Navigating the Art and Science of Valuation

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Overview

Valuation, the process of determining the worth of an asset or a company, is a critical aspect of the financial landscape. Whether it's assessing the value of a business for a potential sale, estimating the worth of securities, or evaluating the fair value of tangible assets, the art and science of valuation play a pivotal role in decision-making across various industries. In this article, we delve into the intricacies of valuation, exploring the approaches, methodologies, and factors that contribute to this nuanced practice. Valuation, is an art, not an exact science. Mathematical certainty is not demanded nor indeed is it possible – Viscount Simon, an acknowledged authority of all times on income-tax law of England Gold Coast Selection Trust Ltd. vs. Humphrey [1949] 17 ITR (Suppl.) 19 (HL).

1. Valuation Approaches

a. *Income Approach*

The income approach values an asset based on its income-producing capability. Methods like Discounted Cash Flow (DCF) and Capitalization of Earnings fall under this category, emphasizing the present value of future cash flows.

b. *Market Approach*

The market approach relies on comparing the asset with similar assets in the market. Comparable Company Analysis (CCA) and Precedent Transaction Analysis (PTA) are common methods, providing a benchmark by considering market prices and multiples.

c. *Asset-Based Approach*

This approach assesses the value of assets and liabilities, focusing on the net asset value. Particularly relevant for tangible assets and real estate, this approach is vital in determining the value of a company's equity.

2. Methodologies in Valuation

a. *Discounted Cash Flow (DCF)*

DCF is a widely used method that involves projecting future cash flows and discounting them back to present value. It requires careful consideration of growth rates, discount rates, and terminal values.

b. *Comparable Company Analysis (CCA)*

CCA involves comparing financial ratios and multiples of a target company to those of similar, publicly traded companies. This method requires access to a comprehensive database of comparable companies.

c. *Precedent Transaction Analysis (PTA)*

PTA looks at the multiples paid in similar transactions, providing insights into what acquirers have been willing to pay for comparable assets. It considers the acquisition prices of similar companies.

3. Factors Influencing Valuation

a. *Market Conditions*

Economic conditions, industry trends, and market volatility significantly impact the valuation of assets. Understanding the broader market context is crucial for accurate assessments.

b. *Company-Specific Factors*

The unique characteristics of a company, including its growth prospects, competitive position, management team, and risk profile, play a pivotal role in valuation.

c. *Regulatory Environment*

Valuation practices are often subject to regulatory frameworks and accounting standards. Adhering to these regulations is essential for maintaining transparency and compliance.

4. Technology and Valuation

a. *Data Analytics*

The advent of data analytics has revolutionized the valuation process. Advanced modeling techniques and big data analytics enable more accurate predictions and assessments.

b. *Machine Learning*

Machine learning algorithms can analyze vast datasets, identifying patterns and trends that may not be immediately apparent. This technology enhances the precision of valuation models.

5. Industry-Specific Considerations

a. *Real Estate Valuation*

Real estate valuation involves assessing factors such as location, property condition, and market demand. Methods like the Comparable Sales Approach and Income Capitalization Approach are common.

b. *Startup Valuation*

Startups, often lacking historical financial data, may require unique valuation methods like the Risk Factor Summation approach or the Berkus Method, which consider qualitative aspects.

Valuation is an intricate dance between art and science, requiring a deep understanding of financial principles, market dynamics, and the unique attributes of the asset or company in question. Whether it's a seasoned financial analyst evaluating a publicly traded company or an entrepreneur determining the value of their startup, the principles of valuation serve as a compass in the complex world of finance. As technology continues to advance, so too will the sophistication of valuation methodologies, ensuring that this essential practice remains at the forefront of informed decision-making in the ever-evolving global economy.

Broad contents of valuation report

A valuation report is a comprehensive document that communicates the methods, assumptions, and findings of the valuation process. It serves to provide stakeholders with a clear and transparent understanding of how the valuation was conducted and the factors that influenced the final value. While the specific contents may vary based on the nature of the valuation and applicable standards, here is a general outline of what a valuation report may include:

1. Executive Summary:

- Brief overview of the valuation purpose and objectives.
- Summary of key findings and the final valuation conclusion.
- Any significant assumptions or limitations.

2. Introduction

- Background information on the entity being valued.
- Purpose of the valuation (e.g., merger and acquisition, financial reporting, tax purposes).
- Scope of the valuation engagement.

3. Valuation Approaches and Methods

- Explanation of the approaches used (Income Approach, Market Approach, Asset-Based Approach).
- Detailed discussion of the specific valuation methods employed (Discounted Cash Flow, Comparable Company Analysis, etc.).
- Rationale for selecting particular methods based on the nature of the subject being valued.

4. Financial Analysis

- Historical and forecasted financial statements, if applicable.
- Analysis of key financial metrics, ratios, and trends.
- Consideration of any non-recurring items or extraordinary circumstances affecting financial performance.

5. Market and Economic Analysis

- Overview of relevant economic conditions and industry trends.
- Analysis of market conditions, including supply and demand factors.
- Identification of comparable companies or transactions in the case of market-based approaches.

6. Risk Factors

- Assessment of specific risk factors that may impact the valuation.
- Discussion of how risk was incorporated into the valuation models.

7. Discounts and Premiums

- Explanation of any discounts applied (e.g., for lack of control, lack of marketability).
- Consideration of any premiums, such as control premiums.

8. Assumptions and Limitations

- Clear statement of the key assumptions made during the valuation.
- Disclosure of caveats, limitations and disclaimers to the extent they explain or elucidate the limitations faced by valuer.

9. Valuation bases

A valuer is required to adopt valuation bases prescribed by regulations or as agreed upon between the parties i.e.

- Fair Value.
- Participant Specific Value.
- Liquidation Value.

10. Premises of Value

Explain Premise of Value refers to the conditions and circumstances how an asset is deployed i.e.

- Going Concern Value.

- As is where basis.
- Orderly liquidation
- Forced Transaction

11. Valuation Results

- Presentation of the final valuation conclusion.
- Explanation of the determined value and any ranges or sensitivity analyses considered.

12. Conclusion and Recommendations

- Summary of key points from the report.
- Any recommendations or considerations for stakeholders based on the valuation results.

13. Appendices

- Detailed supporting information, such as additional financial data, relevant agreements, or industry reports.
- Calculation details for key valuation inputs and outputs.

14. Certification and Compliance

- A statement of compliance with relevant valuation standards or guidelines.
- A statement of compliance with independence of valuer.
- Signatures and qualifications of the individuals responsible for the valuation.

Compliance with Valuation Standards

Valuation standards are fundamental guidelines and principles established to ensure consistency, transparency, and reliability in the process of determining the worth of assets, businesses, or financial instruments. These standards provide a framework for valuation professionals, accountants, and financial analysts, offering a common language and methodology for assessing the value of various entities. Valuation standards play a pivotal role in ensuring the integrity and reliability of valuation processes. They provide a structured framework for practitioners, offering a set of best practices that contribute to the consistency, transparency, and credibility of valuation outcomes. Whether established by global organizations, industry bodies, or regulatory authorities, adherence to these standards fosters trust and confidence in the valuation profession. Any valuation carried by a member of ICAI to follow the standards set by ICAI. In India no other institution has issued valuation standards. Many follow Standards issued by the International Valuation Standards Council.

Regulatory Background

On October 18, 2017, a significant amendment to the Companies Act, 2013, was introduced through the enactment of Section 247 and the Companies (Registered Valuers and Valuation) Rules, 2017. This marked the inception of the concept of a "Registered Valuer" (RV), signalling a move towards standardizing the valuation procedures in alignment with global standards.

Prior to these amendments, the valuation of a company's assets and liabilities in India lacked a well-defined and uniform framework. The absence of formal mechanisms contributed to a lack of structure in the valuation process. The introduction of Section 247 and associated rules was a commendable effort to address this gap and bring regulation to the valuation practices in the country.

While the Companies Act, 2013 covers valuation, it's noteworthy that various transactions may be subject to additional regulatory compliances outlined in different statutes. This complexity arises because a single transaction may fall under the purview of multiple regulatory authorities. Instances where regulatory bodies such as FEMA, the Income Tax Department (as per the Income Tax Act, 1961), SEBI (under the Securities and Exchange Board of India Act, 1992), etc., are involved, they may assert their influence over the valuation process.

A] Companies Act

I. Registered Valuer under the Companies Act

Historically, prior to the Companies Act of 2013, no other company law in India included provisions for valuation or specified who could undertake the responsibilities of a valuer. The introduction of Section 247 in the Companies Act marked a pivotal moment, establishing the framework for matters requiring valuation under this legislation.

Section 247 states that when there is a need to evaluate any property, stocks, debentures, shares, securities, goodwill, or other assets, as well as the net worth or liabilities of a company as per the Act's provisions, such valuation must be carried out by a "Registered Valuer."

The eligibility criteria for a "Registered Valuer" have been explicitly addressed by the Companies (Registered Valuers and Valuation) Rules, 2017 (the Rules), which also outline the process for obtaining the certificate to be recognized as a registered valuer. Additionally, the Rules designate the Insolvency and Bankruptcy Board of India (IBBI) as the "registering authority," responsible for conducting examinations and granting certifications for the qualification of a registered valuer. Any valuation carried under Companies Act 2013 is required to be undertaken by the Registered Valuer only.

II. Practice of Valuation under the Companies Act

Section 247(2) outlines the methodology for valuation under the Companies Act. It mandates that a registered valuer must conduct a fair, impartial, and accurate valuation of a company's assets subject to valuation requirements. The section also emphasizes the importance of due diligence during the valuation process, directing valuers to adhere to rules prescribed by the Ministry of Corporate Affairs.

In addition to the specified duties, Section 247(2) imposes restrictions on registered valuers, prohibiting them from valuing any asset in which they have a direct or indirect interest, or develop such an interest during or after the valuation.

Rule 16 of the Companies (Registered Valuers and Valuation) Rules, 2017, supplements these guidelines by stipulating valuation standards to be followed by registered valuers. The rule empowers the central government to notify valuation methods over time. Until such notification, registered valuers are required to adhere to either internationally accepted valuation methodologies, valuation standards endorsed by a valuation professional organization, or those specified by regulatory bodies such as the Reserve Bank of India or the Securities and Exchange Board of India.

According to the Companies Act, the price of shares to be issued on preferential basis is to be determined by the valuation report given by a registered valuer. The price of shares or other securities to be issued on preferential basis shall not be less than the price determined on the basis of valuation report of a registered valuer. A valuation report of the consideration received by a registered valuer shall also be attached along with the return of allotment.

Following are the sections of Companies Act, 2013 which require valuation by a registered valuer

S. No.	Section	Particulars
1	62(1)C	Valuation report for Further Issue of Shares
2	192(2)	Valuation of Assets Involved in Arrangement of Non-cash transactions involving Directors
3	230(2)(c)(v)	Valuation of shares, property, and assets of the Company under a scheme of Corporate Debt Restructuring
4	230(3)	Valuation report along with Notice of creditors/shareholders meeting – Under the scheme of compromise/Arrangement.
5	232(2)(d)	The report of the expert with regard to valuation, if any, would be circulated for the meeting of creditors/Members
6	232(3)(h)	The Valuation report to be made by the tribunal for an exit opportunity to the shareholders of the transferor Company – Under the scheme of Compromise/Arrangement in case the Transferor company is a Listed Company and the Transferee-company is an unlisted Company.
7	236(2)	Valuation of equity shares held by the Minority Shareholders.
8	260(2)(C)	Preparing a valuation report in respect of shares and assets to arrive at the reserve price for a company Administrator
9	281(1)	Valuing assets for submission of the report by the liquidator

B] Income Tax Act

Various provisions of the Income-tax Act 1961 provides for the valuation of Shares and Securities. Income-tax Act (the 'Act') does not define the term 'Shares and Securities'. Certain provisions of the Act and Income-tax Rules 1962 (the 'Rules' or 'Rule') states that it shall have the same meaning as assigned to it under the Securities Contracts (Regulation) Act, 1956. Majority of the provisions under Income tax act where valuation of shares and securities/ business is required are as follows:

- Section 50CA – Transfer of unquoted shares
- Section 56(2)(viib) & 56(2)(x)(c) – Issue/ receipt of Shares
- Section 17(2) – ESOP/Sweat Equity
- Section 50B – Slump Sale
- Section 9(1)(i) Indirect transfer

Where a method has been prescribed by the legislature, that method alone shall be followed for computation of the fair market value. The legislature in its wisdom has also given a formula for the computation of the fair market value which cannot be ignored by the authorities below. The tax officer has to compute the fair market value following the prescribed method and he cannot adopt the market value as fair market value[1].

1. *Medplus Health Services (P.) Ltd. vs. ITO [2016] 68 taxmann.com 29/158 ITD 105 (Hyd. - Trib.)*

I. Section 50CA i.e. Special provision for full value of consideration for transfer of share other than quoted share read with Rule 11UAA

Where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being share of a company (other than a quoted share), is less than the fair market value of such share determined in accordance with provisions given under Rule 11UAA, the value so determined shall, for the purposes of section 48, be deemed to be the full value of consideration received or accruing as a result of such transfer.

If Consideration received or accruing < fair market value then,

Full value of consideration (FVOC) = FMV of Share, Provided that the provisions of this section shall not apply to any consideration received or accruing as a result of transfer by such class of persons and subject to such conditions as may be prescribed.

II. The Fair Market Value of shares when issued at price exceeding face value u/s 56(2)(viib) and receipt of shares u/s. 56(2)(x)(c)

Issuance of Shares

Sec 56(2)(viib) of the Act provides that in the case of a specified company, where shares are issued for consideration exceeding the fair market value of shares, then the consideration received in excess of the fair market value is taxable under the head 'Income from other sources'.

Prior to Finance Act, 2023 provisions of sec 56(2)(viib) were applicable only to the resident investors. However, effective A.Y. 2024-25, this section is amended to bring within its ambit consideration received from the non-resident investors as well.

For the ascertainment of fair market value of shares u/s. 56(2)(viib), Rule 11UA(2) is to be adopted. In line with amendment in sec 56(2)(viib), Rule 11UA has also been modified vide notification no. 81/2023 dated 25th September, 2023.

Prior to the amendment, Rule 11UA prescribed two methods of valuation of shares to the resident investors viz. Discounted Cash Flow (DCF) method and Net Asset Value (NAV) method. Now, post amendment, additional five methods of valuation are available to non-residents -

1. **Comparable Company Multiple Method:** The Comparable Company Multiple Method involves assessing the value of a subject company by comparing its financial metrics, such as earnings, revenue, or book value, with similar metrics of publicly traded comparable companies. This method is particularly useful in industries with a robust public market presence.

2. **Probability Weighted Expected Return Method:** The Probability Weighted Expected Return Method combines elements of risk and probability, calculating the expected return of an investment by considering different scenarios and assigning probabilities to each outcome. This method is valuable for assessing the potential outcomes of complex projects or investments with varying levels of risk.

3. **Option Pricing Method:** The Option Pricing Method applies principles from financial options to value an asset. This method is commonly used in the valuation of financial instruments, real options, and employee stock options. It involves assessing the flexibility and strategic options associated with an

investment, considering the potential for future uncertainties.

4. **Milestone Analysis Method:** The Milestone Analysis Method is often employed in the valuation of early-stage companies, particularly those in the technology and biotech sectors. This method assigns different values to a company based on the achievement of specific milestones, such as successful clinical trial results or product launches.

5. **Replacement Cost Method:** The Replacement Cost Method determines the value of an asset by assessing the cost of replacing it with a new equivalent. This method is commonly used for the valuation of tangible assets, such as real estate or machinery. It provides insights into the cost implications of recreating the asset at current market rates.

It is to be noted that valuation in all the methods except Net Asset Value method must be determined by the merchant banker only.

Where the shares under consideration are compulsorily convertible preference shares, the above mentioned methods are available to determine the fair value.

Additionally, a safe harbour of 10% variation in value is also provided.

The Net Asset value method is given below

Sr No	Particulars		Amount	Amount
1.	Book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) as reduced by :-			
	(i)	Income-tax paid or Income-tax refund;		
	(ii)	Unamortised amount of deferred expenditure (A)	xx	
2.	Market value of jewellery and artistic works (B)			-
3.	Fair market value of shares and securities (C)			-
4.	The stamp duty value of the immovable property (D)			-
	Book value of liabilities, excluding the below:-			xx
	(i)	Paid up equity share capital	-	
	(ii)	The amount set apart for payment of dividends	-	
	(iii)	Reserves and surplus	-	
	(iv)	Provision for taxation	-	
	(v)	Provisions made for meeting liabilities, other than ascertained liabilities	-	
	(vi)	Contingent liabilities	-	
5.	Book Value of Liabilities (L)		xx	
6.	Net Assets {(A)+(B)+(C)+(D)-(L)}		xx	

Receipt of Shares

In case of sec 56(2)(x)(c), where shares and securities are received either without consideration or inadequate consideration, such that the aggregate fair value of which exceeds fifty thousand rupees, then in such case scenario to the extent of inadequate or lack of consideration exceeds fifty thousand rupees, such sum is taxable under the head 'Income from other sources'.

Determination of fair value is done by adopting Rule 11UA(1)(c).

Valuation of Compulsory Convertible Preference Shares

The Amended Rule introduces provisions for the valuation of Compulsory Convertible Preference Shares (CCPS) and outlines the applicability of a safe harbour threshold. Under this amendment, an option is provided to utilize the fair market value (FMV) of unquoted equity shares as a benchmark for determining the FMV of CCPS.

Additionally, the rule incorporates a price matching facility. In the context of this facility, the price at which unquoted equity shares or CCPS are issued by company in which public is not substantially interested to notified Non-Resident (NR) entities, venture capital funds (VCF), or specified funds will be adopted as the FMV. This adoption serves as a standardized benchmark for the valuation of equity and CCPS investments, applicable to both resident and non-resident entities.

These amendments aim to bring clarity and uniformity to the valuation process, offering a structured approach that aligns with the fair market value of unquoted equity shares.

III. Part C - ESOP/SWEAT EQUITY

Employee Stock Options (ESOPs) have become a ubiquitous component of modern compensation packages, serving as a powerful tool to align the interests of employees with those of the company. As these options grant employees the right to purchase company shares at a predetermined price, understanding the valuation of ESOPs is crucial for both employers and employees. In this article, we delve into the intricacies of ESOP valuation, shedding light on the methods and considerations involved.

Section 17(2)(vi) of the Income Tax act provided for the taxability of the value of any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at concessional rate to the assessee.

"Specified security" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956), and, where employees' stock option has been granted under any plan or scheme therefor, includes the securities offered under such plan or scheme. The "option" means a right but not an obligation granted to an employee to apply for the specified security or sweat equity shares at a predetermined price.

"Sweat equity shares" means equity shares issued by a company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available rights like intellectual property rights or value additions, by whatever name called.

Valuation date (Income-tax)

The fair market value of any specified security or sweat equity share, being an equity share in a company, on the date on which the option is exercised.

Valuation methodology (Income-tax)

a) Share in the company is listed on a recognized stock exchange:

On the date of the exercising of the option, the share in the company is listed on a recognized stock exchange, the FMV shall be the average of the opening price and closing price of the share on that date on the said stock exchange[2]. In case the share is listed on more than one recognized stock exchanges, the FMV shall be the average of opening price and closing price of the share on the recognised stock exchange which records the highest volume of trading in the share.

In case, there is no trading in the share on any recognized stock exchange on the date of exercising of the option, the fair market value shall be—

(i) the closing price of the share on any recognised stock exchange on a date closest to the date of exercising of the option and immediately preceding such date; or

(ii) the closing price of the share on a recognised stock exchange, which records the highest volume of trading in such share, if the closing price, as on the date closest to the date of exercising of the option and immediately preceding such date, is recorded on more than one recognized stock exchange.

However, no guidance is available in case share is not traded for a long time or is suspended for trading for various reason. Whether in such case too above suggested mechanism hold? Whether shares would be treated as unlisted?

b) Share in the company is not listed on a recognized stock exchange:

On the date of exercising of the option, the share in the company is not listed on a recognised stock exchange, the FMV shall be such value of the share in the company as determined on the date of exercise[3]. No guidelines have been prescribed as to how valuation is to be carried. Hence internationally accepted methodology, as well as principals, are required to be followed for the valuation of such ESOPs.

Valuation carried by whom

For the determination of FMV of the unlisted shares on the date of exercise of the option, valuation is required to be carried by the Merchant Banker. Valuation of ESOP is not required under the Act at the time of grant. However the same is required to be valued by the Registered Valuer under Companies Act for accounting treatment in the books of the employer company.

Internationally Valuation Methods:

a. Black-Scholes Model:

The Black-Scholes model is a widely recognized method for valuing European-style stock options. It considers factors such as the current stock price, option strike price, time to expiration, volatility, and risk-free interest rate. While popular, it may have limitations in capturing the complexity of ESOPs, especially those with unique features.

b. Binomial Model:

The binomial model offers a more flexible approach, accommodating variations in option terms and exercise patterns. This method is

2. Income-tax Rule 3(8)(ii)
3. Income-tax Rule 3(8)(iii)

particularly useful for valuing American-style options, allowing for adaptability in the face of changing market conditions.

c. *Monte Carlo Simulation:*

The Monte Carlo simulation involves running multiple simulations to model the uncertainty and variability in factors affecting option value. This method is advantageous for capturing the dynamic nature of ESOPs and accounting for various potential scenarios.

Key Considerations in ESOP Valuation

a. *Vesting Period*

The vesting period, during which employees gradually gain the right to exercise their options, influences the valuation. Longer vesting periods may warrant adjustments to account for the extended timeframe over which the options may be exercised.

b. *Forfeiture Rates*

Factoring in forfeiture rates is essential as not all granted options may be exercised. Companies need to estimate the likelihood of employees leaving before options are vested and adjust valuation accordingly.

c. *Expected Option Life*

Determining the expected life of the options is crucial for accurate valuation. It involves assessing historical exercise patterns, employee retention rates, and other relevant factors.

d. *Dividend Payments*

Companies paying dividends must consider their impact on ESOP valuation. The Black-Scholes model typically adjusts for expected dividend payments during the option's life.

For the purpose of accounting valuation is required to be carried by Registered Valuer. Under the income-tax valuation of shared issued under ESOP is required to be done by Merchant Bankers

Valuing Employee Stock Options is a multifaceted process that demands a careful blend of financial acumen, regulatory awareness, and a nuanced understanding of the company's dynamics. As ESOPs continue to play a pivotal role in talent retention and motivation, a well-executed valuation strategy not only ensures compliance with regulations but also contributes to fostering a positive and transparent relationship between employers and employees. By navigating the complexities of ESOP valuation, companies can optimize the benefits of this powerful incentive tool while mitigating potential risks and uncertainties.

IV. Slump Sale

Section 50B of the Income Tax Act, 1961 deals with the taxability of profits arising on transfer of any business. Sub-section (1) of Section 50B provides that “any profits or gains arising from the slump sale” shall be chargeable to income tax as capital gain.

Valuation comes into picture for calculation of Full value of consideration of slump sale which has been provided in Rule 11UAE of the Income tax Rules which says that FVOC will be higher of FMV 1 or FMV 2 where

FMV 1 is the adjusted Net assets as mentioned above for Rule 11UA, and

FMV 2 is the total consideration including cash and non-cash component

V. INDIRECT TRANSFERS

Section 9(1)(i) of the Act provides that all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India, shall be subject to tax in India. Explanation to the section clarifies that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. Provisions are applicable only if it derives value substantially from the assets (whether tangible or intangible) located in India, if, on the specified date, the value of such assets—

- exceeds the amount of ten crore rupees; and
- represents at least fifty per cent of the value of all the assets owned by the company or entity, as the case may be;

Valuation Date

Valuation is required to be carried on the specified date[4]

- the date on which the accounting period of the company or, as the case may be, the entity ends preceding the date of transfer of a share or an interest; or
- date of transfer, if the book value of the assets of the company or, as the case may be, the entity on the date of transfer exceeds the book value of the assets as on the date referred in earlier bullet point, by fifteen per cent.

Accounting period means each period of twelve months ending with the 31st day of March. However, in case, a company or an entity considering the provisions of the tax laws of the territory, of which it is a tax resident or reporting to persons holding the share or interest, regularly adopts a period of twelve months ending on a day other than the 31st day of March then such other day shall be the accounting period of the company or the entity.

Valuation Methodology

Rule 11UC provides a formula for the computation of income from transfer of a share outside India or interest in a company or an entity which is attributable to assets located in India as A x B/C.

- A = Income from the transfer of a share of, or interest in, the company or the entity computed following the provisions of the Act, as if, such share or interest is located in India
- B = Fair Market Value of assets located in India as on the specified date, from which the share or interest referred to in A derives its value substantially, computed following rule 11UB;
- C = Fair Market Value of all the assets of the company or the entity as on the specified date, computed following rule 11UB:

Fair Market Value

As per Section 2(22B) of the Income-tax Act 1961 "fair market value", concerning a capital asset, means—

- the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and

4. Income-Tax Act Section 9(1)(i) Explanation 6 (d)

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- where the price referred is not ascertainable, such price as may be determined as per the rules made under this Act

As per US Treasury Regulation, the fair market value means "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Fair market value for tax purposes also assumes a hypothetical willing buyer and a hypothetical willing seller. This is in contrast to investment value, which identifies a particular buyer or seller and the attributes that buyer or seller brings to a transaction. Fair market value also assumes an arm's-length deal and that the buyer and seller are able and willing. This is not the same as the definition of market value, an often-used real estate term.

The International Glossary of Business Valuation Terms the fair market value reads: "The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms-length in an open and unrestricted market, where neither is under compulsion to buy or sell and when both have a reasonable knowledge of the relevant facts."

VALUATION OF DIFFERENT ASSETS OF THE COMPANY

(i) SHARES IN LISTED INDIAN COMPANY

Where the asset is a share of an Indian company listed on a recognised stock exchange on the specified date, the fair market value of the share shall be the observable price of such share on the stock exchange. However in case, the shareholding directly or indirectly confers any right of management or control in relation to the aforesaid company, the fair market value of the share shall be determined as per the following formula

Fair market value = (A+B)/C[5]

- A = the market capitalisation of the company based on the observable price of its shares quoted on the recognised stock exchange
- B = the book value of liabilities of the company as on the specified date;
- C = the total number of outstanding shares

If on the specified date, the share is listed on more than one recognised stock exchange, the observable price of the share shall be computed with reference to the recognised stock exchange which records the highest volume of trading in the share during the period considered for determining the price.

Right of management or control shall include the right to appoint a majority of the directors or to control the management or policy decision exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of shareholding or management rights or shareholders agreements or voting agreements or in any other manner

The observable price shall be the higher of the following:—

- the average of the weekly high and low of the closing prices of the shares quoted on the said stock exchange during the six months preceding the specified date; or

5. Income-tax Rule 11UB(2)

- the average of the weekly high and low of the closing price of the shares quoted on the said stock exchange during the two weeks preceding the specified date;

This is similar that what is specified in Regulation 164 of SEBI (Issue of Capital and Disclosure Requirements) Regulations 2018

(ii) SHARES IN UNLISTED INDIAN COMPANY

Valuation methodology

Where the asset is a share of an Indian company not listed on a recognised stock exchange on the specified date, the fair market value[6] of the share shall be determined on such date as per any internationally accepted valuation methodology for valuation of shares on arm's length basis as increased by the liability, if any, considered in such determination.

As per Section 92F(ii) relevant to transfer pricing "arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

The arm's length principle is the condition or the fact that the parties of a transaction are independent and on an equal footing.

Valuation to be carried by

The FMV on such date shall be determined by a merchant banker or an accountant

(iii) INTEREST IN A PARTNERSHIP FIRM OR AN ASSOCIATION OF PERSONS[7]

- the value on the specified date of such partnership firm or Limited Liability Partnership or association of persons, shall be determined by a merchant banker or a chartered accountant and who holds a valid certificate of practice (as per the provision s of the Chartered Accountants Act, 1949) following any internationally accepted valuation methodology as increased by the liability, if any, considered in such determination.
- the portion of the value computed above is equal to the amount of its capital shall be allocated among its partners or members in the proportion in which capital has been contributed by them and the residue of the value shall be allocated among the partners or members as per the agreement of partnership firm or association of persons for distribution of assets in the event of dissolution of the firm or association, or, in the absence of any such agreement, in the proportion in which the partners or members are entitled to share profits and the total of the amount so allocated to a partner or member shall be treated as the fair market value of the interest of that partner or member in the firm/LLP or the association of persons, as the case may be.

6. Income-tax Rule 11UB(3)
7. Income-tax Rule 11UB(4)

Valuation to be carried by

Valuation shall be determined by a merchant banker or a accountant

(iv) Other Assets[8]

The fair market value of the asset other than Shares in a listed or unlisted Indian company or share in partnership firm/LLP or AOP as referred earlier shall be the price it would fetch if sold in the open market on the specified date as increased by the liability, if any, considered in such determination.

The price it would fetch if sold in the open market means – is the price an asset would fetch in the marketplace or the value that the investment community gives to particular equity or business.

Valuation to be carried by

as determined by a merchant banker or accountant

(v) The fair market value of all the assets of a foreign company or an entity

The fair market value of all the assets of a foreign company or an entity shall be determined as under:

a) Unconnected parties

The transfer of a share of, or interest in, the foreign company or entity is between the persons who are not connected, persons-

The fair market value of all the assets owned by the foreign company or the entity as on the specified date, for such transfer, shall be determined as per the formula:

The fair market value of all assets = A+B[9]

- A = Market capitalisation of the foreign company or entity computed based on the full value of consideration for the transfer of the share or interest
- B = Book value of the liabilities of the company or the entity as on the specified date as certified by a merchant banker or an accountant

Connected person means any person who is connected directly or indirectly to another person and includes-

- any relative of the person, if such person is an individual;
- any director of the company or any relative of such director, if the person is a company;
- any partner or member of a firm or association of persons or body of individuals or any relative of such partner or member, if the person is a firm or association of persons or body of individuals;
- any member of the Hindu undivided family or any relative of such member, if the person is a Hindu undivided family;
- any individual who has a substantial interest in the business of the person or any relative of such individual;
- a company, firm or an association of persons or a body of individuals, whether incorporated or not, or a Hindu undivided family having a substantial

8. Income-tax Rule 11UB(5)
9. Income-tax Rule 11UB(6)(i)

interest in the business of the person or any director, partner, or member of the company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member;

- a company, firm or association of persons or body of individuals, whether incorporated or not, or a Hindu undivided family, whose director, partner, or member has a substantial interest in the business of the person, or family or any relative of such director, partner or member;
- any other person who carries on a business, if
  - o the person is an individual, or any relative of such person, has a substantial interest in the business of that other person; or
  - o the person is a company, firm, association of persons, body of individuals, whether incorporated or not, or a Hindu undivided family, or any director, partner or member of such company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member, has a substantial interest in the business of that other person;

Market capitalization refers to the total market value of a company's outstanding shares of stock. It is calculated by multiplying the total number of a company's outstanding shares by the current market price of one share. However, a current set of provisions are silent as to what treatment to be provided to preference shares.

b) In any other case:

i) Shares of a foreign company are listed: The share of the foreign company or entity is listed on a stock exchange on the specified date, the fair market value of all the assets owned by the foreign company or the entity shall be determined as per formula:

The fair market value of all the assets = A + B[10]

- A = Market capitalisation of the foreign company or entity computed based on the observable price of the share on the stock exchange where the share of the foreign company or the entity is listed
- B = book value of the liabilities of the company or the entity as on the specified date

Where on the specified date, the share is listed on more than one stock exchange, the observable price in the aforesaid formula shall be in respect of the stock exchange which records the highest volume of trading in the share during the period considered for determining the price

ii) Shares of a unlisted foreign company: The share in the foreign company or entity is not listed on a stock exchange on the specified date, the value of all the assets owned by the foreign company or the entity shall be determined as per formula:

The fair market value of all the assets = A + B[11]

10. Income-tax Rule 11UB(6)(ii)(a)
11, Income-tax Rule 11UB(6)(ii)(b)

- A = fair market value of the foreign company or the entity as on the specified date as determined by a merchant banker or an accountant as per the internationally accepted valuation methodology
- B = value of liabilities of the company or the entity if any, considered for the determination of fair market value in A

Usually, enterprise value is determined considering debt. Hence in such scenario value of such debt may not be required to be added.

Accountant means

Accountant means a chartered accountant who holds a valid certificate of practice (as per the provision s of the Chartered Accountants Act, 1949) and to determine the fair market value of all the assets of a foreign company or an entity includes any valuer recognised for undertaking similar valuation by the Government of the country where the foreign company or the entity is registered or incorporated or any of its agencies, who fulfils the following conditions

- if he is a member or partner in any entity engaged in rendering accountancy or valuation services then,—
  - (i) the entity or its affiliates has a presence in more than two countries; and
  - (ii) the annual receipt of the entity in the year preceding the year in which valuation is undertaken exceeds ten crore rupees;
- if he is pursuing the profession of accountancy individually or is a valuer then,—
  - (i) his annual receipt in the year preceding the year in which valuation is undertaken, from the exercise of the profession, exceeds one crore rupees; and
  - (ii) he has professional experience of not less than ten years.

Exchange Rate

The rate of exchange for the calculation in foreign currency, of the value of assets located in India and expressed in rupees shall be the telegraphic transfer buying rate of such currency as on the specified date as adopted by the State Bank of India constituted under the State Bank of India Act, 1955 for buying such currency, having regard to the guidelines specified from time to time by the Reserve Bank of India for buying such currency, where such currency is made available to that bank through a telegraphic transfer.

C] Foreign Exchange management Act

FEMA regulations cover various types of securities, including shares, debentures, bonds, and other instruments. The valuation principles apply to both listed and unlisted securities.

In practice, the expression "internationally accepted pricing methodology" primarily turns to the use of the Discounted Cash Flow method (DCF). In many cases, if there is a need to apply any other internationally accepted pricing methodology other than Discounted Cash Flow Method (DCF) then the background needs to be documented.

Valuations triggers in two scenarios:

a. Issue or transfer of equity shares or compulsory convertible instruments of an Indian company is taking place between a resident company and a non-resident company.

b. When an Indian company or resident acquires or transfers, equity shares in an overseas company.

Methodologies

In the case of FDI valuation, the fair valuation of shares on an arm's-length basis has to be done by any internationally accepted methodology. Regulations has not mentioned which internationally recognized methodology shall be used so a valuer has to choose a suitable methodology in case of FDI valuations on its own depending on a case-to-case basis.

Commonly used methods include:

a. ***Market Price:*** The market price prevailing on the recognized stock exchanges for listed securities is often considered as the fair value.

b. ***Fair Value:*** For unlisted securities or those not actively traded, the fair value is determined based on internationally accepted valuation methodologies. This may include the discounted cash flow (DCF) method, comparable company analysis (CCA), or any other method recognized by global financial standards.

Foreign Exchange Management (Overseas Investment) Directions, 2022 provides that the valuation in accordance with pricing guidelines, wherever applicable, shall be done upfront. It also provides that with respect to the documents to be taken by the AD bank, they shall be guided by their board approved policy, which may, inter alia, provide for taking into consideration the valuation as per any internationally accepted pricing methodology for valuation. The AD bank shall put in place a board approved policy within two months from the date of these directions i.e. 22 August 2022. However till date nothing is available in the public domain. It is observed that AD Banks are following erstwhile regulation, only a SEBI (Securities and Exchange of India) registered Merchant Banker (Cat-1) can do the valuation if the transaction exceeds USD 5 Million or the transaction pertains to the swap of shares and valuation by a Chartered Accountants in any other cases. Diminution in value of more than USD 10M or exceeds 20% of total Overseas Investment is to be certified by Registered Valuer as per Companies Act or CPA/Registered valuer in host country

Valuation of securities under the Foreign Exchange Management Act (FEMA) in India is a crucial aspect, especially when there is a foreign investment or transfer of securities involving residents and non-residents. FEMA regulations govern these transactions, and adherence to the prescribed valuation methods is essential to ensure compliance.

Insolvancy and Bankrupcy Code

IBC required valuation to be carried by registered valuaer under following regulation:

- IBC Section 59(3)(b)(ii) Voluntary liquidation of corporate bodies (Asset Valuation Report).
- IBC Section 46(2) The appropriate duration for avoidable transactions (Independent Expert for assessing the evidential value if the transaction.
- IBBI CIRP Regulation 27 read with regulation 35 to determine fair value and liquidation value.
- IBBI Liquidation process Regulation 35 Valuation of assets intended to be sold.
- IBBI Liquidation process Regulation 3(1)(b)(ii) – valuation of assets before Initiation of liquidation.
- IBBI Fast track CIRP Regulation 26 Determination of Fair value and liquidation value

Valuation of securities held by commercial banks

Recently, the Reserve Bank of India (RBI) released updated guidelines governing the classification, valuation, and management of investment portfolios for commercial banks. Aligned with international standards and best practices, the revised 'Reserve Bank of India (Classification, Valuation and Operation of Investment Portfolio of Commercial Banks) Directions, 2023' will come into effect on April 1, 2024, applying to all Commercial Banks with the exception of Regional Rural Banks.

The revised directions introduce a principle-based classification system for investment portfolios. Under the new norms, banks are mandated to classify their entire investment portfolio into three categories: Held to Maturity (HTM), Available for Sale (AFS), and Fair Value through Profit and Loss (FVTPL). The RBI has included fair valuation requirements along with accounting treatment for gain/loss ensuring that investment portfolios are assessed accurately, reflecting their current market values. All investments now shall be measured at fair value on initial recognition. Fair value measurement of investments is based on a hierarchy of Level 1, Level 2, and Level 3 inputs.

Valuation of complex convertible instruments Preference Shares/Debentures:

Convertible preference shares represent a unique financial instrument that combines features of both debt and equity. Valuing these instruments requires a nuanced approach, considering the dual nature of their characteristics. Here are key points to consider in the valuation of convertible preference shares:

1. Face Value and Dividend Yield:

- Begin by understanding the face value of the preference shares and the fixed dividend yield they carry. This fixed income component is a critical factor in the valuation process.

2. Conversion Premium:

- Convertible preference shares typically carry a conversion premium, which is the amount by which the conversion price exceeds the current market price of the common shares. The premium reflects the additional value investors place on the option to convert.

3. Conversion Ratio:

- The conversion ratio is the number of equity shares that can be obtained by converting one preference share. It establishes the relationship between the preference shares and the potential equity shares upon conversion.

4. Market Price of Common Shares:

- Since the conversion feature provides an avenue for preference shareholders to participate in the equity upside, the market price of common shares becomes a crucial input in the valuation model.

5. Discount Rate:

- Apply an appropriate discount rate to the future cash flows, considering the risk profile of the company and the prevailing market conditions. This rate accounts for the time value of money and the risk associated with the investment.

6. Option Pricing Models:

- Employ option pricing models, such as the Black-Scholes model, to value the conversion feature. These models consider factors like the current stock price, exercise price, time to maturity, and volatility.

7. ***Earnings and Cash Flow:***

- Evaluate the company's historical and projected earnings and cash flows. The ability of the company to generate profits and cash is a fundamental determinant of the value of both the preference shares and the potential equity shares upon conversion.

8. ***Market Conditions:***

- Consider current market conditions, industry trends, and the economic outlook. Changes in market conditions can impact the perceived value of the conversion feature.

9. ***Redemption Terms:***

- Take into account any redemption terms associated with the convertible preference shares, as these terms may influence the valuation, particularly if the conversion option is not exercised.

10. ***Discounted Cash Flow (DCF) Analysis:***

- Perform a discounted cash flow analysis, incorporating the cash flows from both the fixed dividends and the potential equity upside upon conversion. This holistic approach accounts for the time value of money and the dual nature of the investment.

11. ***Liquidation Preference:***

- If the preference shares have a liquidation preference, understand the terms and conditions associated with it. This can impact the valuation in the event of a liquidation event.

Valuation of convertible preference shares requires a comprehensive analysis that takes into consideration both the fixed income component and the equity conversion option. By carefully assessing these various factors, investors and issuers can arrive at a reasonable and informed valuation for convertible preference shares. More or less similar steps are required to value compulsorily convertible debentures also.

Epilogue

While numbers may crunch and formulas may swirl, at the heart of valuation lies a fundamental truth: value is ultimately in the eyes of the beholder. It's a tapestry woven from tangible assets, intangible potential, and the ever-shifting tides of market sentiment The true worth of any endeavor often lies not just in a calculated figure, but in the stories it whispers and the dreams it inspires. As technology evolves and global dynamics shift, the landscape of valuation continues to transform. Artificial intelligence and big data are reshaping traditional methodologies, while emerging concepts like ESG (environmental, social, and governance) considerations are taking center stage. By staying adaptable and embracing these cutting-edge frontiers, we can ensure that the art of valuation remains not just a tool for measuring the present, but a compass guiding us towards a more sustainable and equitable future.

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