to new models and unconventional thinking going ahead as a volatile and uncertain environment has undermined the effectiveness of traditional ways of operating businesses. In the recent past, the incredibly volatile and uncertain environment has undermined the effectiveness of long term forecasting and traditional strategic planning. The change in the world ecosystem has been disruptive, pushing people, organizations and economies to the brink. Thus, achieving goals now requires a sea change in our models of operations.

Businesses are facing rapidly changing environments due to the emergence of innovative technologies at a swift pace, the majority of which are disruptive in nature. Coupled with the wide range of obstacles, environmental, digital and geopolitical in nature such as supply chain disruptions, climate action failures, social divisions, digital inequities, and a complicated security concerns in Indian Ocean waters, all of these will have ramifications for businesses, potentially impeding their recovery and development in the long run. India has been very good at managing its finances but the surge in global energy prices after Russia's military operations in Ukraine is going to have a negative impact on its economy, according to IMF Managing Director.

A rebound in overall economic growth with normalization of activity post-pandemic; GDP growth likely to be much stronger in the coming years than a few years before COVID; benefits of many disruptive reforms such as GST, IBC and RERA will start to flow in going forward. Corporate India has deleveraged substantially in the last few years, with improved quality of balance sheets comparatively.

# FROM THE PRESIDENT's DESK

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

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

The Securities and Exchange Board of India (Sebi) has strengthened scrutiny of IPO-bound companies by questioning how key internal business metrics are used to arrive at valuations. It is said that after Paytm debacle, the regulator has come up with stricter norms. The decision by the Sebi hints at the flop listing of online payments firm Paytm's $2.5-billion IPO in November last year which sparked criticism of lax oversight of how loss-making firms price issues at what some say are lofty valuations,

The top 500 Indian companies added $1.2 trillion in value to a total of $3 trillion valuation as stock markets rose to record high in 2021 on the back of a fast-growing digital economy coupled with increased optimism for the post-Covid growth trajectory of the Indian economy. With a valuation of US$ 22.7 billion, HDFC Bank, the private banking major is the highest valued brand in India. The list has been compiled by the world's leading media buyer WPP.

Stock market investors do a whole lot of exercise and mostly their experience over the years into stock markets pays to make a good deal i.e. purchase a stock at an attractive valuation. By attractive valuation herein we mean, reasonable for an investor which though is the case considering the worth of the company, such that an investor is able to make handful gains. Investors need to be cautious about new age Internet businesses. These face valuation headwinds while cash flows and profitability are still question marks

# FROM THE MD's DESK

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

The pricing of Life Insurance Corporation's IPO could prove to be a tricky affair for the government, which is hoping for a windfall by divesting a 5% stake in the state-owned insurance company. Analysts say that if the IPO is priced at 2.5-3 times the embedded value, the IPO would be priced at around Rs 1,800-2,250, making its valuation too expensive. The embedded value of LIC has been estimated at Rs 5.4 lakh crore. Insurance companies already listed on the bourses – SBI Life, HDFC Life and ICICI Prudential Life – command a valuation of 3-4 times the embedded value. If LIC prices its IPO at similar valuations, the IPO would be priced at least Rs 2,200, which analyst say is too high even by LIC's standards.

Valuations of Indian equities seem stretched by most conventional yardsticks, such as price-to-earnings multiples and yield differentials with benchmark bonds, but the trend among promoters to steadily raise ownership in listed companies reflects the confidence they have in their businesses. Valuations on Dalal Street still appear to be higher than their historic averages, but there is a diverse set of opportunities available. UBS has maintained that Indian stock valuations look unattractive. The foreign brokerage assigned an 'underweight' to India while double upgrading the rating for China equities to 'overweight'.

India's equity market has outperformed major equity markets in 2021, triggered by signs of economic recovery and an accommodative monetary policy from the Reserve Bank of India (RBI). The Indian equity market witnessed positive returns this year, buoyed by strengthening signs of economic recovery after the second wave of the pandemic and an accommodative monetary policy stance by the RBI.


# PROFESSIONAL DEVELOPMENT

## ICMAI REGISTERED VALUERS' ORGANISATION

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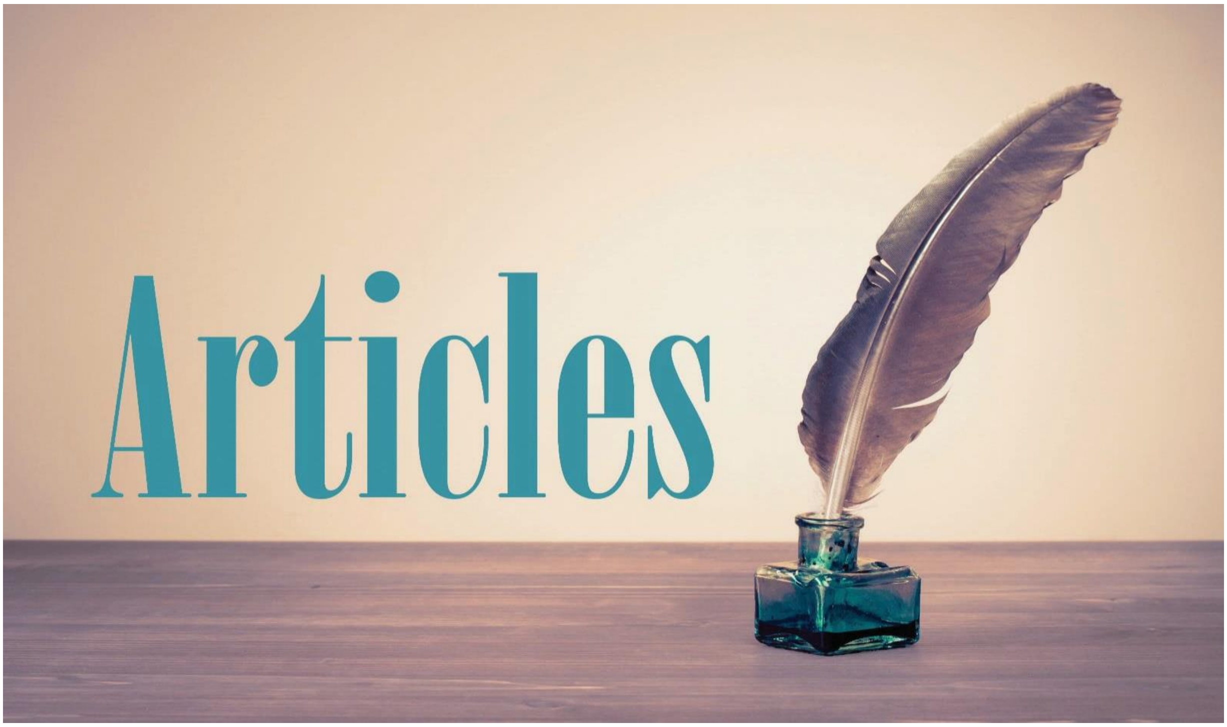
# PROFESSIONAL DEVELOPMENT PROGRAMS

| January '2021 to March '2022 | |
|---|---|
| **Date** | **PD Programs** |
| 08th -09th January 2022 | Workshop on Valuation Report |
| 07th to 09th & 13th -16th January 2022 | 50 hours Valuation Course on Land & Building and Plant & Machinery |
| 15th-16th January 2022 | Certificate Course on Tools for Data Analysis |
| 21st January 2022 | Learning Session |
| 22nd -23rd January 2022 | Master Class How to become an effective Link for Valuation Professional |
| 24th January 2022 | Learning Session on Emerging Business and Economic Environment |
| 29th -30th January 2022 | Power Learning Program on Revised Version of International Valuation Standards Effective from 31st January 2022 |
| 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 |
| 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 |
| 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 |

## PROFESSIONAL DEVELOPMENT PROGRAMS

### Upcoming Professional Development Programs

| Date | PD Programs |
|---|---|
| 25th -26th March 2022 | Professional Development Program Enhancing Valuation Competency –In Physical Mode Hyderabad Chapter |
| 25th -27th March 2022 and 31st March 2022 to 3rd April 2022 | 50 hours Valuation Course on Land & Building and Plant & Machinery |
| 25th -27th March 2022 and 31st March 2022 to 3rd April 2022 | 50 hours Valuation Course on Securities or Financial Assets |
| 12th -13th March 2022 | Professional Development Program Enhancing Valuation Competency –In Physical Mode Jaipur Chapter |
| 2nd -3rd April 2022 | Professional Development Program Enhancing Valuation Competency –In Physical Mode Chennai Chapter |


Articles

# VALUATION OF HUMAN CAPITAL

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

## The Perspective

The phenomenon of globalization has impacted impressively on the competitive environment of businesses all over the world, and one major fall-out of this trend, is that the drivers for value creation in business have changed from financial and physical capital, to human capital. Nowadays, the organizations are witnessed a new economic era. During this era, the organizations not only produce new goods and services but also they create added value for their survival. In this period, there is an emphasis on one particular form of resources (intellectual capital) which is different from other types of resources such as physical and financial capital. Intellectual capital (human and structural) is considered as capital employed (physical and financial) and strategic resource from resource-based theory view.

Human Resource Valuation is not a new issue in the arena of business. It is true that knowledge is a key determinant of economic and business success, but most companies focus on 'Return on investment (ROI)', with very few concrete steps taken to tract 'Return on Knowledge'. However, what is needed in this concept is a measurement of the abilities of all employees in a company, at any level, to produce value from their knowledge and capability

## What is Human Capital

The term and theory of "Human Capital" gained popularity in the 1960s through studies by Gary Becker and Theodore Schultz, who considered the economic valuation of intangible human resource capabilities from which the business can benefit. According to Becker, capital investment intangible assets was no different from investment in human resources, which is critical for a competent production process. The term, however, originated in the 1800s in the book "An Inquiry into the Nature and Causes of the Wealth of Nations" by Adam Smith. Smith examined a nation's wealth, knowledge, training, skills, and experiences. He further proposed that increasing human capital through training and education results in a more lucrative company, contributing to society's collective wealth.

An organization is often said to only be as good as its people from the top down, which is why human capital is so important to a company. Human capital refers to the knowledge, skills, abilities, and individual experiences of employees in an organization. Human capital is defined in the individual level as the combination of individual capabilities in organizations to create a commercial value and solve business problems. The company's human capital is at least equal to the sum of related costs of human capital which is spent for them and all these costs are spread in tax statements. Although some human resource-related costs may not provide the economic benefits for the company over a period of time, some of these costs can surely provide benefits over the coming period. A full human resource-related cost analysis helps the companies to recognize the costs that create future benefits over the coming period and can be converted to investments. It furthermore helps to identify the costs that create periodical benefits for the companies. The key Characteristics of Human Capital are :

- Human capital is an intangible asset not listed on a company's balance sheet.
- Human capital is said to include qualities like an employee's experience and skills.
- Since all labor is not considered equal, employers can improve human capital by investing in the training, education, and benefits of their employees.
- Human capital is perceived to have a relationship with economic growth, productivity, and profitability.
- Like any other asset, human capital has the ability to depreciate through long periods of unemployment, and the inability to keep up with technology and innovation.

Human resource valuation means the identification and measurement of the value of human resources and then supplying this information to the interesting parties. It is sometimes also defined as a method of assigning value to the employees on the basis of their future economic services to the organization.. The employees of value at the present worth of the services they are expected to render during their stay in the organization or a particular period of time. The current global accounting standards do not allow us to record the human capital as an asset on the balance sheet even as a linear figure in intangible assets within the global financial reporting system. The study of Human Capital Valuation helps in : providing numerical information about the cost and value of people as organizational resources; serving as an analytical framework to facilitate decision making , motivating decision-makers to adopt a human resource perspective.

An asset is simply something that can generate cash / value in the future. If you go by this definition, human assets should also be accounted for the balance sheet. So why aren't human assets given their due recognition? It is because the formal definition of asset does not recognize people as 'accountable assets' for a company. According to the formal definition, an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. Simply stated, assets are economic resources which represent ownership of value that can be converted into cash. Human assets do generate cash for a company, but they are not owned by the company. Hence, they cannot be incorporated into the balance sheet. However, the definition and accounting practices do not make human assets any less. They still command the same value and importance for the company.

## Determinants of Human Capital

Various factors can be considered when determining the value of human capital. They can be summarized as (but may not be limited to): Communication skills , Higher education, Working intelligence, Technical and non-technical qualification, Capacity of judgment, Innovation in approach towards work, The brand worth of an individual, e.g., a celebrity who is paid for an endorsement.

## Models of Valuation of Human Capital

The accountants and finance professionals have suggested various models and methods for measuring the value of human resources utilized in an Organization. These methods are based on cost or economic value of human resources. Under these methods human resources of an Organization are translated into a common denominator, i.e., money on which Organizational decisions are taken. Some of the valuation models include:

**Lev and Schwartz Model (1971):** The basic theme of Lev and Schwartz model is to compute the present value of the future direct and indirect payments to their employees as a measure of their human resource value. While doing so, the common assumptions set by the Indian companies are the pattern of employee compensation, normal career growth, and weight age for efficiency. Moreover, companies adapt this model to their practical requirements by making necessary alterations. For instance, different organizations use different discount rates for ascertaining the present value of future cash flows which aims to determine the value of human capital with a particular age associated with an organization.

Lev & Schwartz advocated the estimation of future earnings during the remaining service life of the employee and then arriving at the present value by discounting the estimated earnings at the cost of capital. The assumptions in this method are realistic and scientific. The method has practical applicability when availability of quantifiable and analyzable data is concerned, But this model is unable to give any method to record the value of human resources in the Books of Accounts.

**Stochastic Model of Eric Flamholtz (1972) :** which takes into account the possibility or probability of the movement of an employee from one function to another in his career, and also his untimely departure from the company through death, sickness or retirement. The movement or progress of people through organizational „states" or roles is called a stochastic process. The Stochastic Rewards Model is a direct way of measuring a persons expected conditional value and expected realizable value. Use of this model necessitates the following information: · The set of mutually exclusive states that an individual may estimate of a persons expected tenure in the organization

· The probability that in future, the person will occupy each state for the specified time. · The discount rate to be applied to the future cash flows. The drawback to Stochastic Model of Eric Flamholtz is that it ignores the fact that individuals who operate in a group may have a higher value for the organization, compared to individuals working independently. In the analysis of operational capability, the approach falls short of practical value, to the extent that the odds have to be determined for each individual occupying various states of service, and these probabilities must be determined for all periods and employees on an individual basis.

**Pekin Ogan Model (1996) :** which aims to determine the value of human capital that renders professional services only. Its major limitation is that it only applies to organizations that provide professional services.

## Methods of Valuation of Human Capital

Assessing the value of human capital (HC), the most important asset of any organization, has long been easier said than done. Because it is such an intangible asset, assigning a value on a balance sheet is a perennial challenge. There are no generally accepted standards for measuring the value of people, unlike the readily available tools for quantifying the value of tangible assets such as equipment, office furniture or accounts receivables.

Following are the important methods used for measuring human capital

**Historical Cost Method:** This method is developed by Rensis Likert. Under this method, all actual costs incurred on recruitment, training, familiarization, etc., are capitalized. Then, the capitalized cost is amortized, or say, written off over the period an employee serves in the Organization. In case the employee leaves the Organization before his expected service period, the remaining amount is written off completely in that particular year of his/ her leaving the Organization. The advantage of this method is that the value of human asset can be shown on conventional Balance Sheet and Profit and Loss Account. However, its drawback, if at all, is that human resource is equated resulting in undervaluation.

**Replacement Cost Method:** As the title itself indicates, under this method, replacement cost refers to the cost of replacing an existing employee. In other words, replacing cost is the cost that would cost to replace the existing human resources with human resources capable of rendering equivalent services. Here, the underlying costs included in replacement cost are the cost of recruitment, training and development, opportunity cost for the intervening period till the new recruit attains the efficiency level equal to that of the old (to be replaced) employee.

In this way, this method helps the management in the process of human resource planning for the Organization by making the information available on costs to be involved in the acquisition of people in future. In a sense, this method is inconsistent with the 'historical cost method'. That there may not be similar replacement cost for a certain asset and management may not be willing to replace the present human asset because of its greater value than that of scrap value are some of the drawbacks of this method.

**Opportunity Cost Method:** This method is used to value employees possessing certain skills and, thus, is rare in availability. Managers willing to acquire such scarce employees offer bid prices. One who finally acquires the scarce employees puts the bid price as his investment in such employees. The bid price is arrived at calculating actual or expected rate for capitalisation of the supposed earnings to be earned by such employees. Obviously, if an employee can be hired easily, there will be no opportunity cost for him/her. The main drawback of this method is the absence of a well justified criterion to decide the amount of the bid, or say, offer.

**Asset Multiplier Method:** This method is based on the assumption that there is no direct relationship between cost incurred on an employee and his value for the Organization. This is because the value of an employee depends on factors like motivation, working conditions and their attitude toward work and Organization. In this method, all employees working in an Organization are broadly classified into four categories; viz., top management, middle management, supervisory management and operative and clerical staff.

The salary bill of each category is multiplied with appropriate multiplier to ascertain the total value of each category for the Organization at a given point of time. Here, multiplier is an instrument that relates the personal worth of employees with the total asset values of the Organization. As per principle, the value of human asset should match with the value of goodwill. Inconsistency in the value of human assets in comparison to goodwill is indicative of inaccuracy in multiplier that should be adjusted accordingly.

**Economic Value Method:** Under this method, human asset is valued on the basis of the contribution they are likely to make to the Organization till their retirement from the jobs. The payments made to them in the form of pay, allowances, benefits, etc., are estimated and then discounted appropriately to arrive at the present economic value of the individuals. This model can be expressed in the following formula:

Vr =TΣE (t)/r-r  (I +r)

Where,

Vr = the human capital value of an individual r years old.

E(t) = the individual's annual earnings up-to retirement, represented by the earnings profile. r = discount rate i.e., cost of capital.

T = retirement age.

The drawback of this method is that the under or over-fixation of salary may affect equating the total earnings to the human capital

**Expected Realizable Value Method:** Under this method, the elements of expected realizable value of employee are measured through behavioral measures. For example, the productivity of an employee can be measured by using objective indices and managerial assessment. Psychometric tests and subjective evaluations can be used to measure the promotability and transferability of employees. Similarly, attitude surveys can be used to measure employee satisfaction, motivation, etc.

**Discounted Net Present Value of Future Earnings:** This method is propounded by Rensis Likert. The method is based on three variables— casual, intermediate and output. According to Likert, the effectiveness of human capital/resources can be measured by using these three variables. Casual variables such as leadership style and behavior affect intermediate variables such as morale, motivation, commitment to work, etc., which, in turn, affect output variables such as production, sales, profit, etc.

**Adjusted Discounted Future Wages Method :** This method relates the value of human capital with the extra profit the firm earns over and above the industry expectation. In this method the value of human capital is the capitalized value of extra profit earned by firm. The value of human resources determined on the basis of relative efficiency of an organization in the industry. But the limitation is that the discounting factor is subjective in nature.

### Does Human Capital Depreciate?

Like anything else, human capital is not immune to depreciation. This is often measured in wages or the ability to stay in the workforce. The most common ways human capital can depreciate are through unemployment, injury, mental decline, or the inability to keep up with innovation. Consider an employee who has a specialized skill. If they go through a long period of unemployment, they may be unable to keep these levels of specialization. That's because their skills may no longer be in demand when they finally reenter the workforce. An individual's human capital may depreciate if they can't or won't adopt new technology or techniques. Conversely, the human capital of someone who does adopt them will.

### What Is Human Capital Risk ?

Human capital risk refers to the gap between the human capital requirements of a company or organization and the existing human capital of its workforce. This gap can lead a company towards inefficiencies, inability to achieve its goals, a poor reputation, fraud, financial loss, and eventual closure. To reduce and eliminate human capital risk, an organization should train, foster, and support its workforce.

### Conclusion

People are their organizations' biggest assets. A company's intangible assets, including its human capital and its culture, are estimated to comprise more than half of a company's market value on average. Efforts to introduce robust measures of human capital into financial reporting have accelerated in recent years as there is clear and growing market interest in understanding how companies manage and measure human capital to uphold the principles of stakeholder capitalism.

Just as the field of human resource valuation has grown globally, significant interest in Human Resource Valuation has expanded and crossed over in to fields other than accounting including economics, organizational management and organizational culture and inspired related research. A growing number of studies have attempted to show the link between human resources and performance. We believe that though the case is not watertight, due to a number of methodological reasons, the weight of evidence is beginning to look compelling. One can hope for a day when human capital will receive the same degree of recognition as other assets in accounting practices as well as in the overall management paradigm. A proper reporting of HR in the financial statements of a company will go a long way in giving a fair and complete view of the accounting information, infuse confidence in the people working in the organization, boost their morale and help the management in fulfilling their social responsibilities.

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# PRACTICAL ASPECTS OF VALUATION

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## Executive Summary

The increasingly unstable state of the market has left new entrepreneurs in a state of insecurity. Prevalent fluctuations in the market have created an uncommon fear to investors. Why do we see start-ups coming and going? Now, what are the ways out and possible role of any valuer in this aspect?

## 1. Value Reconciliation.

In plain words, valuation is assuming the worth of a company or business, including all its financial securities. A reasonable valuation attracts investors and helps the business. Valuation of any business you may think of small or large, public, or private, developed, or emerging when the valuation is done in correct ways things fall in favor like cash flows increase, growth rates go up, discount rates go down and earnings to multiply & so on. Valuation gives a rational side to the mountain argument when there is an internal conflict between buying a share or investing in any business.

## 2. Parameters of evaluation of any business or financial securities.

Three broad approaches to value a business: -

1. **Intrinsic valuation: -** in this valuation, you value a company based on its basics like its cash flow, its risks & its growth. This is the most used to estimate intrinsic values by the evaluators.
2. **Relative valuation: -** It is more of putting numbers by looking at the assets and their similar values in the market; here, it is comparing similar prices of the assets and using that equal value for your assets.
3. **Applying option pricing in the assets: -** The price of the asset follows a continuous process. The fact that the prices of securities in the market do fluctuate should be kept in mind and a flexibility in the pricing of these should be set to avoid the hard hits.

## 3. Problems that show up while evaluating a business or its securities: -

All the businesses existing in the market are not the same. Thus, there cannot be a standard code of conduct for all of them to follow. Their size, targeted consumer sections, capital investment, manufacturing category, pricing, inputs, etc. vary from each other. When valuations go bad it's not because of the numbers it's because of-

### a. Preconceptions: -

The primary problem that the valuators face is that they already assume things. Obviously, it's hard to start blank. The more you know about the business, the stronger the preconceptions are. Saying my business is a big one, it's going to deliver a high value. It's more of assumption and forecasting like when failure stop how much can be attained through delusion. Another Preconception is that if you make the models bigger it's going to be better as you build these big models, remember you must make assumptions that derive these inputs and as these models get complex.

### b. Uncertainty: -

The brutal reality of business is risk and uncertainty. You must forecast long term activities, in what ways will the future fluctuations of prices will hit, necessities, choice of methods may turn out correct or fail, valuation, etc. but the risk of uncertainty always prevails. Uncertainty of receipt of principal and interest or dividend and variability of this return. This level of uncertainty is likely to occur in emerging markets or markets during and after major technological, economic, or social disruptions.

### c. Complexity: -

Complexity may also affect judgement and decision quality, as individual differences in-memory processing capabilities or motivation may impact one's (unconscious) choice of information processing strategy. If the model you choose turns out to be complex, two things happen: these models put you in a confusing state either you run the model, or the model runs you. And the problem is that when you enter the values/ digits, it becomes garbage in garbage out.

## 4. Possible causes of problems-

1. Overconfidence always leads to problems adhere too it stands as a cause. The rise of the business, consideration of cash flow to be perennial and rise. Following other's success path instead of creating one's own. Big businesses are always considered to be of big value, but it's not always

about numbers, it's about the worth and quality that decides your longevity in the market. Preconceptions are always challenged by uncertainties of business.

2. Valuation is more of telling the future and the future is uncertain. Uncertainty doesn't have any stronger causes, they are just followed by a chain of events that may not necessarily be happening for you or about you, but you become the victim.

3. The model which you choose to set your business on should be a strong foresighted one, here people face this problem due to lack of good foresighted decision-making skills.

## 5. Role of a Valuer: -

Valuers may be individual professionals or investment bankers who determine the market value and worth of a business, company, or financial securities. In the process of valuation, they presume or estimate the worth of all such followed by judging and comparing the market situations in their own ways.

### A. Evaluations:

Valuers evaluate the values and worth of business / financial securities. In particular, when the valuation is asset-based you value the company by valuing its individual assets, and as usual, these assets can be tangible or intangible. If they are to value a company for its liquidation. fair value accounting they need to prepare a balance sheet, take each asset, and come up with estimated value of the asset.

### B. Reporting:

Valuers are supposed to research and prepare a detailed report that outlines the value of all the assets and financial securities to keep everything in writing to investigate when required for liquidation. A valuer also keeps written reports outlining all activities, such as negotiations between parties involved in a sale or purchase. Keeping accurate reports is important to solve any disputes if they arise in the future.

### C. Advice:

Since the valuer's research and prepare the reports in detail and are aware of all the transactions made and are acquainted with the market status. Valuers advise individual clients on using cost-effective methods, on using appropriate and effective techniques, suggest ways to escape and avoid the activities that may cause any dispute in future legally.

### D. Auctioning:

Valuers are acquainted with many of the business individuals, companies etc so they may act as the ones who help in selling and buying of financial securities. Valuers conduct marketing work to make the assets attractive to potential purchasers and may conduct auctioning work personally.

## 6. Eradication of the loops: -

Above we discussed major problems faced while evaluating the financial securities which came out to be preconceptions, uncertainty & and complexity. Here are the possible ways to eradicate these loops.

a. Instead of having a mind stuffed with the thoughts that ever act on the preconceived thoughts, see the status of the market 360 degrees, compare, contrast, research and then move on the path. Don't perceive that valuation is a science as it works with numbers because they are just assumptions and obviously, they may be wrong because you are forecasting the future.

b. Keep in mind that less is more, build in internal checks on reasonableness, don't sweat the discount rate, use the offsetting principle (risk free rate & the rates that can work in inflation), draw on economic first principles (Terminal value at all the companies), confront uncertainty if you can.

c. Never estimate more inputs that you must always ask yourself whether more details will make your valuation more precise or just will make it look precise. Fundamentals of valuation don't change when you face complexity always fall back on principles. Different models are in option to be chosen by different company that may work out in their favor.

## 7. SEBI seeks for suggestions: -

It is observed that the above parameters are typically descriptive of companies' which are profit-making and do not relate to a company that is loss-making. Thus, these parameters may not aid investors in making investment decisions w.r.t. loss-making issuers.

Planning the future, preparing estimated values requires looking backward, and analyzing the model, what models worked in what conditions, and this may be said here that learning from the past helps in setting business strategies too.

Valuation is of greater concern for any business and should be analyzed by experts so that not only a company desires greater return but also can think for longer run/standing in the market.

We can further extend the scope of the analysis by studying the markets Intra and intercorrelations. First, we should study correlation structures on the level of single markets, the market intra-correlation. Next, we should study the correlation between different market pairs, according to three measures - the market index correlation, market meta-correlation, and market ICF correlation. These methods may turn things in favor.

Keep Reading

# INFLUENCE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) FACTORS ON VALUATIONS UNDER ANY SITUATIONS INCLUDING M & A

CA RV IP Sanjay H. Shah

We keep hearing of Corporate failures, but unlike financial failures we hear due to mismanagement or fraud or negligence, we have failures on account of faulty products.

Few years ago we heard about the European Car manufacturers were under fire for admitting thatdefective devices were installed in their manufactured vehicles and they misguided the emissions tests authorities. This 'Diesel gate' also raised a number of questions about the management practices of these companies. The companies encountered recalls of amajority of their vehicles, leading to exorbitant levels of additional costs. Consequently, these car manufacturers also experienced significant decline intheir market capitalization.

For the mergers and acquisitions (M&A) community, the goal of creating enduringand sustainable value has always been about finding the right balance between risk and return. Now it is getting more complex. Thetransformational move to embrace environmental, social and corporate governance (ESG) is having a dramaticimpactonhow M&Aisconducted.

For any M & A, the board consider the situation of long term sustainability as a duty of care for theacquisition and accordingly the targets are valued. . It's simply an imperative for the deals they pursue.Board of Directors do this for their shareholders because they expect it, but it will also yield a positive IRR is an investment proposition that should be measured over long term. Thus a right Valuation considering the ESG factors is relevant. Nowadays, S & P 500 companies mentioning ESG on earnings calls, which specify the Corporate valuations relevance to these factors.

Investors and corporate directors are also challenging their M&A teams to consider targets that advancetheorganization'spursuit of long term sustainability and would not like any Valuations withoutconsidering ESG.

The direction of travel is clear: ESG issues are taking a more prominent place in the boardroom as arule, including in the context of acquisitions. The ESG literacy at various levels of companies has undoubtedly increased, the pressure from institutional investors is significant and well known, but there are alsopressures dealmakersneedtoconsider.

Dealmakers generally looks at a ESG deal's impact on profit and positioning within the supply chain, an area where more scientific analysis is needed to Value the Company.

It is observed that deal teams increasingly using financial metricsto assign values to ESG factors. For example, teams will apply implied prices on (1) green house gas emissions (2) increased insurance costs from operations in climate-sensitive areas (3) enhanced demand for goods with positive environmentalor social characteristics; and the value of enhanced employee retention and productivity.

The next generation wants to work for companies, buy from companies, and invest incompanies that embrace ESG. This is where the economic demand is going M & A needs to align with this reality.

A growing market of providers of ESG data services, facilitated by technological innovations such as AI and machine learning,presents a host of benefits that go beyond ethical or reputational concerns. Analyzing ESG data and information through the M & A process allows for better comparabilityacross companies, improved identification of opportunities and increased transparency between the companies and other stakeholders. we are entering an era where companies will not want to do business withafirmthatdoesnothave highESGstandards.

On the other hand expects we will start to see more 'stranded assets' that can't be sold because oftheir negative ESG standing. Some companies will beleft behind, in a cycle of declining valuation withstrainedcapital availability.

The situation also highlighted the failure of **Valuation** models of investors and analysts to capturethe full range of risks posed by environmental, social and governance (ESG) factors. Valuation models are typically based on the most commonly used valuation method – the discounted cash flow (DCF) method. Under this method the free cash flows(FCF) of a company are often forecasted until perpetuity.

These cash flows are discounted with a rate equivalent to the expected cost of capital (reflectiveof the risk related tothese cash flows) consisting of both a cost of equity and cost of debt taking into account a target capital structure but the relative risk arising out of ESG factors failure are absent and has significant impact.

Cash flow drivers analysed to perform business valuations typically are expected sales growth,development of profitability and capital investments. Historically, these cash flow drivers were oftendetermined only from a direct financial/economic point of view. For example, salesgrowth was assessed in relation to expected industry growth, development of product/ services line, marketpenetration, market share, etc. Profitability margins were also considered based on various factorssuch as forecastsbased on expected development of cost of production, supply chain relations andexchange rate fluctuations.

Investment levels were also determined based on the required levels of asset base to grow andsustain sales growth in the future, etc. Based on these assessments, management of companies prepared the budgets and long-term forecasts. Factors which are outside the Company but ESG hasconsiderable impact on the company's successor failure.

### ESG factors in cash flows or discount rate?

**Cash flows and discount rate calculations required to perform business valuations, as it is imperative for investors and management of businesses to assess the value drivers of businesses with not just a financial lens but also with an ESG lens.**

Often investors and management attempt to include ESG-related risks in the discount rate by including premia(in case of high ESG risks). Although this approach is considered to be morepractical, my opinion is to recommend including cash flow adjustments related to ESG risks in an explicit manner. This approach would create visibility related to the impact of an ESG factor that is considered material.

### How to incorporate ESG in cash flows?

Below we present some examples of how cash flow driverscould be determined by incorporating an ESG perspective:

- With regard to the **Environment** of the ESG lens, Task force on Climate Related Financial Disclosure recommends two scenarios. As per their analysis one way of reflecting **additional risk** associated with climate change or severe weather events in the future. For example, beverage companies could assess the impact of the shortage/ excess of water on the costs and investments related to water utilization. Another such example that could be applicable for many companies is the introduction of carbon points and its pricing that will lead to Valuations.
- With regard to the **Social** factors of the ESG lens, the impact on revenues and cost-relatedcash flows due to employee unrest in industries such as the garment industry or steel sectors or construction known for poor labour conditions and health and safety issues, is an example of capturing the impact of poor social measures. In such circumstances, additional costs could be incurred to satisfy the compensation or safety-related concernsof the workforce or product sales of companies could plummet due to the damagingimpact of these kinds of news.
- With regard to the **Governance** of the ESG lens, the impact on cash flows in the form of fines/ increased taxation imposed by regulatory authorities due to weak governance policiesof companies, could be an example of internalising the likelihood of governance-related factors. For example, in case of Google, higher taxes were imposed by the European Commission due to their perceived unethical business practices . Thus, while valuing tech companies, the imposition of fines or higher taxes could be considered as a negative cash flow impact in case it is concluded that not enough measures have been taken by techcompanies to mitigate the concerns of regulatory authorities. Indian Companies having cross border dealing may face situation of taxation in the transfer pricing assessment or change in policies.
- By presenting the adjustments in the above manner, management and investors would avoid ambiguity surrounding the positive/ negative impact of ESG-related issues on the future cashflows of the company which would also facilitate focusingon the relevant material ESG issuesconcerning the company.
- **How to incorporate ESG in discount rate?** While applying ESG adjustments to cash flows, care should also be taken that there is no double-counting of the risks (and opportunities) inthe discount rate. For example, if a company belongs to an industry which in general is impacted by ESG factors such as the automotive industry (due to the influx of hybrid and electric vehicle competitors) or the non-availability of the key component ,it could be arguedthat the industry beta (a measure of risk) partly includes this ESG risk. In this case, one wouldneed to be careful while applying additional downward adjustments to the cash flows due to the negative E impact as it could be partly captured in the industry beta. Accordingly, incorporating additional premia or discounts in the discount rate should be carefully considered
- in conjunction with industry- and company-specific characteristics and the ESGadjustments in the cash flows

### How to attempt to circumvent the subjectivity of ESG?

Given the potential subjective nature of the assessment ofthe materiality and application of ESG- related adjustments on the cash flows and the discount rate, these adjustmentscould also be applied in varying degrees under different scenarios, wherein each scenario would reflect the impact of a particular material ESG factor on the business. The final valuation outcome could be a weighted- scenario outcome wherein probabilities and weightings (based on materiality) are attached to the various ESG scenarios based on materiality. Materiality of ESG factors can be determined not only based on internal assessments of companies, but also based on looking into the social media feeds of companies, to understand the market sentiment of ESG risks and opportunities associated with companies. Many standard guidelines are typically considered in relation to the assessment of the materiality of ESG factors in relation to a company in a specific industry. The assessment of the weighted average valuation outcomes could be enhanced by the usage of new technological tools such as big data, artificial intelligence and predictive forecasting tools using smart algorithms.

In the end, business valuation outcomes are a reflection of the story line of the financial figures that serve as input for these valuations. Given the new and expanding view on risks and opportunities associated with businesses, viewing the development of industry and market forces not just with a financial lens but also with an ESG-lens, and incorporating them in the cash flows and discount-rate analysis, is a need of the hour.

# FREQUENTLY ASKED QUESTIONS ON VALUATION


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# FREQUENTLY ASKED QUESTIONS ON VALUATION

**Question 1: Why do I need to understand business valuation?**

The above question is a great conversation starter! Maybe you're a business owner thinking about how to sell your business. Or, you might be seeking a loan for your business from a bank. Alternatively, you could be an investor interested in valuing a company for acquisition. Perhaps you're just curious about the answer to the question, "How are businesses valued?"

Whatever the circumstance, to determine the answer to, "How much is a business worth?," you must go through the meticulous process of business valuation. Before you make a run toward the exit or hide under a pile of blankets, we'll try to make it easy for you to understand!

Much like a commercial real estate appraisal, there is an underlying economic analysis for business valuation. Entrepreneurs can determine worth via several approaches (or methods) available. These approaches to valuing a business are discussed in more detail, below; however, they are each based on specific criteria, from industry performance to market climate.

Now that we understand the "why," it is imperative that you understand the "what" and "how." As such, our experts at The Robert Weiler Company have put together this business valuation 'questions and answers' overview to offer more clarity behind the business appraisal process. By the time you reach the end, we're confident that you'll have a better understanding of what a business valuation is, the critical factors of a business appraisal, and the process that goes into estimating the actual value of a business.

**Question 2: What is business valuation?**

Business valuation is a set of steps used to estimate what your business (or a company you are looking to purchase) is worth. The process, however, is much less straightforward than the definition. So, how are businesses valued? To properly evaluate a company, you must examine the historical earnings and financial outlook that will go into the formulation of the particular business valuation. Elements such as assets (both tangible and intangible), current market conditions, and the circumstances of the business (i.e., the reason behind the sale) will be critical to the overall calculation

**Question 3: What are the most commonly used business valuation methods?**

As with property value in commercial real estate appraisals, a business's worth can be determined in several ways.

There are three common approaches to answering, "how much is my business worth to sell?" They are: (1) the asset-based approach; (2) the earning value approach; and (3) the market value approach. The key is to apply the optimal approach for each business, based on the business's capital structure, management, prospective future earnings, and market value.

1.) The asset-based approach.

This method focuses on investments made in the business, and there are two tactics to take with this option.

(a) A going-concern asset-based approach. Here, buyers are trying to determine commercial valuation according to whether it is worth the investment to purchase the existing business, factoring in all assets and liabilities. Or, the person may find that it makes more sense to start a new business from the ground up. In this specific approach, liabilities are subtracted from the total value of all assets to determine the business worth.

(b) A liquidation asset-based approach. In a business liquidation scenario, you must determine the amount of money left after selling all assets and paying all liabilities.

2.) The earning value approach.

Discovering the earning value involves consideration of the return on investment (ROI). As such, you must assess the potential level of income that the business can generate in the future.

(a) Capitalizing past earnings. The appraiser must refer to the company's past net earnings performance and process that figure by capitalizing this number to a present value. This method will predict the ROI for the purchaser, while also offering the level of risk that the ROI will be achieved.

(b) Discounted future earnings. If the business does not have a long history, this becomes the preferred valuation method; it relies on projected earnings that are discounted, to obtain a present value of future revenues.

3.) The market value approach.

Also known as the sales comparison approach, this method assesses recently sold comparable businesses, as well as asking prices on currently listed businesses. By considering the value of related businesses in your community or region, an appraiser can provide the estimated worth of your company. It should be noted that business valuation under this method is important if there are several other similar businesses available for this type of comparison.

**Question 4: Why are there different methods of business valuation?**

How to value a small business or large enterprise is viewed differently by potential buyers depending on their current situations and standpoints. For example, the fact that a firm holds such an excellent reputation and prominent position in the community might make it valuable for a buyer within that community. On the other hand, a buyer with no community ties may look strictly at the ROI or future earnings of the company.

Also, as stated previously, finding the real value of a business is not a one-size-fits-all approach. Different methods can indicate varying monetary values, depending on which (or which combination) of the aforementioned three business valuation approaches you use.

**Question 5: Why should I consider business valuation for my entity?**

Even if you do not yet want to know how to sell your business, there are

# FREQUENTLY ASKED QUESTIONS ON VALUATION

still several reasons why you should obtain business valuation services. The most important reason? Life's unpredictability. If an unforeseen circumstance arises and you decide to sell, having a credible business valuation is vital in determining the asking price and aiding in negotiations. Other reasons may include:

Unforeseen health conditions

Planning for retirement

The need for financial assistance, such as debt financing, bankruptcy, or financing for expansion

Internal use, such as employees or others who are looking to buy shares in the business

Litigation purposes, such as marital dissolutions or shareholder disputes

**Question 6: What is the general business valuation formula?**

While the nature, assets, and current circumstances of the business weigh heavily on the overall result of the business valuation, there is a base mathematical formula used to calculate the value.

Step 1. Calculate your earnings. Sometimes referred to as Seller's Discretionary Earnings, or SDE, this number is principally used to show your business's earning potential with a new owner. This number is calculated pre-tax and excludes expenses that would not transfer to the new owner. SDE will not include your compensation, bonuses, or any other one-time or non-applicable expenses.

Step 2. Choose your multiplier. The multiplier is where business valuation becomes subjective. Depending on a multitude of factors, buyers will opt to pay generally between one and four times the amount calculated in Step 1. So, how do you choose if you want that to be 1x, 2x, or any other amount? Take a look at the detailed items that are specific to your business, such as:

Industry level of establishment and necessity

Level of desirability of the business location

Market climate and risk

Size and stability of the company

Tangible and intangible assets

Owner risk, in the sense that the business cannot function without you, specifically

Real estate lease agreement, as far as the length of time left on the lease, and whether the new owner will have to negotiate new terms

Step 3. Add in both tangible and intangible assets. We touch on this more in Question 7, but assets are things that add value to your total. Tangible assets are physical goods, and intangible assets are non-physical.

Step 4. Subtract any liabilities. Subtractions apply if the business is in debt, or if there are future expenses that need to be factored in when calculating the overall value.

**Question 7: How do I determine which commercial valuation method(s) will work best for my business?**

Most times, the reason for performing a business appraisal will determine the best method. There is no "right" or "single" answer when it comes to valuing a business. Since the value of the company is impacted by the goals and financial position of the prospective buyer, one method, or a combination of ways, can be used to obtain the value. Also, as with a commercial property appraisal, hiring an experienced professional to assist in your endeavor will ensure that you make an intelligent decision for your business.

**Question 8: What are tangible vs. intangible assets in business valuation?**

Assets are investments made that add value to the business. There is one significant difference in tangible vs. intangible assets, and that lies solely on whether or not they physically exist. Scratching your head? Let's unpack the definition of tangible assets and intangible assets.

Tangible assets are physical items that have value if they were sold. Assets included in this category are items such as:

Land

Real estate, such as buildings owned

Machinery, equipment, fixtures, furniture, trucks, and cars

Inventory

Securities and cash

Intangible assets, on the other hand, are non-physical things that also add value, along with the sale of the business. Examples of intangible assets include:

A positive business reputation

Level of value of the business's customers

Any well-known business trademarks or branding

Industry experience

Established relationships with suppliers, buyers, or partners

Copyrights and patents

Little to no owner risk (meaning that the business can operate free of the current owner)

The circumstances behind the sale of the business may also fall into the intangible assets category. For example, if the company is a successful startup, a voluntary sale scenario with a buyer who recognizes increased future profit will add value to the firm. On the flip side, if the current circumstance is a forced sale, this intangible asset can be a liability that factors into business valuation.

**Question 9: How can a business owner prepare for a favorable business valuation?**

Did you know you can prepare for your business valuation, and help the process move smoothly and efficiently? While the preparation for a positive valuation technically starts at the beginning of the business's existence, it carries on with each passing day.

Refer to your business plan. Before starting your business, you likely created a detailed business plan that outlined your short- and long-term goals. By referring to this planning document, and updating or adding to it as necessary, you're helping yourself stay on track. Adhering to your plan

# FREQUENTLY ASKED QUESTIONS ON VALUATION

and goals will allow you to prove the success of your business to potential buyers or investors in the future.

Keep your books up-to-date. Most commercial business valuations will consider profit and loss records for the previous few years, if available. You will also be asked to provide balance sheets, tax returns, and copies of any budgets and future financial projections. Make sure your books are organized and detailed, showing all income and expenses for each year.

Reduce any risk of liabilities. Reducing liability can be done several ways:

Diversifying your customer portfolio

Having practical and concrete processes in place

Safely storing confidential information like financial records, employee information, and customer information

These are just a few examples that will show that your business is a reliable establishment and encourage confidence in your company.

Pay off debts. Paying off any outstanding debt is partnered with reducing liability risk. If the sale is voluntary, it will prove beneficial to pay off any financial debts before the business valuation and eventual sale.

**Question 10: What else can affect or vary the business valuation process?**

In addition to the items listed above, there are other scenarios and essential pieces of information about which you should be aware.

Non-competition clauses. Commonly included in the business valuation process is a non-competition clause. The main goal with a "non-compete" provision is to prevent the seller from opening a new business to rival your company in the same geographical location. To further complicate the issue, the seller may want to continue working in the same trade elsewhere, or under a different circumstance, which has the potential to prove difficult for the buyer. These clauses usually have to be worked out with the assistance of an attorney, to ensure that they are legally correct.

Sole proprietorships. Business valuation for a sole proprietorship can become complicated in any of the approaches described above.

With an asset-based approach, the sole proprietor must identify business assets vs. personal assets. This becomes a detailed process since many sole proprietors will use the same tools or equipment at home as they would on a job.

With an earning value approach, many sole proprietors have built trustworthy personal relationships with clients. These relationships can mean that any future earnings will decrease if the clients are unwilling to work with a new owner.

With the market value approach, locating another business with public sale information that is similar to the sole proprietorship may prove challenging.

For accuracy, business valuators may use a combination of valuation methods when looking at a sole proprietorship.

Franchises. Franchised businesses typically do not follow the same procedure when it comes to valuing a private business. This is because the owner is subject to the franchise contract, which tends to influence how the business is sold. Often, a franchise contract may also provide guidelines on how or where to obtain the business valuation.

**Question 11: How much is my business worth to sell?**

When estimating how to value a business to sell, there are two central questions you must answer: "How much is my business worth?" and "How much can I sell my business for?"

You may not even be interested in selling your company at this time; however, value is a great measure of success. You've worked hard to build your business! Aren't you a bit curious to know how much it's worth? Keep in mind that what you feel your business is worth may differ from the opinion of an investor looking to buy your business.

Small business valuation can be complex with many factors involved. That's why we've touched on several factors, formulas, and methods throughout this business valuation 'questions and answers' overview. However, if you're just looking for a rough idea as to how to value a small business, start here:

First, consider how profitable your business is. (Subtract expenses from revenue.)

Then, factor in items such as taxes, cash flow, and estimated future earnings.

Finally, project future growth.

And, don't forget to evaluate risks and challenges that both your business and industry may face down the road.

Or, get a simple company valuation with this free calculator. The calculation is partially based on earnings before interest, taxes, depreciation, and amortization (or EBITDA). In traditional private equity investments or mergers and acquisitions situations, EBITDA becomes an important earnings metric, as it's capital structure neutral; thus, not affected by finance decisions and non-cash expenses.

**Question 12: Where can I find certified business valuation companies in Ohio?**

If you need a certified business valuation analyst in the Columbus, Ohio area (or throughout the state of Ohio), look no further than our team at The Robert Weiler Company! For 80 years, investors have turned to us for expertise in our commercial real estate appraisal services, only to find out about our ability to value businesses, too.

As a CRE firm that's been successful through three generations of family leadership, we are passionate about our local business community. Our full-service business valuation services offer decades of experience in the Ohio market. We will treat your business with the same care we would if it were our own.

# OTHER READINGS

## ICMAI REGISTERED VALUERS' ORGANISATION

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# Bringing clarity around private equity asset valuations - KPMG

### Don't panic

The message we are seeing and delivering to clients is clear — "Don't panic." We might be in unprecedented times but uncertainty in financial markets is not that uncommon and the strong valuation policies and procedures maintained by many GPs do not need to be significantly, if at all, altered. Those with good governance, critically in the form of appropriate layers of review and independent challenge will find that the results, while a little unpleasant to see, are not as difficult to derive as might be expected. However, the commercial reality is that investors are ultimately concerned with realized cash returns more than unrealized paper valuations, and unlike other asset classes, PE funds are legally committed and cannot be withdrawn on demand. The fears of the last financial crisis that PE would not survive proved incorrect and in fact very healthy returns were made from funds raised at that time. Investors have clearly learned from that experience and do not anticipate them to be unduly concerned by the corrections to valuations in Q1 and Q2 2020. However, they will be far more interested in the underlying stability of the portfolio and the steps taken by GPs to see them survive and thrive through COVID-19.

### Avoid the double dip

It might not be expected that valuations could decrease too much in the current economic turmoil but there is a risk that this is more likely than investments being overvalued. Due to the nature of the reward structure in the PE industry — carried interest — there is less incentive to over value an asset and with the typical valuation being based on a financial metric such as maintainable earnings, earnings before interest, taxes, depreciation, and amortization (EBITDA) and an applied multiple, there is a risk that both will be adjusted down to reflect the uncertainty in the market. This creates the 'double dip'. Risk adjusting EBITDA as well as the multiple may disproportionately lower the valuation below a true 'arm's length — willing buyer/ willing seller' amount. When performing a valuation assessment it is often easier to project the changes expected in earnings than assessing what the market consensus will be on multiples, this is truer in times of extreme duress as at the current time.

### Follow the markets

The decline in listed prices as at 31 March 2020 was clearly considerable, and we've already seen a strong re-bound in certain markets in the two months since. Therefore care should be taken as to whether this level of decline should also be reflected in private equity valuations. The benefit of the sector is the ability to avoid short term shocks and hold investments for the longer term improving them throughout that period. Current uncertainty is creating more risk and that risk will lead to lower valuations. However it is critical to look at assets individually. Some investments will be in sectors relatively lightly touched by COVID-19 such as telecoms or logistics, but equally some of those investments may not be competitive with their peers and therefore should reflect a larger decrease in value than the listed markets would suggest. Likewise, other investments may be in sectors more obviously impacted by COVID-19 but if they are stronger, more adaptable and already with a clear advantage over their peers then valuations should remain robust.

### The smell test

Robust and tested processes will generate sensible fair values but the 'smell test' is even more critical in the current market. When the results are in, GPs must stand back and make sure that they make sense. Is the value a true reflection of what a willing buyer would pay (is it too much?) but equally is it a true reflection of what a willing seller would accept (quite possibly it will look too low!). No amount of science and mathematics can get away from this critical assessment.

### Disclose, disclose, disclose

It is inevitable that there will be difficult decisions to make in the assumptions into valuations; how long will the lock- down and social distancing last, what exit approach will governments take, what is the impact on consumer and business spending and what will be the new norm are all key questions to consider.

Given that no one has the answers to these right now, disclosure and transparency will be the GPs' friend. LPs will want to understand the rationale behind the valuations that are presented to them. They will need to understand and perhaps for the first time make adjustments to those valuations if they have fundamentally different conclusions to the key questions. Therefore good quality disclosure of the valuation inputs, the sensitivities applied and the rationale for the assumptions will be key. A valuation may turn out to be wrong, but clear and concise explanation of how a valuation arose will ensure that LPs can take them at more than just face value.

### Ranges not points

While the ability to derive a fair value still exists, the potential for assessing 'ranges' as typically seen in infrastructure valuations may become more prevalent. The uncertainties in the market will lead to differing views on what is 'free cash', what is the 'maintainable earnings' as a result providing a range of the fair value of the asset, along with the selected point in that range will be helpful. Such an approach, as noted in the Disclose section above, will enable LPs to consider in more depth the valuations provided to them and, where appropriate, enable them to conclude on a different point in the range for their own financial statements.

### More art than science

In stable times PE valuations can sometimes be very mathematical, multiples are steady, which in the last 12 months EBITDA is reflective of maintainable EBITDA and therefore there is little artistic flair needed. That is less likely for the valuations throughout the remainder of 2020. The assumptions will be fluid and the comparable companies less comparable. Therefore greater subjectivity will exist and more effort is required to arrive at a sensible and fair valuation but it is in no way impossible

# Perspectives Paper *IBOR Reform: A Valuation Guide*

*By: The IBOR Working Group under the IVSC Financial Instruments Board*

The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

*The IVSC has issued this Perspectives Paper to initiate discussion and debate on the topic of IBOR changes and the impact on valuation. Share your feedback and thoughts with us* through *LinkedIn.*


## Abstract

IBOR (interbank offer rates for e.g. LIBOR) cessation requires the transition to alternative reference rates (ARRs), and consideration of the differences in the nature of ARRs compared to IBORs. This move away from IBOR will change the pricing, valuation, and risk management practices, notably in the financial services sector but also for any entity that uses financial instruments.

*IBOR transition is an ongoing, continuous and rapidly evolving process and not some future "big bang" event. It has already impacted valuations today (for example: CCP changes to Price Alignment Interest Cleared derivative valuations, albeit with a centralized compensation mechanism).*

*While there are many complexities around the transition, valuation challenges that the industry will need to navigate are interrelated and can be grouped under three broad headings:*

1. *Valuation impact of terms in existing IBOR inventory - which will survive IBOR cessation and will require consideration of the applicable "fallback" methodology and any potential compensation mechanism;*
2. *Valuation impacts of evolving market liquidity – in new products utilizing the ARRs as the market develops, as well as ongoing impacts on existing exposures;*
3. *Valuation impacts of new risks – including basis risks, tail risks and model risk as portfolios combine IBOR and non-IBOR indexed risks.*


## Introduction

IBOR has been the reference rate or benchmark interest rate for financial markets for decades and it is changing. A change of such significance inevitably creates challenges for the valuation of financial instruments and impacts all entities that use financial instruments.

The aim of this Perspectives Paper is to outline the key challenges that arise for valuation professionals from the cessation of IBOR. It outlines the changes in Governance, Data Management and Model Risk Management that entities need to consider to effectively manage the transition. The paper also outlines the areas that can contribute to 'Valuation Uncertainty' and thereby increase Valuation Risk in valuations of financial instruments arising from the cessation of IBOR[1].

## Background

The UK's Financial Conduct Authority (FCA) announced in July 2017 that it will not compel or persuade panel banks to make LIBOR submissions after the end of 2021. Global regulators have committed to the strengthening of benchmark rates by anchoring the index setting on observable transactional data to the greatest extent possible. IBOR, constructed substantially on survey data rather than observed transactions, does not fit this model and will be phased out as the FCA remove their governance and support.

The impact of the COVID-19 pandemic on global economies and the disruption it has caused to global markets has not changed this path. In March 2020, the FCA reiterated this deadline in a joint statement with the Bank of England by stating that their expectation that LIBOR will not be published after the end of 2021 "has not changed", an expectation reinforced by similar comments from other global regulatory and industry bodies.

There are extensive materials available to valuation practitioners on IBOR transition. These include material on the basis for selection of the ARRs, the financial services' industry working groups materials and prudential regulatory body guidance on the transition process. It is important to understand the implications of industry, regulatory and legislative developments such as ISDA protocols, regulatory reporting requirements, and legislative proposals (NY State, US Federal and European Parliament for example). Given that existing information, and the constantly evolving nature of the transition and currencies involved, this paper focuses on three broad groupings of valuation impacts, and seeks to provide a constructive framework to support the valuation professional through the IBOR transition.

## Valuation impact of terms in existing IBOR inventory

The contractual means for existing IBOR indexed Financial Instruments to transition to replacement rates will depend on a combination of legal documentation, legislative solutions, negotiation, industry protocols, arbitration, multilateral agreement and litigation. For example:

- Contracts may contain "switch" language that provides for the floating rate to be re-indexed to an ARR at a known future date.
- Contracts may contain "hardwired" language that provides for the floating rate to be re-indexed to an ARR at a future date contingent on triggers such as the cessation of IBOR, with a waterfall structure to define how such ARR rates

[1] For details on Governance Frameworks, Data Management, Valuation Uncertainty and Valuation risk see proposed changes to IVS 500 *Financial Instruments*

will be used in the contract.

- Contracts may be subject to industry rulebooks or standard templates such as for cleared derivatives or transactions subject to ISDA transition protocols.
- Contracts may contain "amendment" language that provides for the floating rate index to re-negotiated between the parties in the event of IBOR cessation.
- Contracts may contain language that provides for the floating rate to be re- indexed to an ARR at the sole discretion of one of the parties to the transaction in the event of IBOR cessation.
- Contracts may contain language that provides for the floating rate to be re- indexed to another (non-ARR) reference rate at terms that may or may not be equitable to all parties e.g. falling back to PRIME (typically significantly higher than LIBOR) or to the last available rate (effectively turning the instrument into a fixed rate instrument).
- Contracts may not contain language that contemplates the permanent cessation of IBOR, leaving the remaining cash flows on the contract uncertain. Or the contractual term may not be legally enforceable.

It can clearly be seen that the range of contractual features may result in different contracts that have consistent floating rate cash flows in the current market transitioning to different sets of cash flows in the event of IBOR cessation.

Market observations indicate that, while fallback approaches develop, investors are sensitive to the clarity of fallback procedures in the governing documentation. There is some evidence that investors are applying a valuation basis to contracts with well-documented fallback over contracts with unclear or no fallback language.

There is an additional challenge where the presumptive fallback approach would be to rely on a contractual term which states that, where there is no IBOR fixing, the parties should use the last IBOR fixing. This scenario was designed to accommodate an interruption to IBOR publication. There is ongoing discussion as to whether it would sustain a legal challenge if applied as a permanent fallback, given the profound impact of changing a floating rate instrument into a fixed rate instrument.

Valuation professionals need to consider the impact of such terms on valuations, including:

- The degree of certainty and timing of transition for each of the instruments in the current portfolio.
- Where there are adjustments embedded in the transition agreements that would seek to normalize the cash flows before and after transition (e.g. ISDA protocol credit spread adjustment).
- What exact methodology will be applied to determine periodic cash flows (e.g. monthly or quarterly) from ARRs that are typically overnight indices – for example, will cash flows be derived based on simple interest, compounding in advance of the accrual period, compounding in arrears over the accrual period etc.
- Whether indirect adjustments will be made to address changes to risks on transition – for example, compensation for changes in terms of deliverable swaps under swaption products.
- Whether industry standard solutions (e.g. ISDA protocol) will be applicable to the instruments – for example, instruments requiring rates be fixed at the start rather than the end of the period such as certain FRAs.
- What legislative and/or regulatory solutions may exist to either amend existing contracts, or offer a means to continue providing a usable alternative form of IBOR.

### Valuation impacts of evolving liquidity

Over the transition period, and likely subsequent to the cessation of IBOR, valuation professionals will need to consider the impact of evolving liquidity in ARR indexed products. Examples include:

- Evolving liquidity in ARR indexed products may result in limited price transparency for those entering into transactions in nascent markets, or at the horizon of observable market data.
- Different products will likely evolve at different speeds – for example, observability towards the end of 2021 for linear SOFR products exceeded that for FF-OIS, but there were limited non-linear SOFR transactions.
- Valuation professionals may need to find alternative sources of market data if existing data providers are unable to supply market information.
- Liquidity in ARR indexed products or time series in ARR fixings may not provide sufficient data to support risk requirements, such as those required for VaR and SVaR calculations, or to meet upcoming requirements such as real price observations for FRTB, absent regulatory relief.

Concurrent to the increases in liquidity in ARRs, liquidity in IBOR indexed products is decreasing, which may give rise to challenges in valuing IBOR indexed products. Examples include:

- Reduced observability of market data with a consequent impact on the ability to derive primary instrument pricing, or source independent data for price verification procedures.
- Reduced observability of market data leading to changes in accounting fair value hierarchy classification, and potentially impacting Level 3 capital surcharges for G-SIB institutions.
- Increased uncertainty of pricing inputs, resulting in more onerous valuation allowances under prudent valuation frameworks.
- Certain instrument types may have payoff features that cannot readily align to "in arrears" rates such as the ARRs. For example, barriers, CMS trades, in arrears swaps, spread transactions and certain FRAs may rely on knowing the fixing at the start of the period. Such existing transactions may require amendment or termination, resulting in adverse impact on values.
- Reduced appetite for certain IBOR indexed assets or those without adequate fallback language may result in adverse valuation impacts – for example for collateral with reduced eligibility for central bank funding programs, or where investors are precluded by policy or regulation from investing in such assets.

### Valuation impacts of new risks

The varied paths for amendment of IBOR indexed products to address if, when and how they would "fallback" to ARR indexed rates will introduce additional basis risks. These risks will need to be identified, monitored and managed. Examples include:

- ARRs based on overnight rates will require amendments to valuation models and their associated inputs and outputs to ensure that definitions of input are updated to conform to industry standard quoting conventions; that the modelling approaches are aligned to overnight indices and how such rates are used in financial instruments; and that the outputs are aligned to the terms of the associated cash flows and that downstream systems properly interpret the revised outputs.
- ARRs based on overnight rates, whether secured or unsecured, effectively have minimal bank funding risk embedded into them. This contrasts to the implicit dynamic bank funding levels embedded in IBOR. As a result, the profitability and valuation of products indexed to ARRs may differ from those indexed to IBOR.
- Additional basis risks may emerge where the terms of how ARRs are used to derive cash flows differ in linked transactions. For example, whether as a result of new transactions or variance in the way that fallback provisions operate, a loan transaction deriving cash flows off daily simple SOFR interest conventions may have basis differences with a derivative hedge deriving cash flows through a compounding in arrears approach.
- Similarly, more pronounced basis risks may emerge where underlying collateral (e.g. SOFR ARMs) apply a compounding in advance convention, whereas beneficial interests apply a compounding in arrears convention.
- Different instruments may apply ARR floors at different levels. For example, a LIBOR floor in an existing transaction may be most equitably replaced by a floor on the aggregate of SOFR and the transition credit spread adjustment, whereas a new transaction may apply a floor on the ARR rate directly. New modeling frameworks may be required for option products, given the potential different options on forward-setting interest rates inclusive of bank credit spreads, versus potential future ARR set in arrears with/without compounding features, with/without averaging and with/without a fixed credit adjustment[2].

### Actions for the valuation professional

*"The reforms to interest rate benchmarks will have a big impact across financial markets, from Wall Street to Main Street. Making sure the entire market appreciates the scale of the issue and takes early action is therefore a priority. Given the scale of the task, this is not something that can be resolved in the months before end-2021. To ensure a successful and orderly transition, institutions need to be taking action – and starting now."*

*Scott O'Malia, Chief Executive Officer, International Swaps and Derivatives Association (ISDA), 4 July 2018*

The impacts arising from the IBOR transition are complex and pervasive, and the valuation impacts represent only a portion of the impacts to financial and non-financial institutions alike. This Perspectives Paper groups such valuation challenges under three broad headings: i) valuation impact of terms in existing IBOR inventory; ii) valuation impact of evolving market liquidity and iii) valuation impact of new risks. All entities should have comprehensive IBOR transition programs to address these impacts on all aspect of their businesses, commensurate with the magnitude of the impact to their business.

Valuation professionals should, as part of such a program, ensure that appropriate consideration is given to addressing the valuation impacts of the IBOR transition, including:

- Developing a comprehensive understanding of the IBOR transition exposures affecting the institution, including on and off balance sheet items, direct and indirect exposures, updated on a frequent basis, and providing sufficient granularity into the exposures.
- Developing a detailed understanding of the contractual terms of the instruments in the portfolio, and the range of and expected transition paths for such instruments, and an understanding of the impact of the contractual features on the valuation.
- Developing an understanding of the impacts of the IBOR transition on each of the impacted valuation bases e.g. LOCOM / cost basis, fair value, prudent valuation, capital or stress basis, tax basis, or other calculations.
- Developing processes to monitor market activity and update impacted processes and controls such as those related to market data sources, observability and liquidity assessments on a timely basis throughout the transition period. In such a dynamic environment, the frequency of such assessments may need to be increased compared to existing processes.
- Developing the appropriate governance framework to provide effective challenge to the valuation processes through the transition period.

### Glossary of Abbreviations

ARM – Adjustable Rate Mortgages

CCP – Central Counterparty Clearing House; CMS – Constant Maturity Swap

FRA – Forward Rate Agreements

FRTB – Fundamental Review of the Trading Book

G–SIB – Global systematically important banks IBOR – Interbank Offer Rates

ISDA – International Swaps and Derivatives Association

LIBOR – London Interbank Offer Rates LOCOM – Lower of Cost or Market

SOFR – Secured Overnight Financing Rate SVaR – Stressed Value at Risk

VaR – Value at Risk

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[2] See Piterbarg 2020 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3537925

# *PwC Valuation Index* Tracking the market to understand value

Welcome to this discussion paper, the first in a quarterly PwC Valuation Index series.

In this series, we will be providing insight into the factors which drive stock market prices by observing movements in UK equity markets in comparison to movements in observable fundamental drivers of value, such as economic growth and equity risk premia. The Index is derived by calculating the difference, at each quarter end, between the actual observed price-earnings ratio ("PE ratio") for the overall UK market and the implied PE ratio based on a standard dividend growth model (see the Methodology section on page 6 for further detail).

Our UK Valuations and Economics teams have an in- depth understanding of investment markets, and why market prices and economic values sometimes diverge – we will be drawing upon this experience in this first edition to provide insights into the movement of the Index over the past 20 years. We will look at events such as the bursting of the Dot. Com bubble and the recent economic downturn, how investors have reacted to such events and what this tells us about investor behaviour. Future editions will examine how the Index has moved quarter on quarter, analysing the factors driving change, and will drill down into international and industry sector comparisons.

**Richard Thompson**
Partner
Head of Valuations

## *"Price is what you pay; Value is what you get"*[1]

In its simplest form, the market price of an equity reflects the fundamental drivers of value adjusted positively or negatively for market sentiment. With long-term inputs shaping fundamental values tending to be relatively stable, it is often short term sentiment which leads to volatility in equity prices and the creation of asset bubbles. But what do we mean by sentiment? The answer may be expectations for short-term growth and equity risk, but also the effect of second guessing how other investors will behave.

As John Maynard Keynes put it, referring to newspaper competitions to select the prettiest girl in a line-up, (an unacceptable practice nowadays), but his insight into investor behaviour remains true:

*'It is not a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks is the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees.'*[2]

Equity prices, and hence earnings multiples, are therefore often driven by speculative behaviour, whereas fundamental PE ratios are driven by longer-term value expectations. Certain types of investor, for example trade buyers of controlling equity stakes, may be more interested in fundamental value, whereas a hedge fund, for example, may purely be interested in which way prices are moving rather than underlying value drivers. Neither behaviour is necessarily less rational than the other, but the circumstances are different.

## *Application in valuation practice*

Understanding differences between market price and fundamental value is crucial to many valuation exercises. Value can be considered from three perspectives: market value, economic value and strategic value. Market value represents the price a typical market participant would pay at a point in time in an arm's length transaction, economic value is the intrinsic value of a business or asset and strategic value incorporates any synergistic premium available to specific buyers. There is a good chance all three will be different for any given business or asset, and hence it is imperative to understand the drivers and weightings to attach to each.

If you are assessing the fair value of an asset, for example, where there is no imperative to sell immediately, the Index can guide you on the size of the disparity between market value and fundamental value and help inform your decision as to the price which may be achieved in an orderly transaction. For example, when equity values were at their lowest point during the recent economic downturn the Index stood at 50 (which means that observed earnings multiples were 50% lower than those based on fundamental assumptions) – a willing seller may have been unlikely to sell at this point in time, and hence market value may not have been a proxy for fair value. Indeed, this significant buy-sell gap resulted in a sharp reduction in the number of transactions which took place. You could therefore look at the movement of the Index and consider over what period a willing seller could reasonably be expected to hold out in order to realise a fair value for the asset in question.

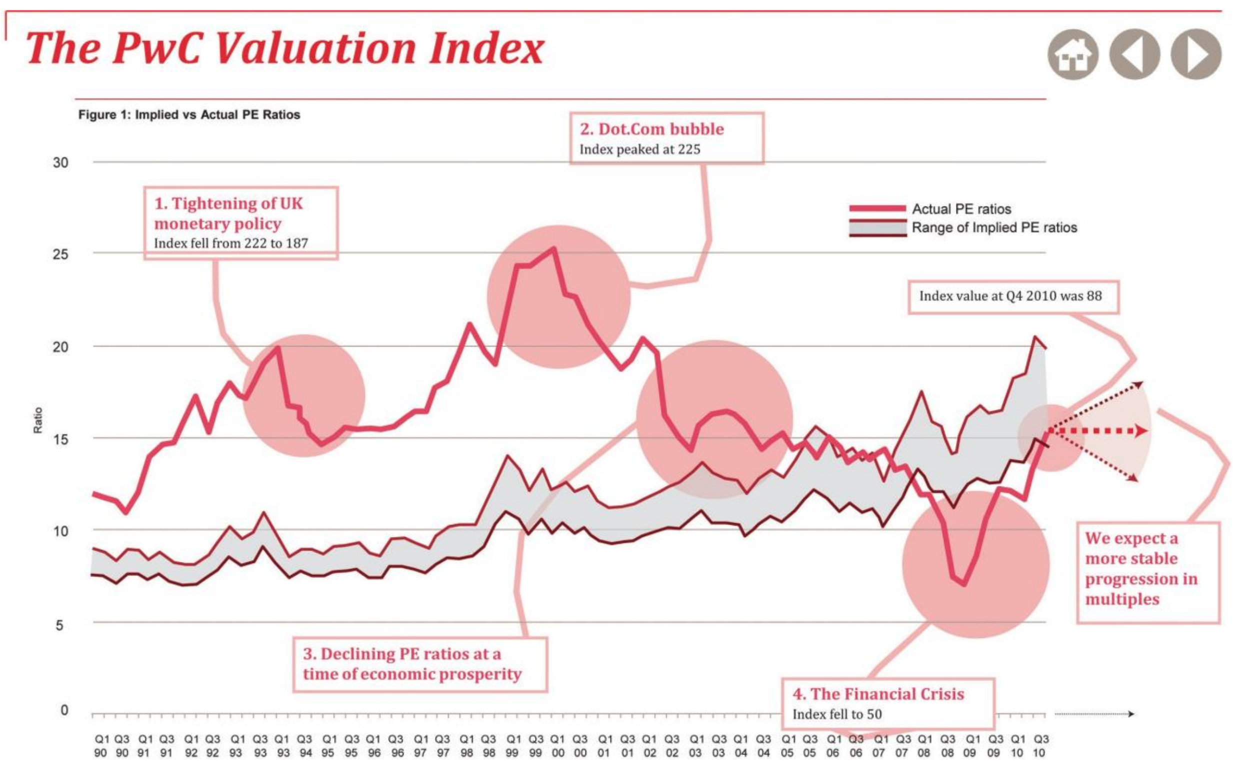
In summary, the Index provides a benchmark of the relationship between market value and economic value; understanding the Index value can act as a starting point for discussions around value and help the valuer to bridge the gap between different valuation concepts.

[1] Warren Buffet, February 2009

[2] The General Theory of Employment, Interest and Money, 1936

## Summary

- The PwC Valuation Index stood at 88 at Q4 2010, which means that observed equity multiples were 12% below the multiples implied by economic fundamentals. Although the gap between the two has narrowed since the nadir of the Financial Crisis, there is still significant uncertainty around economic prospects, and investors continue to be pessimistic in comparison to prevailing longer-term growth expectations, going against the norm for the twenty year period prior to the Crisis when investors consistently took a more optimistic position compared to fundamentals.
- Short-term speculative impacts have driven the extremes in the Index – on occasions the Index has surpassed 200, such as the peak of the Dot.Com bubble, sharp declines in multiples have soon followed. The Index highlights the fact that it is the difference between market value and fundamental value which is most important when testing whether the market is over- or under-valued, rather than the absolute level of multiples themselves.
- Although UK equity prices rallied strongly over the second half of 2010, this was boosted by very low real risk-free rates. If interest rates begin to rise, as many commentators expect, this will have a dampening effect on multiples.
- UK PE ratios began to decrease steadily well before the Financial Crisis hit. We believe this may have been due to investors becoming more pessimistic about long-term UK growth prospects, perhaps due to the changing demographic profile of the population. Further, the supply of investable funds directed into UK equities is likely to diminish as retiring baby boomers take money out of pension funds, some investors rebalance their portfolios towards emerging markets and regulatory impacts on some investing institutions require them to rebalance their portfolios away from equities. We believe making a profit from rising market multiples will be less likely in the short-term and values will be driven primarily through earnings growth.
- A likely scenario for the foreseeable future in our view would be for observed equity multiples to track fundamentals more closely than they have done in the years prior to the Financial Crisis.


## *Key observations highlighted by the Index*

### 1. Tightening of UK monetary policy

Figure 1 shows how PE ratios were impacted by increasing interest rates in 1994, which was a strong year for the UK economy. Economic growth was at its highest rate for six years, infiation was at its lowest level for 27 years, and unemployment was falling. Despite this, PE ratios declined sharply by 25% during the year. A key reason for this is likely to be the rise in UK interest rates to 6.25%. Raised as a pre-emptive strike on infiationary pressures, this would have raised the cost of borrowing and in effect taken money, and importantly leverage, out of the economy. As the Financial Crisis would go on to show, 1994 was not the only time that a reduction in the levels of affordable credit would impact equity prices.

**Key observation: As interest rates rise in future, this will have an impact on the future levels of market multiples.**

### 2. The Dot.Com Bubble

The Financial Crisis is not the only example of speculation and short-term sentiment impacting market value. The Dot.Com bubble in the early 2000s saw an optimistic overreaction by investors to short-term growth prospects, or as Alan Greenspan commented, 'irrational exuberance'3. Despite long-term growth forecasts remaining relatively constant during this time, actual PE ratios grew sharply to over 25 times earnings at the turn of the century before falling to below 20 within a year. This PE ratio infiation was the result of a widespread sentiment that Dot.Com companies were going to push the boundaries of productivity levels which were previously thought possible. A self fulfilling prophecy, investors had been as willing to price in short-term optimism (or to follow those who did) as they were to price in short-term fears during the recent Financial Crisis.

**Key observation: The Index highlights how the gap between observed multiples and fundamentals may be more important in terms of understanding whether the market is under- or over-valued than the absolute level of multiples. When the Index has risen above 200 in the past twenty years, this has generally represented a peak in the market.**

### 3. Declining PE ratios in a healthy economy

For the 17 years prior to the Financial Crisis, PE ratios were consistently above those implied by fundamentals. In other words, the speculative value that investors priced into their market value assessments was generally at a premium. Will this phenomenon return as the economy recovers?

Prior to the Dot.Com bubble, UK PE ratios were on a long- term upward trajectory. In the years following the bubble, economic growth was strong and unemployment was low, yet UK PE ratios steadily declined at the same time as developing economies' ratios saw strong growth. What caused this difference and change in trajectory? Over this period, earnings of UK companies generally grew faster than share prices, indicating that investors believed that the rate of growth in earnings was unsustainable. The drivers of long-term growth look to be the likely causes of this:

- Growth in the working population boosts output and the number of consumers. However, the demographic shape of the UK is changing. An ageing population may see a reduced demand for UK equities as retired people consume rather than save, thereby requiring more draw-down and less accumulation style financial products. An ageing population will not be able to match the long-term economic growth prospects of the likes of India and Brazil, which have growing populations and literacy rates to fuel their economies. As identified in our 'World in 2050' publication, average annual GDP growth per capita (in US $) between 2005 and 2050 is expected to be 7.9% in India, compared to just 1.9% for the UK. Indeed, PwC's 14th Annual CEO Survey reveals that the majority of institutions see future growth coming from the East, far more than that which will be seen in the UK domestic market.
- Yields on 10 year Government bonds in the UK declined from 12% in 1990 to 5.5% in 2000. This fall in yields resulted in more leverage in the economy. However, between 2001 and 2007 yields remained relatively constant and it remains unlikely that capital will be significantly easier to access for some time to come. With expectations for the availability of leverage being lower and future growth in the economy having to come from gains in productivity,

## *Methodology*

The Index uses a dividend growth model ('DGM') to analyse equity markets. This model is based on the assumption that the value of a share at a point in time should equal the discounted present value of expected future dividends. So that we can estimate what those future dividends will be, we calculate an 'equilibrium' dividend yield based on the average of long-term independent economic forecasts of real GDP growth (made at the end of each time period). Implicitly we are assuming that dividends and the economy will grow at the same rate over the long term. Once we have derived an equilibrium dividend yield, we convert this into a price-earnings ratio ('PE ratio') which we then compare to actual PE ratios at the end of each three month period. Our fundamental PE ratios are shown within a range, refiecting what these would be under different perceptions of the additional return investors require for investing in equities (commonly referred to as the Equity Market Risk Premium - we use a range of 4.5% - 5.5%). Our Index is then calculated by dividing the actual PE ratio by the PE ratio implied by fundamentals. This shows in a single measure how much equity prices at a given point in time differ from the value implied by fundamentals. In future editions we will update you on how these move and what that tells us about the market.

Whilst we recognise that this approach may have some limitations and relies upon a number of simplifying assumptions, it is widely understood and offers a consistent measure which can be used to identify and analyse key areas of debate in valuations.

PE ratios in the UK have declined as investors look overseas for stronger growth prospects. In the short to medium term, GDP growth in the UK will also be dampened by austerity measures which are unlikely to have quite the same impact on developing economies.

**Key observation: Multiples have fallen over a long period as investors factor in lower expectations for UK economic growth – in the near future, it may become more difficult to make a profit from rising market multiples and incremental value may need to be driven more by earnings growth.**

### 4. The Financial Crisis

The recent Financial Crisis has had the largest impact on equity markets since the Dot.Com boom at the turn of the century. Figure 1 shows the impact of the Financial Crisis on UK equity PE ratios. A sharp decline in stock values followed the collapse of Lehman Brothers in Q3 2008, reaching a trough in Q1 2009. However, the Index highlights two interesting observations:

- Actual PE ratios fell below fundamental ratios. This is despite the fact that average long-term economic growth forecasts remained above 2% and at no point during the Financial Crisis did this drop below the lowest growth forecast seen during the 20 years covered by the Index. Why then did actual PE ratios fall so dramatically? With long-term fundamentals remaining relatively constant, investors seem to have placed even more focus on short-term prospects, as growth expectations in the UK fell to as low as a one-year contraction of 4.5% during the crisis. Regardless of whether or not all investors believed this short term decline was indicative of the long term, investors did sell and others followed as equity markets went into a steep decline. Simultaneously, investors' perception of equity risk during this period of greater uncertainty and stock market volatility may have increased. Some have argued that this, at least temporarily, increased the Equity Market Risk Premium, so driving down values further.
- The recovery of PE ratios has been as sharp as their decline. Given that the wider economic recovery has not been as sharp as the economic decline, this may indicate a rebalancing of the initial over-reaction by investors to the Crisis.

**Key observation: Multiples are already back to pre-Crisis levels and the Index is close to 100 (i.e. market and fundamental value at parity) – given the uncertainties around short-term prospects it is possible that investors will feel more comfortable basing their investment decisions on fundamental, rather than speculative, factors than they have been in the recent past.**

## *Conclusion*

**The return to fundamentals?**

Market value, strategic value and economic value rarely coincide, yet it is crucial that a valuer understands the reasons why they are different at any given point in time and how much weight to give to each when coming to a valuation conclusion. The PwC Valuation Index provides a single measure of the difference between market value and the value implied by fundamentals, which like economic value is based on long-term assumptions. Understanding this gap and the drivers behind it enables valuers to provide more robust, and more commercial results. The steady decline of PE ratios during the economically prosperous years of the previous decade raises the question as to whether investors are returning to the safety of fundamentals in the pricing of their investments. The demographic profile of the UK will tend to act as a restraint on economic growth. Conversely, productivity gains could act as a renewed catalyst for growth; on balance, we would expect increases in valuation multiples in the short term to be modest. The forthcoming regulation of the balance sheets of financial services institutions is likely to lead to a re-balancing of equity, fixed income and other asset portfolios, which may also impact the growth prospects for equity multiples.

Consequently, investor sentiment, which we have seen from our analysis over the past twenty years has tended to be more positive than fundamentals would imply, may track fundamentals more closely in the medium-term. In our view, it is likely that value growth in this environment will need to be achieved through earnings enhancement rather than multiples appreciation.

### The Index: 88 as at Q4 2010

The PwC Valuation Index was 88 at the end of 2010, which means that market multiples were 12% below fundamental multiples. Although equity values have rebounded from their lowest point during the Financial Crisis, this has been infiuenced significantly by the fact that real spot yields on UK government bonds were very low at this point in time. If interest rates begin to rise again, as many commentators expect, we would anticipate fundamental ratios to track back to a level more in line with the historical trend, with a similar dampening effect on PE ratios. It will be fascinating to see how the Index moves in 2011 at a time of significant uncertainty; we will analyse the underlying factors driving this and make more detailed international and industry sector comparisons.

## Setting values in the current environment
# The impact of COVID-19 on valuations - KPMG

Given the limited time available to assess the impact of the current environment on the cash flows and inherent risks of the investment companies, the initial reaction of some may be to apply an ad-hoc adjustment to equity returns to address potential value impacts. We firmly believe any adjustment to value should be assessed on an individual investment basis, keeping in mind a number of factors.

To assist you in setting your carrying values at 31 March 2020, we have set out below our considerations when thinking about the key issues that will shape the extent of the value impact on any individual asset, as well as the implications on equity returns.

### Assessing value impact

**For context, there are currently more issues at play than just COVID-19.** The equity markets had been on a strong run since the dislocation of the Global Financial Crisis (GFC) and European Debt Crisis passed in 2012. Throughout 2018 and 2019, central banks sought to take measures to unwind the monetary stimulus that had been applied during the GFC as equity markets surpassed record levels. Pressure from political leaders and the business lobby stifled the central banks efforts and as a result, expectations of continued economic growth through 2020 were being tempered by the end of 2019 as economic pressures built. Whilst COVID-19 proved to be the catalyst, amplified by concerns over the oil price tensions between Saudi Arabia and Russia, the reaction of the financial markets finally reflected concerns for short-term growth and the deeper risks in the economy, which were starting to be considered in the valuation of unlisted investments through a dampening of growth expectations, subdued inflation and increasing cost control measures. The impact of this position was seen in a diversion in the capital growth of unlisted investments against the pricing of listed comparables over 2019 and early 2020.

**The profile of the recovery will be a bigger determinant of value impact than the movement in equity markets.** We have a sense of the potential duration of the government measures to arrest the spread of COVID-19 – two to four months of broad “lock-down” measures (China is just now starting to re-engage its factories, some two months after initial lock-down measures). From that point, there will be a period to return to previous activity levels or, for some sectors, establish a new normal. The shape of this return, whether it is an optimistic “V” shape, a more realistic “U” shape or a more concerning “L” shape will be a major contributor to the overall value impact on investments, as well as the timing of the recovery of equity markets in general. Contributing to the speed of recovery will be the success of the widespread global government stimulus measures announced to support industries and individuals in negotiating the downturn. However, whilst these measures may soften the immediate impact, the cost of funding these measures is likely to create a prolonged longer term drag on economic performance. At this moment, it is difficult to estimate what the impact on European economies in 2020 and beyond will be. According to the UK’s latest quarterly Economic Outlook, the impact of COVID-19 is expected to see the UK economy contract by 2.6% in 2020, assuming the pandemic can be contained by the summer, with a sharp recovery in the first half of 2021 as uncertainties around the pandemic dissipate. If the pandemic persists however until the second half of this year, Gross domestic product (GDP) could contract by 5.4% and by another 1.4% in 2021. No doubt in the coming weeks, we will get a better view on the actual economic impact thus far (Q1), which should allow to update the projections.

**The value impact is dependent on the characteristics of the individual investments.** Demand based assets are most at risk from a downward value adjustment, particularly those investments exposed to the travel sector (e.g. airports) and directly correlated with GDP performance (e.g. ports). Availability based or regulated assets are expected to be more stable at a revenue level, unless broader economic pressures force changes to contractual mechanisms. However, demand based assets will have the potential to recover quicker when economic activity returns and will also be potential beneficiaries of initial government stimulus measures. As a result, it will be important to assess the opportunities available to manage cash flows to mitigate short-term revenue impacts and scenario modelling of adjustments to capital expenditure profiles operational expenditure and distribution/financing flows will be important in understanding value impacts.

**The capital expenditure profile may provide flexibility in managing cash flow.** Discretionary capital expenditure spend, particularly when associated with expansion programs, will provide an opportunity for investment companies to manage cash flow in the short- to medium-term through the deferral of projects. This may mitigate adverse short-term value impacts, although it will also potentially affect growth in the medium- to long-term. For those assets with high capital expenditure requirements, a reduction in the capital expenditure profile may also reduce equity risk to the extent delivery and execution risk had been previously factored into the assessment of the overall equity return.

**Gearing position and timing of refinancing events can increase risk.** Governments have taken action to maintain liquidity in credit markets. However, consideration will need to be given to the funding position of each investment, particularly if there are indications that the credit markets may be constricted. Of particular interest will be:

- those investments with refinancing events in the short-term, which will be most at risk given the potential uncertainties in the amount of debt that can be raised and the cost of new debt
- the medium-term margin assumptions adopted, which

may need to be reassessed if credit spreads widen for lower rated investments

- the extent of refinancing assumed in the medium-term that primarily provide an equity release, which may not be available in a dislocated credit environment
- the covenant headroom available, with those investments with limited headroom being at most risk, potentially amplified by any lingering uncertainty in relation to the impact on covenants of recently introduced accounting measures for right of use assets.

**Counterparty risk will be amplified.** A broad economic downturn will increase counterparty risk and the potential for default on existing obligations. Those investments more exposed to counterparty risk (low credit rated counterparties or operating in high risk industries and/or jurisdictions), will be viewed as higher risk.

**The value impact may be greater for shorter life assets.** Those investments with a shorter concession period or asset life, will feel the impact, on an absolute value basis, of any short term cash flow impact to a greater degree than longer life or perpetual investments. The shape of the recovery ("V", "U" or "L") is important for all investments but is critical to investments with shorter lives.

The value contribution from the terminal value may increase. For those companies that do not have whole of life forecasts it is likely that a greater percentage of overall value will be associated with the terminal value period. Inherently, this will require increased focus on the assumptions driving the terminal value and the supporting evidence utilized to establish the long term growth assumption.

### Equity return implications

**Equity returns are being influenced by a range of factors.** Whilst investors may see equity risk as being higher today than it was a month ago, it is difficult to derive the impact of the crisis on the different components. One of the complications is the robustness of the indicators flowing from the markets – since early January 2020, Belgium's 10-year government bond yields declined from 0.089% p.a. to a low of -0.316% p.a. on 9 March 2020, after which a steep increase was witnessed to 0.413% p.a. on 18 March 2020 (just nine days later), possibly as a result of further risk aversion driving funds away from bonds to cash. By the end of March, it had decreased again to 0.05%. The same volatility that we see in bond markets is being seen in equity markets, meaning the quantification of adjustments based on market data in an unstable market may be problematic given the difficulty in identifying the factors driving the market movements – is it repricing of equity return expectations, short- to medium-term earnings reductions, or purely market sentiment driving market performance?

**Introducing an equity premium based on share market performance since the emergence of COVID-19 may overstate the potential value impact to certain defensive asset classes.** The reaction of equity markets in periods of significant dislocation is often one that initially reprices all equities in a similar fashion, before the defensive characteristics of certain sectors are recognized and repriced appropriately (companies which are not otherwise expected to be impacted can initially be sold to cover liquidity requirements elsewhere in broader investment portfolios). Valuers of unlisted investments have generally sought to separate the emotional response of markets which tends to drive "price", both on the upside and the downside, as opposed to "value". This is particularly necessary in periods of market dislocation.

The period by which you measure relative equity market performance is important. Equity markets have declined substantially from their peaks in early 2020. Notwithstanding that we consider a relative assessment to the performance of equity markets in times of dislocation flawed, any assessment should be done over a consistent time period. For many infrastructure asset classes, equity market performance over the course of 2019 was very strong, meaning year-on-year price movement, even post recent market declines, was positive or at worst, flat. Therefore making adjustments based on a short period of market dislocation may not be appropriate.

### Other matters to consider

**Use the valuation range where necessary.** Valuations are typically presented as a range, with the mid-point of that range often being the stated point-estimate of value. Given the uncertainties that exist and the limited information initially available to assess the impact, we consider the risk is currently skewed to the downside. Therefore, consideration should be given to where in the valuation range the point estimate of value is selected, with the lower end perhaps better reflecting the increased risk aversion of market participants.

The frequency of valuations should increase. The balance date of 31 March 2020 is the first quarterly period where the extent of the COVID-19 issue is known, and at this time, detailed analysis of the cash flow impacts and potential mitigations have not been made. As a result, subsequent valuation processes will have access to deeper information to allow a progressively more informed assessment. This may result in changed views as to the inherent risks of specific sectors, as well as the differing profiles adopted by participants within any given sector as they return to "normal".

For that reason, it is recommended that those investors who do not undertake quarterly valuation cycles adopt a more frequent valuation cycle during this period and all investors initiate the reforecasting and valuation processes earlier than usual.

Macro-economic assumptions also require review. The dislocation in the financial markets is also impacting the sources used to support macro-economic assumptions, such as base lending rates, exchange rates and inflation rates. Simply adopting forward curves is not recommended in any valuation, but it is particularly so in the current environment.

Financial reporting and impairment considerations. Impairment assessments will be a key focus of forthcoming audit processes. Evidence to support that underlying financial information has been prepared on a reasonable and supportable basis will be an important part of the process. Demonstrating an appropriate balance of risk assessment between the discount rate and the cash flows will be required to give the auditor appropriate levels of comfort.

# Fair valuation pricing survey, 19th edition, executive summary

## Opportunity on the horizon

### Opportunity on the horizon

Our 19th edition of the Deloitte Fair Valuation Survey (the FV survey) is released at a time when valuation policies and procedures, the role of board governance, and the valuation operating model and use of technology solutions are being challenged, disrupted, and innovated more than ever. This seems incredible to think about, as the industry has dedicated a lot of time, resources, and energy to put in place high-quality valuation processes aimed at "getting daily security valuations right" so that shareholder transactions are executed using an accurate net asset value per share (NAV). A number of recent events and activities have created a confluence of opportunities for fund groups to digest, evaluate, and continue the valuation journey, preparing for change and better outcomes for all industry stakeholders.

One of the most significant events in recent times is the COVID-19 pandemic. Our latest FV survey was conducted and completed in a year in which most fund personnel continued to primarily work virtually from their homes. As noted in last year's survey, the quick transition of the valuation operating model to a remote environment created the need for fund groups to adopt some temporary controls and procedures and ramp up their use of technology, as well as their ability to digitize the valuation process where opportunities presented themselves. Today, fund groups need to continue to balance plans to return to work and the implications of the Delta variant.

Should the valuation team come to the office five days a week? Operate on a hybrid model and commute two to three days a week? Or continue to operate on a fully remote basis? The latter back-to-work model has some desirable characteristics beyond the personal satisfaction of no commute. Valuation teams occasionally need to work late to wrap up the valuation process due to late pricing or data feeds. Working on a remote basis may make it easier for them to balance their personal lives with their job responsibilities when such information becomes available and complete the valuation process more efficiently. The continued expansion of technology solutions such as workflow tools continues to present opportunities to optimize the process. Whatever the valuation operating model, fund groups should always challenge the adequacy of the controls in place, the security of information being accessed on a remote basis, and the integrity of the overall valuation process.

The most significant recent regulatory event affecting the valuation process was the US Securities and Exchange Commission's (SEC) Rule 2a-5, Good Faith Determinations of Fair Value (the FV Rule).1 Given the new FV Rule reporting requirement that fund boards evaluate valuation resources, the final back- to-work model may continue to add complexity and uncertainty to the process. Importantly, the need for and availability of valuation talent seems to be hitting a tipping point. Demand is high for talent specifically to support the valuation of ever-more-complex mutual fund portfolios. Risk managers will need to continue to assess and manage talent risks as fund groups look for opportunities to streamline the valuation process and leverage their current resources.

Since the adoption of the new rule, the SEC has experienced significant turnover, including in its Division of Investment Management. The departure of some SEC staff members who played a key role in drafting the FV Rule creates some uncertainty. Will the SEC staff be able to help the industry interpret key provisions?

There may be an opportunity to work with the SEC staff to publish additional interpretive guidance through additional frequently asked questions and to clarify some FV Rule implementation issues that the industry has been discussing. Some opportunities to provide clarity include the definition of material; the risk assessment process and depth of analysis required; who can be the valuation designee (especially in a series trust and sub-adviser structure); the degree to which conflicts of interest need to be identified and monitored; and the active oversight and reporting necessary for level 2 securities, which are commonly evaluated by pricing vendors. Understanding the importance of this up-front work will go a long way to facilitate efficient implementation and minimize the amount of potential divergence in industry practice that may result upon adoption of the rule. The FV survey asked participants many probing questions about how they will adopt Rule 2a-5, which we will discuss more in upcoming sections.

In the end, those fund groups who have demonstrated organizational discipline and have been proactive in looking for opportunities to innovate their valuation operating model, while implementing the FV Rule, may have the advantage of more seasoned technology solutions. These solutions support the emergence of a stronger, improved, controlled valuation process that will sustain future regulatory inspection headwinds, as well as scale, as the fund industry continues to evolve in complexity and work on a remote or hybrid basis.

This may go beyond the use of technology to looking to outsource some key aspects of the valuation process, such as private equity valuations, board reporting, vendor due diligence, and valuation methodologies testing. As the FV survey highlights, in this time of disruption, why not challenge the current valuation process to enhance future resilience for years to come?

### Finalized regulatory rules willrequire change

The SEC's finalization of the FV Rule in December 2020 marked more than 50 years since the SEC last adopteda major change in fair valuation guidance. It comes as no surprise, then, that 80% of FV survey participants indicated that the FV Rule will have the biggest impact on and pose the largest challenge to the valuation process in the next 12 months. FV survey results suggest that participants are working specifically on developing a more formal risk assessment exercise, enhancing the evaluation of fair value methodologies and third-party pricing providers, improving board reporting, and complying with recordkeeping requirements. Preparing for such change and creating opportunities in the valuation process is clearly top of mind today (and will be going forward) in order to meetthe compliance deadline of September 8, 2022.

As a first step, many fund groups have performed a gap assessment against their current practices to measure the impact of adopting the FV Rule. Among FV survey participants, 66% indicated they had thus far completed a gap assessment by comparing their current valuation practices with FV Rule requirements.Notably, this finding rises to 84% among larger fund groups with AUM of more than $100 billion. Less than 50% of FV survey participants with AUM of less than $10 billion have performed a gap assessment to date. The FV survey identified certain aspects of the FV Rule where gaps exist with current practices (Figure 1), based on those who had completed a gap assessment.

### *Assessment process*

As identified by FV survey participants, the risk assessment aspect of the FV Rule will likely require industry attention. Specifically, the FV Rule includes arequirement to:

*"assess periodically any material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest, and to manage those identified valuation risks."*

The FV Rule also adds a reporting element to the risk assessment process by specifying that quarterlyreports are required to evidence the assessment and management of any material valuation risks, including material conflicts of interest.

**Figure 1. Areas where current practice differs from requirements of the FV Rule**

| Aspect addressed in FV Rule | Percentage identifying gap |
|---|---|
| Board reporting | 69% |
| Risk assessment procedures | 67% |
| Periodic testing procedures | 45% |
| Evaluation of fair value methodologies | 40% |
| Assessment of third-party pricing providers | 33% |
| Recordkeeping | 33% |

While the FV Rule does not identify specific valuation risks other than conflicts of interest that fund groupsmust address, the adopting release does provide a nonexhaustive list of sources or types of valuation risks, such as the types of investments held or intended to be held by a fund, the characteristics of those investments that may affect associated risks, and the extent to which each fair value methodology uses unobservable inputs. The extent to which fund groups will identify additional risks and document anassessment for them is unclear. As of now, 70% of FV survey participants describe the risks they have identified as "a few high-level risks," made up of five or fewer valuation risks. Only 33% have described their valuation risks in writing, and only 5% responded that they have identified additional risks beyond those identified by the SEC. Considering that 67% of FV survey participants identified risk assessment as a gapbetween existing procedures and Rule 2a-5, it is likely that these percentages will change. However, the FV Rule is not as prescriptive in this area, and this may be an area of divergence based on each fund group's preference and assessment of its legal requirements.

Another key component of the FV Rule is the requirement to select and consistently apply appropriate valuation methodologies for determining and calculating fair value, including key inputs and assumptions specific to each asset class or portfolio holding. This is consistent with generally accepted accounting principlesin the United States of America (GAAP) under ASC 820 – *Fair Value Measurement*, which require valuation methodologies to be applied using a "consistent and appropriate basis over time." The FV survey identified that 68% of FV survey participants do not currently have documentation in place that identifies key inputs and assumptions specific to each asset class or portfolio holding. Yet, the FV Rule suggests that, at least for some asset classes, additional granularity is required, as statedin footnote 51:

*"It would not be sufficient, for example, to simply state that private equity investments are valued using a discounted cash flow model, or that options are valued using a Black-Scholes model, without providing any additional detail on the specific qualitative and quantitative factors to be considered, the sources of the methodology's inputs and assumptions, and a description of how the calculation is to be performed (which may, but need not necessarily, take theform of a formula)."*

This is another area where some divergence in practice may result, and it is also an area where fund groups might request enhanced documentation from third-party pricing providers to assist in complying withthis requirement.

The FV Rule acknowledges the important role pricing services play in the fair value process and provides that determining fair value in good faith requires the oversight and evaluation of pricing services, where used.As written:

*"For funds that use pricing services, the final rule will require that the board or valuation designee, as applicable, establisha process for approving, monitoring, and evaluating each pricing service provider. The final rule also will require that the board or valuation designee, as applicable, establish a process for initiating price challenges as appropriate."*

FV survey participants appear to be relatively prepared to comply with this requirement, with 90% responding that they currently ask their pricing vendors to describe how they incorporate information received from pricing challenges into their pricing process. Similarly, 85% responded that they have established a process for initiating price challenges.

Additionally, the FV survey hascaptured a trend emphasizing price challenges over the past decade; the number of fund groups reporting price challenge information to their boards increased from 40% in 2013 to 67% in 2021.

### *Conflicts of interest*

Predominant throughout the FV Rule is its requirement for boards to identify and monitor potential conflictsof interest as part of their oversight duties. The FV Rule states:

*"Boards should approach their oversight of the performance of fair value determinations by the valuation designee of the fund with a skeptical and objective view that takes account ofthe fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determinationprocess, and the skill and resources devoted to it.*

*"The valuation designee must provide at least quarterly, in writing, a summary or description of material fair valuematters that occurred in the prior quarter. This summary or description must include (1) any material changes in the assessment and management of valuation risks, including any material changes in conflicts of interest of the valuationdesignee (and any other service provider)."*

Most survey respondents (36%) stated that conflicts of interest are orally discussed, 20% indicated they have not specifically identified conflicts of interest relating tothe valuation process at all, and 32% responded that conflicts of interest are in writing, with a description of control procedures that address or mitigate those conflicts. Considering the FV Rule may suggest a requirement to report any material changes in conflicts of interest to the board, responses to this question maywell change in future surveys as rule adoption occurs.

When considering conflicts of interest, the majority (94%) of FV survey participants focused on the role of the portfolio manager. This is not surprising, given that the SEC made clear in the FV Rule that certain steps should be taken to reasonably segregate portfolio management from fair value determinations. On the other hand, there may be differing views or interpretations with respect to other potential conflicts of interest, as only 28% identified brokers and only 21% identified pricing services as having potential conflicts of interest. A number of SEC conflict-of-interest examples in the FV Rule are focused on the role of pricing services. Some commenters on the proposed rule questioned the significance of a pricing service's conflicts of interest, stating that pricing services maintain relationships with a wide variety of investment advisers and generally are expected to provide the same valuation information for a particular security to all funds. However, the SEC made it clear that the conflict is not necessarily one of responding to pressure from a particular investment adviser; rather, a pricing service might generally provide higher or more aggressive valuations to retain business. This focus may also result in a bit of unwelcome tunnel vision, too, if fund groups focus more on what the rule text says as opposed to its spirit. There very well may be other conflicts of interest in the entire valuation process that fund groups and their board could identify during a brainstorming session that may be of greater significance and that really should not be overlooked.

### *Valuation reporting*

The SEC has also stressed that board oversight should be active, including several open-ended statements thatrequire board judgments on the amount of information, reporting, and input they provide, respectively, to each fund group's final framework. The FV Rule will:

"require the valuation designee to report to the board with respect to matters related to the valuation designee's fair value process, in part to ensure that the board has sufficient information to conduct this oversight. Boards should also request follow-up information when appropriate and take reasonable steps to see that matters identified are addressed."

In many respects, this appears to be a common industry practice in place within a majority of fund groups. The FV survey indicates that 69% of fund groups already provide a written report on a quarterly basis to the board to address valuation matters, and those reports clearly cover some elements that the FV Rule requires as shown in Figure 2 (although there still may be areas within one ofthe elements that a fund group's current reporting doesnot fully address).

**Figure 2. Elements currently included in written reports to boards**

| Required element | Percentage indicating current report discusses element |
|---|---|
| Testing results | 82% |
| Material changes to or material deviations from approved methodologies | 72% |
| Pricing services | 61% |
| Material valuation risks | 28% |
| Valuation resources | 14% |

These percentages suggest that there are, unsurprisingly, some current gaps in board reporting, and fund groups may collaborate with mutual fund boards to eliminate expectation gaps between written reports generated for FV Rule compliance and mutual fund boards' preferences and desire for information to meet the SEC's expectation ofactive oversight.

Under the FV Rule, the valuation designee will alsobe required to promptly notify the board, at a time determined by the board, but no more than five business days after the designee becomes aware, of material matters that may affect the fair value of the portfolio of investments. The FV Rule noted that such material matterscould include a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair valuation determination process or material errors in the calculation of a fund's NAV. As it stands, only 58% of fund groups do this today. Notably, the industry is making progress in this regard, as only 33% reported such prompt reporting in last year's FV survey.

Percentage of FV survey participants

There continues to be a desire for clarity on what would constitute a “material” matter requiring prompt notification. While the SEC did provide some definitional guidance on material matters and errors, consensus has not yet formed within the industry, as illustrated in Figure 3.

While there may not be consensus on the definition of “material,” it appears that the majority will consider the impact on NAV.

Figure 3. What constitutes “material”?

| **Under which of the following circumstances, if any, will the valuation designee notify theboard of a matter that materially affects the fair value of a portfolio investment?** | **Percentage of FV survey participants indicating that circumstance is material** |
|---|---|
| A fair value pricing error that results in an error in the calculation of the fund’s net asset valuethat exceeds $0.01 per share and half of 1% of the fund’s net asset value | **67%** |
| A fair value pricing error that results in an error in the calculation of the fund’s net asset valuethat requires reimbursement to the fund and/or reprocessing of shareholder transactions | **64%** |
| A fair value pricing error that results in an error in the calculation of the fund’s net asset valuethat exceeds $0.01 per share | **59%** |
| A preliminary determination by management that the fund may have a significant deficiency or material weakness in the design or effectiveness of its fair valuation determination process | **58%** |
| Deviation from a previously approved fair valuation methodology | **36%** |

***All hands on deck***

As mentioned, implementing and complying with the FV Rule within the 18-month transition period is top of mind and will not be without its challenges. The FV survey depicts a few of these challenges (Figure 4).

Figure 4. FV Rule implementation challenges

| **What requirements do you think would create the most challenge and/or SEC risk to thecurrent valuation process?** | **Percentage of FV survey participants indicating thatsuch is a challenge or risk** |
|---|---|
| Development and assessment of valuation risks and related reporting | **65%** |
| Management requirement to provide “prompt” notification of material changes to the board | **38%** |
| Board requirement to provide “active” oversight of the valuation process | **35%** |
| Board requirement to periodically review the financial resources, technology, staff, and expertise of the valuation designee | **29%** |
| Board evaluation and due diligence over pricing services and related reporting | **20%** |
| Board evaluation of fund group conflicts of interest and related reporting | **19%** |

As a reflection of these challenges, only 25% indicated that they will voluntarily comply with the FV Rule in advance of its compliance date. As fund groupscontemplate and continue to assess the FV Rule’s requirements and challenges, we are seeing (and expectto continue to see) fund groups finding it prudent to seek help. This may include third-party assistance with implementation of the FV Rule or with ongoing compliance, as we see many fund groups changing theirvaluation operating models. Though in its early days given the September 2022 compliance date, 10% have either engaged or plan to engage a third party to assist with implementation of the FV Rule. We noted that 28% of FV survey participants indicated they anticipatemaking changes to their current financial resources, technology, staff, and expertise. As noted from survey responses and observed in the marketplace, outsourcing portions of valuation operations is being considered. Only 9% of FV survey participants indicatedthat they would use a third party to perform valuationsor outsource certain requirements of the rule.

We expect this percentage to increase as we reach the September 2022 compliance date.

Finally, who within a fund group is responsible for initial implementation of the FV Rule? The FV survey offers noclear consensus; however, it does seem to indicate the responsibility primarily falling on the fund treasurer's office, chief compliance officer(s), and/or chief risk officer(s). For example, 41% of FV survey participants said that the process for reviewing and updating the assessment of valuation risks will be performed by the chief compliance officer(s), and 38% responded that the fund treasurer's office will lead this process. Regardless, the formation of a working group might help drive the implementation of the FV Rule. We believe the emerging trend and long-term impact of the FV Rule will lead to opportunities for fund groups to innovate their valuation operating models. Thus, an all-hands-on-deck approach with many perspectives and points of view will enhance the generation of such opportunities.

**What are the TOP FIVE actions fund groups are doing now or have already done relative to requirements of Rule 2a-5?**

1. **94%** have already reasonably segregated fair value determinations from the portfolio management of the fund.
2. **66%** have already reassessed current valuation practices to assess whether any gaps exist between them and what is required under Rule 2a-5.
3. **58%** currently report that the adviser promptly reports to the board in writing on matters associated with the adviser's process that materially affect, or could have materially affected, the fair value of the assigned portfolio of investments.
4. **32%** have created documentation that identifies key inputs and assumptions specific to each asset class or portfolio holding, as well as the appropriate application of fair value methodologies.
5. **10%** have or will engage a third-party adviser to help with implementation of the rule.

**What are the TOP FIVE actions fund groups may consider doing in the future to get ready for Rule 2a-5?**

This could include challenges or open interpretations from the SEC.

| | | |
|---|---|---|
| 1. | **65%** identified development and assessment of valuation risks and related reporting as challenging. | Fund groups may consider creating working groups to assess risks at the investment-type level and evaluate how best to manage those risks. |
| 2. | **38%** identified management's requirements to provide "prompt" notification of material changes to the board as challenging. | Fund groups may wish to collaborate with board members to proactively identify what events or issues constituting material changes and requiring "prompt" notification would be challenging. Currently, only 13% have defined what would be considered a "material" valuation risk. |
| 3. | **35%** identified the board requirement to provide "active" oversight over the valuation process as challenging. | The FV Rule states that boards must be active in their oversight role by probing reports written by investment advisers and being inquisitive. However, the line between active oversight and active management may be blurry at times. The SEC may want to provide further guidance on how best to evidence this type of active oversight without assuming the role of management. |
| 4. | **29%** identified the board requirement to periodically review the financial resources, technology, staff, and expertise of the valuation designee as challenging. | Twenty-eight percent anticipate making changes due to this requirement. Should the SEC provide benchmarking for boards to use in this evaluation? Will there be an expectation that certain individuals hold certain certifications, such as the recently created Certified in the Valuation of Financial Instruments (CVFI) designation? |
| 5. | **20%** identified the board evaluation and due diligence over pricing services and related reporting as challenging. | The SEC declined to adopt a specific list of criteria for who may qualify as a pricing service. Instead, the FV Rule refers to pricing services as *"third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information to assist in determining the fair value of fund investments."* While some pricing services are obvious, it may be challenging to identify and perform due diligence on less obvious ones that "provide information," such as a third party whose inputs are used for a model. |

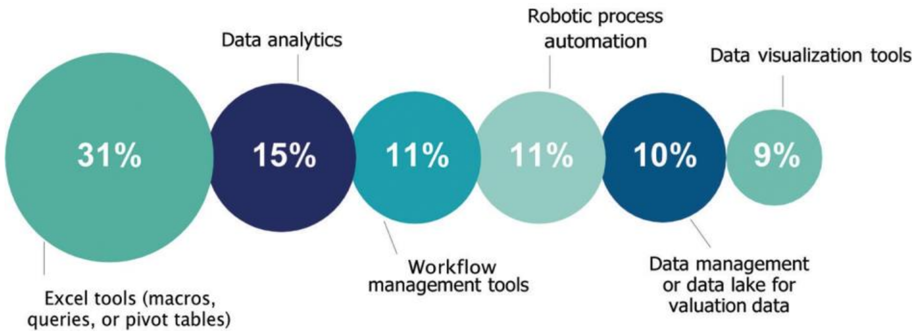
### Use of technology solutions is maturing and providing opportunities

We continue to see the maturing use of technology solutions in the fair value process and operating model.Working remotely accelerated this trend, and FV Rule opportunities lend themselves to further encourage automation and use of technology. As noted in the FV survey, the percentage of FV survey participants that recently adopted the technology solutions shown in Figure 5 increased, with the biggest jumps in the adoption of data analytics and Excel tools. What is clearis that the value proposition of innovating the valuation operating model through the use of technology in the remote work environment has become a strong trend.

Overall, 93% of FV survey participants indicated theycurrently use Excel-based tools in their valuation process. Workflow tools and data analytics are now used by 35% and 36% of FV survey participants, respectively, and use of data visualization has made a year-over-year jump to 26% from 21%. Given the extended period of working from home (and the possibility of it being part of the future of work), a continued increased focus on workflow management tools may be prudent. Workflow management tools can be used for certain aspects of many processes andcontrols, such as facilitating and securing approvals. However, about 23% of FV survey participants indicatedtheir workflow tools are much broader, covering the full end-to-end valuation process. Perhaps, given the practical benefits of workflow management toolsin a remote environment, we may see increased development of this technology solution in the near future. Overall, general year-over-year adoption increased with 21% reporting their use of automationhas increased over the past year. This trend may well continue as 66% of FV survey participants indicated they are exploring new valuation-related technology solutions with workflow management tools being the most popular at 31%. While exploration is different from implementation, we believe technological adoption will continue in the form of quick-hit items that are lower-cost, easier to develop and implement,and based on industry use cases.

**Figure 5. Recent adoption of technological solutions**

Percentage of participants who said their firms began using or added applications to these technologies in the past year




### Board governance remains in allstakeholder sights

The FV Rule further clarifies the responsibilities of a mutual fund board and may have been more prescriptive than many anticipated. As it pertains to valuation, mutual fund boards have increased expectations to perform their duties in the form of active oversight. As in years past, the FV survey provides trends in maturing practices when it comes to active oversight, including the initiation of “ad hoc meetings,” explicit valuation policies and procedures that highlight when mutual fund directors “must be involved” and/or “must be notified,” and risk-based reporting. See Figure 6 and Figure 7.

However, as shown in Figure 6, there were no significant changes in board processes year-over-year, likely in anticipationof making changes in conjunction with adoption of the FV Rule.

Nonetheless, as the fund industry continued to respond to theunanticipated risk of the pandemic, boards made significant pivots as well. Almost all mutual fund board meetings went virtual. In fact, only 1% of FV survey participants noted that there was no impact and that their board meetings have beenin person over the past 12 months. As of completion of the FV survey, 49% of participants had scheduled a fall or winter live board meeting, whereas 44% are unclear when they planto return to live board meetings. In cases where in-person meetings were scheduled, 98% expected that management or, in some instances, potentially all regular board meeting participants would attend live.

It should be noted that FV survey data was collected during the summer, and we know that the Delta variant has negatively affected fall and winter live meeting percentages. However, survey participants were loud and clear in noting that no fund groups concluded that live, in-person board meetings were no longer necessary, as well as indicating (66%) that they donot anticipate any changes to the boardroom postpandemicversus prepandemic.

**Figure 6. Signs of “active” oversight**

| | 2021 | 2020 | 2019 |
|---|---|---|---|
| Ad hoc meetings (held in past 12 months) | 30% | 37% | 26% |

| | | | |
|---|---|---|---|
| Valuation policies and procedures that highlight when mutual fund directors | | | |
| "Must be involved" | **11%** | **11%** | **9%** |
| "Must be notified" | **37%** | **36%** | **37%** |
| Both | **5%** | **4%** | **3%** |
| Risk-based summarized reporting | **98%** | **99%** | **99%** |

**Figure 7. Board oversight: Risk-based reporting**

| | 2021 | 2020 | 2019 |
|---|---|---|---|
| Dashboard reporting, including Key Valuation Indicators (KVIs) | 46% | 46% | 45% |
| Summaries of price challenges | 67% | 63% | 74% |
| Reports on the number of securities whose fair values were determined based on information provided by broker-dealers | 59% | 59% | 59% |
| Reports regarding portfolio holdings for which there has been no change in price or for which investments have been held atcost for an extended period of time | 68% | 68% | 72% |
| Back-testing of foreign equities | 82% | 89% | 87% |
| Back-testing of broker prices | 33% | 32% | 23% |
| Back-testing of level 3 investments | 36% | 29% | 23% |

**Additional key FV survey findings**

The FV survey contained questions and other key FV survey findings, as follows.

- Sixty-one percent of FV survey participants reported using zero triggers to determine when to adjust the prices of fair value equities that trade on foreign exchanges closing before 4 p.m. ET, compared with 56% last year. This seems to be a result of a slight change in composition of survey participants, as just one participant indicated that it had moved to a zerotrigger, and none reported that they were moving away from a zero trigger. However, one participant also reduced their trigger percentage, and one changed the pricing vendor they used to supply these factors.
- Thirty-five percent of FV survey participants whose firms offer both mutual funds and ETFs said their procedures for determining whether a foreign equityprice should be adjusted from its closing exchange price differed significantly between both product types, and 22% indicated that they are slightly different. Forty-three percent indicated they are exactly the same.
- Fifty-five percent and 71% of FV survey participants indicated that their policies and procedures differ between mutual funds and private funds and separateaccounts, respectively. Nearly half of those indicating differences noted that a fair value factor was not applied outside of their mutual funds.
- Eleven percent of FV survey participants changed theirprimary source for certain fixed-income securities in the past 12 months, compared with 31% who made the change last year. Seventeen percent added or changed secondary pricing sources for certain fixed- income securities, which is much lower than the 34% who reported such in the prior year. These are the lowest percentages we have seen for these questions in multiple recent surveys. It's uncertain whether this is a result of the impact of the pandemic, the finalization of the new rule, or other factors.
- Sixty percent of FV survey participants use bid pricing exclusively when valuing fixed-income securities, nearlyunchanged from the prior year.
- Seventy-nine percent value fixed-income investments using a price that considers information through 4 p.m.ET, an increase from the 69% reporting it last year.
- Just one FV survey participant changed policies or procedures relating to non-institutional-sized lots (odd lots). This is the smallest change in the past foursurveys, likely signaling that ongoing analysis does not reveal the need for any additional changes.
- Fifty percent of FV survey participants holding private equities indicated that their volume of privateequity positions has increased in the past 12 months as a result of new market acquisitions or through restructurings.
- Thirty-six percent of those FV survey participants holding investments in equity commitments (including, but not limited to, those associated with SPAC transactions) that are contingent on future events primarily focus on a probability analysis to assess the likelihood that contingencies will be met and determine whether any value exists. Twenty-four percent focus their analysis on a forward-looking method that considers future outcomes or scenarios and may assess potential volatility factors to determine the valueof the commitment, highlighting an area where a clear common practice does not yet exist.

- Fifty-four percent of FV survey participants noted that they made some changes to their policies andprocedures over the past year.

## Looking ahead

### September 8, 2022

As the fund groups have the opportunity to make changes now and through the FV Rule compliance date of September 8, 2022, we believe the formation of a working group made up of many voices and functions may be the best way to optimize implementation of the FV Rule. Looking beyond the mere goal of beingin regulatory compliance with the FV Rule to opportunities to strengthen the valuation operating model through, among other levers, technology tools and outsourcing specific activities will provide long-lasting efficiency and control.

Along the valuation journey, frequent touchpoints and collaboration with the fund board will be necessary to avoid any expectation gaps and provide comfortthat the board will be in a position to achieve active oversight and that the fundgroup will be able to manage SEC risk. It is important to continue to keep an eye on the SEC (especially true today, as the Division of Investment Management has not hired a division director) and other industry organizations to look for interpretive guidance that will not only seek to manage implementation risk, butalso reduce the amount of divergence in industry practice on day one.

### Third-party provider due diligence and extended enterprise risk

Sixty-seven percent of FV survey participants indicated they have performed a virtual visit of third-party pricing vendors. This is up from 36% the year before. Given the importance of pricing vendor due diligence in the FV Rule, we would expect this maturing trend to continue. Also, as fund groups make strategic decisions to outsource portions of the valuation process, heightened awareness should be placed on understanding vendor controls in areas such as application and general system controls (i.e., access and change management), cybersecurity, and business continuity. Fund groups should also understand if any third-party vendor services are outsourced to a fourth party or offshored. A clear understanding of where fund groups' data resides, how it is shared, and who ultimately performs services is critical in a time of crisis. Internal pricing committees (IPCs), the risk function, the chief compliance officer(s), and fund boards may reconvene to collectively agree on a different due diligence model going forward.

### The continuing role of technology

It seems clear that technological adoption and advancement will continue to affect the valuation process. They may be quick fixes to solve an immediate problem or make something easier. They may improve the overall workflow and control environment. Regardless of what they do, the work-from-home environment and future of work will likely cause at least a somewhat different approach and mindset for the fund group's operations, including the valuationfunction, and technology will likely be part of that evolution, just as it has beenduring the pandemic. Ensuring that adequate controls remain in place during the moments and activities outside core day-to-day processes will be key to avoid issues. Fund groups should also bring teams back more effectively by taking advantage of lessons learned during the pandemic and incorporating them into today's valuation operating model.

### Business continuity planning (BCP)

In the current year, 11%, versus 14% in 2020, made changes to their valuation function's BCP related to the investment valuation process. For example, one FV survey participant noted the creation of a new process using proxies in the event a vendor is unable to deliver prices on a given day. Another 14% indicatedthat they plan to adjust their BCP in the future.

Many matters associated with the pandemic discussed in last year's FV survey may represent continued risks in the future. The FV Rule will provide fund groups another opportunity to reassess valuation risks and consider how to manage them. In doing so, they can take what they have learned from the pandemic and reconsider whether new procedures should be developed, or existing processes modified, to improve their identification of and response to similar challenges in the future. For example, many fund groups have instituted flexible or dynamic price tolerances, as opposed to static tolerances used in the daily valuation process, to eliminate exceptions for positions where price may have moved significantly, albeit consistently with other similar securities or proxies. Management may also want to seek preapproval from boards for certain planned responses during a crisis, which could minimize the need for more detailed discussions on a real-time basis when time is of the essence.

However, this type of planning takes time, and some fund groups may feel they do not have the ability to devote resources to such an endeavor. Perhaps the keyto success is the extent of testing performed up front.

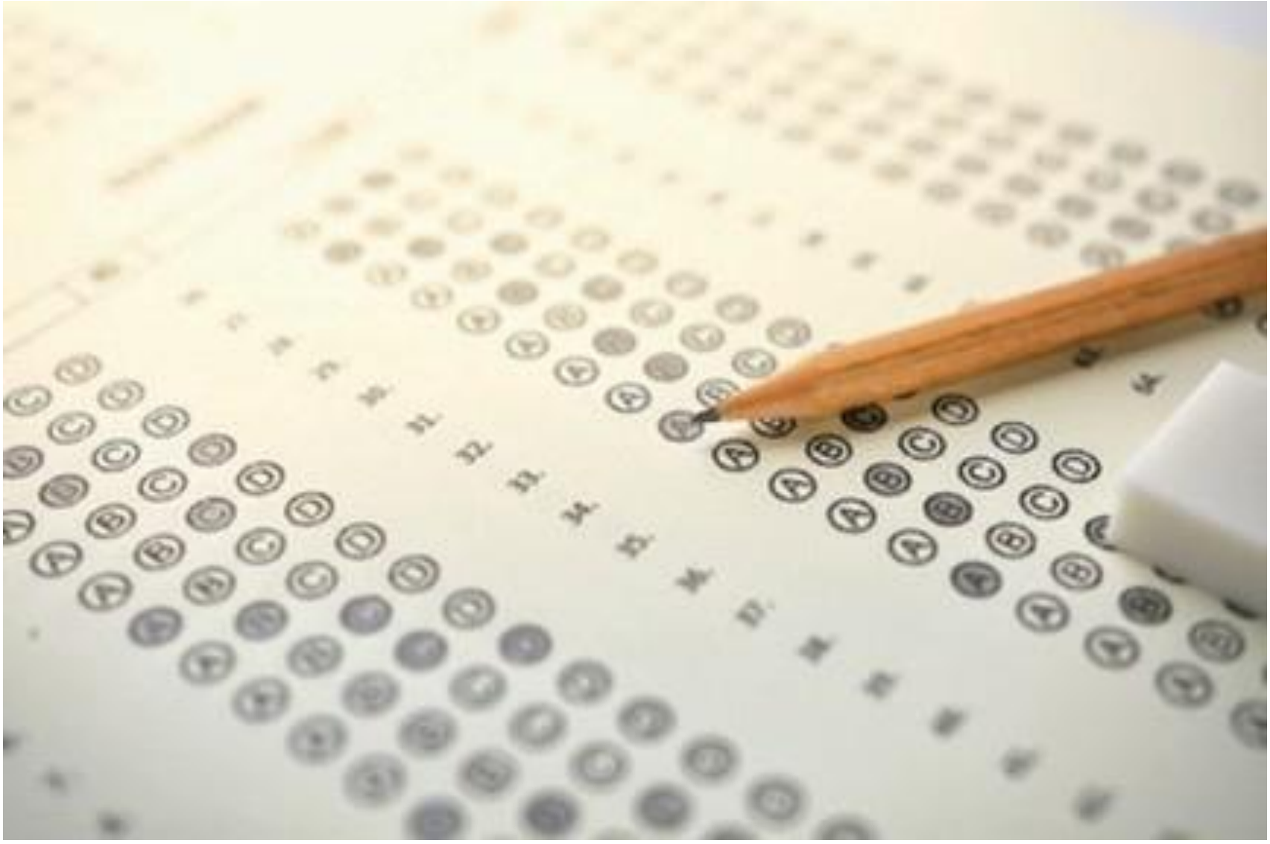
### Collaboration

Planning and being prepared for the next disruptive event are necessary to manage risk. The peer-to-peer sharing of information has always been critical to successfully weathering unexpected storms in the past. Whether it is in the face of the next storm or in working on the adoption of the FV Rule, understanding what others are learning, what they are exploring, and what they are actually doing will remain valuable to those responsible for maintaining an efficient and effectively functioning valuation process.

## Endnote

1. SEC, Final Rule 2a-5 – *Good Faith Determinations of Fair Value*, December 3, 2020.

# MULTIPLE CHOICE QUESTIONS



## ICMAI REGISTERED VALUERS' ORGANISATION

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# MULTIPLE CHOICE QUESTIONS

## MCQ for SFA

**1. If we compare GDP and GNP, then:**
a)GNP = GDP - net income from abroad
b)GNP = GDP + net income from abroad
c)GNP = NNP - net incomefrom abroad
d)GNP = NNP + net income from abroad

**Ans)** GNP = GDP + net income from abroad

**2. The value of national income adjusted for inflation is called**
a) Per capita income
b)Disposable income
c)Inflation rate
d)Real national income

**Ans)** Real national income

**3. The net value of GDP after deducting depreciation from GDP is**
a) Net national product
b) Net domestic product
c) Gross national product
d)Disposable income

**Ans)** Net domestic product

**4. Risk in capital budgeting implies that the decision maker knows _ of the cash flows.**
a) Variability
b)Certainity
c)Probability
d)UnCertainity

**Ans)** Probability

**5. Retained earnings are**
a) an indication of a company's liquidity
b) the same as cash in the bank.
c) not important when determining dividends.
d) the cumulative earningsof the company after dividends.
**Ans)** the cumulative earningsof the company after dividends.

**6. The market value of the firm is the result of__________**
a) dividend decisions
b) working capital decisions
c) capital budgeting decisions
d) trade off betweenrisk and return

**Ans)** trade off between risk and return

**7. Dividends are the ---------- of a company distributed amongst members in proportion to their shares**
a)Divisible profits
b)Indivisible profits
c)Reserves
d)Fund

**Ans)** Divisible profits

**8. Financial decision involve Investment decision, Dividend decisions, Financing decisions or Liquidity decisions**
a)Investment, financingand dividend decisions
b)Investment and financing
c)Investment,financing and liquidity decisions
d)financing and liquidity decisions

**Ans)** Investment, financingand dividend decisions

**9. Which of the following is not a capital budgeting decision?**
a) Expansion Programme
b)Merger
c) Replacement of an Asset
d)Inventory Level

**Ans)** Inventory Level

**10. What type of audit opinion is preferred when analyzing financial statements?**
a)Qualified
b)Adverse
c)Unqualified
d) All of the above

**Ans)** Unqualified

**11. Which of the following helps in analyzing return to equity shareholders?**
a) Net Profit Ratio
b) Earnings Per Share
c) Return of Assets
d) Return on Investments

**Ans)** Earnings Per Share

**12. In 'Percentage of Sales' Method of preparation of projected financial statements, the operating expenses should be projected on the basis of:**
a) % of Gross Profit
b) % of Cost of Goods Sold
c) % of Profit before Tax
d) % of Sales

**Ans)** % of Sales

**13. The best ratio to evaluate short-term liquidity is:**
a) Cash Ratio
b) Current Ratio
c) Working Capital Ratio
d) Debt to Asset Ratio

**Ans)** Cash Ratio

**14. Under which of the following kinds of business concepts it is assumed that the organization will last for a long time.**
a) Accounting Entity
b) Going Concern Entity
c) Money Measuring Entity
d)Accounting Period

**Ans)** Going Concern Entity

**15. The going concern concept is concerned with the following:**
a)Accounting for all enterprises as a going concern
b) Allowing predictions to be used in the preparation of financial statements
c) Valuing assets at their realisable amounts
d) Preparing financial statements based on the assumption that they will operate into the foreseeable future, and abandoning the concept if this assumption does not hold

**Ans)** Preparing financial statements based on the assumption that they will operate into the foreseeable future, and abandoning the concept if this assumption does not hold

**16. Companies not disclosing an immanent bankruptcy would violate the_**
a) Business Entity Concept
b) Going Concern Concept
c)Consistency Concept
d)Monetary Unit Assumption

## MULTIPLE CHOICE QUESTIONS

**Ans)** Going Concern Concept

**17.A declaration of solvency is required to be signed by the directors of the company in order for:**

a) the liquidation to proceed as a creditors voluntary winding-up;
b) the liquidation to proceed as a members voluntary winding-up;
c) the court to make an order for liquidation;
d) a liquidator to resign and the company to continue trading.

**Ans)** the liquidation to proceed as a members voluntary winding-up;

**18. Under which of the following condition can an Adjudicating Authority order the liquidation of corporate debtor:**

a) When the committee of creditors of corporate debtor decides to liquidate after thconfirmation of resolution plan
b) When half of the committee of creditors of corporate debtor decides to liquidatebefore the confirmation of resolution plan
c) When half of the committee of creditors of corporate debtor decides to liquidate after the confirmation of resolution plan
d) When the committee of creditors of corporate debtor decides to liquidate before the confirmation of resolution plan

**Ans)** When the committee of creditors of corporate debtor decides to liquidate before the confirmation of resolution plan

**19. What is the nature of liquidation order:**

a) Deemed to be a notice of discharge to the officers of the corporate debtor
b) Deemed to be a notice of discharge to the financial creditor
c) Deemed to be a notice of discharge to the officers and workmen of the corporatedebtor
d) Deemed to be a notice of discharge to the officers, employees and workmen of the corporate
debtor

**Ans)** Deemed to be a notice of discharge to the officers, employees and workmen of the corporate debtor

**20. The fees for the liquidation process shall be paid to the liquidator from the proceeds of ________________:**

a) Realised liabilities of corporate debtor
b) Liquidation estate
c) Liquidation fund
d) Capital Reserves of the corporate debtor

**Ans)** Liquidation estate

**21. Which of the following assets are included in the liquidation estate:**

a) assets held in trust for any third party
b) bailment contracts
c) tangible assets, whether movable or immovable
d) sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund

**Ans)** tangible assets, whether movable or immovable

**22. Which of the following assets are not included in the liquidation estate:**

a) tangible assets, whether movable or immovable
b) contractual arrangements which do not stipulate transfer of title but only use of theassets
c) assets that may or may not be in possession of the corporate debtor including but not limited to encumbered assets
d) assets subject to the determination of ownership by the court or authority

**Ans)** contractual arrangements which do not stipulate transfer of title but only use of the assets

**23. Which of the following is to be recovered first from the proceeds of liquidation estate**

a) insolvency resolution process costs and the liquidation costs
b) debts owed to a secured creditor
c) workmen's dues for a period of twenty-four months preceding the liquidation commencement ate
d) preference shareholders

**Ans)** insolvency resolution process costs and the liquidation costs

**24. Which of the following is to be recovered last from the proceeds of liquidation estate:**

a) debts owed to a secured creditor for any amount unpaid following the enforcementof security interest
b) any remaining debts and dues
c) workmen's dues for the period of twenty-four months preceding the liquidation commencement date
d) equity shareholders or partners

Ans) equity shareholders or partners

**25. The Indian Stamp Act, 1899 came into force on:**

a) 1st June 1899
b) 1st July 1899
c) 1st November 1899
d) 1st December 1899

**Ans)** 1st July 1899

**26. Any mark of seal or endorsement by any agency or person duly authorized by the state government, for the purpose of duty chargeable under Indian Stamp Act, 1899 is called ............ :**

a) Bond
b) Receipt
c) Bill of Exchange
d) Stamp

**Ans)** Stamp

**27. Every instrument written upon paper stamped with an impressed stamp shall be written in such manner that the stamp may appear on the ......... and cannot be used for or applied to any other instrument:**

a) Face of the instrument
b) Back of the instrument
c) Both (a) and (b)
d) None of the above

**Ans)** Face of the instrument

**28. All instruments chargeable with duty and executed by any person in India shall be stamped ........... :**

a) Before execution
b) At the time of execution
c) Before or at the time of execution
d) None of the above

**Ans)** Before or at the time of execution

**29. Every instrument chargeable with duty executed only out of India, and not being a bill of exchange or promissory note, may be stamped within .............. after it has been first received in India:**

a) One month
b) Two months

## MULTIPLE CHOICE QUESTIONS

c) Three months
d) Six months

**Ans)** Three months

**30. In which of the following instruments, expenses of providing proper stamp shall be borne by the person drawing, making or executing such instrument?**
a) Bill of exchange
b) Debenture
c) Promissory note
d) All of the above

**Ans)** All of the above

**31. Who has the adjudicating authority with respect to proper stamping?**
a) Magistrate
b) Collector
c) Bank Official
d) None of the above

**Ans)** Collector

**32. Fair value is focused on the assumptions of the market place and is not entity specific. Which of the following assumptions does Ind AS113 take into account?**
a) It takes into account any assumptions about the highest price that can be paid
b) It takes into account any assumptions about reliability
c) It takes into account any assumptions about risk
d) It takes into account any assumptions about going concern

**Ans)** c

**33. IFRS 13 does not specify the unit of account for measuring fair value. This means that it is left to the individual standard to determine the unit of account for fair value measurement. What is meant by the 'unit of account'?**
a) The collection of assets or liabilities of which these elements form part
b) The market value of the asset or liability
c) The single asset or liability or group of assets or liabilities
d) The value of the asset or liability

**Ans)** c

**34. Prices to be used under Ind AS113 are those in 'an orderly transaction'. what is meant by an orderly transaction?**
a) One that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities and to ensure that it is a forced transaction
b) One that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities and to ensure that it is not a forced transaction
c) One that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities and there has been significant trading in the asset or liability
d) One that assumes no exposure to the market for a period before the date of measurement to allow for normal marketing activities and to ensure that it is not a forced transaction

**Ans)** b

**35. 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 3 inputs?**
a) Inputs other than quoted prices that are directly or indirectly observable for that asset or liability
b) Unadjusted quoted prices in active markets for items identical to the asset or liability being measured
c) Inputs based on the highest and best use of the asset as determined by a market participant
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)** d

**36. The guidance includes enhanced disclosure requirements that could result in more work for reporting entities. Which of the following disclosures are not required by IFRS 13?**
a) Transfers between Levels 2 and 3
b) Information about the hierarchy level into which fair value measurements fall
c) Disclosures for Level 3 measurements that include a reconciliation of opening and closing balances
d) Methods and inputs to the fair value measurements

**Ans)** a

**37. Fair value is based on, which of the following concept?**
a) Market
b) Cost
c) Market or cost which ever is lower
d) Market or cost which ever is higher

**Ans)** Market

**38. Which of the following is external factors that can affect value?**
a) Product or service diversification
b) Management competence
c) Inflation
d) Inventory control
**Ans)** Inflation

**39. Principal methods of Valuation are:**
a) Market approach, Asset approach, Income approach
b) Discounted cash flow method,Net assets method, Market price method
c) Market approach, discounted cashflow method, Asset approach
d) Asset approach, Income approach, discounted cash flow method

**Ans)** Market approach, Asset approach, Income approach

**40. Investment value is the value**
a) to a particular investor
b) to a hypothetical investor
c) in the marketplace
d) in tax valuations

**Ans)** to a particular investor

**41. What are price-earnings valuations usually based on?**
a) Gross profit.
b) Operating profit.
c) EBITDA
d) Free cash flow.

**Ans)** EBITDA

**42. For which of the following types of company would Net AssetValue (NAV) probably be an unsuitable basis for valuation?**
a) A property investment company like Land Securities.

# MULTIPLE CHOICE QUESTIONS

b) An investment trust like Alliance Trust.
c) An advertising agency like M&C Saatchi
d) A mining company like BHP Billiton

**Ans)** An advertising agency like M&C Saatchi

**43. Allowing for bankruptcy costs and an increasing probability of bankruptcy with increasing financial leverage, we should expect __________ than would be the case without bankruptcy costs.**
a) the premium for business risk to be higher
b) the premium for business risk to be lower
c) the premium for financial risk should rise by less
d) the premium for financial risk should rise by more

**Ans)** the premium for financial risk should rise by more

**44. .........is the use of historic data to determine the direction of future trends:**
a) Due diligence
b) Due care
c) Forecasting
d) Projected report

**Ans)** Forecasting

**45. What is forecasting?**
a) A random target set as per the current performances
b) A scientific guesswork based upon serious study
c) Guessing the future outcome as per whims and whence of the forecasting
d) None of the above

**Ans)** A scientific guesswork based upon serious study

**46. Which of the following is not a forecasting tool?**
a) Cash Flow Statement
b) Production chart
c) Organization
d) None of the above

**Ans)** None of the above

**47. assume that a relationship exists between one or more items and that a change in one item will cause a change in the other:**
a) Scenario writing
b) Time series analysis
c) Causes model
d) Delphi technique

**Ans)** Causes model

**48. Which of the following is/are a forecasting technique?**
a) Judgemental
b) Time series
c) Associative
d) All of the above

**Ans)** All of the above

**49. .......... elements of a time series sit above or below the trend line and may recur for a year or longer:**
a) Cyclical
b) Trend
c) Seasonal
d) Irregular

**Ans)** Cyclical

**50. One of the quantitative techniques of forecasting is:**
a) Causes model
b) Time series analysis
c) Delphi technique
d) Scenario writing

**Ans)** Time series analysis

**51. assumes that forecasts from a group of individuals, with relevant expertise and experience, working in a systematic way, will be more useful than those from unstructured discussion group, where the individuals will have little opportunity to**
a) Delphi Technique
b) Causes model
c) Time series analysis
d) Scenario writing

**Ans)** Delphi Technique

**52. In cash flow statement, the item of interest is shown in:**
a) Financing Activities
b) Investing Activities
c) Operating Activities
d) Both (a) and (b)

**Ans)** Both (a) and (b)

**53. An example of a cash flow from a financing activity is:**
a) Receipt of cash from sale of land
b) Receipt of cash from collection of accounts receivable
c) Payment of cash for acquisition of treasury stock
d) Payment of cash for new machinery

**Ans)** Payment of cash for acquisition of treasury stock

**54. Which of the following is not a cash inflow?**
a) Decrease in creditors
b) Decrease in debtors
c) Sale of fixed assets
d) Issue of shares

**Ans)** Decrease in creditors

**55. Which of the following is not a cash outflow?**
a) Increase in stocks
b) Increase in prepaid expenses
c) Increase in creditors
d) Increase in debtors

**Ans)** Increase in creditors

**56. Discounted cash flow analysis is also classified as:**
a) Time value of bonds
b) Time value of money
c) Time value of gold
d) Time value of stock

**Ans)** Time value of money

**57. Where cash flows are more than capital invested for rate of return than Net Present Value will be:**
a) Positive
b) Independent
c) Zero
d) Negative

**Ans)** Positive

**58. In capital budgeting, a technique which is based upon Discounted Cash Flow is classified as:**
a) Net future value method
b) Net equity budgeting method
c) Net present value method
d) Net capital budgeting method

**Ans)** Net present value method

**59. If compounding is done quarterly**

## MULTIPLE CHOICE QUESTIONS

**in a year, the effective rate of interest is equal to:**
a)(1+nominal rate of interest)/4
b)(1+nominal rate of interest/4)4
c)4*nominal rate of interest
d)(Nominal rate of interest)/4

**Ans)** (1+nominal rate of interest/4)4

**60. Which of the following statements is correct concerning the weighted average cost of capital (WACC):**
a) The WACC may decrease as a firm's debt-equity ratio increases
b) In the computation of WACC, weight assigned to the preferred stock is based on the coupon rate multiplied by the par value of the stock
c) A firm's WACC will decrease as the corporate tax rate decreases
d) The weight of the common stock used in the computation of the WACC is based on the number of shares outstanding multiplied by the book value per share

**Ans)** The WACC may decrease as a firm's debt-equity ratio increases

**61. ........... is to provide a foundation for developing future expectations about the subject company by eliminating non-recurring, non-operating or discretionary items and to present the past results of the subject company on a consistent basis:**
a) Normalizing adjustments
b)Valuation premises
c)Valuation base
d)None of the above

**Ans)** Normalizing adjustments

**62. is based on the premise that an asset which is readily marketable commands a higher value than an asset which requires longer marketing period to be sold or an asset having restriction on its ability to sell:**
a) Discount for Lack of Control (DLOC)
b) Discount for lack of marketability (DLOM)
c) Both (a) and (b)
d) None of the above

**Ans)** Discount for lack of marketability (DLOM)

**63. Higher the liquidity and control, .......... would be the discount on valuation of the financial instrument:**
a)Higher
b)Lower
c) Both ways
d)None

**Ans)** Lower

**64. Funding Cost adjustment adjusts:**
a) Value for the implied benefit of upfront payments on derivatives
b) Value for implied cost of upfront payments on derivatives
c) The cost/benefit of interest on cash collateral
d) The cost of providing initial margin

**Ans)** Value for implied cost of upfront payments on derivatives

**65. Which of the following is the major difference between fixed maturity plans and fixed deposits?**
a) Fixed period investments
b)Guaranteed returns
c) Maturity periods options
d) All of the above

**Ans)** Guaranteed returns

**66. Which of the following is not the feature to invest in fixed income securities:**
a)Liquidity
b) Can be used as a collateral
c)Diversification
d)Cannot be used as a collateral

**Ans)** Cannot be used as a collateral

**67. Which of the following is a fixed income security?**
a)PPF
b)NSE
c) Post office monthly income scheme
d) All of the above

**Ans)** All of the above

**68. A fixed income security is issued by:**
a)Government
b)Corporations
c) Other entity
d) All of the above

**Ans)** All of the above

**69. Medium-term bonds have a maturity of:**
a) 1 to 3 years
b) 1 to 5 years
c) 3 to 5 years
d) 3 to 10 years

**Ans)**3 to 10 years

**70. A bond whose price is equal to its face value is called to be sold at:**
a)Par
b) Below par
c) Above par
d) None of the above

**Ans)** Par

**71. Treasury bills are issued at:**
a) Face value
b)Discount
c) Market value
d) Maturity value

**Ans)** Discount

**72. Treasury bills pay interest at:**
a) Coupon rate monthly
b) Coupon rate semi-annually
c) Coupon rate yearly
d) Bank rate yearly

**Ans)** Coupon rate semi-annually

**73. Government securities commonly referred as:**
a)G-Secs
b) Govt Securities
c) G Securities
d)Government Securities

**Ans)** G-Secs

**74. A commercial paper can be issued for the maximum duration of:**
a) 45 days
b) 90 days
c) 180 days
d) 364 days

**Ans)** 364 days

**75. What is the minimum maturity of a commercial paper:**
a) 3 days
b) 7 days
c) 15 days
d) 30 days

**Ans)** 7 days

# MULTIPLE CHOICE QUESTIONS

**76. Interest rate and bond prices are:**
a) Move in same direction
b) Move in opposite direction
c) Have no relationship
d) Sometimes in same direction, sometimes in opposite direction

**Ans)** Move in opposite direction

**77. Which of the following risk is involved in debt instrument?**
a) Liquidity risk
b) Reinvestment risk
c) Default risk
d) All of the above

**Ans)** All of the above

**78. Who or what is a person or institution designated by a bond issuer as the official representative of the bondholders?**
a) Indenture
b) Debenture
c) Bond
d) Bond Trustee

**Ans)** Bond Trustee

**79. What is the zest of the Supreme Court decision in the case of Hindustan Lever Employee's Union (Supra) (1995) Supp (1) SCC 499:**
a) The Jurisdiction of the court in sanctioning a claim of merger is not to ascertain mathematical accuracy if the determination satisfied the arithmetical test
b) A company court does not exercise an appellate jurisdiction. It exercises a jurisdiction founded on fairness
c) Both (a) and (b)
d) None of the above

**Ans)** Both (a) and (b)

**80. In the case of Hindustan Lever Employee's Union (Supra) (1995) Supp (1) SCC 499, the Supreme Court accepted the ratio of..........as income, market and asset approach on which the valuation was based:**
a) 0.042372685185
b) 0.043078703704
c) 0.084733796296
d) 0.084050925926

**Ans)** 0.084733796296

**The following information relates to Questions 81-84**

Darshan is an analyst and is responsible for issuing either a buy, hold, or sell rating for the shares of Company A and Company B. The appropriate valuation model for each company was chosen based on the following characteristics of each company:

Company A is an employment services firm with no debt and has fixed assets consisting primarily of computers, servers, and commercially available software. Many of the assets are intangible, including human capital. The company has a history of occasionally paying a special cash dividend.

Company B operates in three unrelated industries with differing rates of growth: tobacco (60% of earnings), shipbuilding (30% of earnings), and aerospace consulting (10% of earnings). The company pays a regular dividend that is solely derived from the earnings produced by the tobacco division.

Darshan considers the following development in making any necessary adjustments to the models before assigning ratings:

Company B has finalized the terms to acquire 70% of the outstanding shares of Company X, an actively traded tobacco company, in an all- stock deal.

Darshan assigns ratings to each of the companies and provides a rationale for each rating. The director of research asks Darshan: "How did you arrive at these recommendations? Describe how you used a top- down approach, which is the policy at our company."

Darshan replies, "I arrived at my recommendations through my due diligence process. I have studied all of the public disclosure documents; I have participated in the company conference calls, being careful with my questions in such a public forum; and I have studied the dynamics of the underlying industries. The valuation models are robust and use an extensive set of company- specific quantitative and qualitative inputs."

**81. Based on Company A's characteristics, which of the following absolute valuation models is most appropriate for valuing that company?**
a) Asset based
b) Dividend discount
c) Free cash flow to the firm
d) none of the above

**Ans)** Free cash flow to the firm

**82. Based on Company B's characteristics, which of the following valuation models is most appropriate for valuing that company?**
a) Asset based
b) Sum of the parts
c) Dividend discount
d) none of the above

**Ans)** Sum of the parts

**83. Which of the following is most likely to be appropriate to consider in Company B's valuation of Company X?**
a) Blockage factor
b) Control premium
c) Lack of marketability discount
d) none of the above

**Ans)** Control premium

**84. Based on Darshan's response to the director of research, Darshan's process could have been more consistent with the firm's policy by:**
a) incorporating additional micro- level inputs into her valuation models.
b) evaluating the impact of general economic conditions on each company.
c) asking more probing questions during publicly available company conference calls.
d) none of the above

**Ans)** evaluating the impact of general economic conditions on each company.

# MULTIPLE CHOICE QUESTIONS

The following information relates to Questions 85-87

| Company | Book Value of Equity 2015 (millions of $) | Sales 2015 (millions of $) | Shares Outstanding | Price ($) (millions) |
|---|---|---|---|---|
| Pfeiffer, Inc. | 19,950 | 32,373 | 6,162 | 31.37 |
| Mapps, Inc. | 61,020 | 32,187 | 10,771 | 25.63 |

| Peer Group | Mean P/B | Median P/B | Mean P/S (sales in millions of $) | Median P/S (sales in millions of $) |
|---|---|---|---|---|
| Medical-Drugs | 5.622 | 4.250 | 8.708 | 4.530 |
| Applications Software | 4.100 | 2.140 | 3.420 | 1.440 |

Pfeiffer belongs to the Medical-Drugs group and Mapps belongs to the Applications Software group.

**85. The current price-to-book and price-to-sales ratios for Pfeiffer are closest to:**

P/B P/S

a)3.238 5.254

b)3.238 5.971

c)9.688 5.971

d)none of the above

Ans) 3.238 5.971

**86. The current price-to-book and price-to-sales ratios for Mapps are closest to:**

P/B P/S

a)4.524 8.578

b)5.665 2.988

c)4.524 2.988

d)none of the above

Ans) 4.524 8.578

**87. Which of the following statements is most accurate, given the financial data on Pfeiffer, Mapps, and the two industries?**

a) Both stocks are relatively overvalued.

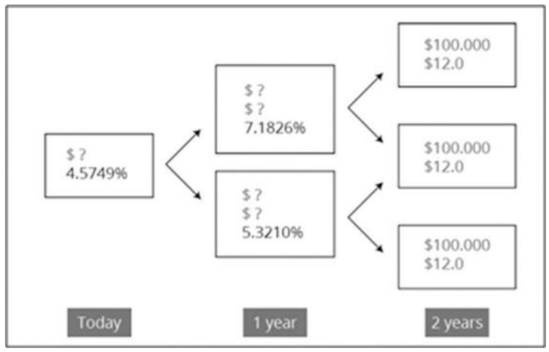
b) Both stocks are relatively undervalued.

c)One stock is relatively overvalued and the other is relatively undervalued.

d)none of the above

Ans) Both stocks are relatively overvalued.

The following information relates to Questions 88-90




**88. The value today of an option-free, 12% annual coupon bond with two years remaining until maturity is closest to:**

a)110.525.

b)111.485.

c)112.282.

d)none of the above

Ans) 112.282.

**89. The value of the bond and the value of the embedded call option, assuming the bond in Question 2 is callable at $105 at the end of Year 1, are closest to:**

| | Callable bond value | Embedded call option value |
|---|---|---|
| a) | 110.573 | 1.709 |
| b) | 110.573 | 0.642 |
| c) | 111.640 | 0.642 |
| d) | none of the above | |
| Ans) | 111.640 | 0.642 |

**90. The value of the bond and the value of the embedded put option, assuming the bond in Question 2 is putable at $105 at the end of Year 1, are closest to:**

| | Putable bond value | Embedded put option value |
|---|---|---|
| a) | 112.523 | 0.241 |
| b) | 112.523 | 1.646 |
| c) | 113.928 | 1.646 |
| d) | none of the above | |
| Ans) | 112.523 | 0.241 |

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
## Maharashtra Seamless Limited Vs Padmanabhan Venkatesh and Ors. (2020)

IN THE SUPREME COURT OF INDIA
Appellant: Maharashtra Seamless Limited Vs.
Respondent: Padmanabhan Venkatesh and Ors.

Civil Appeal Nos. 4242 and 4967-4968 of 2019
Decided On: 22.01.2020

### 1. Brief Facts of the Case

12th June 2017 – The National Company Law Tribunal, Hyderabad Bench admitted the petition filed under Section 7 of IBC, 2016 by Indian Bank and initiated the CIRP proceedings against the United Seamless Tubulaar Pvt. Ltd (hereinafter referred to as the Corporate Debtor).

The Resolution Professional so appointed received four resolution plans and same along with the liquidation value and fair value were placed before the Committee of Creditors (COC). In the 8th COC Meeting, the resolution plan submitted by Maharashtra Seamless Ltd. was approved by the majority of COC by 87.10% of voting share, consisting of the Deutsche Bank International (Asia) Limited holding 73.40% vote share and the Indian Bank holding 12.90% voting share in the CoC.

Two Registered Valuers were initially appointed by the Resolution Professional for determining the value of the Corporate Debtor. Their valuations were to the tune of Rs. 681 crores and Rs. 513 crores respectively. On account of substantial difference in their valuations, the Committee appointed a third Valuer. They valued the Corporate Debtor at Rs. 352 crores. The Committee thereafter took into consideration the average of the two closest estimates of valuation and liquidation value was assessed to be Rs. 432.92 crores.

### 2. Regulations pertaining to Valuation under Insolvency and Bankruptcy Code, 2016

There are two important Regulations under the Insolvency and Bankruptcy Code 2016 which provide guidelines with respect to Valuation.

**i. Regulation** 27 of **Insolvency and Bankruptcy Board** of India **(Insolvency Resolution Process for Corporate Persons) Regulations, 2016: -**

Under Regulation 27, a Resolution Professional has to

a. Appoint two Registered Valuers;
b. Within seven days of his appointment, but not later than forty- seventh day from the insolvency commencement date;
c. to determine the fair value and the liquidation value of the corporate debtor in accordance with Regulation 35;

Further Regulation 27 clearly spells out that the following shall not be appointed as a Registered Valuer by Resolution Professional: -

a. a relative of the Resolution Professional;
b. a related party of the corporate debtor;
c. an auditor of the corporate debtor at any time during the five years preceding the insolvency commencement date; or
d. a partner or director of the Insolvency Professional Entity of which the Resolution Professional is a partner or director;

**ii. Regulation** 35 **(1)** of **Insolvency and Bankruptcy Board** of India **(Insolvency Resolution Process for Corporate Persons) Regulations, 2016: -**

**a. Requirements from a Registered Valuer under Regulation 35(1)**

i. The two Registered Valuers firstly need to undertake physical verification of the inventory and fixed assets of the Corporate Debtor;
ii. Thereafter the two Registered Valuers shall estimate the fair value and the liquidation value in accordance with internationally accepted valuation standards;
iii. The two Registered Valuers shall then submit their report to the Resolution Professional;
iv. The Registered Valuers shall maintain confidentiality of the fair value and the liquidation value.

**b) Requirements from** a **Resolution Professional under Regulation 35(1)**

i. If in his opinion the two estimates of value are significantly different, he may appoint another Registered Valuer who shall submit an estimate of the value computed in the same manner; and
ii. He needs to consider the average of the two closest estimates of a value to determine the fair value or the liquidation value;
iii. Resolution Professional shall provide the fair value and the liquidation value to every member of the committee in electronic form, on receiving an undertaking from the member to the effect that such member shall maintain confidentiality;
iv. The Resolution Professional shall maintain confidentiality of the fair value and the liquidation value;

Further, the term '"Fair Value" and "Liquidation Value" have been defined under Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (hereinafter referred to as CIRP Regulations, 2016) as follows:

*"Clause 2(hb): "Fair Value" means the estimated realizable value of the assets of the corporate debtor, if they were to be exchanged on the insolvency commencement date between a willing buyer and a willing seller in an arm's length transaction, after proper*

*marketing and where the parties had acted knowledgeably, prudently and without compulsion.*

*Clause 2(k): "Liquidation Value" means the estimated realizable value of the assets of the corporate debtor, if the corporate debtor were to be liquidated on the insolvency commencement date.*

**3. Case Analysis – Observations** and **Directions** in **Orders issued** by NCLT and NCLAT

**a. 28th September 2018** – NCLT **Order**

The Resolution Professional filed an application before the NCLT Bench of Hyderabad for the approval of the Resolution Plan of Maharashtra Seamless Ltd. (hereinafter referred to as MSL). The NCLT Bench disposed-off the application and further directed the Resolution Professional to re-determine the liquidation value of the Corporate Debtor by taking into consideration the average of the first and second valuation and consequently, the valuation was revised from INR 432.92 Crores to INR 597.54 Crores. The Adjudicating Authority directed the Resolution Professional to convene a meeting of the Committee of Creditors to place the qualified Resolution Plan for reconsideration in light of revised liquidation value of the Corporate Debtor.

**b. 12th November** 2018 – NCLAT **Order**

The aforesaid order of the NCLT Bench of Hyderabad was challenged before the National Company LawAppellate Tribunal ("NCLAT") by the Resolution Applicant, Maharashtra Seamless Limited. The Tribunal vide its order dated 12th Nov 2018 disposed of the appeal with directions to the NCLT Bench of Hyderabad to pass orders on the Resolution Plan under Section 31 of the IBC, 2016.

**c. 21st January** 2019 – **2nd** NCLT **Order – observations therein**

The National Company Law Tribunal, Hyderabad Bench by an order dated 21.01.2019, approved the Resolution Plan proposed by MSL which involved an upfront payment of Rs. 477 Crores and additional fund infusion on the takeover of Corporate Debtor. The Adjudicating Authority, inter-alia, held.

*The CoC has examined all eligible resolution plans again in the 9th CoC meeting held on 16.10.2018. The Resolution Plan submitted by M/s MSL is below the revised Liquidation Value. The difference is about Rs. 120 crores. However, as per directionsoftheHon'bleNCLAT,thisTribunaltodecidethe plan filed by M/s. MSL without being influenced by its previous order.*

The Adjudication Authority held that as per the order of the NCLAT the Tribunal has to observe question whether the plan submitted by M/s MSL is in conformity with Section 30(2) of the IBC, 2016 and if it is in conformity, then the plan is to be approved under Section 31 of the IBC, 2016. The Liquidation Value prior to re-determination if taken into account, the upfront payment offered by M/s MSL is over and above the Liquidation Value. Therefore, the objection taken by the Director (Suspended Board) and also Indian Bank could notbetakenintoaccountinviewofthedirectionof Hon'bleNCLAT.

**d. 8th April** 2019 – **2nd NCLAT Order**

A number of parties raised objections against the 'Resolution Plan' submitted by 'M/s. Maharashtra Seamless Ltd.' – ('Resolution Applicant') on different

grounds and accordingly, appeals were filed against the same before NCLAT. One of the key grounds was that the approval of the Resolution Plan amounting to Rs. 477 crores were giving the Resolution Applicant windfall gain as they would get assets valued at Rs. 597.54 crores at a much lower amount.

The parties contended that the 'Resolution Plan' is below the liquidation value and the fair value should be adopted before approval ofthe'ResolutionPlan'. The other ground taken by the objectors was that one of the other Resolution Applicants had made a revised offer of Rs. 490 crores, which was more than the amount offered by the MSL.

In this regard, the Resolution Applicant submitted as under: -

- Asper'M/s.MaharashtraSeamlessLtd.'their totalexposure was around Rs. 657.50 crores wherein Rs. 477 crores was upfront amount and in addition to that Rs. 180.50 crores were to be infused directly by them. Further, Rs. 57 crores was to be infused towards 25% margin money of working capital expenditure. Moreover, in fact, the total working capital requirement was Rs. 224 crores, and the balance was to be taken as a loan from Bank(s), which would also require corporate guarantees.
- It was further contended that the Corporate Debtor's plant has been lying closed for the last three years therefore; the aforesaid infusion of funds by MSL aggregating to Rs. 657.50 crores was for the maximization of the assets of the 'Corporate Debtor'.

The NCLAT held that since the amount provided in the Resolution Plan was lower than the average of the liquidation value arrived at by the Valuers, therefore, the Resolution Plan approved by the Adjudication Authority is against Section 30(2) of the IBC, 2016 and is against the statement and object of the 'I&B Code, 2016'.

It held that *"'M/s. Maharashtra Seamless Ltd.'should increase upfront payment of Rs. 477 Crores as proposed to the 'Financial Creditors', 'Operational Creditors'andotherCreditorstoRs.597.54 Crores by paying additional Rs.*

*120.54 Crores approximately to make it at par with the average liquidation*

*value of Rs. 597.54 Crores."*

It held that if the 'Resolution Applicant' modifies the 'Resolution Plan', as ordered above and deposits another sum of Rs. 120.54 Crores within 30 days, by improving the plan, the Adjudication Authority will allow 'M/s. Maharashtra Seamless Limited' to take over the possession of the 'Corporate Debtor' including its moveable and immoveable assets and the plant. On failure, the plan approved in favour of 'M/s. Maharashtra Seamless Ltd.' deemed to be set

**3. 22nd January 2020 – Order of the Hon'ble Supreme Court of India**

**Grounds of Admission**

Aggrieved by the decision of NCLAT, the M/s. Maharashtra Seamless Ltd. preferred an appeal before the Hon'ble Supreme Court of India. The two primary issues for consideration before the Apex Court was whether the scheme of the Insolvency & Bankruptcy Code, 2016 contemplates that the sum forming part of the resolution plan should match the liquidation value or not and whether Section 12-A of the IBC, 2016 is the applicable route through which a successful Resolution Applicant can retreat.

**Judgement**

The Hon'ble Supreme Court held as under: -

i. No provision in the IBC, 2016 or IBBI Regulations has been brought to our notice under which the bid of any Resolution Applicant has to match liquidation value arrived at in the manner provided in Clause 35 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016.

ii. The objective behind prescribing such valuation process is to assist the CoC to take decision on a Resolution Plan properly. Once, a resolution plan is approved by the CoC, the statutory mandate on the Adjudicating Authority under Section 31(1) of the IBC, 2016 is to ascertain that a resolution plan meets the requirement of sub-sections (2) and (4) of Section 30 thereof.

iii. MSL cannot withdraw from the proceeding in the manner they have approached the Court. The exit route prescribed in Section 12-A of the IBC, 2016 is not applicable to a Resolution Applicant. The procedure envisaged in the said provision only applies to applicants invoking Sections 7, 9 and 10 of the IBC, 2016.

iv. Court ought to cede ground to the commercial wisdom of the creditors rather than assess the Resolution Plan on the basis of quantitative analysis. Such is the scheme of the IBC, 2016. Section 31(1) of the IBC, 2016 lays down in clear terms that for final approval of a Resolution Plan, the Adjudication Authority has to be satisfied that the requirement of sub- section (2) of Section 30 of the IBC, 2016 has been complied with.

The Supreme Court, after taking into consideration the facts of the case held that there is no breach of the provisions of the IBC, 2016 or the Regulations thereunder; upheld the order of the Adjudicating Authority approving the Resolution Plan and set aside the order of NCLAT dated 8 April, 2019.

4. Key **Learnings for Valuers** from **the above Case**

The Preamble of the Insolvency & Bankruptcy Code, 2016 states: -

*"An Act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.* "

Hence, the IBC, 2016 effectively lays emphasis on reorganisation and insolvency resolution, albeit in a time bound manner to promote going concern, with liquidation as the last resort. The IBC, 2016 is first and foremost, a Code for reorganisation and insolvency debtors. Unless such reorganisation is effected in a time-bound manner, the value of the assets of such persons will deplete. Therefore, maximisation of value of the assets of such persons so that they are efficiently run as going concerns is another very important objective of the IBC, 2016.

The Adjudicating Authorities have to act on substantive matters of law and concede to the wisdom of the COC on commercial aspects provided other legal requirements have been met.

The Valuation process prescribed under the IBC, 2016 is to assist the Committee of Creditors to take decision on the resolution plan and no provision in the IBC, 2016 or Regulation thereunder lays down that the bid of any Resolution Applicant has to match liquidation value arrived at in the manner provided in clause 35 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016.

## Alok Kaushik Vs Bhuvaneshwari Ramanathan and Ors (2021)

**IN THE SUPREME COURT OF INDIA**

Appellant: Alok Kaushik Vs.

**Respondent: Bhuvaneshwari Ramanathan and Ors.**

Civil Appeal No. 4065 of 2020

Decided On: 15.03.2021

**1. Brief Facts of the** Case

- The Appellant was appointed as a Registered Valuer of the Corporate Debtor, under Regulation 27 of the Insolvency and Bankruptcy Board of India Regulations, 2016. The Appellant was appointed to value the plant and machinery of "Kavveri Telecom Infrastructure Limited" (hereinafter referred to as "Corporate Debtor") across India.
- The Appellant's appointment fee and other expenses were ratified by the Committee of Creditors (CoC), led by second respondent.
- The Appellant claimed to have conducted valuation work of over eighty- four sites and to have visited forty sites. Further, several outstation meetings were also stated to have been conducted between the Appellant and the first Respondent i.e., the Resolution Professional.

- The National Company Law Appellate Tribunal (NCLAT) set aside the initiation of CIRP against the Corporate Debtor. The NCLAT remanded the matter back to the NCLT to decide on the issue of CIRP costs. The NCLT decided on the fee of the Resolution Professional and reduced it by twenty percent from the fee ratified by the CoC.
- In view of the order of the NCLAT, the Resolution Professional cancelled the appointment of the Appellant. In relation to the fee payable to the Appellant, the first Respondent requested him to consider a waiver. In return, the Appellant agreed to reduce his fee by twenty five percent from the fee ratified by the CoC, along with the expenses payable. However, the first Respondent informed the Appellant that the fee as ratified could not be paid and paid a certain sum.
- The Appellant then filed an application under Section 60(5) of the Insolvency and Bankruptcy Code, 2016 before the NCLT challenging the non-payment of the fees. However, the NCLT dismissed the application concluding that it had been rendered functus officio. In appeal, the NCLAT rejected the contention of the Appellant, noted that a certain amount had already been paid over (Rs. 50,000/-).

2. Key **Grounds of Appeal**

The real issue which has been sought to be canvassed in the appeal is that in a situation such as present, where the CIRP was set aside by the Appellate Authority, there has to be within the framework of the Insolvency and Bankruptcy Code, 2016 (IBC, 2016) a modality for determining the claim of a professional valuer such as the Appellant.

**3. Decision**

The Hon'ble Supreme Court set aside the impugned judgment and order of the NCLAT and remitted the proceedings back to the NCLT for determining the claim of the Appellant for the payment of the professional charges as a Registered Valuer appointed by the Resolution Professional in pursuance of the initiation ofthe CIRP. The Hon'bleApex Courtheldas under: -

i. The view of NCLT that it was rendered functus officio in relation to the Appellant's claim is an incorrect reading of the jurisdiction of the NCLT as an Adjudicating Authority under the IBC. The Hon'ble Apex Court relied upon its decision in the case *of Gujrat Urja Vikas Nigam Ltd. Vs. Amit Gupta and Ors.* and held that though the CIRP was set aside later, the claim of the Appellant as Registered Valuer related to the period when he was discharging his functions as a Registered Valuer appointed as an incident of the CIRP and hence, the NCLT would have been justified in exercising its jurisdiction under Section 60(5)(c) of the IBC, 2016 and, in exercise of jurisdiction under Article 142 of the Constitution to make a determination of the amount which is payable to an expert Valuer as an intrinsic part of the CIRP costs.

ii. The Appellant was justified in contending that there must be a forum within the ambit and purview of the IBC, 2016 which had the jurisdiction to make a determination on a claim of the present nature, which had been instituted by a Valuer who was appointed in pursuance of the initiation of the CIRP by the Resolution Professional.

iii. Regulation 34 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 20161 defines 'insolvency resolution process cost' to include the fees of other professionals appointed by the Resolution Professional.

iv. The availability of a grievance redressal mechanism under the IBC, 2016 against an Insolvency Professional does not divest the NCLT of its jurisdiction under Section 60(5)(c) of the IBC, 2016 to consider the amount payable to the Appellant. In any event, the purpose of such a grievance redressal mechanism was to penalize errant conduct of the RP and not to determine the claims of other professionals which form part of the CIRP costs.

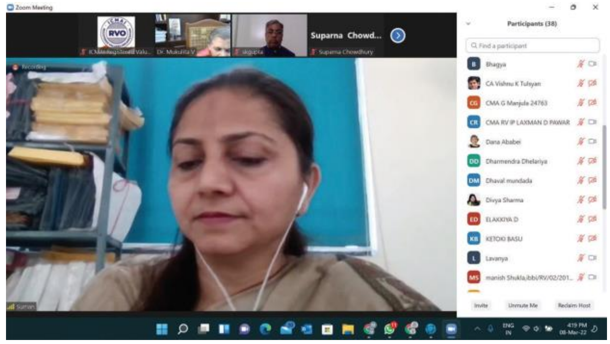
4. Key **Learnings for Valuers** from **the above Case**

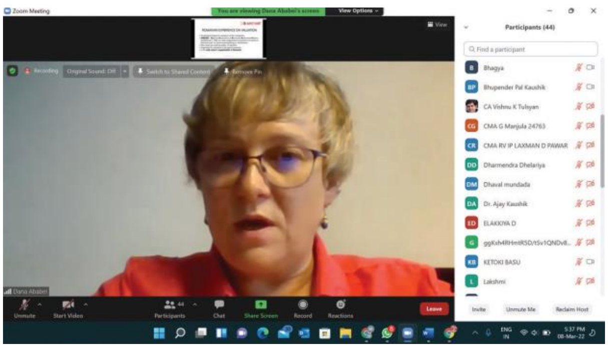
i. Section 217 of the IBC 2016 empowers a person aggrieved by the functioning of a Resolution Professional to file a complaint to the IBBI. If the IBBI believes on the receipt of the complaint that any Resolution Professional has contravened the provisions of IBC 2016 or the Rules, Regulations or Directions issued by the IBBI, it can, under Section 218 of the IBC 2016 direct an inspection or investigation. Under Section 220 of the IBC 2016, IBBI can constitute a Disciplinary Committee to consider the report submitted by the Investigating Authority. If the Disciplinary Committee is satisfied that sufficient cause exists, it can impose a penalty.

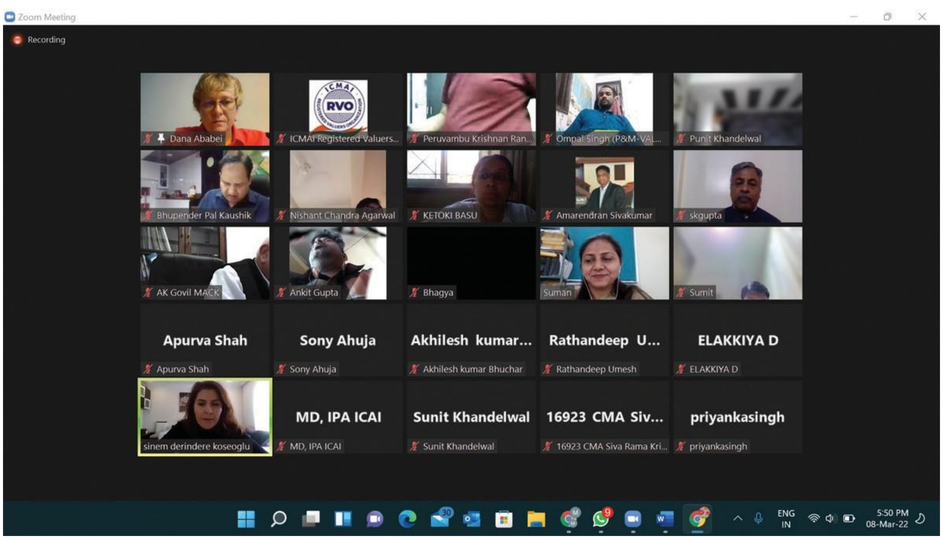
ii. The availability of above grievance redressal mechanism under the IBC 2016 against an Insolvency Professional does not divest the NCLT of its jurisdiction Under Section 60(5)(c) of the IBC 2016 to consider the amount payable to a Registered Valuer appointed under the IBBI Regulations. The purpose of such a grievance redressal mechanism is to penalize errant conduct of the RP and not to determine the claims of other professionals which form part of the CIRP costs.

iii. A Registered Valuer appointed under Regulation 27 of the Insolvency and Bankruptcy Board of India Regulations, 2016 can approach NCLT to settle its claims forming part of CIRP cost as NCLT in exercising its jurisdiction under Section 60(5)(c) of the IBC 2016 and, in exercise of jurisdiction under Article 142 of the Constitution, can make a determination of the amount which is payable to an expert valuer as an intrinsic part of the CIRP costs.

# INTERNATIONAL WOMEN'S DAY PROGRAM ON 8th March 2022





## ICMAI Registered Valuers Organisation
## &
## Insolvency Professional Agency of IPA ICAI

Seminar on

# "EVOLUTION AND EMERGING SCENARIO UNDER INSOLVENCY & BANKRUPTCY CODE & VALUATION"

**Organised on 02nd March 2022**

*Venue:- Mirza Ghalib Chamber, Scope Convention Centre, CGO Complex, New Delhi*



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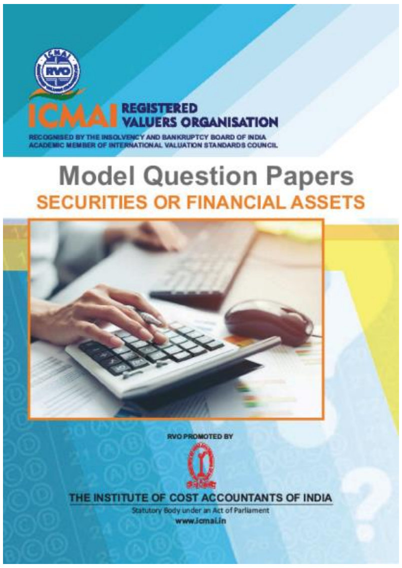
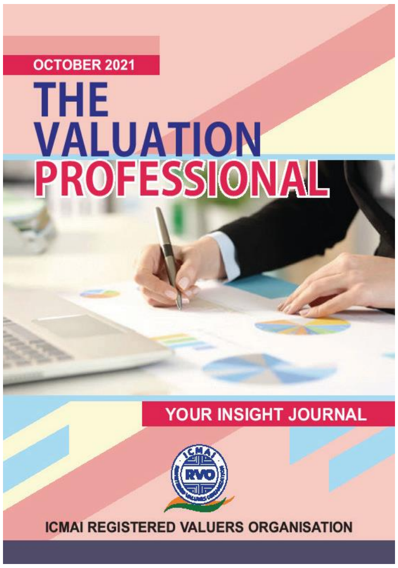
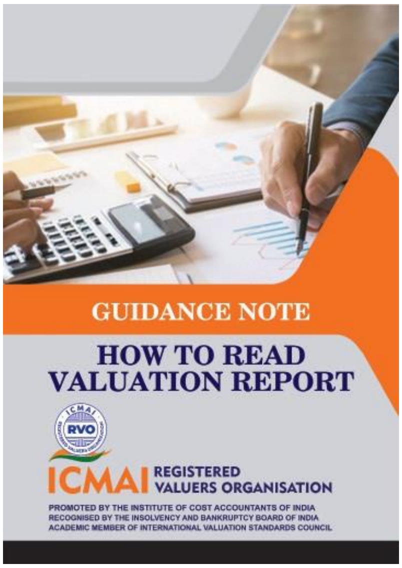
# PUBLICATIONS



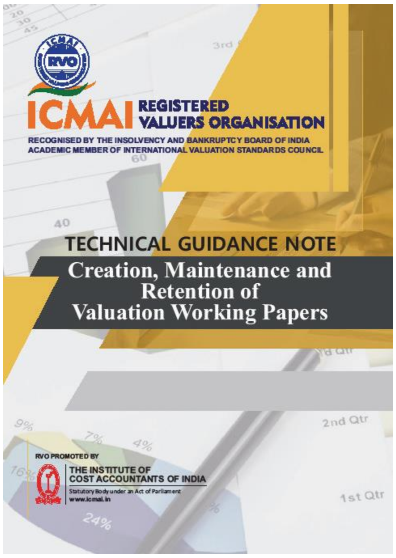

Model Question Papers
Securities or Financial Assets



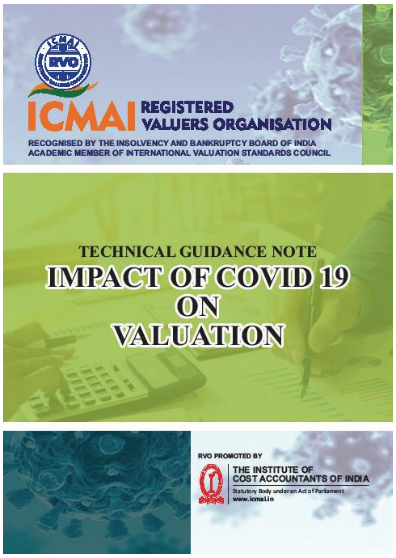

The Valuation Professional




Guidance Note
How to Read Valuation Report




Technical Guidance Note
Creation Maintenance and
Retention of Valuation




Technical Guidence Note
Impact of Covid 19
on Valuation

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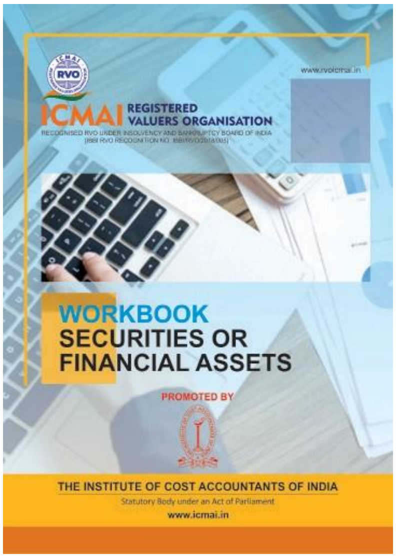
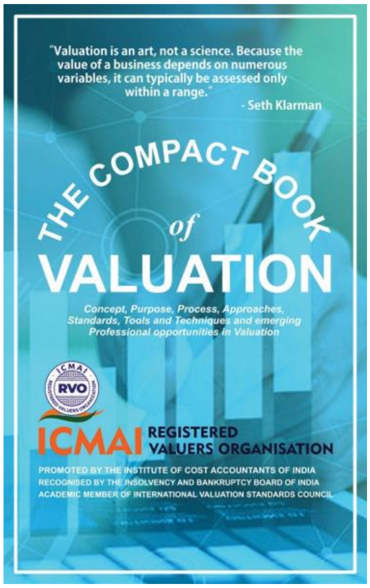
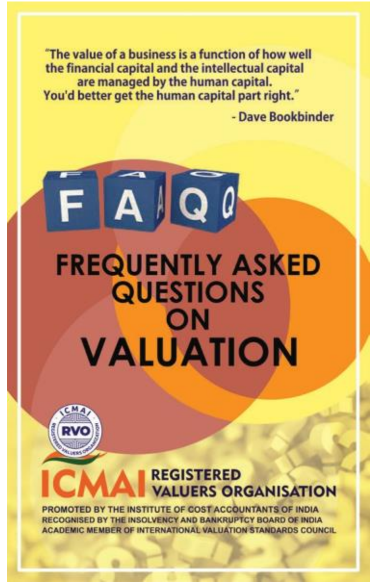


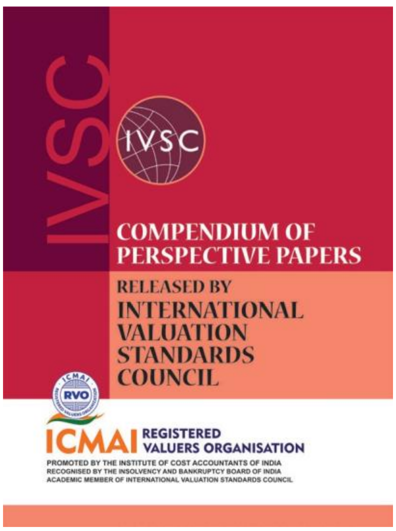

Work Book
Securities or Financial Assets



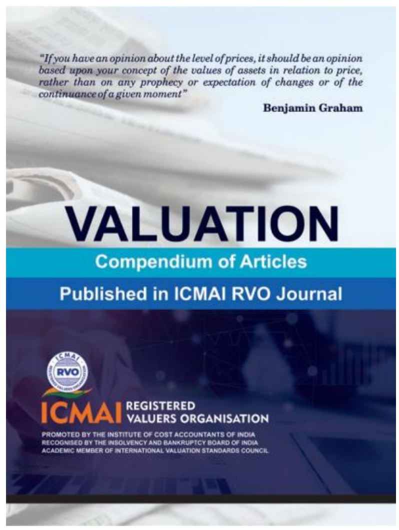

The Compact Book of
Valuation




FAQ
Frequently Asked Questions on
Valuation




Compendium of
Perspective Papers




Compendium of Articles

**Link:-** https://www.rvoicmai.in/publication/

# Ambassadors-ICMAI RVO

| Sl. No. | EMAIL | Name of RV | Place | Asset Class | CA/CMA/ CS/MBA/ Engineer | MOBILE |
|---|---|---|---|---|---|---|
| 1 | ajeeshrsnair@gmail.com | Ajeesh R S Nair | THIRUVANANTHAPURAM , KERELA | Securities or Financial Assets | CMA | 9995167649 |
| 2 | acrout.carv@gmail.com | Alekha Charan Rout | PUNE , MAHARASHTRA | Securities or Financial Assets | MBA | 754212 |
| 3 | mehta_amish@hotmail.com | Amish Shashikant Mehta | MUMBAI , MAHARASHTRA | Securities or Financial Assets | CMA,CA | 9820781780 |
| 4 | caamit02@hotmail.com | Amit Bhatia | YAMUNANAGAR , HARYANA | Securities or Financial Assets | CA | 9896595019 |
| 5 | amitbindlish@gmail.com | Amit Bindlish | GURUGRAM , HARYANA | Securities or Financial Assets | CMA | 9717948889 |
| 6 | anilxavier.v@gmail.com | Anil Xavier | ERNAKULAM , KERALA | Securities or Financial Assets | CMA,CS | 9349895916 |
| 7 | gupta.ankit2002@gmail.com | Ankit Gupta | MUKERIAN , PUNJAB | Securities or Financial Assets | CMA | 8837784662 |
| 8 | ashutosh_debata@rediffmail.com | ASUTOSH DEBATA | BHUBANESWAR , ORISSA | Securities or Financial Assets | CMA | 9437060997 |
| 9 | cmablgurjar@gmail.com | Babu Lal Gurjar | JAIPUR , RAJASTHAN | Securities or Financial Assets | CMA | 9414097481 |
| 10 | patra.debayan@gmail.com | Debayan Patra | KOLKATA , WEST BENGAL | Securities or Financial Assets | CA | 9331016968 |
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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
- Mergers and Aquisionts
- Demergers
- Scheme of compromise or arrangement with creditors/ member
- 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

# Process for becoming Register Valuer

1. Meet eligibility requirements, qualification and experience prescribed under Rule 4 of the Companies (Registered Valuers and valuation) Rules, 2017
2. Seek enrolment as a valuer member of ICMAI RVO
3. Complete 50 Hours Educational Course
4. Register and pass computer based Examination conducted by IBBI
5. Submit required Form along with fee in favour of IBBI and supporting documents to ICMAI RVO
6. ICMAI RVO shall verify Form & other Requirements and forward the same along with its recommendation to IBBI
7. On receipt of Form along with recommendation of ICMAI RVO, fee and other documents, IBBI shall Process the application for registration
8. After registration with IBBI, take up COP training with ICMAI RVO
9. On completion of training ICMAI RVO shall issue a Certificate of Practice to the Registered Valuer
10. Valuation certificate can be issued only after obtaining Certificate of Practice

## 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.

ICMAI REGISTERED VALUERS ORGANISATION

RECOGNISED RVO UNDER INSOLVENCY AND BANKRUPTCY BOARD OF INDIA

## 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.

ICMAI REGISTERED VALUERS ORGANISATION

RECOGNISED RVO UNDER INSOLVENCY AND BANKRUPTCY BOARD OF INDIA

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